U.S. RAILROAD RETIREMENT BOARD

OFFICE OF INSPECTOR GENERAL

Management Information Report

Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk

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OFFICE OF INSPECTOR GENERAL
U.S. RAILROAD RETIREMENT BOARD

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Background

The Railroad Retirement Board (RRB) administers retirement-survivor and unemployment-sickness insurance benefit programs for railroad workers and their families under the Railroad Retirement Act (RRA) and the Railroad Unemployment Insurance Act (RUIA). RRA provides Tier I and Tier II benefits funded by RRA tax receipts of which Tier I is comparable to social security and Tier II is similar to a private pension. The National Railroad Retirement Investment Trust (NRRIT) was established by Railroad Retirement Survivors' Improvement Act of 2001 (RRSIA) to manage and invest RRB assets reserved for payment of these benefits.

The Office of Inspector General conducted a review of RRB's NRRIT oversight responsibilities. The objective was to evaluate the adequacy of the RRB's oversight of NRRIT and its enforcement authority in protecting the RRB's trust funds as required by RRSIA.

Key Findings

RRB's oversight of NRRIT under RRSIA has not been effective in protecting the railroad retirement program and its trust funds and minimizing the taxation of railroad employers and employees under the RRA. Over a ten year period from calendar year 2006 through 2015, we estimate that NRRIT's increased expenses resulting from its active management investment strategy generally caused the NRRIT to underperform compared to traditional passive index based funds managed by the Thrift Savings Plan (TSP) and the Social Security Trust Fund and resulted in potential losses to railroad retirement net assets. NRRIT's active management strategy and resulting administrative expenses also potentially impacted the railroad retirement account benefit ratio and may have resulted in the payment of additional Tier II taxes by railroad employers and employees totaling between $200 million and $1.2 billion or between $800 and $4,802 per railroad employee during calendar year 2015. Overall, since inception and consistent with academic research, NRRIT's active management strategy failed to surpass the TSP's three indexed stock market benchmarks.

From our academically supported analysis, we can conclude NRRIT is not adding value, but rather expense for the railroad retirement program by creating an unnecessary investment function with limited usefulness that already exists in the form of significantly less expensive indexed funds with greater oversight. This informational report makes no recommendations with regard to NRRIT's investment portfolio options, rather the RRB and Congress should determine how the now more than $70 million in annual administrative and investment

management expense could be better utilized to reduce Tier II tax rates for railroad workers and their employers while maintaining long term railroad retirement program investment solvency. By fiscal year 2019, NRRIT's lost investment potential in the form of administrative expenses will have exceeded $1 billion.

NRRIT's active management investment strategy operates counter to proven investment logic. To date NRRIT's efforts to "beat the market" have generally failed and these results are likely to continue over the long term. A possible solution to this dilemma is either greater oversight combined with significantly less administrative expense or dissolution of the trust. The true performance results of NRRIT's investment strategy are not disclosed as a whole or comparatively versus traditional stock market benchmarks and therefore cannot be fully understood by the railroad community.

We identified a variety of concerns impacting the operations and reporting of NRRIT activities including:

- more than $17.4 billion in unidentified investments;
- compensation anomalies between key executives;
- a conflict of interest involving the NRRIT's former Chief Executive Officer;
- unexplained office leasing increases and renovation costs;
- active management investment fees that have risen by 2,945 percent; and
- a lack of oversight policy and procedures.

Matter for Congressional Consideration

In order to improve oversight and better protect the more than $25 billion in federal pension assets, we request that Congress consider amending RRSIA to make the NRRIT subject to the Employee Retirement Income Security Act of 1974 (ERISA). Mandating NRRIT's compliance with ERISA would strengthen NRRIT investment and operational oversight comparable to that of other large pensions and increase transparency for the public and those charged with governance.

MANAGEMENT'S RESPONSE AND OUR COMMENTS

We provided RRB and NRRIT officials a draft report of our findings to obtain their views. RRB management did not concur with our findings and believes it has established adequate NRRIT oversight. NRRIT management vigorously disagreed with nearly all of our findings and methods of analysis, and believes its financial performance has resulted in optimal investment diversification and returns. As a result of the voluminous and detailed nature of NRRIT's comments, we have encapsulated NRRIT's primary concerns within the body of the report along with our responses. In addition, we made appropriate changes to the report after validating information provided by NRRIT and note those changes in Appendix I. Copies of both RRB and NRRIT's comments are presented in Appendices II and III, as is our customary practice.

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INTRODUCTION

This management information report evaluates the adequacy of the Railroad Retirement Board's (RRB) oversight of the National Railroad Retirement Investment Trust (NRRIT) and its enforcement authority in protecting the RRB's trust funds, as required by the Railroad Retirement Survivors' Improvement Act of 2001 (RRSIA).[1] The review considers the long term effect of NRRIT's nongovernmental structure on railroad retirement program benefits and Tier II taxation and was performed to provide decision making information useful in evaluating NRRIT's future impact on railroad workers, employers, and other parties with a vested interest. The report also identifies a matter for congressional consideration concerning Employee Retirement Income Security Act of 1974 (ERISA) compliance requirements.[2] The review was limited to RRB provided records and other publicly available documents.

Background

The RRB is an independent agency in the executive branch of the Federal Government. RRB administers retirement-survivor and unemployment-sickness insurance benefit programs for railroad workers and their families under the Railroad Retirement Act (RRA) and the Railroad Unemployment Insurance Act (RUIA).[3] RRA provides for Tier I and Tier II benefits. Tier I benefits are retirement benefits comparable to social security benefits for railroad workers. Tier II benefits provide additional benefits and are similar to a private pension.

NRRIT was established by RRSIA to manage and invest RRB assets reserved for payment of some RRA benefits. NRRIT's asset balance is used in the computation of the accounts benefit ratio (ABR), which represents sustainability, in years, for the railroad retirement program considering only the availability of its total assets. The ABR is the ratio of the RRA and NRRIT assets to the total benefits and RRB and NRRIT expenses paid for the fiscal year. The average ABR (AABR) or ten year average of the ABR is used to determine Tier II tax rates for railroad employers and employees. NRRIT was ranked as the nation's 87th and the world's 228th largest pension fund with assets totaling $25.1 billion at the end of fiscal year 2016.[4]

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[1] Pub. L. No. 107-90 (2001).
[2] Pub. L. No. 93-406.
[3] 45 USC § 231-231v. Chapter 9 and 45 USC § 351-369. Chapter 11.
[4] *Top 1000 Global Institutional Investors*, Investments & Pensions Europe 2016, IPE.com, accessed March 9, 2017.

Establishment of NRRIT

NRRIT was established by RRSIA in February 2002. In September and October 2002, $3.0 billion in federal assets were transferred from the United States Treasury (Treasury) to NRRIT. NRRIT assets are mandated in RRSIA for payment of RRB benefits. A memorandum of understanding (MOU) delineates the responsibilities of the NRRIT and RRB. Reference to assets as NRRIT's assets should not be deemed to suggest ownership of RRB assets by NRRIT. Funds held by NRRIT are RRB funds held exclusively for payment of RRB benefits by law. Section 105(a)(2) of RRSIA provides that "the Trust [NRRIT] is not a department, agency or instrumentality of the Government of the United States and shall not be subject to title 31, United States Code."[5] NRRIT is operated by a seven member Board of Trustees (Trustees); three representing labor, three representing management, and an independent member selected by the other six members. The Trustees cannot be officers or employees of the Government of the United States.

By statute, NRRIT is not subject to ERISA, which regulates private sector and nongovernmental pension plans. NRRIT Trustees are subject to fiduciary standards comparable to those under ERISA. Section 105(a)(5)(A) of RRSIA requires NRRIT Trustees to discharge their duties with respect to the assets of NRRIT solely in the interest of the RRB for the exclusive purpose of providing benefits to program funded participants and their beneficiaries; and defraying the reasonable expenses of administering the functions of NRRIT. The Trustees must also diversify investments to minimize the risk of large losses and to avoid disproportionate influence over a particular industry or firm.

NRRIT Committee Structure

NRRIT functions are delegated to appointed committees comprised of two or more NRRIT Trustees. RRSIA requires that NRRIT committee decisions be made by a quorum consisting of five of the seven NRRIT Trustees without the agreement of the Independent Trustee. Investment guideline decisions must be made by unanimous vote of all seven Trustees.

NRRIT's Administrative Committee makes recommendations to the Trustees regarding investment staff base compensation, annual bonuses, deferred compensation, employee benefits, and the benchmarks used to assess NRRIT investment performance. The Audit Committee is responsible for retaining an independent auditor, affirms the integrity of NRRIT's internal control structure, oversees and ensures compliance with NRRIT's conflicts of interest and confidentiality policies, manages NRRIT's internal audit program, establishes and

[5] 45 USC § 231n(j)(2). Pub. L. No. 107-90, 115 Stat. 883 (2001).

maintains NRRIT's whistleblower process, and oversees NRRIT's Internal Revenue Service (IRS) Form 990 filings and compliance with its MOU with RRB.

NRRIT's Investment Strategy

During 2002, NRRIT's Trustees developed investment guidelines with the principal objectives of ensuring the timely and certain payment of benefits to eligible railroad retirement plan participants and beneficiaries, and achieving a long term rate of return on assets sufficient to enhance the financial strength of the railroad retirement system. In 2002, NRRIT's Trustees reported that the use of indexation was an appropriate first step to diversify investment of its assets. The Trustees also began the planning process to move NRRIT's investment portfolio beyond indexed only investments. Significant portions of NRRIT Trustee meetings were devoted to the analysis and review of the active management investment process.[6] Discussion topics included: expanding portfolio investment options on the efficient frontier, risk management and budgeting, performance benchmarks, analysis and attribution, and fiduciary responsibility. An *Investment Plan and Procedures Manual* was developed by NRRIT staff and reviewed by the Trustees in 2003. NRRIT subsequently began active management during fiscal year 2004.

In 2006, NRRIT reported that its target diversification was based on an assessment of the potential for active management to add value to expected market returns, net of expenses, and at reasonable levels of risk. NRRIT's investment strategy and longevity of the railroad retirement program are dependent on the stability of railroad employment and a projected seven percent rate of return on NRRIT investments.

Thrift Savings Plan and Old Age, Survivor and Disability Insurance

The Federal Thrift Savings Plan (TSP) manages $458 billion in federal employee retirement assets and primarily invests in passive index based funds and Treasury securities. The TSP's fees are approximately 0.04 percent annually. The TSP has five major funds:

- C Fund ($142 billion in assets, as of December 31, 2015) tracks the Standard & Poor's (S&P) 500 (S&P 500) index;
- S Fund ($50 billion in assets, as of December 31, 2015) tracks the Dow Jones United States (U.S.) Completion Total Stock Market (Dow Jones TSM) index;

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[6] The active manager of a fund or portfolio makes proactive trading decisions in order to maximize returns. The opposite is passive management, when a fund or portfolio is tied to an index and the manager's role is limited. Active managers believe they can outperform the market by identifying mispricing through a variety of strategies. [*Financial Times,* ft.com/lexicon, accessed June 26, 2017]

- I Fund ($34 billion in assets, as of December 31, 2015) emulates the Morgan Stanley Capital International Europe, Australasia, Far East (MSCI EAFE) index;
- F Fund ($25 billion in assets, as of December 31, 2015) follows the Bloomberg Barclays U.S. bond index; and
- G Fund ($207 billion in assets, as of December 31, 2015) follows short term U.S. Treasury securities.

Social Security or Old Age, Survivor, and Disability Insurance (OASDI) program investments are maintained in the Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds (Social Security Trust Fund). The OASDI program consists of the OASI and DI programs with combined program assets of $2.8 trillion, as of December 31, 2015. The Social Security Trust Fund assets are required by law to be invested in nonmarketable securities issued and guaranteed by the full faith and credit of the Federal Government.[7] Similarly, G Fund principle and interest is guaranteed by the Federal Government.

RRB's Oversight and Enforcement Authority of NRRIT

RRB has established a strategic goal of serving as responsible stewards for its customers' trust funds by ensuring that NRRIT fund assets are protected, collected, recorded, and reported appropriately.

Section 105(a)(5)(F) of the RRSIA establishes RRB's enforcement authority over NRRIT. RRB may bring a civil action:[8]

1. to enjoin any act or practice by the Trust [NRRIT], its Board of Trustees, or its employees or agents that violates the provisions of this Act; or
2. to obtain other appropriate relief to redress such violations, or to enforce any provisions of this Act.

NRRIT submits an annual management report to Congress and engages an independent qualified public accountant to audit its financial statements.

Review Objective

Our objective was to evaluate the adequacy of the RRB's oversight of NRRIT and its enforcement authority in protecting the RRB's funds as required by RRSIA. Consistent with RRB's responsibility to protect the railroad retirement program and its trust funds, we evaluated whether RRB's oversight efforts functioned to

[7] 42 USC § 401(a).
[8] 45 USC § 231n(j)(5)(F). Pub. L. No. 107-90, 115 Stat. 886 (2001).

minimize administrative expenses and the taxation of railroad employers and employees under RRA.

Scope

The scope of our review was RRB's oversight of NRRIT's financial and operational activities from inception in 2002 through 2016. Certain information supporting NRRIT's activities is not publicly available to federal agencies or instrumentalities. As such, our scope was limited to RRB provided and publicly available information.

Methodology

To accomplish our objective, we:

- identified and reviewed applicable laws, regulations, and related criteria;
- reviewed NRRIT emails and other known correspondence with RRB applicable for the period of review;
- reviewed NRRIT's annual and quarterly management reports, transfer schedules, MOUs, and IRS Form 990s for fiscal years 2005 through 2015;
- interviewed RRB agency personnel responsible for NRRIT oversight including the RRB's former General Counsel and acting General Counsel, Director of Legislative Affairs, and former Chief Financial Officer (CFO);[9]
- reviewed academic research on the results of active and passive management strategies;
- researched and compared the fiscal and calendar year returns of NRRIT over a ten year, thirteen year, fourteen year, and fifteen year period, with passive index based returns considering the impact of NRRIT's administrative costs and compensation;[10]
- assessed the potential long term impact of NRRIT's investment strategy on Tier II tax rates;
- analyzed NRRIT disclosures and compared with other Internal Revenue Code 501(c) nonprofit pension funds;[11] and

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[9] Railroad Retirement Board's (RRB) former General Counsel retired on December 30, 2016 and the former Chief Financial Officer accepted a position at another agency as of August 1, 2016.
[10] For the purpose of our analysis, the compounded annual returns of the National Railroad Retirement Investment Trust (NRRIT) reported by fiscal year were restated by calendar year from inception through calendar year 2015, 2016, and 2017 for comparison with the returns of the passive index based funds reported by calendar year. Past performance may not be indicative of future results.
[11] 26 USC § 501.

- studied and compared NRRIT's management, policy, and oversight structure with that of similar private and public pension trust funds.

We conducted our fieldwork at RRB's headquarters in Chicago, Illinois from January 2016 to August 2017. From August 2016 through December 2016 and from September 2018 through November 2018, fieldwork was halted to complete mandated work. After receiving the NRRIT's technical comments on our draft report in December 2017, additional follow up work was performed during January 2018 and February 2018, June 2018 through August 2018, and November 2018.

RESULTS OF REVIEW

RRB oversight of the NRRIT under RRSIA has not been effective in protecting the railroad retirement program and its trust funds and minimizing the taxation of railroad employers and employees under the RRA.

RRB practices what it refers to as arm's length oversight to insulate NRRIT's investment decisions from political interference. This has resulted in limited agency oversight of NRRIT. In contrast to other governmental, public, and private pension funds, NRRIT operational and investment oversight generally consists of an annual management report provided to RRB, a financial statement audit, periodic meetings of the RRB's General Counsel with NRRIT officials, semiannual meetings of RRB's Board Members with the NRRIT's Trustees to discuss operations and other issues, and limited scope reviews conducted triennially and selected at NRRIT's discretion. Our review identified issues where NRRIT may be in violation of RRSIA, IRS, and Securities and Exchange Commission (SEC) requirements. Under the current oversight structure, RRB has not expressed a willingness and does not have the informational readiness to exercise its enforcement authority under RRSIA.

RRB's current oversight procedures do not assess the impact of NRRIT's investment strategy, which has heavily focused on active management since fiscal year 2004. Extensive academic research has concluded that an active management strategy carries increased administrative and investment costs and over the long term results in investment returns that are on average lower than their passive index fund counterparts, which we found to be true at NRRIT.

Over a ten year period from calendar year 2006 through 2015, we estimate that NRRIT's active management investment performance generally underperformed traditional passive index based funds managed by the TSP, and the Social Security Trust Fund and resulted in a potential decrease in NRRIT net assets. The differences in performance can be attributed to the stable performance of index based funds and the significant growth in administrative expenses incurred by NRRIT for active management.

NRRIT's active management strategy and resulting administrative expenses also potentially impacted the railroad retirement ABR and may have resulted in the payment of additional Tier II taxes by railroad employers and employees. Had NRRIT invested in passive indexed investments similar to the TSP, the increase in asset value may have improved the railroad retirement ABR and reduced Tier II taxes. Estimated additional payments of Tier II taxes by railroad employers and employees totaled between $200 million and $1.2 billion during calendar year 2015, or between $800 and $4,802 per railroad employee during the year. Because active management is unlikely to outperform passive indexed funds over the long term, increased Tier II taxes could continue in future years.

Since inception and consistent with academic studies, NRRIT's calendar year compounded annual rate of return failed to surpass the TSP C Fund, S Fund, or I Fund. These three passively managed TSP funds track the S&P 500, Dow Jones TSM, and MSCI EAFE index benchmarks, respectively.

From our academically supported analysis and results, we can conclude the NRRIT is not adding value, rather it is adding expense for the railroad retirement program by creating an unnecessary investment function with limited usefulness and minimal oversight that already exists in the form of significantly less expensive indexed funds with preexisting and greater oversight. This informational report makes no recommendations with regard to NRRIT's investment portfolio options, rather the RRB and Congress should determine how the now more than $70 million in annual administrative and investment management expense could be better utilized to reduce Tier II tax rates for railroad workers and their employers while maintaining long term railroad retirement program investment solvency. By fiscal year 2019, NRRIT's lost investment potential in the form of administrative expenses will have exceeded $1 billion.

NRRIT's active management investment strategy operates counter to proven investment logic. To date NRRIT's efforts to "beat the market" have generally failed and these results are likely to continue over the long term. A possible solution to this dilemma is either greater oversight combined with significantly less administrative expense or dissolution of the trust. The true performance results of the NRRIT's investment strategy are not disclosed as a whole or comparatively versus traditional stock market benchmarks and therefore cannot be fully understood by the railroad community.

RRB's decision to minimize NRRIT oversight may also have contributed to several other concerns. For example, we identified more than $17.4 billion in undisclosed investments during fiscal year 2016, key executive compensation anomalies, a conflict of interest involving the NRRIT's former Chief Executive Officer (CEO)/Chief Investment Officer (CIO), unexplained office leasing increases and renovation costs, investment management fees that have risen by 2,945 percent since NRRIT began active management of investments, and oversight policy and procedure weaknesses. NRRIT's investment strategy also includes offshore and other investments that carry greater risk, an undeterminable portion of which may be undisclosed. NRRIT's investment disclosures also do not identify investments in funds that yield social and economic benefits.

Under NRRIT's current legislation, RRB asset losses are not insured by the Pension Benefit Guaranty Corporation (PBGC) but, as has been the case historically, pose a potential liability to the Federal Government.[12] These issues are discussed in this report.

In November 2017, we provided the NRRIT with a draft of our report for its comments, as is our customary procedure. In its comments on the draft report, NRRIT vigorously disagreed with nearly all of our findings and methods of analysis. Further, NRRIT referred to various aspect of the report as "allegations," a term most frequently associated with a civil or criminal complaint; which these report findings are not. As discussed in our report, we provided information on RRB's oversight of NRRIT and various analyses of NRRIT expenses, investment outcomes, and other operating activities. Our analysis and estimates were based on publicly available information as the NRRIT discloses only minimal and legislatively required information, which we noted in our report.

Based on the information we collected, we reported a variety of areas that we continue to believe will be of interest to the men and women working in the railroad industry whose retirement, disability, unemployment, and sickness benefits depend on the efficient and effective administration of NRRIT; taxpayers who are ultimately responsible for any liability of such benefits; and the Congress.

Given the structure of NRRIT and oversight of RRB, we specifically did not make any recommendations for improvement, as we might have otherwise done, and instead determined that the most appropriate place for determining proper oversight and administration of NRRIT is the Congress.

We believe NRRIT interpreted our analysis with a bias toward active management investment and responded to the results of our analysis in an unprofessional manner. Their response did generate additional concerns and was consistent with our conclusion that additional oversight is needed as the NRRIT wishes to shield their financial decisions and operations from oversight. Their comments and tone appear to be issued in part as damage control and an understandable need for self-preservation. Fact checking of the NRRIT's comments shows the comments to be often unsubstantiated.

In numerous instances, the NRRIT's comments support our Congressional request for ERISA oversight. Overall, the NRRIT's comments are redundant in their concerns over their ability to obtain a lower expense ratio due to only having $25 billion in assets to invest, and their praise of active management in spite of the

[12] For example, Treasury funding authorized under section 401 of the Railroad Retirement Solvency Act of 1983 compensated the railroad retirement system for a windfall benefits shortfall of $2.1 billion occurring between 1974 and 1981. [Government Accountability Office (GAO), *Railroad Retirement Board: Status of Amounts Transferred Pursuant to Section 401 of the Railroad Retirement Solvency Act of 1983*, B-287158 (Washington, D.C.: October 10, 2002).]

consequences well documented by academia. The NRRIT's comments also fail to acknowledge the cost savings from passively investing the NRRIT's investment management and other administrative expenses in index based funds.

It is clear and concerning from its comments that the NRRIT is resistant to oversight and believes it is immune to the regulations of its peers. In its comments, the NRRIT states that it has no responsibility for complying with SEC requirements, District of Colombia trust laws, or any need to consider the social impact of investments or to address geopolitical risks.

Given the often repetitive nature of NRRIT's responses, we sought to distill their comments and concerns throughout this report and present our response. We made appropriate changes to the report after validating information provided by NRRIT and note those changes in Appendix I. The entirety of NRRIT's comments are in Appendix II.

Oversight of NRRIT is Not Effective in Deterring Program Risk

RRB's oversight of NRRIT is not an effective deterrent to railroad retirement program risk. NRRIT's establishment as a nongovernmental, nonprofit entity precludes NRRIT from traditional governmental, public, and private pension oversight. NRRIT has not complied with all established requirements. In one instance, NRRIT has not registered as an investment adviser with SEC.

RRB's Oversight of NRRIT is Inadequate

RRB's oversight of NRRIT does not provide adequate safeguards against program risks and vulnerabilities. RRB's former General Counsel stated that RRSIA compliance records, oversight policies and procedures, and documentation of its oversight efforts are not maintained.[13] Based on discussions with RRB officials and analysis of agency controls, we found NRRIT oversight activities are limited to the arm's length actions of RRB's Board Members, General Counsel, CFO, and Chief Actuary who attend meetings and conduct reviews of NRRIT provided documentation. RRSIA does not establish an authority, or delegate responsibility, for oversight of the NRRIT.

RRB Board Members meet with NRRIT Trustees and officials twice each year to discuss NRRIT operations and other issues of mutual interest. RRB's General Counsel oversees the agency's review of materials provided by NRRIT. RRB's General Counsel also meets periodically with NRRIT's CEO/CIO and General Counsel to review actions taken during NRRIT Board meetings. RRB's former

[13] The RRB's former General Counsel retired on December 30, 2016. NRRIT oversight responsibilities were delegated to the Director of Legislative Affairs until the new General Counsel assumed this responsibility on May 30, 2017.

General Counsel told us he met with NRRIT officials after every quarterly meeting of the NRRIT's Board of Trustees. Attendance at these meetings is reflected in the General Counsel's performance measure appraisal. RRB's CFO serves primarily as a point of contact for NRRIT and indicated participation at two meetings with NRRIT officials but has no specific oversight responsibilities.

The materials reviewed include the annual management report, audited data provided for preparation of the Statement of Social Insurance, and monthly investment data provided by NRRIT pursuant to the MOU between RRB and NRRIT. The General Counsel and Bureau of Fiscal Operations accountants are responsible for reviewing NRRIT's annual management report. RRB's Chief Actuary is responsible for reviewing monthly investment information and audited data supporting the statement of social insurance. Issues identified during reviews of any materials are to be provided to the General Counsel who is to advise RRB Board Members of any significant matters.[14] However, according to the former General Counsel, no record is maintained of RRB's oversight activities or material reviews.

NRRIT's annual management report includes the report resulting from the financial statement audit. The purpose of the annual management report is to inform Congress about the operations and financial condition of NRRIT. The President, RRB, and the Director of the Office of Management and Budget (OMB) receive a copy of the management report. The financial statement audit is the only annually recurring review of NRRIT and it focuses solely on reporting the results of its operations. NRRIT's financial statement auditor is not required to and has not expressed an opinion on the effectiveness of NRRIT's internal controls.

Lack of NRRIT Oversight Increases Risk

NRRIT's establishment as a nongovernmental, nonprofit entity has resulted in regulatory consequences that preclude NRRIT from traditional governmental, public, and private pension oversight; and in some instances NRRIT has not complied with established requirements.

- As NRRIT is not a department, agency, or instrumentality of the Government of the United States, it is excluded from RRB Inspector General oversight. NRRIT is also not subject to ERISA, which precludes Department of Labor reviews and limits financial safeguards, which are available to other private pension plans through the PBGC.[15] NRRIT's Trustees have fiduciary responsibilities similar to those under ERISA and under RRSIA are subject

[14] RRB Management Control Review Committee, *Legal Services Assessable Unit and Chart of Controls*, February 26, 2009 and March 20, 2009.

[15] The Pension Benefit Guaranty Corporation, created by the Employee Retirement Income Security Act of 1974 (ERISA), protects the retirement incomes of nearly 40 million American workers in nearly 24,000 private-sector defined benefit pension plans.

to civil action by the Railroad Retirement Board. However, under ERISA, trustees are personally liable to the fund's participants and beneficiaries for a breach of fiduciary duty, required to reimburse any associated losses, and assessed a 20 percent civil penalty.[16] RRSIA's delegation of enforcement authority to the RRB may legally shield the NRRIT's Trustees from personal liability.

- As a related party transaction, NRRIT disclosed that legal counsel was provided by firms that may also provide services to the major railroads and railway labor unions whose representatives are members of the Board of Trustees. NRRIT paid an average of $1.7 million per year to these law firms. As the firm's legal decisions and opinions can overlap, independence is potentially weakened creating the appearance of a conflict of interest.
- NRRIT's exclusion from ERISA is associated with RRA. NRRIT is a tax exempt organization and, by RRSIA definition, not a governmental entity; therefore, ERISA compliance would seemingly be required. Railroad workers are also private sector employees. However, because the Railroad Retirement program is defined as a governmental plan under ERISA Section (32), it is exempt from ERISA's requirements.[17]
- NRRIT has not registered as an investment adviser with SEC, and has not disclosed whether it is in compliance with the antifraud provisions of the U.S. Investment Advisers Act of 1940 (Advisers Act).[18] Investment advisers are regulated by SEC under the Advisers Act. Sections 202, 203, and 203A of the Advisers Act require an adviser (defined as an entity or person (1) in business (2) for compensation (3) giving advice about securities) with over $100 million in assets to register as an investment adviser. Prior to 2011, the Advisers Act only required such registration if the adviser had fifteen or more clients. After 2011 registration was required for anyone with at least one client regardless of whether they are public or private investment advisers. Section 202 (a) (11) defines an ''Investment adviser'' as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…" Section 206 of the Advisers Act prohibits misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of the investment activities. Based on these criteria, NRRIT appears to be subject to the Advisers Act.[19] A search of SEC's registered advisers

[16] 29 U.S. Code § 1132(l). ERISA Section 502(l). Pub. L. No. 93-406.
[17] 29 USC § 1002(32).
[18] 15 USC § 80b-3. 15 USC § 80b-2(a)(5). 15 U.S. Code § 80b-6. Section 206 of the Adviser's Act.
[19] On June 22, 2011, the Securities and Exchange Commission adopted new rules under the U.S. Investment Advisers Act of 1940 to implement provisions of the Dodd-Frank Wall Street Reform and

and the District of Columbia's public records did not identify NRRIT as registered as an investment adviser. The Office of Inspector General (OIG) communicated with an SEC official who confirmed that the NRRIT was not registered as an investment adviser though it met the criteria requiring registration.

- NRRIT has not disclosed any form of Sarbanes-Oxley compliance. Nonprofit entities commonly adopt Sarbanes-Oxley as a voluntary financial management best practice. In its comments to our draft report, NRRIT told us that while not publicly disclosed they have voluntarily adopted select provisions of Sarbanes-Oxley.
- On May 26, 2004, IRS determined that, as a supplement to its annual management report, NRRIT must annually file IRS Form 990, *Return of Organization Exempt From Income Tax*, to include only the information that relates to the names and addresses of its officers, directors, trustees, and key employees, including their titles, compensation, and hours devoted to their position and indicating that NRRIT is an Internal Revenue Code 501(c)(28) organization.[20] In four of the years since reporting began, reporting disclosures were inadequate to determine if NRRIT had reported all employees earning over $100,000 in accordance with IRS requirements. RRB officials stated that they do not review NRRIT's key executive compensation and bonuses submitted annually on its IRS Form 990.
- NRRIT is domiciled in the District of Columbia and subject to its Trust laws. NRRIT was not in compliance with the Principal Place of Administration section of the Code of the District of Columbia because it did not notify railroad retirement beneficiaries 60 days prior to relocating in 2013.[21]
- When NRRIT was established in 2002, RRB, NRRIT, Treasury, and OMB entered into a MOU. This MOU details NRRIT's reporting and disclosure requirements to RRB.[22] The MOU establishes monthly reporting of disbursements, transfers, expenses and investment values to Treasury, OMB, and RRB. The MOU, which has not been revised since 2002, references an obsolete financial system and has not been updated to reflect

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Consumer Protection Act (Dodd-Frank Act). The Dodd-Frank Act was passed to promote the financial stability of the United States by improving accountability and transparency in the financial system.

[20] The Internal Revenue Service concluded that: "While the Trust [NRRIT] is not a department, agency, or instrumentality of the Federal Government, the cash and investments held by the Trust for the Railroad Retirement Board (RRB) are nevertheless assets of the Federal Government." The Trust is exempt from federal income taxation as an organization established under IRC 501(c) (28).

[21] District of Columbia Code § 19-1301.08.

[22] Section 1.0 of NRRIT's Memorandum of Understanding (MOU) with RRB states that cash and investments held by the NRRIT are assets of the Federal Government and must be accounted for and reported as such. Section 6.3 of the MOU states the RRB will record all cash and investments held by the NRRIT as federal funds held outside of Treasury.

annual changes in OMB Circular A-11, *Preparation, Submission and Execution of the Budget*, reporting requirements.

- NRRIT has established bylaws. However, we were not able to determine whether NRRIT complies with the bylaws because RRB officials do not verify compliance, as explained below.

RRB's former General Counsel opined that certain NRRIT information is outside the authority of RRB. Therefore, while we attempted to determine if NRRIT was in compliance with all of the reporting requirements of RRSIA, we were unable to verify that such compliance was taking place, nor could RRB. RRB's then General Counsel stated that oversight of NRRIT is conducted at arm's length to prevent government interference and influence on investment decisions. Discussions with and the legal opinion of the former General Counsel stipulated that oversight could be misconstrued as government intervention and therefore RRB's actions were limited to maintaining basic knowledge of NRRIT activities and all management decisions had been delegated to the NRRIT's Trustees.[23] The former Acting General Counsel and Director of Legislative Affairs asserted the same impression from their respective periods of oversight of NRRIT. RRB Board Members reiterated that, "Congress intentionally created the NRRIT as an independent entity to avoid problems that it saw with close control by the Federal Government over investment in the equities markets."[24]

While RRB has the ability to take legal action against NRRIT to enforce RRSIA, based on our discussions with RRB officials, RRB does not obtain adequate oversight information to administer its enforcement authority. RRB's organizational point paper analysis of the NRRIT dated March 10, 2016 states that, "in the event that NRRIT's portfolio decreases substantially, legislation provides for an automatic increase in tax surcharges of rail employers and rail employees to keep [the] trust solvent." Further, because NRRIT is not subject to ERISA, losses are not insured by the PBGC as with other defined benefit plans. Instead, as has occurred in the past to fund struggling financial entities, an influx of federal funds would likely be required if rail employers and employee taxes could not address NRRIT insolvency. In light of these potential consequences, oversight and enforcement of NRRIT's compliance with RRSIA should not be misconstrued as interfering with its investment decisions.

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[23] In 2014, GAO reported that RRB Board members and NRRIT Trustees meet face to face twice annually, during which the RRB Board receives a presentation on economic, legal and other issues affecting the NRRIT in the format of question and answer sessions. [GAO, *Oversight of the National Railroad Retirement Investment Trust*, GAO-14-312 (Washington, D.C.: May 2014).]

[24] RRB, *Semiannual Report to the Congress, October 1, 2016 through March 31, 2017, RRB Transmittal Letter to the President of the United States* (Chicago, IL: May 25, 2017).

Management's Comments and Our Response

- In its response NRRIT stated:

> The OIG Report illustrates why Congress established NRRIT as an independent, nongovernmental entity. For example, by taking a position that NRRIT should not invest in actively managed funds, and taking a position that NRRIT should establish social and geopolitical investment policy, the OIG is doing exactly what Congress wanted to avoid – government officials attempting to influence the Trust's investment decisions.
>
> ... In other words, the assets are contributed by and managed for the benefit of those in the rail industry, and Congress set up an accountability structure to ensure that those with the most to gain and the most to lose through NRRIT's performance would be responsible for managing those assets.

The intent of our report was not to influence the Trust's investment decisions and it should not be interpreted as such. We made no recommendations to either NRRIT or RRB for changes to investment decisions. Instead, we reported on various comparative investment outcomes, investment priorities, NRRIT expenses, and other areas that we believe will be of interest to the men and women working in the railroad industry whose retirement, disability, unemployment, and sickness benefits depend on the efficient and effective administration of NRRIT; taxpayers; and the Congress.

- NRRIT further stated:

> Under the Advisers Act, an investment adviser is any person or firm that, for compensation, engages in the business of advising others as to the value of securities or the advisability of purchasing or selling securities. This word – "others" – is an integral one that the OIG left out. NRRIT invests its own assets on its own behalf, and its Trustees and staff do not provide investment advice to others. Additionally, the OIG even points out the stricter requirement that registration is now required for any adviser with at least one client, but ignores the fact that NRRIT has no clients. Lastly, in no way does NRRIT hold itself out to the public as an investment adviser.

There is no greater concern by the OIG than that of NRRIT declaring the assets it invests are its own. This is inaccurate and misrepresents both RRISA and various agreements between Treasury, OMB, RRB, and NRRIT. NRRIT was established exclusively to manage and invest RRB assets for the benefit and financial protection of its railroad employers and employees.

The NRRIT's belief is misguided as its Trustees cannot perform their fiduciary duties under RRISA without engaging in the business of advising others. The assets it holds are not NRRIT assets. These are federal assets, transferred in a series of transfers from the Treasury to NRRIT, and are mandated in RRSIA for payment of RRB benefits. To state that NRRIT has no clients when it is investing RRB assets ignores the federal ownership of these assets and disregards its client, RRB. Further, as defined by the registration requirements of Section 202 of the Adviser's Act, the NRRIT "issues or promulgates analyses or reports concerning securities" in the form of its annual report. Under the Dodd-Frank Act, whether the NRRIT advises publicly or privately has no bearing on registration. As such, we believe that NRRIT should be registered under the Advisers Act. And this declaration of asset ownership is another example of the lack of oversight demonstrated by RRB. If RRB were actively overseeing the NRRIT as it invests RRB assets, there would be no question as to ownership of the approximately $26.5 billion held by NRRIT, as of September 30, 2017. In the report, we are very clear in stating that any reference to NRRIT assets does not suggest ownership and that the assets invested by NRRIT are held for payment of RRB benefits by law. We have updated the report to address the NRRIT's concerns over advising others as Section 202 of the Adviser's Act further enforces the NRRIT's need to register as an investment adviser.

- NRRIT went on to state:

> Moreover, the law firms that provide services for NRRIT are bound by ethical rules and have their own conflict check procedures that they run to ensure there are no conflicts of interest, and independence is not weakened in any way.
>
> The OIG Report states that "NRRIT has not disclosed any form of Sarbanes-Oxley compliance. Nonprofit entities commonly adopt Sarbanes-Oxley as a voluntary financial management best practice." While the Sarbanes-Oxley Act applies principally to publicly-traded companies, the Trust has nonetheless voluntarily adopted many provisions of the Sarbanes-Oxley Act as best practices, where such practices are cost-beneficial and appropriate given the Trust's business model.

We are pleased that NRRIT reports to have voluntarily adopted many provisions of the Sarbanes-Oxley Act as best practices and have noted this progress in our report. Further reporting transparency and additional RRB oversight could make these best practices better understood and known.

- NRRIT went on to state:

> The Trust conducts performance audits triennially in accordance with an MOU signed with the RRB in 2014. The MOU lays out specific scope areas for consideration in these performance reviews, as agreed upon by both NRRIT and the RRB. One scope area covers "internal financial controls and management of operations." In 2012, the Trust engaged the Protiviti consulting firm to conduct a performance review of this area of Trust operations. No significant recommendations resulted from the performance review, and a summary of the results were shared with the RRB.

The limited scope review of the NRRIT's policies, procedures and financial controls completed more than five years ago was a positive step; however, such reviews should be performed more frequently and should be performed by a licensed and registered public accounting firm. The referenced review also did not address NRRIT's active management strategy or external investment management fee and expense structure.

RRB management in their response to our report disclosed that:

> In December 2015, the NRRIT engaged the independent firm of KPMG to conduct the first audit under the agreement, on the topic of Corporate Governance Framework. In September 2016, NRRIT provided the RRB with a copy of the report and advised that the audit had identified no significant gaps in the corporate governance framework of the NRRIT. The NRRIT noted that it agreed with several auditor recommendations to strengthen the existing governance policies and procedures.

While not required by their MOU, the RRB also stated that it will consult with NRRIT concerning the "… key subject areas, timeline, and scope … [of a] 2018 performance review."

- NRRIT went on to state:

> The OIG Report states that the 2002 MOU between NRRIT, RRB, Treasury and OMB references an obsolete financial system and has not been updated to reflect annual changes in OMB Circular A-11 reporting requirements.… NRRIT has faithfully provided the financial reporting set forth in the MOU for the past 15 years, and there is no indication that any of the other three parties are dissatisfied with NRRIT's reporting or compliance with the MOU.

According to OMB Circular A-11 requirements, the MOU should be updated each year. Because it had not been updated it included outdated financial system information.

- NRRIT went on to state:

> Despite Congress's insistence that government officials refrain from influencing or interfering with the Trust's management of railroad retirement assets, the OIG Report criticizes NRRIT's investment strategy, performance, and expenses. It does this despite the OIG's own assurance and admission to the Government Accountability Office ("GAO") that it "would not seek to advise the Trust on investment policy, which is beyond the OIG's area of expertise." The OIG Report now suggests that the Trust should have invested all of its assets in passively managed stock index funds eight years after the RRB Inspector General stated, in 2009, that "it is 'ludicrous' for the pension agency to be 'investing one dime into the stock market at any time.'"

The purpose of our analysis and report was not to advise NRRIT on investment policy or to suggest that the NRRIT invest in any specific area of the stock market, and we did not do so. Our analysis observed NRRIT's performance in the context of the regulatory and investment criteria established when it was formed and in comparison to several other investment options. We made no recommendations for changes in investment strategy to NRRIT nor did we recommend changes in this area for the Congress to consider. Instead, we outlined our analysis as a comparative point to NRRIT activities and results.

NRRIT's Investment Strategy Increases Risk and Expense, Potentially Resulting in Higher Taxes

In fiscal year 2004, NRRIT implemented an active management strategy with the objective of adding "value relative to indexation within acceptable limits of risk." NRRIT's decision to actively manage RRB assets resulted in below index investment performance, created additional risks, increased administrative expenses, has not been fully effective in minimizing railroad employer and employee Tier II taxes, and is considered academically unsustainable.

<u>NRRIT's Investment Results Have Not Surpassed Passive Benchmarks</u>

In order to assess NRRIT's active management strategy, we compared the results of NRRIT's investment outcomes to those that would have resulted had its assets and investment and administrative expenses instead been invested in the OASDI

or the TSP index funds. The calculations assume NRRIT's net asset balance as of December 31, 2005, was instead invested in OASDI or passively managed individual TSP funds over a ten year period and NRRIT's investment and administrative expenses were invested in these funds rather than expended.[25] Average monthly transfers to RRB to pay program expenses were incorporated in the calculation.

Based on these calculations, as of December 31, 2015, NRRIT could have increased RRB assets by between $2.1 billion and $24.7 billion by investing in one of several TSP funds.[26] Maintaining assets in the OASDI would have resulted in an increase of assets of approximately $600 million during the 10 year period. Table 1 presents the estimated asset value of NRRIT assets had they been invested in each of the alternative investment options and the associated increase or decrease in NRRIT assets in comparison to actual NRRIT performance.

Table 1: Estimated Net Assets as of December 31, 2015, under Various Comparative Investment Options

	Comparative Investment Options							
	NRRIT (Actual)	**OASDI**	**TSP G**	**TSP C**	**TSP S**	**TSP I**	**TSP F**	**TSP CSIF**
Estimated Net Assets (Billions)	$24.7	$25.3	$20.8	$41.4	$49.4	$29.2	$26.8	$31.5
Estimated Increase (Decrease) in NRRIT Assets (Billions)	-	$0.6	($3.9)	$16.7	$24.7	$4.5	$2.1	$6.8

Source: RRB OIG Analysis of Calendar Year 2015 NRRIT, TSP, and OASDI financial data.

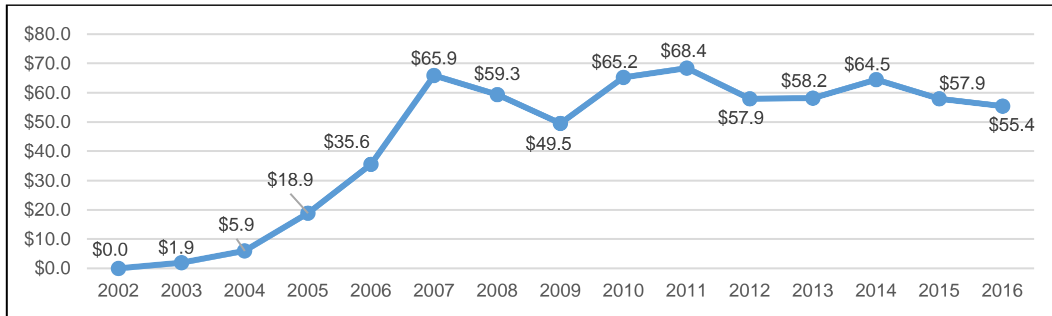
As shown above, NRRIT's decision to utilize an active management strategy resulted in a decrease in RRB assets, potentially up to $24.7 billion, over a 10 year period.

A significant contributing factor to the calculated increases in assets as a result of investing in the TSP or comparable to OASDI is the administrative and investment expenses that have resulted from NRRIT's active management strategy. These expenses are paid from the RRB's assets held by NRRIT.

[25] For consistency, the investment expenses were considered as invested with monthly compounded interest in the respective benchmark fund.
[26] NRRIT's administrative expenses include investment management fees, compensation and benefits, investment related fees and expenses, professional fees, network software and systems, occupancy expense, Trustee fees and expenses, custodial fees, and other expenses.

During the period from 2005 through 2015, NRRIT's annual administrative expense tripled in correlation with NRRIT's active management investment fees, as shown in Figure 1. Additional information concerning the increase in administrative expense is discussed later in this report.

Figure 1: NRRIT Investment Management Expense (In Millions)



Source: RRB OIG Analysis of Fiscal Year 2002 to 2016 NRRIT Financial Statement data.

In addition, we compared the investment fees to net assets of NRRIT, OASDI, and TSP funds since inception and over the last 10 years, as shown in Table 2. NRRIT's investment fees exceeded those of OASDI and significantly exceeded those of all TSP funds. Average 2015 TSP indexed investment fees are 0.04 percent of TSP assets.[27] NRRIT's reported 2015 investment fees were 0.27 percent of RRB assets. In comparison, 2010 research over a 16 year period indicates that private defined benefit pension fund investment fee expense ratios range from .15 percent to .40 percent.[28] While NRRIT incurred greater investment fees, its investment performance did not yield better results when compared with the TSP's passively managed indexed funds, as shown on Table 2.

[27] To be conservative, offsets in the form of loan fees and account forfeitures were not applied to our calculations. As reported by the Thrift Savings Plan (TSP), its gross administrative expenses were calculated as .043 percent and net of fees and forfeitures these expenses were .029 percent. The TSP's total net expense ratio including administrative expense, trading costs, and investment management fees is estimated at .04 percent.

[28] Bauer, Rob and Cremers, Martijn and Frehen, Rik, Pension Fund Performance and Costs: Small is Beautiful (April 30, 2010).

Table 2: Average Compounded Returns and Investment Fees of NRRIT, OASDI, and TSP Funds[29]

	Comparative Investment Options							
	NRRIT	OASDI	TSP G	TSP F	TSP C	TSP S	TSP I	TSP AVG
Compounded Return Since Inception [a]	6.92%	4.74%	3.25%	4.47%	8.93%	11.77%	7.55%	7.20%
Ten Year Compounded Return [b]	4.96%	4.45%	2.94%	4.74%	7.36%	8.03%	3.20%	5.25%
Total Expense Ratio of Net Assets	0.27%	0.22%	0.03%	0.04%	0.03%	0.07%	0.04%	0.04%

Source: RRB OIG Analysis of Calendar Year 2003 through 2015 NRRIT Financial Statement, TSP, and OASDI data.

[a] Average Compounded Rates of Return by Fund – Calendar Year 2003 through 2015.
[b] Average Compounded Rates of Return by Fund – Calendar Year 2006 through 2015.

RRB management did not question NRRIT's decision to use active management or evaluate the impact of the administrative expenses on investment results because they believed such actions would be inconsistent with its arm's length oversight approach and misconstrued as government interference.

Management's Comments and Our Response

- In its response NRRIT stated, "… any comparison of the investment performance of the OASDI and NRRIT is inappropriate and irrelevant."

  In addition, the NRRIT stated:

  > … To suggest that the Trust should have invested all of its assets in any single investment or fund, as the OIG does, violates the basic tenets of diversification and is inconsistent with best practices within the investment industry, as well as the Trust's explicit statutory mandate. The principles and benefits of diversification are essential in understanding the Trust's investment strategy and its long-term performance (and in understanding those of any defined benefit pension plan, for that matter)....

[29] NRRIT's 10 year compounded annual rate of return of 4.96 percent did not outperform the TSP C and S funds that parallel Standard & Poor's 500 (S&P 500) or Dow Jones U.S. Completion Total Stock Market (Dow Jones TSM) benchmarks that are commonly measured against active management performance.

The OIG's analysis utilized the TSP and OASDI funds as examples of passive indexed based investments for comparative purposes only, which was clear in the draft report using terms such as "we compared the results" and "comparative investment options." OASDI returns were considered as an alternative secure investment had the NRRIT not been established; the TSP provides a diverse portfolio of indexed funds managed by a quasi governmental organization. Providing a mix of various investments across those funds or any other funds would have provided an endless supply of possible outcomes. It is worth noting that in our analysis, only the G Fund resulted in a decrease in NRRIT assets. We did not and do not recommend an investment change. Instead, we note the more economical outcome of a passive investment approach and provided comparative investment returns under various options.

- NRRIT further stated:

> Even if the OIG had applied the TSP funds' extremely low, subsidized administrative expense ratio in its calculations (and there is no indication that it did), it would have falsely assumed that the Trust could have benefitted from the economies of scale available to an entity eighteen times its size, and the offsets and subsidies available to investors in the Federal Government's TSP funds. In reality, the Trust's expenses are actually below those of its true peers, and assuming, as the OIG does, that any such pension plan could be operated with zero costs is absolutely incorrect.

The OIG's analysis and calculations used annualized and compounded published rates of return net of expense for both the NRRIT and TSP and considered what NRRIT refers to as the TSP's "extremely low, subsidized administrative expense ratio" in the analysis. The comparative rates of return and projected impact on Tier II taxation were net of investment and administrative expenses. As discussed in Footnote 27, the TSP's average total net asset expense ratio conservatively excluded administrative expense offsets in the form of loan fees and account forfeitures. The TSP has not reported the availability or use of any subsidies. The OIG makes no such statement or implications regarding zero cost operations in our projections. And while NRRIT notes the economies of scale available; it excludes mention of any additional expenses that the TSP may be subject to that NRRIT is not. For example, TSP has established greater communication with its beneficiaries and provides customer service and support both electronically and by mail as each beneficiary receives statements and other communication. TSP also provides withdrawal services and annuity options for its beneficiaries. NRRIT has not

considered these extra expenses unique to the TSP that still permit the TSP to outperform the NRRIT.

During its inception, NRRIT promoted the economies of scale associated with passive index fund investments and has since changed course.

- NRRIT went on to state:

> First, by limiting the analysis to the 10-year period ended September 30, 2015, the OIG only uses a portion of the Trust's investment track record in the analysis and gives no explanation as to why a full five years of performance was excluded. Any thorough analysis of investment performance should include all available information and time periods in order to ensure the validity and fairness of the analysis. Otherwise, the analysis is subject to selection biases in terms of the time periods chosen and does not present a complete and accurate picture of what is being measured. Had the Trust's entire investment track record been utilized, rather than one specific limited time period, the comparisons and the resulting conclusions would have been much different, as shown in the Trust's since-inception performance comparisons in the Introduction section of this response.

We used a ten year analysis to mirror the period of the NRRIT's use of an active management strategy. In addition, during the time of our analysis, only 13 years of NRRIT investment return was available. As previously discussed, we included the results of our 13 year analysis in Table 2 of our report. The OIG's intent in performing the analysis was to present a snapshot of the NRRIT's active management performance as compared with passive indexed based investment returns. The point being made by the OIG, which is consistent and widely supported by academic research, is that regardless of the NRRIT's professional expertise, the end result is that there is little difference between the NRRIT's active management performance and that of a "layman's" passive investment strategy. Further, over the long term a significantly less expensive passive indexed based approach is expected to outperform the NRRIT's cost intensive active management strategy and lower the Tier II tax burden while strengthening the sustainability of the Railroad Retirement Program.

- NRRIT went on to state:

> Another basic, and quite troubling, error in the OIG's analysis is that, in comparing the returns of NRRIT with those of the various TSP funds, the OIG uses different time periods for each in doing so. Inconspicuously in a footnote on page 5 of the report, the OIG notes that it used fiscal year returns for NRRIT but calendar year returns for the TSP and OASDI passive index funds. Thus, the analysis compares NRRIT's 10-year return through September 30, 2015, with the 10-year return of the index funds through a different ending date, December 31, 2015. The quarter (4Q 2015) that was excluded from NRRIT's returns but included in the TSP funds' returns was an excellent one for equites, with U.S. stocks (as represented by the Russell 3000 Index) up 6.27 percent, thus unfairly boosting the TSP funds' returns in the comparison. The quarter (4Q 2005) that was included in NRRIT's returns but excluded from the TSP funds' returns also was a good one for U.S. stocks (up 2.21 percent), but to a much lesser degree. In using these time periods that do not match, the OIG's analysis is flawed to such an extent to render the analysis worthless in the first place.

The OIG initially used both fiscal year and calendar year rates of return for our Table 2 comparative investment projections. This is because comparable annualized rate of return data for the NRRIT, TSP, and OASDI were not available. The NRRIT does not report the performance of its active management investment returns versus traditional S&P 500 and Dow Jones TSM index benchmarks, or its own comparative strategic benchmarks, in its annual report and does not disclose its comparative calendar year rates of return. Therefore, we used the rates of return published by the NRRIT, TSP, and OASDI for our calculations to evaluate the NRRIT's performance versus index funds. We also considered the materiality of the three month time difference during our calculations and its impact on NRRIT performance to ensure an "apples to apples" comparison. Specifically, the use of the NRRIT's fiscal year rate of return provided the NRRIT with a higher 2.2 percent three month rate of return from October 1, 2005 through December 31, 2005 versus the omitted 1.96 percent rate of return during the final quarter of the ten year projection period, from October 1, 2015 through December 31, 2015. In essence, our projections provided the NRRIT with a 2.2 percent rather than a 1.96 percent return for the three month period the NRRIT has questioned. The resulting calculation unintentionally increased the NRRIT's rate of return by 24 basis points for one quarter of the ten year period thus slightly overstating the NRRIT's ten year return performance by approximately 2 basis points. To

ensure consistency, we used the TSP's formula for compound annual returns with one basis point equaling .01 percent.

In response to the NRRIT's concerns, we have restated the NRRIT's compounded rates of return by calendar year and updated Table 2 to reflect these changes.[30] We restated the NRRIT's compounded rates of return by calendar year since inception through fiscal years 2015, 2016, and 2017. We observed during our analysis that since inception, and using the same methodology, the TSP C Fund, S Fund, and I Fund rates of return of 8.93 percent, 11.77 percent, and 7.55 percent after expense rates of return, respectively, exceeded the NRRIT's 6.92 percent rate of return for the thirteen year period ending December 31, 2015. The TSP's performance over the NRRIT since inception continued in fiscal year 2016 with the C Fund's 9.15 percent, S Fund's 12.09 percent, and I Fund's 7.15 percent exceeding the NRRIT's 6.93 percent restated calendar year rate of return over the fourteen year period and during calendar year 2017 with the C Fund's 9.95 percent, S Fund's 12.49 percent, and I Fund's 8.28 percent exceeding NRRIT's 7.56 percent restated calendar year rate of return over the fifteen year period.

Prior to restatement, in each of the three periods since inception, the NRRIT's fiscal year 2003 first quarter rate of return of 7.6 percent more than offset the last quarter returns that were omitted for calendar year comparative purposes, as discussed above concerning our ten year comparison. The comparative rates of return since inception were provided in Table 2 of our report and calculated more conservatively by omitting the NRRIT's 17 day negative return of (-5.3) percent during its September 2002 startup. While rates of return are continuously in flux and in limited instances the use of active management may be beneficial, the results of our analysis are consistent with academic theory and indicate the economic benefits of passive index based investments over the use of active management.

The NRRIT does not provide an active management versus passive indexed fund benchmark comparison in its annual management report which limits the transparency of its true rate of return performance.

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[30] Because the NRRIT's calendar year rates of return are not published in its annual report, we restated the NRRIT's reported rates of return from fiscal year to calendar year by offsetting the NRRIT's fiscal year beginning quarter rate of return with its theoretical calendar year ending quarter. For example, the NRRIT's 4th Quarter of 2002 when offset by the 4th Quarter of 2016 yields an overstated rate of return. The NRRIT's fiscal year rate of return was adjusted by the difference between the two quarters including the impact of compounding to determine the restated compounded annual rate of return by calendar year for the period.

- NRRIT went on to state:

> The OIG points specifically to the TSP S fund as an example of a fund in which the Trust could have invested its entire portfolio and cites an erroneous amount by which the Trust's assets could have increased had it invested only in TSP S. The TSP S fund consists solely of small and medium-sized U.S. stocks, with a risk level described on the TSP web site as "moderate to high." To suggest that the Trust, or any large institutional investor for that matter, should put all of their assets in one fund, particularly one investing exclusively in highly volatile small-cap stocks, is imprudent. Moreover, such an action would certainly not be considered passive investing, as the TSP S fund is not representative of the equity market universe but rather a very small sub-component of it.

The OIG provided the TSP funds as examples of the returns from passive indexed based funds and as a means for diversification because they mirror the traditional S&P 500 and Dow Jones TSM index benchmarks and their time proven investment results. The OIG's use of the G, F, C, S, and I funds provides comparative investment options only. We do not make any investment recommendations nor suggest all of NRRIT's assets be invested in one type of investment. In addition, the TSP utilizes BlackRock investment funds similar to those used by the NRRIT. The results of our analysis were provided for the RRB's use in comparing and analyzing the results of the NRRIT's active management strategy versus the potential yields from passive indexed based investments. The OIG did not develop or recommend an alternate investment strategy.

- NRRIT went on to state:

> The OIG also mischaracterizes the TSP funds as purely passive index funds, when in fact most of the TSP funds have active management components built into their strategies. Most of the TSP funds have actually outperformed their passives benchmarks, in some cases by a fairly wide margin, due to various active management practices….
>
> … Such large return variances are common with actively-managed funds, but not with passive index funds, so the OIG's characterization of the TSP funds as purely passive index funds is inaccurate and misleading….

> … NRRIT believes its total costs are reasonable and indeed lower than the costs of the Trust's true peers. Moreover, the Trust has been able to deliver attractive rates of return over the short and long term, while also outperforming passive benchmarks, net of all fees and expenses.

The TSP's funds are widely known and commonly used as an example of passive index funds. According to the TSP's Glossary of Terms definition of Passive Investing: "Passive strategies are often based on the assumption that it is impossible to accurately forecast future trends in securities prices over long periods of time. Management fees and trading costs are generally lower in passively managed funds than in actively managed funds. The F, C, S, and I Funds are invested in passively managed index funds." The TSP contracts with BlackRock and Mercer Investment Consulting. The need for professional expertise and human intervention would be expected with any investment strategy. However, the expense ratio associated with passive indexed based investments considering the impact of economies of scale is expected and attainable in the range of .05 percent in non-governmental private industry. Additional research indicates that BlackRock's securities lending fees may increase the TSP's total expense ratio by up to .01 percent or 1 basis point increasing the TSP's total expense ratio to as much as .05 percent consistent with private industry. Regardless, TSP's rates of return are reported net of these expenses as with NRRIT's. The TSP F, I, and S fund benchmark return variances provided in NRRIT's comments average .24 percent over a 10 year period. This fluctuation would appear to be the result of benchmark tracking differences. If the variances were the result of active management, such immaterial variances do not support the use of a more expensive active management strategy. Contrary to NRRIT's statement, our research and analysis based on NRRIT and TSP published rates of return indicates that the TSP C, S, and I funds have outperformed the NRRIT over the long term since inception through calendar year 2017.

- NRRIT went on to state, "… NRRIT's expense ratio of 27 basis points is much lower than peers based on current industry data."

  NRRIT points to an expense ratio of 27 basis points as of fiscal year 2015. As reported in the NRRIT's Annual Management Report Financial Highlights, its expense ratio has since increased to 31 basis points for fiscal year 2017. Industry passive indexed fund expense ratios range from .05 to .07 percent.[31] It

[31] SeekingAlpha.com, *BlackRock Throws Down The Gauntlet With An Upgraded Total U.S. Market ETF*, November 12, 2015.

is the NRRIT's additional expense of 20 to 26 basis points required for active investment management that appears to negatively impact the NRRIT's total returns, net assets, and, as a result, Tier II taxes.

- NRRIT went on to state, "the description of the Trust's 'active management strategy' is incorrect, mischaracterizes the Trust's investment program and strategy, and demonstrates a general lack of understanding of the basic principles of institutional investment management."

  An overview of the NRRIT's current investment plan and strategy is included in its annual management report and its investment guidelines are included as an appendix to the report. The NRRIT's investment plan, strategy, and guidelines were considered and applied throughout our analysis.

- NRRIT went on to state:

  > Within U.S. equity, the Trust does utilize passive investments to a certain degree (currently 28 percent of the asset class), as these index funds provide the Trust with cost-effective exposure to U.S. stocks, particularly large cap equities, and can be a good source of liquidity. For other asset classes in which the Trust invests, including private equity, private real estate, and absolute return, there are no passive investment alternatives, so to characterize investing in those asset classes as pursuing an active management strategy is misleading....

  For fiscal year 2016, NRRIT's Condensed Schedule of Investments shows its passive investments represented 29 percent of its U.S. equity and 12 percent of its non-U.S. equity. The approximately $1.8 billion (U.S. equity) and $0.7 billion (non-U.S. equity) in passive investments would represent an estimated 10 percent of NRRIT's net assets. NRRIT does not disclose the rates of return and fees for these passive investments for the purpose of comparison with its active management returns and fees.

  With a passive indexed based approach, private equity, real estate, and absolute return investments, which carry an elevated risk, would not be necessary. Academic research has shown that passive indexed based returns outperform the NRRIT's high risk investments over the long term.

- NRRIT went on to state:

> The .04 percent administrative expense ratio cited in the OIG Report is an artificial number that does not represent the actual cost of administering the TSP funds. Rather, it is the net expense that is passed on to investors after certain expenses are offset and subsidized.
>
> According to an August 2017 Congressional Budget Office report, "expenses related to administering TSP are mostly offset by forfeitures of the agencies' automatic 1 percent contributions to workers enrolled in FERS who leave federal service before they become vested, other forfeitures, and loan fees. TSP participants share in the remainder of the costs," which are the .04 percent cited by the OIG Report.

In reporting the TSP's administrative expense ratio of .04 percent, the OIG included forfeitures. The TSP's reported net administrative expense ratio was.03 percent.[32] To ensure the fairness of our comparison, we included the forfeiture and loan fee offsets, which totaled approximately .01 percent. TSP administrative expenses also include participant recordkeeping, notification, and other support services not performed by NRRIT.

<u>NRRIT's Investment Strategy Potentially Increased Tier II Taxes and Railroad Retirement Program Expenses</u>

Had NRRIT invested in passive indexed investments similar to the TSP, the increase in asset value may have improved the railroad retirement ABR and reduced Tier II taxes. Railroad Retirement Tier II tax rates are calculated yearly based on RRB's ten year ABR average.[33] The AABR represents the maximum number of years of sustainability for the railroad retirement program without an inflow of Tier II tax receipts.

We estimate that NRRIT's current ten year AABR was between 0.4 and 2.2 points lower than if NRRIT funds had been invested in OASDI or TSP funds, excluding the G Fund which invests only in Treasury securities. As a result, additional Tier II taxes ranging from 1 to 6 percent more were required to maintain the AABR during calendar year 2015. The additional payments of Tier II taxes by railroad employers and employees totaled between $200 million and $1.2 billion during calendar year 2015, or between $800 and $4,802 per railroad employee during the year, as

[32] Thrift Savings Plan (TSP) Highlights, July 2016, Page 2.
[33] The Account Benefit Ratio (ABR) is calculated as the total RRA and NRRIT Cash and Investment Balance for the fiscal year divided by the total Railroad Retirement Account (RRA) and NRRIT benefits and administrative expense. The ABR represents the surplus or deficit ratio of assets to expenses.

shown in Table 3. The required additional Tier II payments are projected to continue and potentially increase in future years.

Table 3: Impact of NRRIT's Active Management on the Average Accounts Benefit Ratio and Railroad Employee Tier II Taxes for 2015

	Comparative Investment Options [a]							
	NRRIT	**OASDI**	**TSP G**	**TSP C**	**TSP S**	**TSP I**	**TSP F**	**TSP CSIF**
Average Account Benefit Ratio	5.8 [b]	6.2	5.8	7.0	8.0	6.9	6.5	6.8
Estimated Tier II Tax Rate	18% [c]	17%	18%	15%	12%	16%	16%	16%
Total Tier II Tax Savings (Billions)	-	$0.2	$0.0	$0.6	$1.2	$0.4	$0.4	$0.4
Employer Tax Savings (Actual)	-	$400	$0	$1,200	$2,401	$800	$800	$800
Employee Tax Savings (Actual)	-	$400	$0	$1,200	$2,401	$800	$800	$800
Total Tier II Tax Savings (Actual) [d]	-	$800	$0	$2,401	$4,802	$1,601	$1,601	$1,601

Source: RRB OIG analysis of 2015 fiscal year and quarterly NRRIT Financial Statement data and 2015 calendar year TSP, OASDI, and Tier II tax rate data.

[a] For each alternate investment option, the AABR was calculated based on actual returns for each fund. The applicable Tier II Tax Rate from IRS's Tier II tax rate schedule was determined based on the calculated AABR for each fund. The total Tier II Tax Savings was calculated as the percentage difference between NRRIT's Tier II tax rate and the alternate funds tax rate applied to the average railroad salary and employment and invested at an average rate of return for the alternate funds.
[b] RRB computes the AABR on a fiscal year basis. The investment return impact of the three month difference would not change the prevailing AABR of 5.8.
[c] Actual NRRIT Tier II Tax Rate (railroad employer 13.1 percent and railroad employee 4.9 percent).
[d] Employer and employee share of the Tier II tax savings per railroad employee as determined in Table 3. The total Tier II Tax Savings represents both the employee and employer share.

As shown above and based on our analysis, investment decisions by NRRIT have a significant effect on Tier II taxes being paid by both railroad employees and employers. For example, if NRRIT assets had been invested in the TSP S Fund, the actual railroad employer and railroad employee Tier II tax rates of 13.1 and 4.9 percent would have been reduced to 10.1 and 1.9 percent during fiscal year 2015, respectively. Additional increases in NRRIT net assets resulting from these alternative investment options could further minimize the railroad employer Tier II tax rate and possibly eliminate the need for railroad employee Tier II tax contributions.

Management's Comments and Our Response

- In its response NRRIT stated:

> The OIG gives no explanation for why its calculation did not include the G Fund, unless its exclusion assumes that NRRIT does not invest in Treasury securities, which is not the case. NRRIT, like almost every defined benefit plan, owns Treasury securities, as such bonds are an essential component of a diversified portfolio. The reality is that more TSP assets are invested in the G Fund than in any other fund -- $0.45 of every TSP dollar. If anything, the G Fund not only should have been included in the OIG's calculations, but its returns, which are significantly lower than NRRIT's over every time period, should have accounted for 45 percent of the calculations.

As shown in Table 3, we calculated the total Tier II tax savings and determined that investment solely in the G fund would have no Tier II tax savings. It appears that NRRIT misunderstood our sentence to suggest we did not consider the G fund. Our calculation considered the Tier II tax savings given each comparative investment option. We did not seek to replicate NRRIT's investment allocations to determine a weighted comparative Tier II tax increase or savings through different investment options.

We also note that during fiscal year 2017, there is no disclosure of NRRIT's investments in Treasury securities in its annual management report. During fiscal year 2016, NRRIT disclosed net assets included investments of only 0.27 percent in Treasury securities, as shown in its annual management report.

- NRRIT further stated:

> Using the actual dollars invested in the various TSP funds provided in the OIG's report to represent such a diversified portfolio, the Trust has handily outperformed the TSP portfolio over the 15-year period ended September 30, 2017. For that 15-year period, the Trust has generated an annualized return of 7.80% versus an annualized return of 6.73% for the TSP funds' portfolio, for an outperformance of 107 bps, net of all fees and expenses.

Updating our analysis for calendar year and fiscal year 2017 for the 15-year period since inception (omitting the NRRIT's negative -5.3 percent initial return for 2002 and providing the NRRIT with a one quarter fiscal year advantage at inception), TSP's G, F, C, S, and I funds yielded after expense returns of

3.10 percent, 4.33 percent, 9.95 percent, 12.49 percent, and 8.28 percent versus the NRRIT's 7.81 percent. Considering the NRRIT's current target allocation and utilizing a laymen's passive TSP allocation of 20 percent F Fund, 40 percent C Fund, 30 percent S Fund, and 10 percent I Fund yields a 15 year return of 9.42 percent versus the NRRIT's 7.81 percent. This comparison reflects both investment performance and the impact of the administrative expense lost to the NRRIT's active management strategy, as discussed in our report. The long term results are consistent with passive investment theory which indicates that active management sometimes will exceed the index but not consistently over the long term. The laymen's passive TSP allocation also carries a risk comparable to that of the NRRIT's current asset portfolio.

- NRRIT went on to state:

> The OIG Report suggests that NRRIT's investment strategy has increased Tier II taxes. In reality, since NRRIT's inception, rail employers and workers have benefited from billions of dollars' worth of reduced taxes, together with increased benefits for retirees and a much more solvent retirement system.

NRRIT did not provide any evidence to support their claim of a reduction in taxes or an increase in retirement benefits. NRRIT's comments appear unsubstantiated as evidenced by our report findings in which we compared the results of NRRIT's investment outcomes to those that would have resulted had its assets and investment and administrative expenses instead been invested in the OASDI or the TSP index funds. We selected these as either governmental or quasi governmental entities that hold federal retirement funds. Our analysis concluded that establishment of the NRRIT's active management investment performance generally underperformed traditional passive index based funds and may have resulted in the payment of additional Tier II taxes by railroad employers and employees. Based on the increase or decrease in assets under each of these comparative investment options, we estimated the effect on Tier II taxes.

Academic Studies Find Active Management Unsustainable

Research from a variety of academic and policy sources have identified many risks in an active management investment strategy. Pension analysis reports that an active management strategy cannot be adequately supported by rational evidence and is more likely prone to failure.[34] The research goes on to explain that, in practice, the average active manager does not outperform the market. Strategy

[34] Ron Bird, Jack Gray, and Massimo Scotti, *Why Do Investors Favor Active Management … To the Extent They Do?,* Rotman International Journal of Pension Management, Volume 6 Issue 2, Fall 2013.

selection can also be influenced by psychological and behavioral factors; for example, the overconfident belief that managers who outperform can be identified, the differing risk thresholds of fiduciaries and investment staff, the desire for personal monetary gain, a gambling or game mindset, and the illusion of control. In addition, society often views passivity as unacceptable. Such considerations can influence strategy selection and bias independence.

In the 1960s, University of Chicago professor of economics, Eugene Fama conducted extensive research on stock price patterns, which led to his development of the Efficient Market Hypothesis.[35] The Efficient Market Hypothesis states that no active investor will consistently beat the market over long periods of time, except by chance, which means active management strategies using stock selection and market timing cannot consistently add enough value to outperform passive management strategies. This early groundwork on the merits of passive management led to further research that continues to the present day.

In the 1990s, early research by Nobel laureate William Sharpe demonstrated that the average actively managed dollar will underperform the average passively managed dollar as the costs of active management including management fees and transaction costs typically exceed those of passive management. Sharpe found that, after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar, for any time period.[36] Sharpe later concluded that low cost passive investments provide a standard of living throughout retirement more than 20 percent higher than actively managed investments.[37]

A study in 2001 by the Schwab Center for Investment Research reported that:

- Index funds outperformed actively managed funds in 55 percent of the down markets.
- In the worst downturns, defined as declines of 10 percent or more, index funds outperformed actively managed funds 75 percent of the time.
- In the longest downturns, defined as declines of five consecutive months or longer, index funds outperformed actively managed funds 100 percent of the time.[38]

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[35] Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* Journal of Finance, Volume 25, Issue 2, May 1970.
[36] William F. Sharpe, *The Arithmetic of Active Management*, Financial Analysts Journal, Volume 47, Number 1, January/February 1991.
[37] William F. Sharpe, *The Arithmetic of Investment Expenses*, Financial Analysts Journal, Volume 69, Number 2, April 4, 2013.
[38] *Index or Actively Managed Equity Mutual Funds: Which Way to Go In a Down Market*, Schwab Center for Investment Research, July 2001.

Investment research in 2013 concluded that over the past 20 years, less than 25 percent of actively managed U.S. equity mutual funds outperformed their relevant style benchmarks. The underperformance of actively managed funds is relatively consistent both internationally and across market segments and time periods.[39]

As of 2016 year end, S&P's analysis of a complete market cycle over the 15 year period ending December 2016, concluded that 92 percent of large capital, 95 percent of mid capital, and 93 percent of small capital managers trailed their respective S&P benchmarks. For this same 15 year period, international equity categories underperformed their comparative S&P benchmarks by a range of 82 to 89 percent.[40]

Active management performance has been more attributable to the performance of the underlying benchmark index rather than the fund's active management team. Consistent with our NRRIT analysis and due to the lost investment potential, an actively managed fund's actual expense ratio is typically 5 to 7 percent higher than the fund's stated expense ratio.[41]

NRRIT also discussed the benefits of indexation during its inception:

> *The Trustees determined that the use of indexation was an appropriate first step to diversify the portfolio. In addition to providing broad investment exposure in the major asset classes designated in the Investment Guidelines, indexation provides significant benefits to the Trust [NRRIT] in terms of low management fees, reduced administrative costs and low transition expense....*
>
> *Operating expenses are much lower with passive management or indexation than with active management. Administrative costs are reduced because indexation is achieved through the use of a large commingled investment fund which provides significant economies of scale and, therefore, savings in the areas of accounting, custody, transaction activity, management, and reporting. Transition expenses, the cost of moving from cash into indexed investments, are low at large index managers because of the large volume of transaction activity....*

[39] *The Case for Vanguard Active Management: Solving the Low-cost/Top-talent Paradox?* Vanguard Research, January 2013.
[40] S&P Dow Jones Indices, *S&P Indices Versus Active Funds, U.S. Scorecard,* December 31, 2016.
[41] James W. Watkins, III, JD, CFP, AWMA*, The Active Management Value Ratio, Quantifying Prudence to Protect Investors and Fiduciaries,* InvestSense, LLC, 2013.

> *Indexation also required a relatively low level of management oversight….*[42]

Contrary to these statements, NRRIT's Trustees ultimately transitioned to an active management investment strategy. This transition resulted in increased administrative costs and decreased returns on its investments; as predicted in the statement. Nationally, the top 200 pension funds have migrated away from active management in recent years. As of 2015, there has been a 15 percent decline in active management over a ten year period.[43] In 2016, approximately $423 billion in investments have left actively managed stock funds with $390 billion of this transitioned into index funds. In 2017, BlackRock Investments shifted approximately 11 percent of its actively managed equity funds into low cost artificial intelligence based investments. RRB officials stated that due to their arm's length relationship with NRRIT they do not monitor or have any role in investment decisions.

Management's Comments and Our Response

- In its response NRRIT stated:

  > That leaves only U.S. equities, which currently account for approximately 25 percent of Trust assets, for which this debate is relevant. Indeed, as noted above, the Trust does utilize passive investment strategies within U.S. equities, particularly large-cap, to a certain degree.
  >
  > … Much of the information in the OIG Report to the contrary is of limited relevance because (1) it is focused on retail mutual fund flows and (2) it appears to pertain to only one asset class, U.S. equities.

  Our analysis assumes diversified passive investment of the NRRIT's total net assets to minimize investment expense and maximize investment potential.

  In its response NRRIT stated:

  > The OIG Report first cites a 1970 article written by Eugene Fama, developer of the Efficient Frontier Hypothesis, that was based on research performed in the 1960s.

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[42] NRRIT, *NRRIT A*nnual Management Report for Fiscal Year 2002 (Washington, D.C.: January 31, 2003).
[43] Pensions and Investments, *Top 200 pension funds actively moving to passive strategies*, February 6, 2012; *The world's going passive. Is it a mistake?*, October 1, 2015.

> … Moreover, Fama currently is a Director at one of the largest active investment managers in the U.S., Dimensional Fund Advisors (DFA), whose active strategies are based in large part on Fama's academic research. Needless to say, Fama himself likely believes there are some merits to active management.

Professor Fama's work and theories continue to be highly regarded in academia and the investment industry. Our research indicated that active management can have limited success in certain market scenarios. However, as recent as November 27, 2017, Professor Fama of the University of Chicago recommends embracing passive management and concludes that the market cannot be beat over the long term.[44] As discussed previously, NRRIT's long term performance record is consistent with Fama's research, which recognizes the strengths of passive investment management.

- NRRIT further stated:

> Also noteworthy is a 2013 paper published by Vanguard, one of the world's largest managers of passive index funds, which concluded that "low-cost active talent can achieve outperformance; and that investors, to the extent they stick with a disciplined approach, can be successful using actively managed funds."

We agree that active management can outperform passive management in certain instances and scenarios. However, the cited academic research concluded that such outperformance is not possible in the long term. Further, NRRIT's active management would not be classified as low cost based on NRRIT's IRS reported compensation and its annually reported investment management expense; its investment management expenses for fiscal year 2016 and 2017 were $55.4 million and $67 million, respectively.

NRRIT Compensation and Rent Exceed Industry Norms and Lack Transparency

Limited information is disclosed in order for interested parties to understand the compensation received by NRRIT's officers, directors, key employees, investment managers, and independent trustee. Further, compensation of certain employees exceeded comparable industry compensation. NRRIT's compensation, investment management fees, and office rental expense reduce the investment potential of

[44] Eugene F. Fama, *Embrace Passive Management Already*, University of Chicago, November 27, 2017.

NRRIT net assets. This loss of investment potential is compounded over time and can significantly increase Tier II tax rates and railroad employer and employee tax contributions. RRB has not reviewed or questioned NRRIT's compensation policy. In addition, rental costs significantly increased for NRRIT office space due to expansion, relocation, and leased space upgrades. NRRIT did not properly disclose its office space relocation, as required by District of Columbia law.

Officer and Director Compensation Exceeds Pension Industry Norms

NRRIT employee compensation, when considering the value of assets under management, exceeded that of its industry counterparts. For example, information reported by NRRIT on IRS Form 990 indicates that, while NRRIT's CEO also functions as CIO, the compensation paid to NRRIT's former CEO/CIO exceeded that of the CEO's responsible for the largest pension funds, both nationally and globally. IRS has established guidelines for determining if executive compensation is "reasonable and not excessive" and comparable with industry standards. Whether NRRIT's compensation practices are IRS compliant cannot be determined without additional disclosure by NRRIT.

Beyond IRS's reasonableness standard, NRRIT's compensation is not subject to additional federal regulation, because NRRIT is a nongovernmental entity as established by RRSIA, and not subject to ERISA. The disclosed salaries of NRRIT's key officers and directors and comparative compensation examples are shown in Table 4.

Table 4: NRRIT Employee Compensation Compared to Professional Counterparts

Position and Responsibility	Assets Managed [e]	FY 2015 Compensation
Largest U.S. Pension Fund CIO [a]	$285.8 Billion	$947,107
NRRIT CEO/CIO	**$24.5 Billion**	**$916,968**
NRRIT Senior Managing Director - Investments	**$24.5 Billion**	**$540,761**
Largest U.S. Pension Fund CEO [b]	$285.8 Billion	$536,633
NRRIT Senior Administrative/Accounting Officer (Average)	**Noninvestment**	**$418,103**
Global Top 5 Pension CEOs Median Salary [b]	$665.8 Billion	$416,000
Contracted NRRIT Investment Manager (Average)	**Not Disclosed**	**$388,544**
NRRIT Investment Director (Average)	**$2.1-$6 Billion**	**$324,009**
World's Largest Pension Fund CEO [c]	$1.2 Trillion	$260,000
Federal Thrift Savings Plan Executive Director	$458.3 Billion	$178,700
Average U.S. CEO Salary [d]	Varies By Industry	$175,110
NRRIT Independent Trustee (30 Days Worked)	**Noninvestment**	**$88,500**
Average Railroad Worker (Annual Salary)	Noninvestment	$75,355

Source: Analysis of NRRIT reported IRS Form 990 compensation, General Services Administration Federal Salary data, California Public Employees' Retirement System salary data, Bloomberg salary data, and other sources noted.
[a] California Public Employees' Retirement System.
[b] Ambachtsheer Global Pension Study.
[c] Japan's Government Pension Investment Fund.
[d] Bureau of Labor Statistics.
[e] Assets managed from NRRIT's Annual Management Report, TSP financial statements, and Pensions & Investments and Willis Towers Watson research.

Compensation paid to NRRIT's officers, directors, and key employees can also be influenced by the choice of investment strategy. While NRRIT engaged a consultant to conduct an independent study to determine the appropriate levels of compensation, an active management strategy requires the payment of greater compensation and bonuses than a passive index strategy as it requires an investment staff with heightened knowledge and expertise.

RRB officials stated that NRRIT compensation decisions are the responsibility of the Trustees and RRB officials do not participate in compensation decisions as their involvement may imply government interference. Excessive executive compensation increases NRRIT's administrative expense and reduces NRRIT's investment returns. If IRS determines that compensation paid to an executive is

unreasonable or excessive, the individual may be personally liable and subject to IRS tax penalties.[45]

NRRIT first reported executive compensation to IRS during 2007. Compensation is paid from RRB assets held by NRRIT or investment returns. As a result, compensation rates directly affect Tier II tax rates.

Management's Comments and Our Response

- In its response NRRIT stated:

> In the introductory paragraph of this section, the OIG Report states that it is evaluating "compensation paid to NRRIT's former CEO/CIO," however, in Table 4 in this section it reports a dollar figure much larger than the amount that was paid to this individual in the cited year. While the Report states that the CEO/CIO was paid $916,968 in FY 2015, that amount includes amounts that were not actually paid to the CEO/CIO that year. Both deferred compensation paid and deferred compensation earned in that year are included in the total reported by the OIG. The Trust has in place for Directors and Officers a deferred compensation plan that is used as a retention tool. Under the plan, a portion of one's annual bonus is deferred for five years and, if the individual is still employed by the Trust five years after it is earned, it vests and the individual receives that amount, with interest. To include both deferred compensation earned and deferred compensation paid in one's annual compensation is a misrepresentation that results in double counting. In this case, the total amount of compensation that NRRIT's CEO/CIO was actually paid in FY 2015 was $697,641 (versus the $916,968 reported by the OIG).

NRRIT also stated, "Another problem with the OIG Report is that it states amounts paid to similar positions at other pension funds, without citing the source of the information or describing what is included in the reported compensation for those positions."

We stand by our comparative compensation calculations. The difference of $219,327 is comprised of deferred compensation and nontaxable benefits, which one must presume are valuable to the employee and considered part of overall compensation. Generally Accepted Accounting Principles (GAAP) require that this amount be recorded as an expense and liability. We cannot determine if this has occurred due to the lack of disclosure. Deferred compensation commonly provides a tax advantage and may yield an

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[45] 26 CFR 1.162-7 Compensation for Personal Services.

undisclosed amount of interest that is not reported on the IRS Form 990. Deferred compensation is an additional expense to the NRRIT that if accounted for in accordance with GAAP reduces its investment returns. Regarding NRRIT's assertion that our report cites pay to similar positions at other pensions without citing the source of the information or what is included in the compensation, we disagree. Table 4, as provided in the draft report, included both source notes and table notes indicating our sources. Our comparative analysis of total compensation is supported by reputable and verifiable sources as indicated in Table 4.

Executive Bonuses Are Not Consistent with NRRIT Performance

Executive bonuses reported to IRS did not correlate with NRRIT's investment returns and often exceeded 30 percent of base compensation in years when NRRIT yielded negative returns. As shown in Table 5, during fiscal years 2008, 2009, 2011, and 2015 when NRRIT's investments yielded negative returns, NRRIT's CEO received bonuses of 34, 51, 43 and 65 percent of their base compensation, respectively. From fiscal years 2008 through 2015, the CEO's total bonuses exceeded $1.2 million. Further, the Senior Administrative Officer and Senior Accounting Officer, both noninvestment roles, frequently received bonuses that, when compared to their base compensation, were equivalent to those with investment responsibilities.

Table 5: NRRIT Bonuses Compared to Investment Returns

Fiscal Year	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**Average**
NRRIT Investment Returns	-19.07%	-0.67%	11.15%	-0.10%	16.38%	12.84%	10.24%	-1.53%	3.66%
	Bonus and Incentive as a Percentage of Base Compensation								
NRRIT CEO/CIO	34%	51%	21%	43%	43%	54%	54%	65%	46%
Senior Administrative/ Operating Officer	34%	7%	19%	33%	30%	40%	42%	46%	31%
Senior Accounting Officer	33%	8%	18%	33%	29%	38%	38%	47%	31%
Senior Managing Director Investments	33%	9%	21%	37%	34%	38%	36%	45%	32%

Source: RRB OIG analysis of fiscal year 2008 through 2015 NRRIT Financial Statement and NRRIT reported IRS Form 990 data.

Information supporting NRRIT's bonus and incentive policy is not disclosed to the public. For example, information on the requirements to earn bonuses, timing of bonuses, and other factors for NRRIT's CEO, CIO, Officers, and Directors have not been released to RRB officials, the railroad community, or the public. We identified this information through IRS Form 990 disclosures. Further, an evaluation of the potential impact of NRRIT compensation and expenses on Tier II employer and

employee taxes has not been made available. RRB officials could not provide information explaining NRRIT's bonus and incentive policy.

Management's Comments and Our Response

- In its response NRRIT stated:

> First, the IRS Form 990 instructions require NRRIT to report compensation paid in the calendar year ending within the fiscal year for the respective report. Because NRRIT has an October 1 – September 30 fiscal year, the compensation reported on NRRIT's Form 990 in a given year relates to the compensation earned with respect to the prior year's performance (e.g., the 2015 Form 990 contains compensation information earned in calendar year 2014 and any incentive compensation included is with respect to FY 2014 performance). The OIG Report does not account for this and, therefore, does not accurately assess compensation levels in relation to the Trust's performance in a given year.
>
> A second flaw in the OIG's argument is that it suggests that bonus compensation is earned for one-year performance. This is not the case. NRRIT's staff bonus structure measures quantitative criteria over three and five-year performance periods to ensure that incentives are focused on long term performance.
>
> A third flaw in the OIG's argument is that it suggests that bonus compensation should only be earned in years in which the Trust earns positive returns. This is a naïve view of the investment industry and the value that a highly skilled staff can provide….

Without regular and transparent NRRIT bonus structure disclosures it is impossible to confirm its fairness and effectiveness. We considered both current and prior year bonuses and compensation during our analysis based on publicly available information. As Table 5 shows, the NRRIT's investment return performance averaged 3.66 percent from fiscal year 2008 through 2015 (with annual rates from -19.07 percent to 16.38 percent) while its bonuses and incentives averaged from 31 percent to 46 percent of officers and director's base compensation each year (with annual rates from 7 percent to 65 percent). While there may be long term incentives based on the bonus structure and a delay in earning bonuses or incentives until the following year, since 2011 bonus and incentives as a percent of base compensation have been at or above 29 percent annually, and for most years and positions from 2011 through 2015, the bonus and incentives as a percentage of base compensation were 30 percent or more. Thus,

demonstrating our concern that bonus and incentive payments have ballooned in recent years and further add to the cost of active management, with no significant increase in investment outcomes.

Independent Trustee Compensation and Responsibilities Are Not Fully Disclosed

The Independent Trustee of NRRIT is responsible for Board related activities and works approximately 30 days annually, based on information reported on IRS Form 990's historically. Since fiscal year 2006, with the exception of fiscal year 2009, the Independent Trustee received annual base compensation of $60,000 or approximately $2,000 per day for 30 days of work. The Independent Trustee also received stipends of $5,000 per conference and $1,000 per teleconference, regardless of the number of hours of participation. We initially reported this issue in fiscal year 2012.[46]

After fiscal year 2009, the NRRIT stopped reporting the Independent Trustee's actual hours worked on its IRS Form 990. Section 1.6033-2(a)(2)(ii) of the IRS Income Tax Regulations and Form 990 require the NRRIT to report the number of hours devoted by each trustee to the position. Section 6652(c)(1) of the Internal Revenue Code provides in part that failure to include this information will result in a penalty of $100 for each day the failure continues, up to a maximum of $50,000 per return. RRB officials did not identify this reporting failure and had not established an oversight procedure requiring review of the IRS Form 990s.

In its 2011 management report, NRRIT reported that the Independent Trustee played a leadership role, participated in NRRIT Board meetings, served on the audit and administrative committees, contributed experience and advice, met with staff, and prepared handwritten charts and spreadsheets for use in NRRIT Board meeting educational sessions. Table 6 estimates the total compensation of the current and prior Independent Trustees based on IRS Form 990 submissions from fiscal years 2006 through 2015.

[46] RRB Office of Inspector General (OIG), *NRRIT Investment Staff and Trustee Compensation*, (Chicago, IL: August 30, 2012).

Table 6: NRRIT Independent Trustee Compensation

Fiscal Year	2006	2007	2008	2009	2010	2011	2012 [a]	2013	2014	2015
Base Compensation [d]	$60,000	$60,000	$60,000	$60,000	$60,000	$60,000	$65,000	$60,000	$60,000	$60,000
Average Days Worked Per Year [b]	30	30	30	84	30	30	32.5	30	30	30
Estimated Base Compensation Per Day	$2,000	$2,000	$2,000	$714	$2,000	$2,000	$2,000	$2,000	$2,000	$2,000
Estimated Conferences[c]	7	8	7	10	7	7	7	6	5	5
Conference Compensation	$35,000	$40,000	$35,000	$50,000	$35,000	$35,000	$35,000	$30,000	$25,000	$25,000
Estimated Teleconferences [c]	1	0	1	1	1	4	2	3	0	4
Teleconference Compensation	$1,333	$0	$1,000	$1,000	$1,000	$4,000	$2,000	$3,000	$0	$3,500
Total Compensation [d]	$96,333	$100,000	$96,000	$111,000	$96,000	$99,000	$102,000	$93,000	$85,000	$88,500

Source: RRB OIG analysis of fiscal year 2006 through 2015 NRRIT Annual Management Report and NRRIT reported IRS Form 990 data.

[a] In Fiscal Year 2012, during transition, two Independent Trustees each received partial compensation.
[b] Derived from IRS Form 990 and from NRRIT's Annual Management Report.
[c] Using the base compensation and the known costs per conference and teleconference, we were able to reasonably estimate the number of each and the associated compensation.
[d] Actual reported base and total compensation.

NRRIT's six Trustees establish the Independent Trustee's compensation. RRB officials do not review NRRIT's IRS Form 990 submission and could not provide justification for the Independent Trustee's compensation. Over the 10 fiscal year period from 2006 through 2015, the NRRIT's Independent Trustee reported earnings totaling approximately $1 million for Trustee responsibilities indicated as generally requiring 2 to 3 days of work per month. However, the Independent Trustee's responsibilities and performance are not disclosed publicly or to RRB. District of Columbia law allows court adjustment where the Trustee's compensation is unreasonably high.[47]

Management's Comments and Our Response

- In its response NRRIT stated:

> One thing pointed out in the OIG Report is that NRRIT stopped reporting the Independent Trustee's hours worked on its IRS Form 990 after fiscal year 2009. This omission from subsequent Forms 990 was not intentional, and we believe it is not a material one. The time dedicated to the Trust by the Independent Trustee remained

[47] District of Columbia Code § 19-1307.08.

> relatively unchanged from FY 2009 until Trust year 2012 (which coincides with the Trust's FY 2013) when, in recognition of his particular acumen and leadership abilities, the Board of Trustees appointed him as Chairman. As Chairman, the Independent Trustee's responsibilities increased, primarily due to the Chairman's role as the primary liaison between the Board and NRRIT staff and counsel, especially in between Board meetings. The Independent Trustee's time commitment also increased, to approximately 3-3.5 days per month. The Independent Trustee was similarly appointed Chairman in Trust years 2013, 2015, and 2016….
>
> … For all of these years, the base compensation and meeting fees remained unchanged. Going forward, NRRIT will ensure that it includes the Independent Trustee's average hours worked on all Forms 990 filed by the Trust.

NRRIT's future disclosure of the average hours worked on IRS Form 990 will provide transparency. The Independent Trustee's 0.5 hour increased time commitment was considered but did not impact the analysis in our report.

NRRIT's Office Space Usage and Rental Expense Lack Transparency

Since its inception, rental costs for NRRIT have grown as a result of the size and cost of the space it rents, office space relocation, and upgrades to leased space. Further, NRRIT did not properly disclose its office relocation, as required by District of Columbia law.[48]

In 2003, NRRIT began leasing 7,000 square feet of Class A office space at 1250 I Street in Washington, D.C.[49] During August 2012, NRRIT commissioned an architectural firm to redesign its office space listed on the architectural firm's website as 1250 I Street. We were unable to determine the cost of this redesign or rationale for conducting the redesign. Two months later, in October 2012, NRRIT established a new lease agreement less than a mile away for approximately 9,200 square feet at 2001 K Street, Washington, D.C., where its offices are currently located. In its comments on a draft of this report, NRRIT stated that the redesign was for its new office space and the 1250 I Street address had been subsequently removed from the architectural firm's website. The new lease

[48] District of Columbia Code § 19-1301.08.

[49] According to the Building Owners and Managers Association (BOMA), Class A office buildings include the "most prestigious buildings competing for premier office users with rents above average for the area." Class A facilities have "high quality standard finishes, state of the art systems, exceptional accessibility and a definite market presence."

increased NRRIT's office space expense by 69 percent, while the number of NRRIT employees increased by 43 percent, from 14 in fiscal year 2007 to 20 in fiscal year 2015.

An approximate nine month lease overlap occurred during which NRRIT potentially incurred additional rental expense estimated at more than $300,000. In its comments on a draft of this report, NRRIT told us that, while the lease was executed in October 2012, the NRRIT did not occupy the new office space until May 2013. While the NRRIT's lease at 1250 I Street did not end until July 31, 2013, there was no lease overlap or additional rental expense. NRRIT negotiated an abatement of monthly rent for the first year of the 2001 K Street lease and NRRIT did not make any rental payments on any lease for a period of nine months, from August 2013 through April 2014. NRRIT stated that the new lease resulted in a net savings to the Trust of approximately $330,000 through the negotiated rent abatement. While the NRRIT's negotiated rent abatement prevented a duplicative rental overpayment, presumed cost savings are commonly offset by moving expenses and other upfront costs necessary to prepare the office space.

NRRIT's current office space is undergoing Trophy Class renovation with expected completion in 2017 at a cost of approximately $275,000.[50] In its comments on a draft of this report, NRRIT told us that they were fully reimbursed for the renovation costs by the landlord of the new office space but did not provide documentation to support its comments. The space will provide offices for approximately 20 investment staff and a meeting space for its 7 Trustees who work 2 to 3 days per month. NRRIT's current annual office lease expense is approximately $442,000. Since its inception, NRRIT office lease expense averaged $26,265 per employee through fiscal year 2015. By comparison, in the District of Columbia, the average office rental expense is $9,008 per federal employee.[51] From its limited disclosures, we estimated the average office space since inception per NRRIT employee exceeds 500 square feet. The industry standard is 200 usable square feet (USF) per employee and the federal benchmark is 190 USF per employee with the General Services Administration's (GSA) headquarters achieving a new model standard of 80 USF per employee.[52]

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[50] Trophy class office buildings assume all of the characteristics of the most prestigious Class A office buildings. In addition, the Trophy Class building is a status symbol, landmark building with distinctive design features and the very best construction and finishes. It generally has widespread name recognition and is considered a prestigious address. [Denise L. Evans, JD & O. William Evans, JD. "*The Complete Real Estate Encyclopedia*" The McGraw-Hill Companies, Inc. 2007.]

[51] Average General Services Administration leasing cost for 200 square feet per employee at $45.04 per square foot for the Washington D.C. area. [GAO*, Federal Real Property Commodity Futures Trading Commission Needs Better Leasing Guidance to Improve Cost-effectiveness*, GAO-16-434 (Washington, D.C.: April 2016).]

[52] U.S. General Services Administration, *Workspace Utilization and Allocation Benchmark*, Effective July 2012.

In its comments on a draft of this report, NRRIT told us that its office space must also accommodate Trustee conferences, IT personnel, interns, auditors, and contractors; however, it did not disclose its actual office space square footage or staff headcount. From its comments, we estimate that the NRRIT's new office space is approximately 9,514 square feet with 7,611 of usable square footage or 381 square feet per NRRIT employee. We applied a .80 load factor in our calculations to account for USF. Adding an additional five offices to accommodate the NRRIT's Trustees, IT personnel, and other business visitors would generously yield 20-25 office spaces ranging from 304 to 381 square feet at an annual rental cost of $17,688 to $22,110 per employee. While exceeding GSA and industry standards of 190 to 200 USF by more than 50 percent, the flexible square footage can also be configured to provide the NRRIT's officers and directors with their desired executive level offices.

In addition, NRRIT did not publicly disclose a change in its principal location that was executed on October 2012 and resulted in relocation during May 2013. The NRRIT informed us of the change in its technical comments on our draft report. District of Columbia trust laws require that beneficiaries be notified 60 days prior to a change in principal location.[53] Under these laws, the RRB's beneficiaries had the authority to terminate the change but were not provided this opportunity. The change of principal office space was not disclosed in NRRIT's annual management report. NRRIT's correspondence with RRB officials identified the change of address; but, there is no indication that a press release or other form of public notification was issued. NRRIT's new Trophy Class office address was not released to the public until the NRRIT submitted the annual management report to the Congress on January 31, 2015. The new address was included on the back page of the annual management report without notice of a change. NRRIT also does not maintain a public website with its address.

These upgrades to rental space, relocation, square footage, and leasing expense details were not disclosed in NRRIT's financial statements or by other means to inform the impacted railroad community. RRB officials had no knowledge of square footage allotments per employee, whether the Trustees who only work a few days per month maintain private or shared offices, or whether NRRIT staff telework while maintaining individual office space. RRB officials were not aware of the quality or arrangements of the office space and stated that they had never toured either the current or the former NRRIT office facility to evaluate its suitability and reasonableness.

NRRIT's bylaws state that the principal office of NRRIT shall be fixed and located at such address as NRRIT shall determine. NRRIT is granted full power and authority to change said principal office from one location to another. NRRIT's bylaws established Washington D.C. as its principal office space; but, there is no

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[53] District of Columbia Code § 19-1301.08 (d).

indication that the Trustees provided a location analysis or strategy identifying any specific benefits of the location to RRB. In its comments on a draft of this report, NRRIT told us they had performed extensive research on the new office space; however, this research has not been disclosed publicly. In maintaining its arm's length relationship with NRRIT, RRB has never questioned NRRIT's need or justification for its office space. Rental expense is paid from NRRIT assets or investment returns and increases directly affect Tier II tax rates.

Management's Comments and Our Response

- In its response NRRIT stated**:**

> This redesign was not for the existing office space as indicated in the report, but rather for the Trust's new office space at 2001 K Street in Washington, DC. The cost of the redesign was reimbursed fully by the landlord of the new office space. Trust staff negotiated a tenant improvement allowance to be "used to pay the 'hard' and 'soft' costs of the initial improvements (including all architectural, engineering and permit fees)."

At the time of our review, the cited RTKL narrative identified the site address as 1250 I Street. This address has since been deleted from the website. Discussion concerning the landlord's reimbursement was added to our report.

- NRRIT further stated:

> The lease for the Trust's new office space was executed in October 2012, however, the Trust did not occupy the space until May 2013. While the Trust's lease at 1250 I Street did not end until July 31, 2013, there was no lease overlap resulting in additional rental expense. Trust staff negotiated an abatement of monthly rent for the 1st year of the 2001 K Street lease. Therefore, the Trust did not make any rental payments on any lease for a period of nine months, from August 2013 through April 2014. The new lease resulted in a net savings to the Trust of approximately $330,000 through the negotiated rent abatement, rather than additional rental expense as claimed in the report.

We have updated the report accordingly. However, NRRIT has provided information that we cannot corroborate as support for this information is not disclosed publicly. As previously explained, NRRIT's negotiated rent abatement prevented a duplicative rental overpayment, the presumed cost

savings are commonly offset in business practice by moving expenses and other upfront costs necessary to prepare the office space. NRRIT did not disclose the rent abatement in its annual management report.

- NRRIT went on to state:

> As an initial matter, for its comparison purposes, the OIG inexplicably uses NRRIT's 2007 employment number (four years after the initial lease began). Setting that aside, the OIG's claims are otherwise flawed. The Trust's rent expense increased by 52 percent (not 69 percent), from 2007 to 2015.

Fiscal year 2007 was the last year of the NRRIT's initial lease. At this time, NRRIT had 14 employees. As of fiscal year 2015, the NRRIT was under the terms of its most recent lease and had 20 employees. This provides the most accurate comparison of the change in annual lease expense versus the change in employees. Comparing NRRIT's initial annual lease expense of $2.9 million with its current expense of $4.9 million based on information published in its annual reports yields a 69 percent increase in office space expense.

- NRRIT went on to state, "… The Trust's 2001 K Street lease resulted in an increase in rent per square foot in line with expectations, from $41.21 to $46.48, driven by increases in rental rates over the 10-year period from 2003-2013."

The OIG's square footage estimates derived from public information were consistent with the square footage rates of $41.21 and $46.48 provided in NRRIT's comments.

- NRRIT went on to state, "…NRRIT is not responsible for any of the costs of the renovations. It is unclear how the $275,000 cost of the renovations cited in the OIG report is derived…."

The $275,000 cost was obtained from the building permit issued for alteration and repair of the NRRIT's office space on February 15, 2013. This cost was incurred after the establishment of the October 2012 lease agreement.

- NRRIT went on to state:

> First, as is noted in the GAO report cited in the OIG's calculation, its "analysis of average lease costs did not account for the ratio of rentable square feet ("RSF") to usable square feet ("USF") because this information is not available in the GSA lease inventory data. Therefore, these costs do not consider the 'add-on' factor commonly used to compare building space."

We applied a .80 load factor in our calculations to account for the NRRIT's USF and noted the applicable load factor in our report. The GSA report cited in our calculations references USF. The Federal Benchmark is 190 USF and GSA's headquarters office averages approximately 80 USF per person of workspace. For fiscal year 2013, applying the .80 load factor and GSA's rate of $44.77 to 250 square feet results in a cost of $11,193 per person for the industry standard of 200 USF of workspace per person with 25 offices including five guest offices for the NRRIT's Trustees, Trust auditors, and Information Technology managed services personnel. Comparatively, the NRRIT's quoted fiscal year 2013 rate of $46.48 and lease of an estimated 9,514 square feet, for an estimated headcount of 20 plus 5 additional guest offices, would have resulted in 304 USF of workspace at a cost of $17,688 per person. From this comparison, NRRIT's lease resulted in an estimated $162,389 of additional rental expense per year.

- NRRIT went on to state:

> Second, and more importantly, all per-person GSA benchmarking metrics define headcount as follows: "Headcount: The total number of employees, including full-time, part-time, interns, and contractors, that work at a designated office location." Any calculations that exclude NRRIT Trustees, Trust auditors, Information Technology managed services personnel, and other contractors from the analysis dramatically overstate the Trust's Space Allocation Rate.

The OIG's calculated average square footage since inception of 500 square feet considered all of the NRRIT's office spaces and represents the average office space per employee since inception through 2015. Based on the new information provided in the NRRIT's comments, we estimate that the NRRIT's new office space is approximately 9,514 square feet with 7,611 of usable square footage or 381 square feet per NRRIT employee. While NRRIT has not disclosed its actual headcount, we estimate that adding an additional five shared offices for Trustee conferences, IT personnel, interns,

auditors, and contractors would generously yield 20-25 office spaces ranging from 304 to 381 square feet at an annual rental cost of $17,688 to $22,110 per employee. While exceeding GSA and industry standards of 190 to 200 USF by more than 50 percent, the flexible square footage can be configured to provide the NRRIT's officers with their desired larger executive level offices. We have updated the report with the NRRIT's updated information.

- NRRIT went on to state: "The Trust's governing statute establishes Washington, D.C. as its principal location. The bylaws of the Trust reflect adherence to the statute."

  NRRIT was established as a trust domiciled in and subject to the laws of the District of Colombia in accordance with RRSIA. A location analysis or strategy identifying the specific benefits of the NRRIT's principle location and physical address was not provided to its beneficiaries for their consideration.

- NRRIT went on to state:

  > The cited District of Columbia Code section requires a Trust to notify its beneficiaries of such a move in the event that it moves to another jurisdiction (i.e., outside the District of Columbia). The Trust remained in the District of Columbia. Moreover, the Trust does not have beneficiaries to notify even if it had located to another jurisdiction….

  By law, remaining in the District of Columbia does not waive the requirement for notification. While NRRIT remained in the same District of Colombia jurisdiction, its principle place of administration or office location had changed requiring the NRRIT to notify the RRB's beneficiaries of the transfer. Further, the RRB's beneficiaries had the authority to terminate the transfer but were denied this opportunity.

  Code of the District of Columbia, Section 19-1301.08, Principal Place of Administration (d) requires that:

  > The trustee shall notify the qualified beneficiaries of a proposed transfer of a trust's principal place of administration not less than 60 days before initiating the transfer. The notice of proposed transfer must include:

(1) The name of the jurisdiction to which the principal place of administration is to be transferred;

(2) The address and telephone number at the new location at which the trustee can be contacted;

(3) An explanation of the reasons for the proposed transfer;

(4) The date on which the proposed transfer is anticipated to occur; and

(5) The date, not less than 60 days after the giving of the notice, by which the qualified beneficiary must notify the trustee of an objection to the proposed transfer."

(e) The authority of a trustee under this section to transfer a trust's principal place of administration terminates if a qualified beneficiary notifies the trustee of an objection to the proposed transfer on or before the date specified in the notice.

Implying that the railroad retirement program annuitants are not beneficiaries of the NRRIT generates further concern.

- NRRIT went on to state, "[t]he Trust has adopted an Investment Procedures Manual that requires rigorous due diligence of prospective investment managers, and ongoing monitoring of existing investment managers."

  This statement cannot be validated as the NRRIT does not release this information publicly and there is no way to determine if the manual has been subject to audit or external review.

- In its response NRRIT stated, "[w]ith a staff of approximately 20 employees, NRRIT is unable to take advantage of the same economies of scale enjoyed by larger organizations with respect to common areas."

  This statement further supports a location analysis, which can add value in identifying an economical office space. It is unknown whether NRRIT considered the comparative "economies of scale" and rental cost savings offered by its new principle location. It is also unclear whether the NRRIT's new principle location offers any advantages to the NRRIT's investment model.

- NRRIT went on to state:

> In 2007, the GAO conducted a study of the administrative expenses of the Federal Retirement Thrift Investment Board (FRTIB), which administers the TSP. As it relates to workplace utilization, a GSA official told the GAO that, "based on FRTIB's mission, [its] space needs are likely similar to a model that proposes 368 rentable square feet per person." At the time the report was drafted, "FRTIB's headquarters provided more than 670 square feet per person." The similar mission of the FRTIB and the Trust make comparisons across the two organizations more meaningful than comparisons against the GSA's benchmark.

It is unclear why the NRRIT references this report when the more current footnoted GSA 2011 and GAO 2016 reports provide more current information. NRRIT's implication that its mission supports office spaces ranging from 368 to 670 square feet per person further substantiates our concerns with the NRRIT's excessive use of office space.

- NRRIT went on to state:

> The Trust performed extensive research on the new office space (and other options) prior to signing the lease in October 2012. The former space at 1250 Eye Street was a Class B building and the Trust's rent was approximately 5 percent above market rates for that category of office space….

NRRIT's office space research was not provided to the RRB and has not been disclosed publicly to its beneficiaries. NRRIT's 1250 I Street office was at the time of our review and continues to be classified as a Class A building. As such, NRRIT's move to the 2001 K Street location resulted in a 12.8 percent rental expense increase, as stated by NRRIT from $41.21 to $46.48 per square foot, while upgrading unnecessarily to one of the largest Trophy Class developments in Washington, D.C.

NRRIT Fees and Investments Lack Transparency

NRRIT's external investment management fees, totaling more than $660 million, and its current investment portfolio, totaling more than $25 billion, lack transparency. NRRIT's current reporting mechanisms do not provide adequate disclosure to interested parties.

External Investment Management Fees Are Not Adequately Explained

NRRIT works with approximately 140 external investment managers who each have full discretion under their individual portfolio agreements with NRRIT to select securities and properties, and to determine the timing of, and execute transactions in their respective active management portfolio totaling up to 10 percent of the NRRIT's assets. The investment fees received by each external investment manager and their contract terms and bonus structure are not required to be disclosed to RRB or those with a vested interest in NRRIT. NRRIT's total investment management fees have exceeded $660 million since implementation of its active management strategy in fiscal year 2004. On average for the five year period ending with fiscal year 2015, NRRIT's external investment managers received commission and performance based fees of $440,000 per year and in fiscal year 2011 each of the 124 investment managers received an average of more than $550,000.

NRRIT's Investment Guidelines state that, "[a] separate agreement between the Trust [NRRIT] and each individual investment manager will document the specific responsibilities, limitations, and compensation arrangements of each investment manager." While compensation decisions are subject to a three of five member Board of Trustees agreement, the quorum members are not disclosed, may include members of the other committees, and are not required to include the Independent Trustee, resulting in weakened independence. RRB officials do not participate in compensation decisions and could not provide information detailing NRRIT compensation and fees. NRRIT's investment management fees reduce NRRIT net assets and impact the Tier II tax burden of railroad employers and employees.

NRRIT Investments Are Not Fully Disclosed

NRRIT only publicly discloses the 50 largest holdings in its investment portfolio. The largest holdings within each asset class, including those exceeding 5 percent of net assets, are presented in NRRIT's Condensed Schedule of Investments. For fiscal year 2016, only NRRIT holdings totaling $7.2 billion and representing 29 percent of its investments were disclosed. NRRIT's other investments including offshore, international, and private investment holdings, which collectively totaled $17.4 billion and represented 71 percent of NRRIT's net assets, were not disclosed to the public, during fiscal year 2016. NRRIT provides no explanation for this disclosure limitation. Private pension funds subject to ERISA and public pension funds, such as the California Public Employees' Retirement System, are required by federal or state law to fully disclose all of their investments. Undisclosed investments could potentially include investments that pose greater investment risk or conflicts of interest. NRRIT's nongovernmental status prevents requests for the

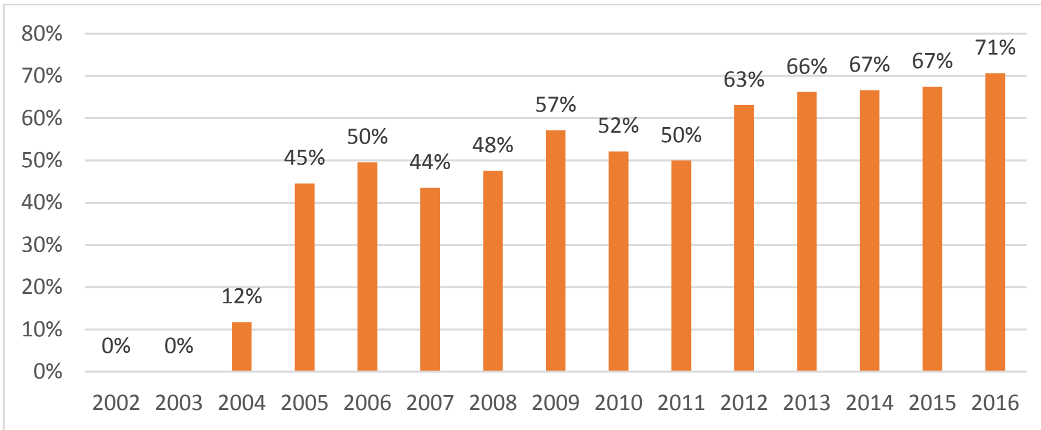
public release of documentation such as those under the Freedom of Information Act.[54] Disclosure information is detailed in Table 7 and Figure 2.

Table 7: Fiscal Year 2016 NRRIT Investment Disclosure (In Billions)

Disclosed and Nondisclosed NRRIT Investments		
BlackRock Funds	$2.5	
Offshore Funds	$1.6	
Other Funds	$3.1	
Total NRRIT Investments – Disclosed	$7.2	29%
Total NRRIT Investments – Not Disclosed	**$17.4**	**71%**
Total NRRIT Investments	$24.7	100.0%

Source: Analysis of fiscal year 2016 NRRIT financial statement data.

Figure 2: Undisclosed NRRIT Assets by Fiscal Year



Source: RRB OIG analysis of fiscal year 2002 through 2016 NRRIT Annual Management Report data.

[54] NRRIT's disclosure policy included in its annual management report states, "[a]ny request for confidential information from any other agency or instrumentality of the Federal Government shall be reviewed by the Trustees on a case-by-case basis and in consultation with the Railroad Retirement Board."

Management's Comments and Our Response

- In its response NRRIT stated:

> The Trust's explanation for its financial reporting practices is included in the footnotes to its financial statements. The Trust's footnote on Significant Accounting Policies states that "[t]he accompanying financial statements were prepared in accordance with accounting principles generally accepted in the United States of America (GAAP), including but not limited to ASC 946." Furthermore, the Trust's Condensed Schedule of Investments is characterized as a "disclosure limitation" in the OIG report. On the contrary, the Trust has voluntarily adopted the requirements of registered investment companies in its Condensed Schedule of Investments. The disclosure requirements for non-registered investment partnerships are less restrictive and require less disclosure than is provided by NRRIT.

- The NRRIT also stated that:

> It is important to differentiate between the terms "specifically identified" and "disclosed." One hundred percent of Trust assets are disclosed in its financial statements. There are no "undisclosed" or off balance sheet assets excluded from the financial statements. The OIG's references to "undisclosed" assets refers to those assets not required to be "specifically identified" within the Condensed Schedule of Investments under GAAP.

While the NRRIT's investment disclosures were subject to audit this does not solve the problem of disclosure. As indicated in our report there is a significant and increasing volume of unknown investments described by the NRRIT as "other." As stated in our report, these other publicly undisclosed investments totaled $17.4 billion and represented 71 percent of NRRIT's net assets, during fiscal year 2016. From the NRRIT's comments, the RRB's program annuitants can infer that the NRRIT believes its investments classified as "other" can be considered fully disclosed as a total monetary amount without specifically identifying the type of investment or their source or geographical location. Without access to this unidentified investment information, it is impossible for Congress, the RRB, and RRB's constituents, i.e., railroad employers and their employees, to fully understand and make a determination with regard to the NRRIT's operational performance, and the investment risks inherent within its strategy. In response to transparency concerns, the Financial Accounting Standards Board has proposed disclosure of those investments whose fair values aggregate more than 1 percent of net assets, to include the related industry, country, or

geographic region of the investment.[55] Strangely, NRRIT has voluntarily adopted the requirements of registered investment companies under the SEC's Investment Company Act of 1940 while choosing to ignore the registration requirements under the same Act. As we noted in our report, private pension funds subject to ERISA and public pension funds such as California Public Employees' Retirement System, are required by federal or state law to fully disclose all of their investments.

NRRIT's Offshore Investments Introduce Risks

During fiscal years 2015 and 2016, NRRIT maintained approximately $2.2 billion and $2.0 billion in offshore investments representing 9.4 percent and 8.0 percent, respectively, of its total investments that are not directly subject to U.S. banking regulations. Because the offshore accounts are maintained within the British Virgin Islands, the Cayman Islands, and Luxembourg, the types of investments and associated foreign investors are unknown. Audit and valuation of offshore account balances is especially difficult. Known risks of offshore investments include records of withdrawals and transfers from offshore accounts not being maintained, and account assets being silently withdrawn as insider loans. Because NRRIT is tax exempt, the investments are not required to be reported to IRS. NRRIT maintains offshore investments as a component of its active management strategy with the objective of enhancing the financial strength of the railroad retirement system through diversification of assets. RRB officials stated that they have no knowledge of these investments and have not inquired to protect their arm's length relationship with NRRIT.

Management's Comments and Our Response

- In its response NRRIT stated:

> The allegation in the OIG's report that the "types of investments" in these offshore vehicles are unknown is simply not true. NRRIT's investment staff knows quite well the types of investments in each of its accounts, irrespective of the fund's legal jurisdiction. The Trust receives regular investment reports from each of its managers on a monthly or quarterly basis containing the holdings, key exposures, and/or portfolio characteristics for each applicable fund, as well as updated investment performance information. Also, none of the events contained in the OIG's list of "known risks of offshore investments" have occurred since NRRIT's inception, as the Trust's thorough manager due diligence and monitoring process minimizes the likelihood of such events. The Trust conducts due diligence on all

[55] Financial Accounting Standards Board Exposure Draft, Financial Services – Investment Companies (Topic 946), Disclosures about Investments in Other Investment Companies, December 4, 2014.

> of its managers prior to hiring, including those utilizing offshore investment vehicles, following the comprehensive process laid out in the Trust's Investment Procedures Manual. In addition, NRRIT actively monitors each of its managers, including a thorough review of periodic investment reports and quarterly calls or meetings with each manager on NRRIT's roster.
>
> The OIG also states in this section that, because NRRIT is tax exempt, its offshore investments are not required to be reported to the IRS. This contention is incorrect. On an annual basis, NRRIT reports relevant contributions to, and ownership of, the Trust's offshore investment vehicles on IRS Forms 926, 5471, and/or 8865 as required.

We reiterate our point that only NRRIT knows fully what it invests in due to its limited disclosure requirements. Despite the NRRIT's assurances, there is currently no means of assuring that adequate controls are in place to minimize risks inherent with the NRRIT's undisclosed offshore investments. The RRB does not review the NRRIT's due diligence and monitoring process or the NRRIT's Investment Procedures Manual. The IRS forms mentioned are not publicly available and we have no way of determining what information has been disclosed and whether such information is complete. This lack of oversight and confirmation by an independent third party is one of numerous examples that we believe supports our Matter for Congressional Consideration that NRRIT be subject to ERISA.

NRRIT Administrative Expenses Are Rapidly Increasing

Since inception, NRRIT's administrative expenses totaled more than $800 million and averaged $54 million annually, with investment management expenses representing 82 percent of the NRRIT's administrative expenses, as shown in Table 8. Since fiscal year 2006, NRRIT's administrative expenses have continued to increase, and averaged approximately $72 million annually, over the 10 year period from fiscal year 2007 through 2016 and peaking at $83 million in fiscal year 2011. NRRIT incurred additional expenses for Network, Software and Systems, Investment Related Fees and Expenses, and Occupancy Expense during fiscal year's 2013, 2014, and 2015, respectively.

Table 8: Total NRRIT Administrative Expenses from Inception to 2016 (In Thousands)

Type of Expenses	Total Since 2002	Percentage	Annual Average
Investment Management Fees	$664,590	82.4%	$44,306
Compensation	48,757	6.0%	3,751
Other Expenses	42,276	5.2%	2,818
Investment Related Fees and Expenses	7,602	0.9%	2,534
Professional Fees	34,474	4.3%	2,298
Network, Software and Systems	3,374	0.4%	844
Occupancy Expense	1,456	0.2%	728
Insurance	560	0.1%	280
Trustee Fees and Expenses	2,573	0.3%	172
Custodial Fees	1,348	0.2%	104
Total Administrative Expense	**$807,010**	**100.0%**	**$53,801**

Source: RRB OIG analysis of fiscal year 2002 through 2016 NRRIT annual management reports.

As shown in Table 9, NRRIT's administrative expense increased by 1,391 percent from fiscal year 2003 to 2016, investment management fees increased by 2,812 percent, executive compensation increased by 747 percent, and other expenses increased by 232 percent, as of fiscal year 2016, when compared with these expenses prior to active management. NRRIT's *Other Expenses* are not explained or accounted for in the financial statements or annual management report and averaged $3.2 million annually since active management began. NRRIT's *Other Expenses* vary considerably by year and exceeded $7.9 million during fiscal year 2009. NRRIT also disclosed legal fees paid to law firms totaling $26.2 million since inception and averaging $1.7 million per year.

Table 9: Growth of NRRIT Expenses (in Thousands)

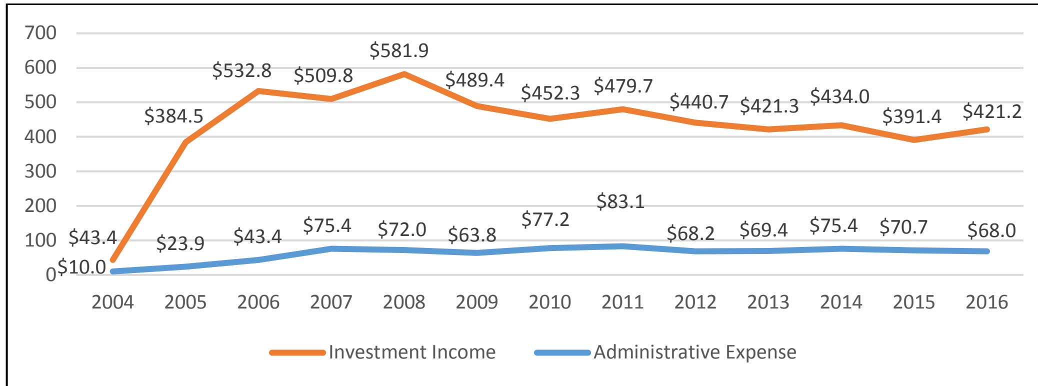
	FY 2003 (Indexed)	FY 2016 (Active)	Percentage Change [a]
Administrative Expense	$4,558	$67,974	1,391%
Investment Management Fees	$1,901	$55,355	2,812%
Compensation	$624	$5,287	747%
Other Expenses	$225	$746	232%

Source: RRB OIG analysis of fiscal year 2003 and 2016 NRRIT financial statement data.

[a] Growth of NRRIT active management expenses versus NRRIT passive management.

As shown in Figure 3, NRRIT's administrative expenses have generally increased as its active management strategy has matured, without associated comparable growth in investment income. NRRIT's administrative expenses reduce the investment potential of NRRIT net assets. As discussed earlier in this report, the loss of investment potential compounded over time can significantly increase railroad employer and employee Tier II taxes.

Figure 3: NRRIT Investment Income and Administrative Expense (In Millions)

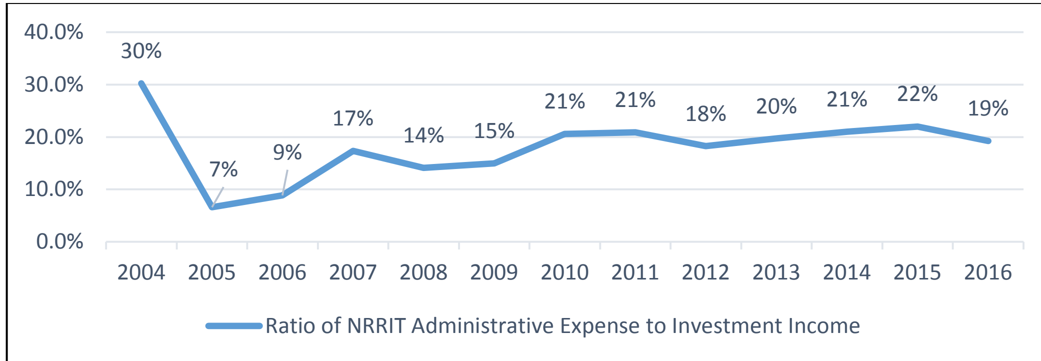


Source: RRB OIG analysis of fiscal year 2004 through 2016 NRRIT financial statement data.

Academic research indicates that while commonly used, an administrative expense ratio calculated as a ratio of net assets rather than as a ratio of net income can be misleading to investors in terms of significance. Generally, there is a better relationship between investment income and expense, as investment assets are relatively larger making the related expenses seem nominal.[56] For example, during the period when NRRIT's active management strategy was in effect from fiscal year 2004 through fiscal year 2016, NRRIT's average administrative expense to net asset ratio was 0.2 percent; however, its average administrative expense to net investment income ratio was 18 percent, as illustrated in Figure 4.[57]

[56] Charles Ellis, *Investment Management Fees Are (Much) Higher Than You Think*, CFAInstitute.org, June 28, 2012.
[57] As discussed previously in this report, investment management fees represent a significant portion of administrative fees.

Figure 4: Ratio of NRRIT Administrative Expense to Investment Income



Source: RRB OIG analysis of fiscal year 2004 through 2016 NRRIT financial statement data.

Management's Comments and Our Response

- In its response NRRIT stated:

> Regarding the OIG's criticism of NRRIT's expenses, two important points are worth considering:
>
> 1) NRRIT's expense ratio of 27 bps is significantly lower than its defined benefit plan peers (66 bps on average); and
> 2) NRRIT's portfolio has outperformed its passive benchmark, net of all fees and expenses, over the trailing 1-year, 3-year, and 5-year time periods through September 30, 2017, as well as since NRRIT's inception in 2002.
>
> The percentage increases cited by the OIG may appear high on their face, but the starting point for these increases was the early days in the Trust's history when there were only a few staff members and the Trust had not yet fully developed its investment strategies and asset allocation. Thus, these percentage increases are artificially inflated due to the unsustainably low expenses incurred during the Trust's initial years of existence and, while eye-catching, are essentially meaningless. The Trust's costs did increase, as expected, in those early years as the portfolio was gradually built out, but expense levels have plateaued as the Trust has matured over the last decade. Indeed, as shown in the OIG report, the Trust's costs actually have declined slightly over the last ten years, going from $75 million in FY 2007 to $68 million in FY 2016. NRRIT's total expenses have been fairly consistent and range-bound over the last decade, ranging from $64 million to $83 million in each fiscal year from FY 2007 through FY 2016.

> The OIG's analysis included at Table 8 of the report also contains inaccuracies. The table is represented as an analysis of NRRIT financial statement data for fiscal years 2002 through 2015. While Trust staff were not able to review the details of this analysis, it appears that the analysis actually covers the Trust's financial statements through FY 2016, not FY 2015. Therefore, while the table indicates that the Trust incurred $807 million of expenses over a 14-year period, these expenses were actually incurred over a 15-year period. If this had been accurately represented, each of the annual averages in Table 8 would have been less than the amount reported by the OIG.
>
> Finally, the methodology used by the OIG in arriving at the figures in Table 8 includes a full 15 years of data for some captions, but as few as 2 years of data for other captions. It is important to understand that the Trust's financial statements follow GAAP for investment companies. GAAP for investment companies requires separate disclosure of each expense exceeding 5 percent of total expense. Therefore, the expense captions reflected in the Trust's Statement of Operations will vary from year to year, as the amount of these expenses will vary over time. Similarly, the specific expenses included in the "Other Expenses" caption will vary each year. The OIG's computation of average annual "Other Expenses" of $2.8 million in Table 8 results in a meaningless figure that is not a reasonable basis for evaluating Trust expenses.

While the NRRIT referred to its fiscal year 2017 rates of return in its comments, it quoted its .27 percent expense ratio from fiscal year 2015. According to its Annual Management Reports, Financial Highlights, NRRIT's expense ratio has since increased to .28 percent and .31 percent for fiscal years 2016 and 2017, respectively. More notably, over this current one year period, NRRIT's expense ratio increase of 3 basis points reflected a 21 percent increase in investment management fees and a 17 percent increase in administrative expenses. NRRIT rightfully compares its expense ratio with its active management peers. However, our analysis also considers the passive investment expense ratios of TSP, Vanguard, and BlackRock with current reported S&P 500 expense ratios of .04 percent, .04 percent, and .11 percent, respectively, versus NRRIT's .31 percent expense ratio. NRRIT states that its performance had exceeded its 1 year, 3 year, and 5 year established benchmarks through September 30, 2017; *however, our restated calendar year analysis found that the NRRIT's compounded rate of return over the fifteen year period from inception through December 31, 2017 did not surpass the TSP C Fund, S Fund, or I Fund. These three TSP funds track the S&P 500, Dow Jones TSM, and MSCI EAFE index benchmarks, respectively.*

With regard to the maturity of the NRRIT's active management strategy and increased costs, we add additional clarification. Over the 10 year period from fiscal year 2006 through fiscal year 2015, the NRRIT's investment management expense increased by 260 percent and its compensation expense increased by 172 percent. In fiscal year 2005, NRRIT's investments were reported as 34 percent actively managed and by 2015 NRRIT's investments were approximately 88 percent actively managed, a 160 percent increase. During this same 10 year period from fiscal year 2006 through fiscal year 2015, NRRIT's investment management staff increased from approximately 40 managers to 149 managers, a 273 percent increase. Another component of its NRRIT's total administrative expense, its in-house staff, also increased from 10 employees to 20 employees, a 100 percent increase. The NRRIT's rate of return during this 10 fiscal year period was 4.98 percent.

The caption for Table 8 has been changed to reflect fiscal year 2016 and for consistency Table 9 has been updated to include fiscal year 2016. The OIG averaged NRRIT's total annual expenses reported over a 15 year period for fiscal year 2002 through fiscal year 2016 resulting in average administrative expenses of $53.8 million, as previously reported in the table. NRRIT incurred average administrative expenses of $69.8 million over the 10 year period from fiscal year 2006 through fiscal year 2015, as previously reported. To address the NRRIT's concern regarding different periods of expense in Table 8, we have added further clarification in the report addressing the NRRIT's incurrence of new and more recent expenses. Specifically, while continuing to maintain the "Other Expenses" category, the NRRIT has added new expense captions during fiscal years 2013 through 2015 that have seemingly increased its total administrative expenses. The largest of the three new expenses, Investment Related Fees and Expenses resulted in $10.4 million in expenses over the four year period from fiscal years 2014 through 2017. NRRIT also incurred total expenses of $4.4 million for Network, Software and Systems over the five year period from fiscal years 2013 through 2017. NRRIT also reported Occupancy Expense of $2.2 million for fiscal years 2015 through 2017. It is unclear from the limited disclosure whether these expenses were previously reported as "Other Expenses."

We do not believe that the RRB's program annuitants (i.e., railroad employees and employers) would find annual average "Other Expenses" totaling $2.8 million to be "meaningless." These variable "Other Expenses" have averaged $3.2 million annually since active management began and exceeded $7.9 million during fiscal year 2009. In its response, NRRIT offered no explanation for these expenses. These still unexplained NRRIT expenses are paid directly from the earnings of railroad employees and decrease the income of railroad employers. Federal regulations require

separate disclosure on the income statement of any item of other expense, which exceeds one percent of the aggregate of total interest income and other income.[58] Without footnote disclosure, NRRIT's other expenses lack transparency and compliance with its one percent disclosure requirements cannot be observed. We have addressed the variability of these "Other Expenses" by reporting the average annual expense and adding clarifying detail in the report.

- NRRIT further stated:

> Interestingly, if one was to calculate the Trust's administrative expense ratio as a ratio of net income rather than as a ratio of net assets, as the OIG advocates, the Trust's administrative expense ratio would have been significantly higher in its early years, when the Trust's portfolio was mostly passively managed: 23.04 in 2004 versus 16.14 in 2016….

Based on its reported Statement of Operations for fiscal years 2004 and 2016 and utilizing a ratio of total administrative expenses to net investment income, NRRIT's expense ratio calculations are in error and should be 30 percent and 19 percent, respectively, as shown in Figure 4 of the report. In contrast to the ratio of administrative expense to total net assets, which results in diluted perception of actual expense, the ratio of administrative expense to net income more realistically reflects current year investment performance excluding realized and unrealized gains. The expense to net income ratio also clearly indicates if administrative expense exceeds net income whereas the ratio of expense to total net assets will not disclose negative performance. During fiscal year 2004, the NRRIT's rate of return was 13.3 percent versus 8.13 percent during fiscal year 2016. The NRRIT reported total net assets of $25.0 billion during fiscal year 2004 and total net assets of $25.1 billion during fiscal year 2016. In summary, both administrative expense ratios provide different perspectives to a reader of the financial statements. As stated in our report, NRRIT's active management expenses averaged 18 percent of its net income from fiscal year 2004 through fiscal year 2016.

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[58] 17 CFR Part 210 - Form and Content of and Requirements for Financial Statements, Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940, Investment Advisers Act of 1940, and Energy Policy and Conservation Act of 1975, 17 CFR 210.9-04 - Statements of Comprehensive Income, #14.

NRRIT CEO/CIO Conflict of Interest Not Reported

NRRIT bylaws have been established to govern conflicts of interest; however, our review of public information identified one such conflict that RRB was not informed of until RRB OIG auditors brought it to their attention. RRB has not taken steps to ensure future compliance by NRRIT with these bylaws.

Conflict of Interest Involving NRRIT's CEO/CIO Was Not Adequately Reported

A former NRRIT CIO/CEO accepted a position as director of BlackRock Investments, one of NRRIT's largest investment funds, during her employment with NRRIT. [59] Table 10 details the timeline and events related to this matter that we have been able to identify from meetings with RRB officials and public documents, including our office's identification of the matter.

Table 10: Timeline of Events for the Departure of NRRIT's CEO/CIO

Date	Event
December 1, 2015	NRRIT's then CEO/CIO submitted a request to the Board of Trustees to serve as a trustee for BlackRock funds. This request is denied by NRRIT.
December 31, 2015	BlackRock issued a press release stating that NRRIT's CEO/CIO will serve as both director and trustee for BlackRock funds effective July 1, 2016.
February 9, 2016	RRB OIG provided a copy of BlackRock press release dated December 31, 2015, to RRB's then General Counsel who told OIG staff that RRB had not been informed of the situation and NRRIT had not discussed the potential conflict of interest with RRB prior to the CIO/CEO's acceptance of the director's position. RRB officials did not comment when asked by RRB OIG if a cooling off period would be enforced.
February 23, 2016	RRB received notification that NRRIT's CEO/CIO had been terminated by NRRIT as of this date.
February 25, 2016	RRB's then CFO told OIG staff that he was not aware of NRRIT's CEO/CIO intent to join BlackRock.
March 1, 2016	The former NRRIT CEO/CIO began to serve as Director of BlackRock Funds' registered closed-end funds, approximately seven days after her termination and four months earlier than previously announced. The former NRRIT CEO/CIO also joined the BlackRock Board's audit, performance oversight and governance, and nominating committees.
March 14, 2016	RRB's then General Counsel notified RRB OIG that in February 2016, NRRIT learned of the former NRRIT CEO/CIO's decision to join BlackRock funds and as a result terminated her employment at NRRIT's Board meeting on February 23, 2016.
April 15, 2016	NRRIT selected a new CEO/CIO and indicated that he had been acting in the position since February 23, 2016.

Source: RRB OIG research and discussions with RRB's former General Counsel.

[59] BlackRock is the world's largest fund manager and during 2015 accounted for 7.6 percent of overall global assets. As of September 30, 2015, NRRIT publicly disclosed investments in BlackRock funds totaling more than $2.9 billion or 12.4 percent of NRRIT investments. Additional BlackRock fund investments may be undisclosed, as reported earlier in this report.

A cooling off period is a length of time subsequent to employment when the employee cannot participate in activities involving the former employer. It serves as an independence safeguard and provides an additional layer of protection against even the appearance of impropriety when former employees take on new jobs. For CEO's, cooling off periods generally range from a minimum of one year up to five years or more based on the potential and severity of the conflict of interest.[60] Therefore, a significant conflict of interest may exist or appear to exist as there is an investment relationship between NRRIT and BlackRock. NRRIT has not established a cooling off period and RRB has not questioned its lack of policy or taken any responsive action. Magnifying this issue is NRRIT's failure to register as an Investment Adviser with SEC, which was discussed previously in this report.

According to NRRIT's *Conflict of Interest Policy*, conflicts of interest are to be addressed by the Trustees but are not required to be reported to RRB. NRRIT's policy statement on conflicts of interest, applicable to the Trustees and all employees, is disclosed in Appendix E of the annual management report. We identified the following weaknesses in NRRIT's conflict of interest policy:

- NRRIT policy exceptions are permitted with the consent of the Board of Trustees.
- Procedures for reporting to the Board of Trustees, independently investigating, and addressing the conflict of interest are not included in the policy.

If conflicts of interest are not reported to RRB or RRB does not actively seek information as part of its mandated oversight under RRSIA, RRSIA oversight and enforcement is limited.

Management's Comments and Our Response

- In its response NRRIT stated:

> The OIG Report states that a conflict of interest involving NRRIT's former CEO/CIO occurred and that this conflict of interest was not disclosed to the RRB until after the OIG brought it to the RRB's attention. In reality, NRRIT's Board was confronted with a personnel situation that it handled swiftly, decisively, and appropriately, including its notification to the RRB about what had occurred.
>
> At NRRIT's December 2015 Board meeting, the Trust's then CEO/CIO asked for permission to serve as a compensated director of a number of BlackRock closed-end mutual funds. These are not funds that NRRIT invests in or would consider investing in, however,

[60] *ISS Releases 2015 Benchmark Policy Updates, Definition of Independence*, Institutional Shareholder Services Inc., issgovernance.com, November 6, 2014.

NRRIT's Board declined the request for various reasons. On February 9, 2016, NRRIT's Board learned that, notwithstanding the Board's decision, the then CEO/CIO had accepted the BlackRock position, to be effective July 1, 2016. That same week, members of NRRIT's Board of Trustees, together with counsel, met with the then CEO/CIO to confirm this. Once confirmed, NRRIT's Board began the process of terminating this individual's employment, consistent with terms in the employment contract. Importantly, the individual's employment contract provided ten days for the individual to remedy the situation giving rise to termination. Once those ten days elapsed, on February 23, 2016, and sufficient remedy was not provided, the members of the RRB and the RRB General Counsel were notified about what had occurred. Given what transpired, NRRIT's Board handled the situation as swiftly as possible and, to this day, believes the matter was handled correctly.

The timeline of events related to the former CEO/CIO's departure presented at Table 10 of the OIG Report is dubious and relies heavily on information supposedly provided by the RRB's former General Counsel, who has since retired and is not available to corroborate the information attributed to him in the report. Nonetheless, an email dated February 29, 2016 from the RRB's former General Counsel to NRRIT's counsel indicates that the OIG brought this issue to his attention on that day, following its discovery of a brief article regarding the matter in Pensions & Investments Online. Moreover, neither the former General Counsel nor the RRB Members ever indicated that the issue involving NRRIT's former CEO/CIO had been brought to their attention by the OIG prior to February 23, 2016, when they were informed of the matter by the Trust.

… What this ISS statement speaks to is the cooling off period required for a former CEO of a company to be considered an independent director/trustee of the same company. In other words, a former CEO of Company A would have to observe a five-year cooling off period before he or she could be considered an independent board member of Company A. This is completely irrelevant to the scenario involving NRRIT's former CEO/CIO. In fact, we are unaware of any cooling off requirements that would relate to this situation."

… In any event, the former CEO/CIO has not been in contact with NRRIT staff regarding Trust business, and has had no involvement with NRRIT since departing the Trust."

The NRRIT states, "[o]n February 9, 2016, NRRIT's Board learned that, notwithstanding the Board's decision, the then CEO/CIO had accepted the BlackRock position, to be effective July 1, 2016." Regardless of NRRIT implying that we did not notify RRB of this matter until February 23, 2016, we notified the RRB of this matter on February 9, 2016. A copy of the email we sent to the then General Counsel is presented in Appendix IV. In addition, while the NRRIT states that it learned of the CEO/CIO decision on this date, this same information had been released publicly as a BlackRock press release more than a month prior, on December 31, 2015. The NRRIT stated that swift action had been taken; however, 14 days passed before the CEO/CIO termination process began, exceeding the NRRIT's noted 10 day contract remedy period and which seemingly had elapsed 10 days after the December 31, 2015 BlackRock press release. According to the NRRIT, the RRB's General Counsel stated that he was notified, on February 29, 2016, 20 days after the OIG actually notified him during an interview and by subsequent email on February 9, 2016. Further, the NRRIT states that it did not notify the RRB of the CEO/CIO's departure until February 23, 2016, 54 days after the information was released publicly.

As of March 1, 2016, the former NRRIT CEO/CIO began to serve as Director of BlackRock Funds' registered closed-end funds, approximately seven days after her termination and four months earlier than previously announced. The former NRRIT CEO/CIO also joined the BlackRock Board's audit, performance oversight and governance, and nominating committees.

Our cited source, Institutional Shareholder Services Inc. (ISS), which addressed our concern, is a leading provider of corporate governance solutions to the global financial community including the Americas, Europe, the Middle East and Africa, and Asia-Pacific region. ISS gathers worldwide input from institutional investors, issuers, and other market constituents through a variety of channels and mediums in which governance stakeholders globally have provided wide-ranging feedback. ISS' policies involve the efforts of hundreds of investors, issuers, corporate directors, and other market participants. A cooling off period is a best practice and other United States based financial entities have proposed similar time frames for establishing independence. For example, the New York Stock Exchange has proposed a five-year "cooling off" period for former employees. Similarly, NASDAQ has proposed a three year "cooling off' period for former employees. The California Public Employees Retirement System's definition of independent director excludes former employees who have served in an executive capacity in the last five years.

The OIG concludes from these facts that it is impossible to assess the impact of the former NRRIT CEO/CIO's current and future BlackRock investment responsibilities, and whether safeguards are in place to address the conflict of interest and its potential legal ramifications.

- NRRIT further stated:

> The February 29, 2016 email from the RRB's former General Counsel to NRRIT's counsel contained an email he received from the OIG that same day. In that email, the OIG inquired about issues related to the former CEO/CIO's departure, and attached a brief article, dated February 26, 2016, related to the departure and the Trust's appointment of an interim CIO. Given the significance of the February 29, 2016 communications between the OIG and the former General Counsel, they are conspicuously absent from the OIG's timeline of events on the matter.

The NRRIT's reported dates do not accurately reflect the OIG's initial communication with the then RRB General Counsel on this matter, which occurred on February 9, 2016. The OIG formally interviewed the RRB's General Counsel and informed him of the CEO/CIO's departure on February 9, 2016 at approximately 10:30 a.m. On this same day, subsequent to the interview, the OIG sent an email at 12:09 p.m. to the General Counsel with the BlackRock press release dated December 31, 2015 detailing the former CEO/CIO's departure. The OIG's email notifying the General Counsel is highlighted in Appendix IV. That RRB's oversight of NRRIT did not address this matter in a more timely and meaningful manner is the type of lacking oversight we highlight in this report as ineffectual in protecting RRB assets. We do not note any February 29, 2016, communication as our communication on this matter happened 20 days prior; 14 days before the NRRIT reports it notified the RRB.

NRRIT Trustee Term Limits and Experience Requirements Are Not Enforced

NRRIT Trustee term limits have not been enforced and some investment staff have not fully met their experience and qualification requirements. RRB officials told us that it is not responsible for enforcing term limits or ensuring that NRRIT's professional and educational bylaw requirements have been met.

NRRIT's Trustee Term Limits Are Not Effective and May Not Comply with RRSIA

NRRIT Trustee term limits are not enforced and several Trustees have served beyond their initial three year term. RRSIA states that each member of the Board of Trustees shall be appointed for a three year term and shall continue to serve until a successor is appointed.[61] However, RRSIA does not specify if each member may be reappointed indefinitely after their term has expired. While RRSIA's three year term is not clear, its instruction on the selection of a successor implies the

[61] 45 USC § 231n(j)(3)(C). Pub. L. No. 107-90, 115 Stat. 883 (2001).

establishment of a three year term limit rather than a recurring three year term cycle. Term limits can serve as a valuable internal control.

Two of the seven current Trustees have served since inception of NRRIT, one former Trustee served for eleven years, and three former Trustees served terms ranging from seven to nine years. As shown in Table 11, each of the seven current NRRIT Trustees and four of the nine former Trustees served beyond their initial three year term length.

Table 11: Number of Years Served as NRRIT Trustee

Current Trustee	Years Served As Trustee	Former Trustee	Years Served As Trustee
Francisco	15	Hixon [b]	11
Parker	15	MacMurray	9
Quinn	6	Barrows [a]	8
Vincent [b]	6	Gutschewski [b]	7
Walpert	6	Goodwin	3
Jones [b]	5	Hund	3
Patsy [b]	5	Hurt	3
		Sparrow	3
		Johnson	2

Source: NRRIT Annual Management Report for fiscal years 2002 through 2016.

[a] As of June 2017, Mr. Barrows is the Labor Member at the RRB. In the role of RRB Labor Member, a former eight year NRRIT Trustee, would be one of three RRB Board members responsible for initiating any necessary litigation against NRRIT.
[b] All of the years served were not consecutive.

Term limits function as a deterrent to prevent fraud and abuse from occurring without detection. Indefinitely extending the terms of the Trustees may be counter to process improvement and may allow fraud and abuse, if occurring, to go undetected. RRB officials told us they do not believe term limits should be enforced.

Management's Comments and Our Response

- In its response NRRIT stated:

> … Further, to the extent that the statute is silent on whether a member may be reappointed after the expiration of the initial term, the D.C. Nonprofit Code is instructive. The D.C. law provides no limit on the number of terms an individual may serve as a director for a nonprofit (i.e., 501(c) organization) domiciled in the District of

> Columbia. Finally, the District of Columbia Retirement Board's ("DCRB") Board of Trustees is illustrative of the common practice of reappointment of experienced Trustees….

RRSIA implies the need for but does specify term limits. As we reported, current Trustees have served terms ranging from 2 to 15 years. The continuous reappointment of the same Trustees centralize the power structure while limiting access to fresh and innovative ideas.

NRRIT Investment Managers Lack Required Experience and Qualifications

As of fiscal year 2015, two of the three senior investment staff members with investment responsibilities had not achieved the Chartered Financial Analyst (CFA) designation and the former CEO/CIO had not earned a Master of Business Administration (MBA) degree, as required by NRRIT. Of the fourteen remaining investment staff with investment responsibilities, one did not have significant investment experience, nine had not earned their MBA degree, and five had not achieved their CFA designation. RRB's arm's length oversight procedures did not identify this even though these are expected qualifications.

Both RRSIA and NRRIT bylaws grant the Trustees with the responsibility to select the investment managers. NRRIT's 2002 Annual Management Report stated that NRRIT investment staff members are expected to have earned their MBA degree and to be working toward or to have achieved the CFA designation or have accumulated equivalent knowledge and experience in the investment workplace suitable for NRRIT responsibilities, depending on their position.

Management's Comments and Our Response

- In its response NRRIT stated:

> Citing a sentence that appeared only in the Trust's 2002 annual management report as a Trust requirement is irresponsible. In 2002, in its year of inception, NRRIT's Board of Trustees identified general criteria for its hiring of initial investment professionals, which included the expectation that they would possess either an MBA degree, a CFA designation, or equivalent investment knowledge and experience. That expectation was noted in the Trust's very first annual management report in 2002, however, the Trustees soon realized that it was neither necessary nor realistic to require all investment staff to have obtained each of these degrees and/or certifications. Since that time, the Board has undergone numerous cycles of hiring investment staff, and some of these individuals have attained their MBAs or CFAs while others have not. This result justifiably captures the Board's better understanding of the talent pool

> and the requirements for various investment staff since 2002. Significantly, it is worth reporting that, as set forth in NRRIT's 2016 Annual Management Report, all NRRIT senior staff have a CFA or MBA, and ten of the eleven investment staff possess either a CFA or an MBA, and the eleventh person is making progress toward achieving the CFA designation. In short, the Trust's investment staff is very highly qualified.

The NRRIT's 2002 annual management report provided the only publicly available information concerning the NRRIT's experience and qualification requirements. It appears that these criteria are still the standard to which NRRIT aspires since its comments indicate progress towards these goals.

Industry Comparable Pension Policies and Operational Information Is Not Disclosed by NRRIT

Unlike the transparency of comparable pensions, NRRIT's policies concerning the acceptability of travel expenses, the prohibition of insider activities, unacceptable incentives, and social and geopolitical investment policy considerations have not been publicly disclosed. In addition, NRRIT's meeting minutes are not fully disclosed. It is unclear whether such policies exist since RRB does not oversee the establishment of NRRIT policy or disclosure requirements.

<u>Acceptability of Travel and Other Expenses Is Not Monitored</u>

NRRIT's travel and expense approval policy has not been publicly disclosed, though other pension funds release this information. For example, approved travel locations and reasonable travel expenses have not been defined. NRRIT Trustee and investment staff travel dates, locations, and expenses are not disclosed. The travel expenses for NRRIT's Trustees and officers are not disclosed. RRB does not review the validity or support for these expenses.

Management's Comments and Our Response

In its response NRRIT stated:

> Procedures have been put in place demonstrating that the acceptability of travel and related expenses is, in fact, monitored. NRRIT Trustees review and approve the Trust's travel budget annually. Staff presents an analysis of total travel expenses versus budget on a quarter-to-date and fiscal-year-to-date basis to the Trustees each quarter.

> In addition, all staff travel requests require written pre-approval by each staff member's supervisor. For travel requests for which the expected total cost of the trip exceeds $5,000, completion of a separate pre-approval form is required, including a detailed breakdown of expected costs, and the approval of either the Trust's CEO/CIO or Chief Financial and Operating Officer. The specific details, including total costs, of trips exceeding $5,000 are reported to NRRIT Trustees quarterly. Such trips are rare and generally involve overseas travel as part of prospective manager due diligence or existing manager monitoring.

Again consistent with our report findings, we reiterate that the NRRIT's travel policy and procedure has never been subjected to an external review and the RRB's limited oversight has not addressed the potential concern. Such travel expense is an expense to the NRRIT and reduces investment returns, and as a result, assets available to pay RRB program benefits. Without any form of disclosure or oversight, the RRB and its annuitants have no means of ensuring whether the frequency and duration of overseas travel with costs exceeding $5,000 per trip are justified in a time when video conferencing is a more economical and prevalent means of conducting business.

<u>NRRIT Board Meeting Minutes Are Not Released to the Public</u>

NRRIT Board meeting minutes are treated as confidential and not disclosed to the railroad community or those with a vested interest. Board meeting minutes include topics, dates, duration, location, and decisions made by the Board. The frequency and duration of Trustee compensated conferences and teleconferences are also private. Without adequate information regarding NRRIT investment decisions, interested parties cannot fully ascertain whether NRRIT assets are being properly managed and protected. Board meetings for pension funds are typically open to the public or offered via video broadcast with minutes accessible online; and, where the plan participant is impacted, minutes for ERISA compliant pension funds are required to be disclosed publicly. RRB officials stated that they do not request or review the meeting minutes.

<u>NRRIT Has Not Established Social and Geopolitical Investment Policy</u>

There is no indication that NRRIT has established a policy for investing in socially and economically responsible funds, as its ERISA and state pension counterparts are permitted to do and have released publicly. Such policy helps to ensure that, where possible, NRRIT's investments benefit rather than harm society. ERISA defines an economically targeted investment as any investment that is selected, in

part, for its collateral benefits, apart from the investment return to the employee benefit plan investor.[62]

For example, NRRIT's investments could have been directed toward homeland security, military defense, national infrastructure improvements, high speed rail innovation, or women, veteran, or minority owned business interests, while still potentially maximizing returns. Within a similar timeframe, socially responsible investment funds have outperformed NRRIT's 10 year compounded rate of return, 4.96 percent, as of September 30, 2015. Our analysis identified 26 social funds that outperformed the NRRIT. Of these 26 funds, 10 outperformed the NRRIT by less than 10 percent, 12 outperformed the NRRIT between 10 and 36 percent. The remaining 4 social funds outperformed the NRRIT at a range between 61 and 113 percent.[63]

Under District of Columbia common law, pension funds are also prohibited from investing in companies that do not abide by international law or that involve geopolitical risks, for example, investments linked to Northern Ireland and Iran's political factions.[64] Similar restrictions apply to ERISA regulated pension funds. While NRRIT is subject to these prohibitions, its limited public disclosures do not address its compliance with these international investment concerns. The RRSIA does not address investment in socially and economically responsible funds, compliance with international law, or geopolitical investment risks.

Management's Comments and Our Response

- In its response NRRIT stated:

> Congress did not provide the Trust with flexibility to invest assets for the purpose of achieving social or political goals. Rather, Congress directed the Trust to invest the assets solely for the benefit of the railroad retirement system, free from political interference. The OIG Report suggests that NRRIT should develop investment policy that violates its statute.

RRSIA does not prohibit investments that consider social and geopolitical goals; only that assets solely benefit the railroad retirement system. In its comments, NRRIT infers that RRSIA gives no consideration to investing in socially and economically responsible funds. Again, as we stated clearly in our report, we do not suggest or make investment recommendations to NRRIT; instead we note this to highlight an area where oversight could be considered.

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[62] 29 CFR Part 2509 and Interpretive Bulletin 2015-01 (IB 2015-01).
[63] Social Funds Fund Performance, SocialFunds.com, as of February 28, 2016.
[64] District of Columbia Law 17-337 and District of Columbia Code § 1-907.01.

- NRRIT further stated:

> The OIG also states in the Report that it has identified 26 socially responsible investment funds that outperformed NRRIT over the 10-year period ending September 30, 2015. We have no way of verifying this claim because the OIG simply cites to the web site SocialFunds.com -- it does not provide the names of the funds that supposedly outperformed NRRIT or indicate how they were identified, nor does the OIG indicate what percentage of socially responsible investment funds outperformed NRRIT….

Our statement regarding the social funds' performance was fully supported. The social funds and their performance statistics are both current and readily available for analysis in the SocialFunds.com, Fund Performance section. More specifically, 26 of the 46 (57 percent) listed domestic equity funds outperformed the NRRIT. Additionally, another 11 of 19 (58 percent) socially responsible funds, not previously reported, were identified in institutional fund types. Another 1 of 17 (6 percent) balanced funds and 1 of 12 (8 percent) fixed income funds outperformed the NRRIT in a socially responsible manner. In total, we identified 39 of 94 (41 percent) socially responsible funds whose performance exceeded the NRRIT's 4.96 percent rate of return over the comparable 10 year period, as of September 30, 2015. As we noted throughout our report, we make no recommendation to NRRIT on investment or other matters. Instead, we note this to inform interested parties of the results of socially responsible investments from a variety of funds compared to NRRIT's results and to highlight certain outcomes as a result of the lack of oversight of NRRIT.

- NRRIT went on to state:

> The OIG Report also states that under District of Columbia common law, pension funds are prohibited from investing in companies that do not abide by international law or that involve geopolitical risks, for example, investments linked to Northern Ireland and Iran's political factions. The District of Columbia legal requirements that are cited, and which the OIG says NRRIT is subject to, do not in fact apply to NRRIT. District of Columbia Law 17-337 and District of Columbia Code § 1-907.01 detail prohibitions on the investments of certain D.C. Government pension plans and are not applicable to NRRIT….

Section 105(a)(1) of RRSIA provides that:

> The National Railroad Retirement Investment Trust (hereinafter in this subsection referred to as the 'Trust') is hereby established as a trust domiciled in the District of Columbia and shall, to the extent not

> inconsistent with this Act, be subject to the laws of the District of Columbia applicable to such trusts.

From its response, we can only infer that NRRIT's investment policy does not address international law prohibitions or geopolitical risks. If the NRRIT is in fact exempt from the requirements of these District of Colombia trust laws, compliance should be addressed as a best practice.

NRRIT's Committee and Performance Review Structure Lack Independence

NRRIT's committee, decision making, and performance review structure as established by its MOU lacks independence and effectiveness. RRB does not participate in the selection of NRRIT's committee members or performance reviews.

Committee Structure May Violate RRSIA and Hinder Effective NRRIT Management

NRRIT's audit committee lacks independence as the Trustees who are on the audit committee also have a fiduciary duty under the RRSIA to strengthen the financial position of the railroad retirement program. NRRIT has not disclosed to RRB whether Trustees on the audit committee, who must maintain independence, also serve on the investment committee, which makes investment decisions. Cross committee participation may impact independence. SEC stipulates that an audit committee comprised of independent directors is better situated to assess objectively the quality of financial disclosure and the adequacy of internal controls than a committee that is affiliated with management and potentially influenced or motivated by self interest. NRRIT has also not disclosed whether it has at least one "financial expert" serving on its audit committee, as would be required if NRRIT was subject to the requirements of Sarbanes-Oxley.[65]

NRRIT's bylaws allow for the establishment of administrative, audit, and investment committees comprised of two or more of its seven Trustees. The established committees influence and make recommendations on the actions to be taken by the NRRIT's Trustees. Section 105(a)(7) of the RRSIA requires that NRRIT decisions be made by a quorum majority of three of the five Trustees present during a Board meeting.[66] However, there is no RRSIA or NRRIT bylaw requirement that the Independent Trustee be present when an NRRIT decision is made. Further, the identities of NRRIT's Committee members, their activities and recommendations, and the quorum decisions approved by the Trustees are not required to be disclosed to the public or to those with an interest in NRRIT.

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[65] Sarbanes Oxley Act of 2002, Section 407.
[66] 45 USC § 231n(j)(7). Pub. L. No. 107-90 (2001).

NRRIT's cross functional responsibilities can also overlap and create conflicts of interest if the committees are not properly formed. For example, the Administrative Committee, comprised of two or more NRRIT Trustees, governs NRRIT compensation decisions, Trustee expense reimbursement, staff receipt of gifts, and travel reimbursements. Trustee members of the Administrative Committee also control retention of legal counsel. Therefore, a conflict of interest may occur as the Administrative Committee may influence decisions involving legal counsel through their retention authority.

RRB officials were unaware of the identity and roles of the committee members and would be unable to identify potential conflicts of interest among the committees without this information.

Management's Comments and Our Response

- In its response NRRIT stated:

> … By this definition, all of NRRIT's Trustees are independent – none of them are employed by the Trust. The term "Independent Trustee" as used by NRRIT (or "independent member" as set forth in NRRIT's statute) has nothing to do with the SEC's definition of independent director. It simply indicates the Trustee who is not affiliated with rail management or rail labor. Thus, the arguments made in this section of the OIG Report with respect to independence concerns, which are based on SEC final rule 33-8220 related to independent directors of listed companies, are irrelevant.

Our reference to the SEC was only for the purpose of defining the need for an independent audit committee. Contrary to NRRIT's belief and consistent with RRSIA, only the independent trustee can be considered independent. Our concerns stem from the fact that while the NRRIT's six management and labor trustees all have a vested interest in the sustainability of the railroad retirement program as future beneficiaries they all make decisions on the management of the NRRIT. As such, the Trustee's prior decisions may conflict with their responsibilities as members of the audit committee.

- NRRIT further stated:

> Lastly, this section of the report alleges that NRRIT's committee structure and responsibilities may create conflicts of interest if the committees are not properly formed. This allegation includes a mention of the Administrative Committee's control of retention of legal counsel and suggests that a conflict of interest may occur as the Administrative Committee may influence decisions involving legal counsel through their retention authority. We have been unable to

> decipher what the OIG means by this and, therefore, have not addressed this allegation.

The NRRIT's comments imply a lack of understanding of the NRRIT's committee structure and quorum rules as published in the NRRIT's bylaws. Conflicts of interest can occur if the NRRIT's committees are not properly formed potentially influencing compensation decisions, Trustee expense reimbursement, staff receipt of gifts, travel reimbursements, and legal counsel.

- NRRIT went on to state:

> It is inaccurate to state that NRRIT functions are overseen by the two committees. Rather, all NRRIT functions are overseen by the full Board, and certain responsibilities are delegated to NRRIT's two committees, the Audit and Administrative Committees, each of which is comprised of two or more Trustees. These committees make certain recommendations to the Board, but the ultimate decision making authority rests with the full Board.
>
> It is not clear how the OIG Report could reach the contradictory conclusions that a committee may consist of as few as two members, and "committee decisions [are required to] be made by a quorum consisting of five of the seven NRRIT Trustees without the agreement of the Independent Trustee." NRRIT's quorum requirement applies to meetings and decisions of the full Board. Five Trustees are required for a quorum, and decisions must be approved by a majority of those present and voting. Moreover, the Independent Trustee has the same voting rights as every other Trustee.

This section refers only to the NRRIT's committee structure and not the structure of the NRRIT Board. The NRRIT's Trustees are discussed in the previous section of the report. Our understanding and reporting of the NRRIT's operations is consistent with RRSIA.

Section 105(a)(7) of RRSIA provides that:

> … QUORUM.—Five members of the Board of Trustees constitute a quorum to do business. Investment guidelines must be adopted by a unanimous vote of the entire Board of Trustees. All other decisions of the Board of Trustees shall be decided by a majority vote of the quorum present. All decisions of the Board of Trustees shall be entered upon the records of the Board of Trustees."

Therefore, for purpose of example, NRRIT committees that can consist of as few as two Trustees could make recommendations subject to approval by a quorum majority, which may consist of the agreement of any three of the five Trustees present, and theoretically including the two members of the committee making the recommendation. Therefore, the committees would only need to obtain the agreement of one additional Trustee. As NRRIT meeting minutes and decisions are not made public there is no way to confirm the Trustee's compliance with RRSIA.

Performance Review Structure Is Not Fully Effective

As we have previously reported, the NRRIT's performance review structure does not provide adequate information for enforcement actions by the RRB.[67] While changes were made to NRRIT's MOU, on October 22, 2014, in response to our concerns, NRRIT's triennial performance review structure continues to lack independence and effectiveness.

NRRIT's MOU with RRB states that its past performance reviews have periodically focused on aspects of its operations, including its internal financial controls, and its investment operations. While NRRIT and RRB have agreed to mutually prioritize subject areas and the scope of review, based on our interviews, there is no indication that RRB officials have participated in the selection of performance reviews or provided feedback. Performance reviews should be selected independently, based on assessed risk, and promote accountability, economy, efficiency, and effectiveness in the use of NRRIT's assets. Yet at NRRIT, a performance review is only performed once every three years and only one of fourteen predetermined areas in the MOU can be addressed triennially. NRRIT's performance review structure does not address the multitude of audit and internal control risks including information and investment system security, investment strategy risk, adequacy of financial disclosure, potential for conflicts of interest, and allowability of administrative costs. Under NRRIT's current performance review structure, a performance review of internal financial controls could be delayed for decades or not performed at all.

While the GAO has reported that NRRIT's performance review frequency is consistent with other private pension funds, NRRIT's performance review structure does not provide adequate protection of NRRIT assets given the concerns RRB OIG identified in this review.[68] As an example of its ineffectiveness, NRRIT's previous accounting firm conducted NRRIT's financial statement audit unchallenged by RRB management, while the firm had received a peer review rating of pass with deficiencies.

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[67] RRB OIG, *National Railroad Retirement Investment Trust Lack of Provision for Performance Audits* (Chicago, IL: March 31, 2008).
[68] GAO-14-312.

According to NRRIT's MOU with RRB, effective October 22, 2014:

> Since its inception, NRRIT periodically has retained qualified independent professionals to review aspects of its operations, including its internal financial controls and aspects of its investment operations. The results of each of these written reviews have been shared with the RRB by NRRIT with explanatory information about actions taken with respect to recommendations received. Evaluating the results of these performance reviews has contributed to the RRB's management of its oversight responsibilities with respect to NRRIT under the Act….
>
> After the completion of each performance review, the parties shall meet to review the results of the performance review and assess what changes to NRRIT practices or procedures, if any, might be appropriate.

However, the former RRB CFO and then General Counsel stated during our interviews that while they reviewed the correspondence and reports received, their oversight is conducted at arm's length to ensure that interference does not occur that could impact NRRIT's investment decisions. Minutes of meetings with NRRIT officials discussing the results of the performance reviews are not required to be disclosed. Further, the then General Counsel stated that while RRB is informed of the interviewees and the process that takes place during performance reviews, NRRIT's contracts are not subject to federal procurement requirements.

Conclusion

NRRIT was established nearly two decades ago and since that time the RRB assets it invests in and the returns on those assets have been used to pay billions in RRB program benefits. Over this same time, many U.S. pension funds have faced challenges including significant solvency issues. NRRIT is not immune to these challenges. Those charged with managing NRRIT hold a high responsibility to taxpayers and those who will receive such benefits. NRRIT's stability is paramount to RRB's ability to pay benefits and to protect the Federal Government from a potentially significant liability should those funds not be adequately protected. As railroad employment falls and NRRIT expenses remain high and unchecked, the long term stability of NRRIT is at increased risk, and, as a result, so too is RRB's ability to pay its program benefits.

RRB's former General Counsel interpreted RRSIA's reporting and enforcement provisions as purposely excluding RRB oversight in order to shield RRB assets held by NRRIT from governmental influence. The lack of clearly defined, mandated, independent, and consistent oversight may have contributed to the increased expenses being paid by NRRIT, the move to active management when many pension funds are moving away from just this type of investment strategy,

and the other matters reported throughout this report. This lack of oversight leaves RRB assets held by NRRIT at risk and may prevent the lowering of federal taxes paid by rail employers and employees. Ultimately, failure to properly oversee NRRIT may leave the Federal Government facing a significant financial liability.

Oversight of NRRIT has been discussed in a variety of forums. Given the significance of RRB assets held by NRRIT to the railroad industry and the issues identified in this report, the RRB OIG feels that additional oversight of NRRIT is necessary and prudent.

Matter for Congressional Consideration

In order to improve oversight and better protect the more than $25 billion in federal assets held by NRRIT, we request that Congress amend RRSIA to make the NRRIT subject to ERISA. Mandating NRRIT's compliance with ERISA would strengthen NRRIT investment and operational oversight comparable to that of other large pensions and increase transparency for the public and those charged with governance.

RRB Management's Comments and Our Response

RRB management outlined four areas of comment on the draft of this report. Our response follows.

Influence or Control over NRRIT

Regarding its oversight of NRRIT, RRB management disagreed with our concerns and believes "[t]he legislative history of the RRSIA makes clear that an overriding concern of Congress in creating NRRIT was ensuring that the federal government would not exercise influence or control over the investment activities of NRRIT." RRB management indicated that "Congress made such intent clear in various ways" including:

- RRSIA provides that "NRRIT is not a 'department, agency or instrumentality of the Government of the United States and shall not be subject to title 31, United States Code.'"
- "… Congress expressly limited federal government influence in the NRRIT trustee structure."
- "… Independent advisors, and *not* the federal government, are responsible for directing investment decisions of the NRRIT."

Report Lacks Framework for Proper Evaluation

Management opined that while this report:

> … purports to evaluate the adequacy of the RRB's oversight, it does not provide a framework for such evaluation by engaging in meaningful analysis of the RRB's specific oversight authority and its means of exercising such authority under the constraints placed by Congress through the enacting statute.

RRB management believes the report's focus "… on NRRIT investment strategies, decisions, and administrative costs are exclusively within the authority of NRRIT." RRB further states that, "… [t]he report also claims, notably with a lack of legal analysis, that NRRIT *possibly* violated statutes and policies, but [believe] the report itself admits that compliance with these is in many cases not required."

RRB's Approach to NRRIT Oversight

RRB management stated that it "… takes its oversight role very seriously and strongly believes that it is meeting its oversight obligations. RRB management also stated that RRB has "… repeatedly explained … the clear limitations" it has with regard to its "… oversight authority."

> … The RRA provides that the RRB may "bring a civil action – (i) to enjoin any act or practice by the Trust, its Board of Trustees, or its employees or agents that violates any provision of this Act; or (ii) to obtain any other appropriate relief to redress such violations, or to enforce any provisions of this Act."

RRB management stated that:

> There is no other provision in the statute that specifically directs the RRB in the exercise of its oversight authority. While NRRIT is subject to the laws of the District of Columbia applicable to trusts, it is not subject to other federal trust statutes, and therefore, the RRB cannot impose any of those requirements on NRRIT. Furthermore … Congress made it clear that the federal government is not to influence or control the investment activities of NRRIT, which constrains the RRB's oversight.

RRB management also outlined "a number of tools in [its] oversight of NRRIT," including the RRA mandated requirement that NRRIT:

> … annually "engage an independent qualified public accountant to audit the financial statements of the Trust." The RRA also requires that the trust provide the President, Congress, the Director of the Office of Management

> and Budget (OMB), and the RRB with an annual management report … [and] any other comments and information necessary to inform the Congress about the operations and financial condition of the Trust.

RRB management stated that it engages "… in a thorough review of the annual management report and discusses any questions or issues that arise from review of these documents with NRRIT officials…."
RRB management stated that:

> … the RRB and NRRIT [also] entered into an MOU in October of 2014 setting forth periodic performance review procedures. The MOU provides for regularly scheduled performance reviews every three years, beginning in 2015 "with the understanding that additional reviews could be scheduled, if warranted."

RRB management also stated that:

> In December 2015, the NRRIT engaged the independent firm of KPMG to conduct the first audit under the agreement, on the topic of Corporate Governance Framework. In September 2016, NRRIT provided the RRB with a copy of the report and advised that the audit had identified no significant gaps in the corporate governance framework of the NRRIT. The NRRIT noted that it agreed with several auditor recommendations to strengthen the existing governance policies and procedures. The NRRIT appointed a Chief Compliance Officer to be responsible for a more formalized compliance program; expanded the NRRIT's Code of Conduct to trustees; expanded the Conflict of Interest Policy; and formalized policies and procedures to define the risk assessment process and corresponding level of review which needs to be performed. In the near future, the RRB shall engage with NRRIT to consult on key subject areas, timeline, and scope, among other issues, for the 2018 performance review.

<u>Additional Oversight Mechanisms</u>

RRB management summarized additional "… oversight from stakeholders other than the RRB. … the annual management report and report of the audited financial statements is provided to the President, Congress, the Director of OMB, any of which could raise issues of concern with the RRB or directly with NRRIT."

RRB management added that:

> Furthermore, the structure of the board of trustees provides a form of oversight in that not only can rail labor and rail management, two bodies whose membership will be directly affected by decisions and actions of NRRIT, raise issues of concern with the RRB or directly with NRRIT and

> remove their respective trustees if needed, but the trustees themselves, as current or former employees of the railroad industry, are directly impacted by the performance of NRRIT as they are also current or future beneficiaries of the railroad retirement system and could be directly affected by trust performance. The importance of such a strong check on the system should not be discounted.

RRB management concluded that:

> We are always open to working with the Office of the Inspector General on this and other issues that are of mutual interest and concern to our two organizations. However, for that working relationship to be as productive as possible, the statutory and other constraints under which the RRB operates must be taken into consideration.

During the review, the OIG was made aware of RRB management's position regarding the requirements of RRISA, the steps RRB takes to oversee NRRIT, and other oversight actions. We obtained legal analysis from the RRB's General Counsel stipulating the RRB's arm's length approach to oversight. We also evaluated the effectiveness of the RRB's procedural approach and the effectiveness of the NRRIT's mandated reporting. RRB did not maintain documentation supporting its oversight activities of NRRIT. Further, NRRIT's operational activities are confidential and were not made available to OIG, which we also noted in our report. We reported on these matters throughout the report and concluded that RRB's actions do not adequately deter program risk.

The OIG conducted analysis and interviewed responsible officials concerning the RRB's specific oversight authority and its means of exercising such authority under the constraints placed by Congress. However, OIG does not concur that RRISA limits all oversight by RRB and remains concerned that RRB's current oversight activities would not provide adequate insight into NRRIT's administration in order to enjoin any act or practice by NRRIT, its Board of Trustees, or employees for violating NRRIT. In fact, we were so concerned with the oversight that we felt it most appropriate to not make recommendations to RRB given its current arm's length oversight but to instead ask Congress to consider this matter.

Finally, during our work, we were not notified of the results of the latest performance review reported in September 2016 and which was not available publicly. However, we are pleased that NRRIT undertook a review of its Corporate Governance Framework. OIG has long held that a robust system of audits of NRRIT is necessary to protect taxpayer assets. That KPMG's review identified several recommendations points to the importance of such oversight and NRRIT's expanded compliance program is noted. It should be noted that KPMG is also the financial statement auditor of NRRIT.

Appendix I – Updates and Edits Based on NRRIT's Technical Comments

We responded to and addressed the NRRIT's concerns where warranted and made the following changes to our draft report prior to its release:

Lack of Oversight Increases NRRIT Risk

We updated this section to address the NRRIT's concerns over advising others as Section 202 of the Adviser's Act further enforces the NRRIT's need to register as an investment adviser.

We noted that NRRIT reports to have voluntarily adopted many provisions of the Sarbanes-Oxley Act as best practices. Further reporting transparency and additional RRB oversight could make these best practices better understood and known.

NRRIT's Investment Results Have Not Surpassed Passive Benchmarks

Table 2: NRRIT's average compounded rates of return since inception and for the 10 year period were restated by calendar year to provide more precise comparative investment options.

We added footnote clarification concerning why offsets in the form of loan and retirement forfeitures were not applied for purposes of conservatism.

In our response to NRRIT's technical comments, we explained why our initial calendar year versus fiscal year analysis was performed and how the first quarter compounding provided an overall advantage to the NRRIT.

NRRIT's Investment Strategy Potentially Increased Tier II Taxes and Railroad Retirement Program Expenses

In our response to NRRIT's technical comments, we provided an investment return update since inception through fiscal and calendar year 2017.

NRRIT's Office Space Usage and Rental Expense Lack Transparency

We added discussion concerning the landlord's reimbursement, rent abatement, and the use of load factor in our square footage calculations.

We updated our office space square footage analysis to include offices for the NRRIT's support staff and visitors.

We noted that the RRB's beneficiaries had the authority to terminate the NRRIT's change in office space but were denied this opportunity.

NRRIT Administrative Expenses Are Rapidly Increasing

We clarified that NRRIT incurred additional expenses for Network, Software and Systems, Investment Related Fees and Expenses, and Occupancy Expense during fiscal years 2013, 2014, and 2015.

Table 8: The table's caption was edited and changed to 2016 and its source was changed to NRRIT annual management reports.

Table 9: The table was updated with 2016 data for consistency with Table 8 and percentage change detail was updated for the section.

We noted that Other Expenses vary considerably by year and exceeded $7.9 million during fiscal year 2009.

Conflict of Interest Involving NRRIT's CEO/CIO Was Not Adequately Reported

We added reference to Appendix 4 which provides OIG email support for NRRIT's incorrect timeline of events and delayed notification of the RRB regarding the NRRIT's CEO/CIO appointment as BlackRock director and potential conflict of interest.

NRRIT Investment Managers Lack Required Experience and Qualifications

We noted the NRRIT's progress in ensuring its compliance with NRRIT's experience and qualification requirements, to ensure the report's accuracy.

Appendix II – Management Comments

UNITED STATES GOVERNMENT
MEMORANDUM

FORM G-115f (1-92)
RAILROAD RETIREMENT BOARD

November 27, 2017

TO: Heather J. Dunahoo
Assistant Inspector General for Audit

FROM: Ana M. Kocur
General Counsel

ANA KOCUR Digitally signed by ANA KOCUR DN: c=US, o=U.S. Government, ou=Railroad Retirement Board, cn=ANA KOCUR, 0.9.2342.19200300.100.1.1=60001000472757 Date: 2017.11.27 13:56:27 -06'00'

SUBJECT: Draft Report – Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk

Below are Management's comments in response to the draft management information report issued by the Railroad Retirement Board (RRB) Office of the Inspector General (OIG) entitled "Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk."

I. Congress did not intend for Federal Influence or Control over the National Railroad Retirement Investment Trust

The Railroad Retirement and Survivors' Improvement Act of 2001 (RRSIA)[1] amended the Railroad Retirement Act (RRA) by adding section 15(j) that provided for the establishment of the National Railroad Retirement Investment Trust (NRRIT).[2] NRRIT was created to invest railroad retirement funds with the same freedom in which private-sector retirement funds are invested. The legislative history of the RRSIA makes clear that an overriding concern of Congress in creating NRRIT was ensuring that the federal government would not exercise influence or control over the investment activities of NRRIT. Congress made such intent clear in various ways.

First, the statute provides that NRRIT is not a "department, agency or instrumentality of the Government of the United States and shall not be subject to title 31, United States Code."[3] Title 31 governs monetary and financial matters within the federal government.[4] By inclusion of the provision that NRRIT "shall not be subject to title 31," Congress made clear that control

[1] Pub. L. 107-90, 115 Stat. 878 (2001).
[2] *See* section 15(j) of the RRA, 45 U.S.C. § 231n(j).
[3] *Id.* § 15(j)(2).
[4] 31 U.S.C. *et. seq.*

normally exercised over government agencies through the budgeting, appropriation, and auditing functions of the federal government would not apply to NRRIT.

Second, Congress expressly limited federal government influence in the NRRIT trustee structure. NRRIT is led by a seven-member board of trustees, three of which are "selected by the joint recommendation of labor organizations, national in scope," three of which are "selected by the joint recommendation of carriers," with the seventh independent member selected by a majority of the other six members of the board of trustees.[5] In addition, no member of the RRB shall be a trustee.[6] Originally, the legislation provided for appointment and removal of the trustees by a unanimous vote of the RRB.[7] However, that language was changed to the present language providing for direct selection and removal by rail labor and management: "[t]o address concerns about protecting the investment of tier 2 pension assets **from possible influence by the Federal Government.**"[8] The change in the appointment and removal mechanism further establishes Congressional intent to limit the federal government's influence or control.

Third, independent advisors, and *not* the federal government, are responsible for directing investment decisions of the NRRIT. The statute provides that the board of trustees shall "retain independent advisors to assist in the formulation and adoption of its investment guidelines" and "invest assets of the Trust in a manner consistent with such investment guidelines, either directly or through the retention of independent investment managers."[9] This section makes clear that the board of trustees may only invest assets of the trust after formulating investment guidelines pursuant to the advice of *independent* advisors, not the RRB or other government entities.

II. The OIG's report lacks a framework for proper evaluation of the RRB's oversight of NRRIT

The introductory section of the OIG's report states that it "evaluates the adequacy of the Railroad Retirement Board's (RRB) oversight of the National Railroad Retirement Investment Trust (NRRIT) and its enforcement authority in protecting the RRB's trust funds, as required by the Railroad Retirement Survivor's Improvement Act of 2001 (RRSIA)." After review of the report, we find that while it purports to evaluate the adequacy of the RRB's oversight, it does not provide a framework for such evaluation by engaging in meaningful analysis of the RRB's specific oversight authority and its means of exercising such authority under the constraints placed by Congress through the enacting statute.

The report instead appears to be an attempt at an audit of NRRIT, which the RRB Inspector General does not have authority to conduct as noted on page 8 of the draft report. Additionally, the report spends many pages focusing on NRRIT investment strategies, decisions, and administrative costs that are exclusively within the authority of NRRIT. The report also claims, notably with a lack of legal analysis, that NRRIT *possibly* violated statutes and policies, but the report itself admits that compliance with these is in many cases not required.

[5] *Id.* § 15(j)(3)(A).
[6] *Id.* § 15(j)(3)(B).
[7] 146 Cong. Rec. H7335, 7336 (daily ed. Sept. 7, 2000).
[8] 147 Cong. Rec. H4955, 4959 (daily ed. July 31, 2001) (emphasis added).
[9] Section 15(j)(4)(A)-(B) of the RRA.

III. The RRB takes a serious and disciplined approach to NRRIT oversight

The RRB takes its oversight role very seriously and has devoted significant effort in carrying out these functions. The RRB strongly believes that the Agency is meeting its oversight obligations. The RRB has repeatedly explained to the OIG the clear limitations we have with regard to our oversight authority; however, the report does not specifically address or analyze these limitations.

Regarding the RRB's limited oversight authority, the RRA provides that the RRB may "bring a civil action – (i) to enjoin any act or practice by the Trust, its Board of Trustees, or its employees or agents that violates any provision of this Act; or (ii) to obtain any other appropriate relief to redress such violations, or to enforce any provisions of this Act."[10] There is no other provision in the statute that specifically directs the RRB in the exercise of its oversight authority. While NRRIT is subject to the laws of the District of Columbia applicable to trusts,[11] it is not subject to other federal trust statutes, and therefore, the RRB cannot impose any of those requirements on NRRIT. Furthermore, as noted above, Congress made it clear that the federal government is not to influence or control the investment activities of NRRIT, which constrains the RRB's oversight.

The RRB does incorporate a number of tools in our oversight of NRRIT. The RRA specifically requires the trust to annually "engage an independent qualified public accountant to audit the financial statements of the Trust."[12] The RRA also requires that the trust provide the President, Congress, the Director of the Office of Management and Budget (OMB), and the RRB with an annual management report, which includes:

- (I) a statement of financial position;
- (II) a statement of operations;
- (III) a statement of cash flows:
- (IV) a statement on internal accounting and administrative control systems;
- (V) the report resulting from an audit of the financial statements of the Trust conducted under clause (i); and
- (VI) any other comments and information necessary to inform the Congress about the operations and financial condition of the Trust.[13]

In addition to engaging in a thorough review of the annual management report and discussing any questions or issues that arise from review of these documents with NRRIT officials, the RRB also conducts its NRRIT oversight by consideration and use of:

- Detailed monthly financial data submitted to the RRB pursuant to the Memorandum of Understanding (MOU) between the RRB, NRRIT, the Department of the Treasury, and OMB;

- Semi-annual meetings between RRB Board members and the board of trustees of the NRRIT;

[10] *Id.* § 15(j)(5)(f).
[11] *See id.* § 15(j)(1).
[12] *Id.* § 15(j)(5)(E)(i).
[13] *Id.* § 15(j)(5)(E)(ii).

- Meetings between the RRB General Counsel and Chief Financial Officer and NRRIT Counsel and Chief Executive Officer/Chief Investment Officer following each meeting of the NRRIT board of trustees; and

- Regular and frequent contacts between RRB officials and NRRIT officials concerning financial reporting and any other issues that may arise.

Finally, the RRB and NRRIT entered into an MOU in October of 2014 setting forth periodic performance review procedures.[14] The MOU provides for regularly scheduled performance reviews every three years, beginning in 2015 "with the understanding that additional reviews could be scheduled, if warranted."[15] Section 5.2 of the MOU further provides that the RRB and NRRIT will consult as to the key subject areas and timeline for consideration, as well as the scope of each individual review, from a list of 14 areas identified in section 5.3, to include:

- Overall organizational structure and resources;
- Board governance structure and practices, including investment recommendation and approval processes, use of committees, adequacy of meeting minutes, etc.;
- Fiduciary responsibility issues;
- Conflict of interest policies;
- Investment staff structure, recruitment and retention, qualifications, and compensation;
- Investment Guidelines, asset allocation, and performance benchmarks;
- Investment Plan;
- Measurement of investment performance;
- Practices with respect to alternative or non-traditional investments;
- Manager search practices, due diligence, and investment management contract templates;
- Manager costs and fees;
- Internal financial controls and management of operations;
- Trust and custody arrangements;
- Brokerage, trading and transitional costs.

The review will be conducted by a "qualified, independent, non-governmental organization."[16] Finally, "[a]fter the completion of each performance review, the parties shall meet to review the results of the performance review and assess what changes to NRRIT practices or procedures, if any, might be appropriate."[17]

In December 2015, the NRRIT engaged the independent firm of KPMG to conduct the first audit under the agreement, on the topic of Corporate Governance Framework.[18] In September 2016,

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[14] Memorandum of Understanding: *Delineating Responsibilities and Procedures for (i) Financial Audits and (ii) Performance Assessment Evaluations with Respect to Assets Held by the National Railroad Investment Trust* (effective October 22, 2014) (MOU).
[15] MOU § 5.1.
[16] *Id.* § 5.2.
[17] *Id.* § 5.5.
[18] Prior to the execution of the MOU, NRRIT commissioned four performance reviews on the following topics: selected trust systems and processes, internal risk assessment, operations review, and internal financial control assessment.

NRRIT provided the RRB with a copy of the report and advised that the audit had identified no significant gaps in the corporate governance framework of the NRRIT. The NRRIT noted that it agreed with several auditor recommendations to strengthen the existing governance policies and procedures. The NRRIT appointed a Chief Compliance Officer to be responsible for a more formalized compliance program; expanded the NRRIT's Code of Conduct to trustees; expanded the Conflict of Interest Policy; and formalized policies and procedures to define the risk assessment process and corresponding level of review which needs to be performed. In the near future, the RRB shall engage with NRRIT to consult on key subject areas, timeline, and scope, among other issues, for the 2018 performance review.

IV. Additional oversight

In addition to the oversight directly exercised by the RRB, the statute provides for oversight from stakeholders other than the RRB. As noted above, the annual management report and report of the audited financial statements is provided to the President, Congress, the Director of OMB, any of which could raise issues of concern with the RRB or directly with NRRIT.

Furthermore, the structure of the board of trustees provides a form of oversight in that not only can rail labor and rail management, two bodies whose membership will be directly affected by decisions and actions of NRRIT, raise issues of concern with the RRB or directly with NRRIT and remove their respective trustees if needed, but the trustees themselves, as current or former employees of the railroad industry, are directly impacted by the performance of NRRIT as they are also current or future beneficiaries of the railroad retirement system and could be directly affected by trust performance. The importance of such a strong check on the system should not be discounted.

V. Conclusion

We are always open to working with the Office of the Inspector General on this and other issues that are of mutual interest and concern to our two organizations. However, for that working relationship to be as productive as possible, the statutory and other constraints under which the RRB operates must be taken into consideration.

cc: Shawna R. Weekley, Acting Chief Financial Officer
Jeffrey G. Baer, Director of Audit Affairs and Compliance
Timothy Hogueisson, Financial Management & Program Analysis Manager

Appendix III – NRRIT Comments

National Railroad Retirement Investment Trust

December 4, 2017

Heather J. Dunahoo
Assistant Inspector General for Audit
U.S. Railroad Retirement Board
Office of Inspector General
844 North Rush Street
Chicago, IL 60611

Dear Ms. Dunahoo:

The National Railroad Retirement Investment Trust ("NRRIT") hereby submits its comments to the Railroad Retirement Board Office of Inspector General's ("OIG") November 9, 2017 draft report entitled "Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk."

Especially given the significant amount of time and resources the OIG dedicated to its investigation and report, and particularly relative to the short timeframe NRRIT was given to provide comments, we are disappointed by the numerous errors, misrepresentations, and erroneous allegations contained throughout the report. NRRIT is not obligated to respond to the OIG, however, given the extent of the errors and misrepresentations in the report and the manner in which it characterizes NRRIT and its practices, we feel compelled to set the record straight.

NRRIT

Pursuant to our November 13, 2017 communications with your office, these comments are timely provided and will be appended in their entirety to the OIG's report. If the report is further amended, we request an additional opportunity to review it and provide comment.

NRRIT Board of Trustees Signatures

C. Alec Vincent, Chair
George J. Francisco, Trustee

Mary Sanders Jones, Trustee
Joel Parker, Trustee

Richard G. Patsy, Trustee
William F. Quinn, Trustee
William C. Walpert, Trustee

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Suite 1100
Washington, DC 20006
202 589 0100

Comments of the
National Railroad Retirement Investment Trust ("NRRIT")

In Response to the
Office of Inspector General of the Railroad Retirement Board's
November 9, 2017
Draft Information Management Report Entitled:
"Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk"

December 4, 2017

EXECUTIVE SUMMARY

On November 9, 2017, the Railroad Retirement Board ("RRB") Office of Inspector General ("OIG") transmitted a draft report to the National Railroad Retirement Investment Trust ("NRRIT" or "Trust") entitled *Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk* ("OIG Report"). NRRIT welcomes the opportunity to address a number of factual errors, misrepresentations, and incorrect allegations in the report.

NRRIT'S Establishment as a Nongovernmental Entity

In the legislation that created NRRIT in 2001, one of the highest priorities for Congress was that the Trust and its investment decisions be free from government influence and interference. Put simply, Congress did not want the Federal Government to have any role in the investment of railroad retirement assets in the financial markets, and did not want such investments subject to any political influence. As a result, Congress created NRRIT as an independent, nongovernmental entity. Government officials could not serve on NRRIT's Board of Trustees, nor would they have any role in appointing Trustees. Without this separation from the Federal Government, it is unlikely that the legislation creating NRRIT would have passed. With it, the legislation passed overwhelmingly – by a vote of 90-9 in the Senate and 369-33 in the House.

NRRIT's Governance and Accountability Structure

NRRIT was created by statute, but originated from a joint effort between rail labor and rail management to reform railroad retirement in a way that would improve benefits, reduce taxes, and put the retirement system on a more solid financial footing. While the assets of the Trust would be managed for the sole purpose of providing railroad retirement benefits administered by the RRB, Congress recognized that the assets originated as tax contributions paid by rail workers and employers and are expended to pay benefits for railroad retirees. Thus, the resulting legislation created a system that ensures the risks and rewards of the Trust's success would be borne by rail workers and employers. A tax mechanism was statutorily established whereby taxes on rail workers and employers would be increased or decreased depending on the level of railroad retirement asset reserves.

Congress set up an accountability structure designed to mirror the risks and rewards of the system and to ensure that those with the most to gain and the most to lose through NRRIT's performance would be responsible for managing those assets. The Trust's statute mandates that three of NRRIT's Trustees be appointed by rail labor, three by rail management, and one independent Trustee be appointed by the other six. As a result, NRRIT's Board is comprised of Trustees who manage the assets of the Trust in the best interest of their respective constituencies. NRRIT began as a joint effort between labor and management and successfully continues as one today.

After more than a year of deliberation, including numerous meetings with committee and member staff, several committee hearings, and extensive floor debate, Congress affirmatively wrote into the enabling legislation the reporting and transparency requirements it deemed necessary for the new Trust. While Congress imposed on NRRIT's Trustees fiduciary obligations parallel to those in ERISA, for various reasons it decided against requiring ERISA reporting standards and instead established alternative reporting requirements for the Trust. Under these requirements, NRRIT must engage an independent qualified public accountant to audit the financial statements of the Trust, and must submit an annual management report to Congress that includes a statement of financial position, a statement of operations, a statement of cash flows, a statement of internal accounting and administrative control

systems, the independent auditor's report of the Trust's financial statement, and any other comments and information necessary to inform Congress about the operations and financial condition of the Trust. This annual report also is provided to the President, the RRB, and the Office of Management and Budget ("OMB"), and is posted on the RRB's web site. NRRIT has faithfully complied with the statutory reporting regimen that Congress established and, in its fifteen years of existence, has received an unqualified opinion from its auditor every year. NRRIT's annual management reports have been well received by Congress and the Administration, NRRIT's work has been roundly applauded at a Congressional hearing, and Congress has never requested more detailed reporting or disclosure requirements. As important, both rail labor and rail management, who have the most to gain or lose from NRRIT's performance, have been more than satisfied with the Trust through its first fifteen years.

NRRIT Has Been a Resounding Success

The Trust's long-term investment track record is strong, as the Trust has produced an attractive absolute rate of return, consistent with NRRIT's investment expectations, while also outperforming passive benchmarks, net of all fees and expenses. NRRIT's performance also compares favorably with its peer universe of public and corporate pension funds, and its total costs are lower than other similar plans. Throughout its entire history, the Trust has met all of its obligations in a timely manner, including monthly payments to the RRB and all financial reporting required by the Federal Government.

- As of October 2017, the Trust had returned to the RRB/Treasury its full initial funding amount of $21.3 billion for the payment of benefits, and still has remaining assets of more than $26 billion.

- As of September 30, 2017, the railroad retirement system had assets of $18.2 billion greater than it would have had if the Trust never had been created ($26.4 billion versus $8.2 billion), and investments had continued to be limited to Par-Value Treasury Specials ("par value specials") (Treasury securities available only to government agencies) over the trailing fifteen years.

- NRRIT has delivered an attractive net of fee annualized return of 7.4 percent since its inception, outperforming its benchmark. Trust assets are approximately $980 million greater than if the Trust had adopted a purely passive investment strategy with a traditional asset mix of 60% equities and 40% fixed income.

- NRRIT has outperformed the Pension Benefit Guaranty Corporation ("PBGC") over the trailing 3-year and 5-year periods through September 30, 2017, by 110 basis points ("bps") and 310 bps, respectively (net of fees). The Trust's 1-year outperformance versus the PBGC is even more striking: 780 bps (net of fees).

- Reflecting NRRIT's growing diversification over time and the maturity of its portfolio, recent returns are some of the best in the entire pension universe. For FY 2017, NRRIT's 13.38% return, net of fees, significantly outperformed the median fund return of 11.68% in the more than 300 funds in its custodian's pension fund peer universe.

For more information related to NRRIT's investment performance, please see pages 1-2 and 17-18 of the Trust's comments.

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The OIG Report Is Severely Flawed

In its comments contained in this document, NRRIT addresses in detail the factual errors, mischaracterizations, and inaccurate allegations throughout the OIG Report, and rebuts the OIG's conclusions, which are based on incorrect and incomplete analysis. A thorough response from NRRIT is necessary because the OIG Report paints an inaccurate picture of the overall health and investment performance of NRRIT. It also fails to recognize or take into account the extensive Congressional deliberation that led to the current Trust governance and oversight structure and the related requirements, which have been faithfully and demonstrably executed and adhered to. NRRIT's detailed comments address the following issues.

- Despite Congress's insistence that government officials refrain from influencing or interfering with the Trust's management of railroad retirement assets, the OIG Report criticizes NRRIT's investment strategy, performance, and expenses. **It does this despite the OIG's own assurance and admission to the Government Accountability Office ("GAO") that it "would not seek to advise the Trust on investment policy, which is beyond the OIG's area of expertise."**[1] The OIG's lack of investment expertise is reflected throughout its report and summarized here.
    - **The OIG Report now suggests that the Trust should have invested all of its assets in passively managed stock index funds eight years after the RRB Inspector General stated, in 2009, that "it is 'ludicrous' for the pension agency to be 'investing one dime into the stock market at any time.'"**[2] The 2009 comments came on the heels of the stock market crash, while the OIG's more recent position in the OIG Report was taken during an historic bull market that is seeing stocks at an all-time high. Such contradictory comments are based entirely on 20/20 hindsight, which is not a luxury afforded to those charged with prudently investing $26 billion in a diversified manner to balance expected returns with acceptable levels of risk. The OIG had previously and appropriately indicated it would not seek to advise the Trust on investment policy.
    - The OIG's analysis and critique of NRRIT's performance is singularly focused on investment returns, and doesn't acknowledge that in the real world, investment professionals managing billions of dollars of retirement assets have to continually consider issues such as diversification, volatility, and liquidity (issues that are not even addressed by the OIG).
    - The OIG's analysis of NRRIT's returns, especially in comparison to alternative funds, is severely flawed. For example, the OIG Report argues that NRRIT's investment results have not surpassed passive benchmarks by comparing the Trust's performance to that of individual passively managed stock index funds that are part of the Federal Thrift Savings Plan ("TSP"). By suggesting that NRRIT would have performed significantly better if all of its assets were instead invested in any one of these funds, the OIG suggests that NRRIT should have violated its statutory requirement to diversify its portfolio. For more on this issue, please see pages 10-16 of the Trust's comments.

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[1] U.S. Government Accountability Office Report, GAO-14-312, *Oversight of the National Railroad Retirement Investment Trust* (May 15, 2014) at 26.

[2] Michael Kranish, "Pension stock loss may be lesson: Plunge in value comes amid investment debate," *The Boston Globe* (April 16, 2009).

- When comparing NRRIT's investment results to the results of various TSP funds, the OIG Report uses a different ten-year period for NRRIT than it uses for the TSP funds. Not only does this violate common sense, but the result is to skew the comparison in favor of the TSP funds' return because the quarter (4Q 2015) that was excluded from NRRIT's returns was an excellent one for equities, with U.S. stocks up 6.27%. For more on this issue, please see page 12 of the Trust's comments.

- In support of its argument that NRRIT has underperformed, the OIG relies heavily on the TSP's administrative expenses and a comparison of them to NRRIT's. What the OIG does not acknowledge is that the TSP's administrative expense ratio is not a fair comparator, as is demonstrated in our detailed rebuttal. In fact, NRRIT has made keeping investment management fees and other administrative expenses low a key priority, and has succeeded in achieving one of the lower administrative expense ratios in the pension fund universe. For more on this issue, please see pages 3-5 and 14-15 of the Trust's comments.

- The OIG Report suggests that NRRIT's use of active management makes it an outlier in the investment fund world when, in fact, its use of active management is in line with its peers. Moreover, the OIG does not recognize or acknowledge that there are certain asset classes in a diversified portfolio for which active management is the best or only alternative. Instead, the OIG suggests that NRRIT could have invested all of its assets in a single passive 100% U.S. equity fund, a move so risky that no qualified investment professional would even consider it. For more on this issue, please see pages 10 and 16 of the Trust's comments.

- The OIG Report states that NRRIT's use of active managers in lieu of passive index funds has resulted in increased risk and expense. In reality, NRRIT and most other funds utilize active management, in part, to provide better risk management. While NRRIT's use of active management may result in higher expenses than passive alternatives, it also has resulted in excess returns, *net of fees*, when compared to passive benchmarks. For more on this issue, please see pages 1-2 and 17-18 of the Trust's comments.

- The OIG Report states that NRRIT's administrative expenses are rapidly increasing. The percentage increases, as presented by the OIG, appear high on their face, but the starting point for these is the early years of the Trust when it employed only a few staff members and had not fully developed its asset allocation or investment strategies. There are two important points regarding the OIG's criticism:

  - NRRIT's expense ratio of 27 basis points is significantly lower than its defined benefit plan peers (66 basis points average); and

  - NRRIT's portfolio has outperformed its passive benchmark, *net of all fees and expenses*, over the trailing 1-year, 3-year, and 5-year time periods through September 30, 2017, as well as since NRRIT's inception in 2002.

  For more on this issue, please see pages 29-30 of the Trust's comments.

- The OIG Report suggests that NRRIT's investment strategy has increased Tier II taxes. In reality, since NRRIT's inception, rail employers and workers have benefited from billions of dollars' worth of reduced taxes, together with increased benefits for retirees and a much more solvent

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retirement system. The OIG's argument that rail workers and employers have been subject to higher taxes is based entirely on the flawed investment analysis throughout the report, as we further detail in the attached. For more on this issue, please see page 10 of the Trust's comments.

- The OIG Report mischaracterizes NRRIT's governance and decision-making structure, which is set forth clearly in the Trust's statute and its publicly available bylaws. The OIG's lack of understanding results in erroneous statements related to independence concerns and conflicts of interest. For more on this issue, please see pages 3, 8 and 34-35 of the Trust's comments.

- The OIG Report erroneously alleges that NRRIT has violated Securities and Exchange Commission ("SEC") requirements by not registering as an investment adviser, and District of Columbia ("D.C.") Trust law by not notifying its beneficiaries (which NRRIT does not have) of its changed office location. In both cases the OIG is completely wrong, perhaps due to incorrect statutory interpretation, a failure to understand what NRRIT does and how it operates, or a combination of the two. For more on this issue, please see pages 8 and 27 of the Trust's comments.

- The OIG Report questions why the Trust, unlike many nonprofit entities, has not voluntarily adopted Sarbanes-Oxley financial management best practices, when in fact it has adopted many of these best practices. For more on this issue, please see pages 8-9 of the Trust's comments.

- The OIG Report alleges that NRRIT's officer and director compensation exceeds pension industry norms. The OIG's analysis is flawed and its allegations are unfounded. The report does not appear to provide apples-to-apples comparisons between NRRIT compensation and that of other funds, and the OIG significantly overstates the compensation paid with respect to every NRRIT position. In reality, NRRIT's staff compensation structure has been well developed through the use of outside consultants and is benchmarked against compensation paid to similar positions at peer organizations. Compensation paid to NRRIT officers and directors does, in fact, fall within pension industry norms. For more on this issue, please see pages 18-20 of the Trust's comments.

- The OIG Report argues that, due to the Trust's active management strategy, compensation paid to NRRIT's officers and directors is higher than if the Trust implemented a strictly passive management strategy, because it requires an investment staff with heightened knowledge and expertise. The OIG is actually correct on this count, but contrary to its portrayal, it is a positive thing. With their heightened knowledge and expertise, NRRIT's investment staff has been able to execute active management strategies that have generated excess returns for the Trust, net of fees and administrative expenses (which include their compensation). For more on this issue, please see page 20 of the Trust's comments.

- The OIG Report argues that executive bonuses are not consistent with NRRIT performance. Once again, the OIG's analysis is flawed. First, the OIG recognizes only absolute return performance and does not understand that staff can add tremendous value even in down markets. Next, the OIG misaligns bonus compensation and Trust fiscal year performance. More importantly, the appropriateness of bonuses cannot be measured simply against one-year Trust performance, because the staff bonus structure measures quantitative criteria over three and five-year performance periods to ensure that incentives are focused on long term performance. Lastly, the bonus structure assesses risk adjusted return in addition to total Trust performance against its benchmark. For more on this issue, please see page 20 of the Trust's comments.

- The OIG Report states that NRRIT's Independent Trustee compensation and responsibilities are not fully disclosed. The Independent Trustee's compensation is fully disclosed in the Trust's Form 990 filing each year. Moreover, while the Trust is not required to disclose the Independent Trustee's responsibilities, the responsibilities are the same as any other NRRIT Trustee, and more details about the Independent Trustee position and its value to the Trust since its inception are provided in our comments. The OIG Report does point out that NRRIT has not reported the average hours worked by the Independent Trustee on its annual Form 990 filings since 2009, and is correct. This was an inadvertent omission that we do not believe is material, however, our comments provide information about the average hours worked for these years, and the Trust will ensure to include this information on all future Form 990 filings. For more on this issue, please see pages 21-22 of the Trust's comments.

- The OIG Report states that NRRIT's office space usage and rental expense lack transparency. NRRIT's financial statements disclose all required information with respect to the Trust's lease in accordance with U.S. Generally Accepted Accounting Principles ("GAAP").

- The OIG Report erroneously alleges that the square footage and cost of Trust office space are both excessive, and that the Trust has undergone renovations and incurred costs that it has not. The OIG also misstates increases in NRRIT office space costs and otherwise presents flawed comparisons and other information. NRRIT's comments refute in detail each of these allegations and demonstrate that the Trust's office space usage and expense are appropriate. For more on this issue, please see pages 22-27 of the Trust's comments.

- The OIG Report states that, in its bylaws, NRRIT established Washington, D.C. as its principal office space without providing a location analysis or strategy identifying any specific benefits of the location to the RRB. The OIG ignores the fact that it was Congress who mandated in NRRIT's statute that it shall be domiciled in the District of Columbia. For more on this issue, please see pages 26-27 of the Trust's comments.

- The OIG Report alleges that NRRIT investments are not fully disclosed. NRRIT prepares its financial statements in accordance with GAAP for Investment Companies, and specifically identifies all holdings that are required to be disclosed under Financial Accounting Standards Board ("FASB") accounting standards. For more on this issue, please see pages 27-28 of the Trust's comments.

- The OIG Report alleges that NRRIT's offshore investments introduce risk. The Trust utilizes perfectly legitimate legal structures and performs significant due diligence and monitoring related to all foreign investments, all common practices in the investment industry. NRRIT has experienced none of the "known risks of offshore investments" identified by the OIG since its inception. The OIG's description of the small portion of the Trust's investments that are through offshore investment vehicles is inaccurate. For more on this issue, please see pages 28-29 of the Trust's comments.

- The OIG Report alleges that a conflict of interest involving the former CEO/CIO was not reported. The OIG describes a personnel issue that NRRIT's Board of Trustees handled swiftly, decisively, and appropriately, and reported to the RRB instantly once it was resolved. This issue never presented a conflict of interest. For more on this issue, please see pages 30-31 of the Trust's comments.

- The OIG Report alleges that NRRIT's Trustee term limits are not effective and may not comply with its statute. NRRIT's Trustees are not subject to term limits. For more on this issue, please see pages 31-32 of the Trust's comments.

- The OIG Report alleges that NRRIT's investment staff lacks required experience and qualifications. Every member of NRRIT's senior investment staff has earned a Chartered Financial Analyst ("CFA") designation or MBA, and ten of the eleven investment staff members possess either a CFA or an MBA (the eleventh is making progress toward achieving the CFA designation). The Trust's investment staff is highly qualified and possesses significant experience. For more on this issue, please see page 32 of the Trust's comments.

- The OIG Report alleges that the acceptability of travel and other NRRIT expenses is not monitored. NRRIT has significant procedures in place whereby travel and other expenses are, in fact, monitored. Trustees review and approve the Trust's administrative budget, which contains the travel budget, annually and the staff presents an analysis of total travel expenses versus budget on a quarter-to-date and fiscal-year-to-date basis each quarter. In addition, staff travel requests are subject to a written pre-approval process. For more on this issue, please see page 33 of the Trust's comments.

- The OIG Report criticizes NRRIT for not establishing social and geopolitical investment policy. When it created NRRIT as an independent entity not subject to government control or influence, this is one of the things Congress was specifically trying to avoid -- investment decisions based on social or political preferences rather than for the sole purpose for which the Trust was established. NRRIT's statute requires it to manage the assets of the Trust *solely* in the interest of railroad retirement participants and beneficiaries and does not permit it to base investment policy on the achievement of social or geopolitical goals. For more on this issue, please see page 34 of the Trust's comments.

INTRODUCTION

The report drafted by the Office of Inspector General ("OIG") of the Railroad Retirement Board ("RRB") entitled, *Limited Oversight of the National Railroad Retirement Investment Trust Puts Railroad Retirement Assets at Risk* ("OIG Report"), on its face, appears to be a serious attempt by the OIG to critique the National Railroad Retirement Investment Trust ("NRRIT" or "Trust") and its oversight structure. After reading the report, however, it is clear that it is based upon errors, misrepresentations, false allegations, and faulty analysis.

Since its inception in 2002 through today, NRRIT has been a resounding success on multiple levels. The Trust's long-term investment track record is a good one, as the Trust has produced an attractive absolute rate of return, consistent with NRRIT's investment expectations, while also outperforming passive benchmarks, net of all fees and expenses. NRRIT's performance also compares favorably with its peer universe of public and corporate pension funds, and its total costs are lower than other similar plans. Throughout its history, the Trust has met all of its obligations in a timely manner, including monthly payments to the RRB and all financial reporting required by the Federal Government. Unquestionably, the overall health of the railroad retirement system is now much stronger due to NRRIT's existence and its long-term investment performance.

From the outset, it is important to note the purpose of NRRIT, as set forth in its statute and contained in the Trust's Mission Statement: "The mission of the National Railroad Retirement Investment Trust is to help secure the retirement benefits of all participants of the railroad retirement system. Through the diligent oversight and prudent investment of railroad retirement assets, and an adherence to the highest ethical and professional standards within the industry, NRRIT's trustees and investment professionals contribute to the financial security of rail workers, retirees, and their families, and the strength of the American rail industry." It also is important to note NRRIT's investment objectives, as contained in the Trust's Investment Guidelines: "The Trust's primary investment objectives are to establish a portfolio that will achieve a long-term rate-of-return on assets sufficient to enhance the financial strength of the railroad retirement system and to do so in a diversified manner that minimizes the risk of large losses."

Both the Trust's mission statement and its investment objectives are rooted firmly in its Congressional mandate, and in NRRIT's more than 15 years of existence, its Trustees and staff have faithfully managed the Trust's assets with a commitment to that mandate. A large part of assessing whether the Trust has succeeded can be aided by answering two fundamental questions:[3]

1. Looking back over the last 15 years since the Trust's inception, is the railroad retirement system in a better overall position now than it would have been had the Trust never been established?

[3] In answering these questions, the following assumptions were made: for comparison purposes in cash flow analysis, we assumed the Trust inception date was October 1, 2002, although the Trust received some cash in mid-September 2002; we used net calendar year cash flows to/from RRB based on actual transfer data, and assumed RRB cash flows occurred evenly throughout each year; for Trust market values, we used Northern Trust Fundamentals, NRRIT-Only; for par value special comparison, we used the average annual rate quoted each month of the applicable calendar year; for a 60/40 stock/bond comparison, we used the blended annual return of 60% Russell 3000 Index and 40% Bloomberg Barclays US Aggregate Index, less 4 bps in estimated fees to represent net-of-fee returns, and assumed rebalancing at the end of each calendar year to 60/40.

2. Has the Trust accomplished its investment objectives, including outperforming its own benchmark as well as a typical passive 60/40 (stock/bond) portfolio, since its inception and net of all fees and expenses?

Regarding question 1 as of October 2017, the Trust has returned to the RRB/Treasury its initial full funding amount of $21.3 billion and still has a remaining portfolio net asset value ("NAV") of over $26 billion. Moreover, comparing the Trust's portfolio NAV as of September 30, 2017, to that of a portfolio that would have been invested in par value specials over the trailing 15 years (as would have been the case if the Trust had never been created), the railroad retirement system now has assets of $18.2 billion greater than it would have had if the Trust never had been formed ($26.4 billion versus $8.2 billion). Clearly, the railroad retirement system is in a much better position now due to the strong long-term performance of NRRIT.

Regarding question 2, the Trust has delivered an attractive net of fee annualized return of 7.4 percent since its inception in September 2002 through September 2017, which is consistent with NRRIT's long-term performance expectations. In doing so, the Trust's portfolio also outperformed its benchmark by 13 basis points since the Trust's inception, net of all fees and expenses. In addition, the Trust is in a better position today than it would have been if it had invested in a purely passive portfolio consisting of 60 percent U.S. stocks and 40 percent U.S. bonds, representing a typical diversified portfolio allocation. Comparing the Trust's portfolio NAV as of September 30, 2017, to that of a passive 60/40 portfolio invested over the trailing 15 years, the Trust's assets are approximately $980 million greater than if the Trust had adopted such a purely passive investment strategy. These results are since inception and are net of all fees and expenses. Since its inception in 2002, the Trust has accomplished its long-term investment objectives by generating an attractive absolute rate of return and also outperforming multiple passive benchmarks, net of all fees and expenses.

In addition, NRRIT's investment performance has grown stronger over time and generally has exceeded that of its peer institutional investors, including ERISA funds and public pension funds, net of all fees and expenses. Based on the most recent Fund Universe survey conducted by Northern Trust as of September 30, 2017, which consists of more than 300 ERISA, public pension fund, and foundation and endowment participants, NRRIT slightly outperformed the median fund over the trailing 5-year period, returning an annualized 8.47 percent (net of all fees) compared to the 8.43 percent return of the median fund. Looking at more recent performance, NRRIT's trailing 1-year return through September 30, 2017, was 13.38 percent (net of all fees), significantly outperforming the median fund return of 11.68 percent and ranking the Trust near the top quartile of all 300+ funds in the peer universe.[4]

It also is noteworthy that the Trust has outperformed the Pension Benefit Guaranty Corporation ("PBGC") over the trailing 3-year and 5-year periods through September 30, 2017, by 110 basis points ("bps") (6.5% versus 5.4%) and 310 bps (8.5% versus 5.4%), respectively (net of fees). The Trust's 1-year outperformance versus the PBGC is even more striking: 13.4% versus 5.6%, or 780 bps (net of fees). This outperformance by the Trust is despite the economies-of-scale advantages that the PBGC possesses given that its assets are approximately $97 billion, or nearly four times greater than those of the Trust.

[4] Northern Trust, Fund Universe Book (Sept. 30, 2017), at 9.

NRRIT Committee Structure

The OIG Report states that "NRRIT functions are overseen by appointed committees comprised of two or more NRRIT Trustees. RRSIA requires that NRRIT committee decisions be made by a quorum consisting of five of the seven NRRIT Trustees without the agreement of the Independent Trustee." It is not clear how the OIG developed this understanding of how NRRIT operates, but it is mistaken. Pursuant to statute, NRRIT has three Trustees appointed by rail labor ("Labor Trustees"), three Trustees appointed by rail management ("Management Trustees"), and one Trustee selected by the other six Trustees (the "Independent Trustee"). Each of these seven Trustees has the same authority and responsibilities under the Act and the Trust's Bylaws. The only thing that differentiates them is how they are selected.

It is inaccurate to state that NRRIT functions are overseen by the two committees. Rather, all NRRIT functions are overseen by the full Board, and certain responsibilities are delegated to NRRIT's two committees, the Audit and Administrative Committees, each of which is comprised of two or more Trustees. These committees make certain recommendations to the Board, but the ultimate decision making authority rests with the full Board.

It is not clear how the OIG Report could reach the contradictory conclusions that a committee may consist of as few as two members, and "committee decisions [are required to] be made by a quorum consisting of five of the seven NRRIT Trustees without the agreement of the Independent Trustee." NRRIT's quorum requirement applies to meetings and decisions of the full Board. Five Trustees are required for a quorum, and decisions must be approved by a majority of those present and voting. Moreover, the Independent Trustee has the same voting rights as every other Trustee.

The Trust's decision making structure is consistent with the requirements of the Act, is set forth clearly in NRRIT's Bylaws, and is the same structure that is commonly employed by boards of trustees and boards of directors.

Thrift Savings Plan and Old Age, Survivor and Disability Insurance

The OIG Report provides information about the Federal Thrift Savings Plan ("TSP") and the Old Age, Survivor, and Disability Insurance ("OASDI" or "Social Security") program. This information, ostensibly, is provided to set up an argument later in the report that the railroad retirement system would be in better financial position if NRRIT had invested its assets in passive index funds similar to TSP funds. This larger issue of active vs. passive investment is addressed elsewhere throughout these comments, however, a fundamental part of the OIG Report's premise is severely flawed and misleading, and is addressed here. Specifically, the OIG Report states that "[t]he TSP's fees are approximately .04 percent annually."

As an initial matter, it is common knowledge that the fees paid by TSP participants are the lowest of any investment funds anywhere. So the reality is, administrative expenses as low as those reported by the TSP are not available to NRRIT or any other institutional investor. The reasons for the TSP's extremely low reported administrative fees are numerous, and include:

- The TSP is the largest defined contribution plan in the U.S. and has the benefit of significant economies of scale, allowing it to distribute its fixed costs over a much larger base of assets than a much smaller fund. The assets managed in TSP funds are approximately 18 times the amount of assets managed by NRRIT. This means that certain fixed costs that all funds incur result in

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administrative expenses approximately 18 times greater for NRRIT than for the TSP funds, when expressed in terms of administrative expense ratio. For example, 1 basis point for NRRIT is approximately $2.6 million, whereas 1 basis point for TSP is approximately $46 million. TSP can also use its massive size as an advantage when negotiating investment management fees, including the ability to take advantage of fee breaks that decrease the basis points charged as certain tiered levels of assets under management are reached.

- The .04 percent administrative expense ratio cited in the OIG Report is an artificial number that does not represent the actual cost of administering the TSP funds. Rather, it is the net expense that is passed on to investors after certain expenses are offset and subsidized.
  - According to an August 2017 Congressional Budget Office report, "expenses related to administering TSP are mostly offset by forfeitures of the agencies' automatic 1 percent contributions to workers enrolled in FERS who leave federal service before they become vested, other forfeitures, and loan fees. TSP participants share in the remainder of the costs," which are the .04 percent cited by the OIG Report.[5]
  - The reported administrative expenses for the TSP do not appear to include all of the costs of administering the funds. For example, according to the Federal Retirement Thrift Investment Board ("FRTIB"), which administers the TSP program, "[f]ees associated with securities lending are not included in 2016 administrative expenses."[6] That begs the question – what *is* included in the TSP's reported administrative expenses?
    - According to the FRTIB, "TSP expenses (i.e., the cost of administering the program) include the costs of operating and maintaining the TSP's recordkeeping system, providing participant services, and the printing and mailing of notices, statements, and publications."[7] Nowhere in that description of administrative expenses are investment management expenses mentioned and, in fact, the GAO has indicated that "FRTIB's financial statements list these investment expenses as adjustments to investment income; they are not included in the line item for administrative expenses."[8] Further, in the same report, GAO noted that "[t]here is no standard governmentwide definition of administrative expenses. For the purposes of this review, and consistent with how FRTIB presented its budget to the board for approval, we considered all expenses other than investment expenses to be administrative."[9] In other words, it appears that TSP's reported administrative expenses do not include investment fees, which are often the largest investment expense for investment funds, including NRRIT.

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[5] Congressional Budget Office, "Options for Changing the Retirement System for Federal Civilian Workers," (Aug. 2017) at 10, n. 18.

[6] Thrift Savings Plan, Administrative Expenses, *available at* https://www.tsp.gov/PlanParticipation/BeneficiaryParticipants/administrativeExpenses.html (accessed Nov. 29, 2017).

[7] *Id.*

[8] U.S. Government Accountability Office Report, GAO-07-541, *Federal Retirement Thrift Investment Board* (May 2007) at 6, *available at* http://www.gao.gov/assets/270/260588.pdf (last accessed Dec. 1, 2017).

[9] *Id.* at 8.

- The administrative expenses for administering the TSP funds appear to be subsidized by taxpayers. According to the Investment Company Institute, "other federal agencies perform some portion of the TSP's administrative work, and these costs are subsidized by U.S. taxpayers. The extent of these costs is unknown, and they are not reflected in the TSP fee structure."[10]

As congressional testimony provided by GAO makes clear, the TSP is a unique arrangement that cannot be compared with or duplicated by other plans.[11] Elsewhere in these comments, we have drawn comparisons between NRRIT and more logical peer funds to demonstrate how NRRIT compares in terms of reasonableness of its expenses and also its performance.

OIG Allegation: Oversight of NRRIT Is Not Effective in Deterring Program Risk

The OIG Report states that RRB's oversight of NRRIT is inadequate. The issue of whether oversight of NRRIT is adequate is certainly subjective, however, two things are clear: NRRIT's oversight and governance structure is being carried out just as Congress contemplated and, as demonstrated by NRRIT's performance, as discussed throughout these comments, it is working.

When Congress established NRRIT in 2001, a key requirement for legislators was that they did not want government officials to influence or interfere with the investment decisions of the Trust. It is why the original version of the legislation, which included the RRB members as NRRIT Trustees, and the second version of the legislation, which gave the RRB members the authority to appoint NRRIT's Trustees, were amended before passage. The Trust's statute, as enacted, removes the RRB and the Federal Government from the Trustee appointment process entirely because Congress did not want the Trust's investment decisions to be subject in any way to political influence. The OIG Report illustrates why Congress established NRRIT as an independent, nongovernmental entity. For example, by taking a position that NRRIT should not invest in actively managed funds, and taking a position that NRRIT should establish social and geopolitical investment policy, the OIG is doing exactly what Congress wanted to avoid – government officials attempting to influence the Trust's investment decisions. The OIG itself has previously assured the GAO that it would not attempt to influence the Trust's investment decisions, and admitted that it lacks the expertise to do so.[12]

Congress set up an accountability structure that mirrors the risks and rewards of the reformed railroad retirement system. It is true that the assets of the Trust are managed for the sole purpose of providing railroad retirement benefits administered by the RRB, however, Congress also recognized that the assets originated as tax contributions paid by railroad workers and employers and will be expended to pay benefits for railroad retirees. In other words, the assets are contributed by and managed for the benefit of those in the rail industry, and Congress set up an accountability structure to ensure that those with

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[10] Investment Company Institute, *The Federal Thrift Savings Plan: Can It Be Duplicated?* (Sept. 2015) at 1, *available at* https://www.ici.org/pdf/ppr_tsp.pdf (last accessed Dec. 1, 2017).

[11] Oral testimony of Barbara D. Bovbjerg, Director, Health, Education, Human Services Division, Government Accountability Office, before the Committee on Education and Labor, United States House of Representatives (March 6, 2007), *available at* https://www.gpo.gov/fdsys/pkg/CHRG-110hhrg33655/pdf/CHRG-110hhrg33655.pdf (last accessed Dec. 1, 2017).

[12] U.S. Government Accountability Office Report, GAO-14-312, *Oversight of the National Railroad Retirement Investment Trust* (May 15, 2014) at 26 (the RRB OIG stated to GAO that it "would not seek to advise the Trust on investment policy, which is beyond the OIG's area of expertise").

the most to gain and the most to lose through NRRIT's performance would be responsible for managing those assets.

By statute, if railroad retirement reserves fall below four years-worth of benefits, taxes on the industry will increase. Alternatively, if reserves exceed six years-worth of benefits, taxes on the industry will decrease. These automatic tax adjustments are referred to as the "tax ratchet," and it ensures that the risks and rewards that flow from NRRIT's performance are borne by rail employees and rail workers. In an alignment of interests, the Trust is managed by Trustees appointed by rail labor and rail management, and they manage the assets of the Trust in the best interest of their respective constituencies.

Solvency projections performed by the RRB's actuary demonstrate that the tax ratchet and the accountability structure created by Congress successfully work together to ensure that the railroad retirement system will be on extremely sound financial footing for years to come.

Federal accounting standards require the RRB to present a Statement of Social Insurance (SOSI) as a basic financial statement. The SOSI presents the present values of estimated future revenue and expenditures of the railroad retirement program, and covers a period of 75 years into the future. In its most recent 75 year Projection (as of October 1, 2015), the SOSI reflected an actuarial surplus of $1.7 billion for the open group. This measure is intended to provide an assessment of the long-term financial stability of the program, taking into account all those who are projected to be participants in the program over the 75 year period, whether paying payroll taxes or receiving benefits. The SOSI projection is based on Employment Assumption II (intermediate), which is described in more detail below.

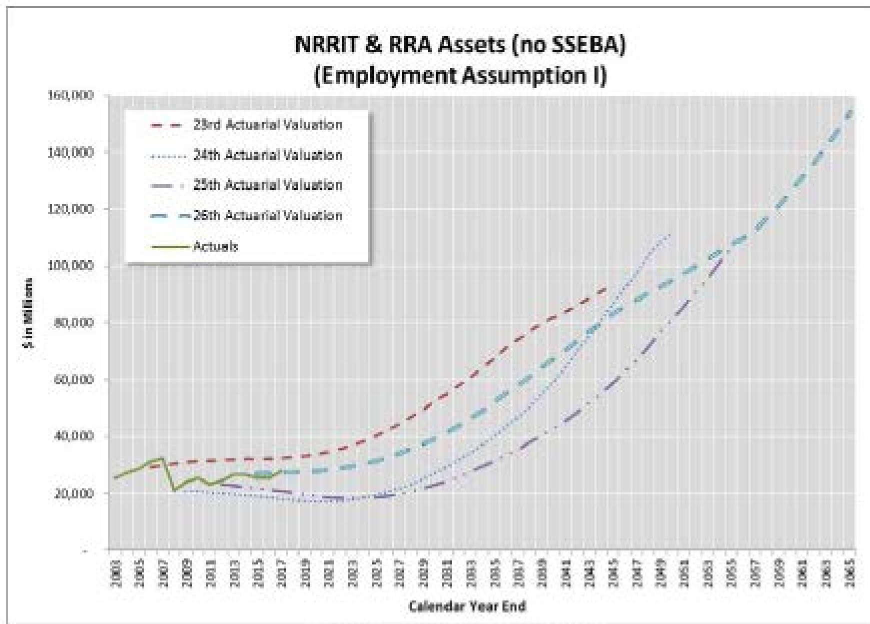
In addition, the RRB prepares Actuarial Valuations every 3 years, which project asset balances in the Railroad Retirement Account in the future based upon three different employment assumptions. Employment Assumptions I (optimistic) and II (intermediate) are based on a model developed by the Association of American Railroads (AAR). Employment assumption III presents a pessimistic assumption developed by the RRB.

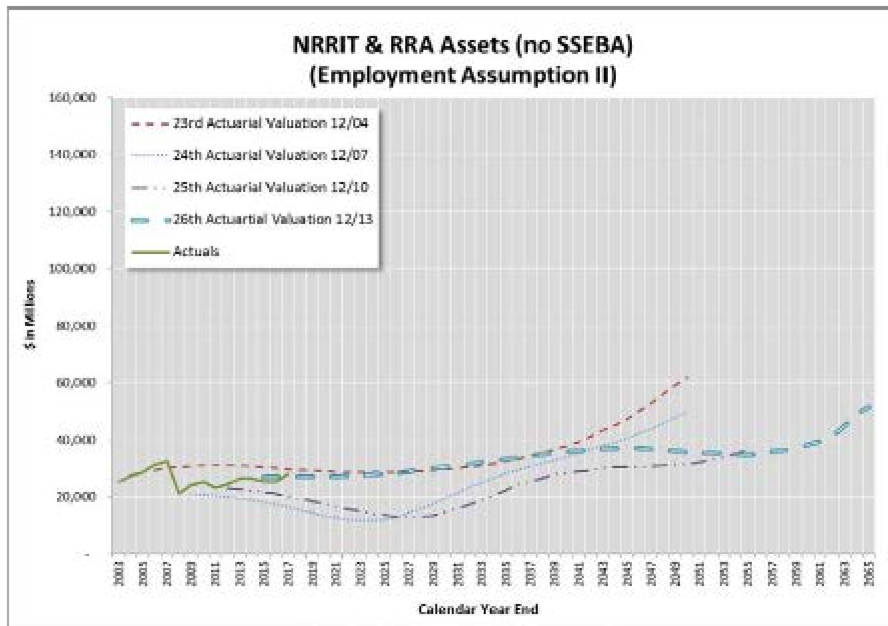
Employment Assumptions I and II assume that (1) passenger employment will remain at the level of 46,000, and (2) the employment base, excluding passenger employment, will decline at a constant annual rate (0.5 percent for Assumption I and 2.0 percent for Assumption II) for 25 years, at a reducing rate over the next 25 years, and remain level thereafter. Employment assumption III differs from Assumptions I and II by assuming that (1) passenger employment will decline by 500 per year until a level of 35,000 is reached and then remain level, and (2) the employment base, excluding passenger employment, will decline at a constant annual rate of 3.5 percent for 25 years, at a reducing rate over the next 25 years, and remain level thereafter.

Historically over time, actual rail employment has proven to track much more closely to Employment Assumption I than either of the other Assumptions. Trust staff has maintained that based on actual results, Assumption I is the intermediate (base case) assumption, Assumption II is the pessimistic assumption, and that a new Assumption should be created as an optimistic assumption. The current pessimistic assumption, Assumption III, should be dropped from the analysis.

The charts below reflect the projected Railroad Retirement Assets under the 4 most recent Actuarial Valuations, based on the two Employment Assumptions in the model developed by the AAR. Both

charts show the strong solvency of Railroad Retirement for the full period covered by the Actuarial Valuations.





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OIG Allegation: Lack of NRRIT Oversight Increases Risk

This section of the OIG Report levels certain allegations against the Trust and its practices. Some of these are introduced in this section but discussed in more detail later in the report. Comments on these are provided later in this response. For those allegations discussed only in this section, we provide comments immediately below.

The OIG Report states that "NRRIT has not registered as an investment advisor with SEC, and has not disclosed whether it is in compliance with the antifraud provisions of the U.S. Investment Advisers Act of 1940 (Advisers Act)." The OIG has incorrectly stated that NRRIT appears to be subject to the Advisers Act and is required to register as an investment advisor. Under the Advisers Act, an investment adviser is any person or firm that, for compensation, engages in the business of advising *others* as to the value of securities or the advisability of purchasing or selling securities. This word – "others" – is an integral one that the OIG left out. NRRIT invests its own assets on its own behalf, and its Trustees and staff do not provide investment advice to others. Additionally, the OIG even points out the stricter requirement that registration is now required for any adviser with at least one client, but ignores the fact that NRRIT has no clients. Lastly, in no way does NRRIT hold itself out to the public as an investment adviser.

The OIG Report states that "[a]s a related party transaction, NRRIT disclosed that legal counsel was provided by firms that may also provide services to the major railroads and railway labor unions whose representatives are members of the Board of Trustees.... As the firm's legal decisions and opinions can overlap, independence is potentially weakened creating the appearance of a conflict of interest." The OIG Report references a standard disclosure in NRRIT's financial statement that originated in the early years of the Trust when one of the law firms representing the Trust also provided legal services to the major railroads. The work performed for the railroads had nothing to do with the work performed for the Trust, and there were never any legal decisions or opinions that overlapped. Any inference drawn by the OIG that independence is potentially weakened, creating the appearance of a conflict of interest, is unfounded. Moreover, the law firms that provide services for NRRIT are bound by ethical rules and have their own conflict check procedures that they run to ensure there are no conflicts of interest, and independence is not weakened in any way.

The OIG Report states that "NRRIT has not disclosed any form of Sarbanes-Oxley compliance. Nonprofit entities commonly adopt Sarbanes-Oxley as a voluntary financial management best practice." While the Sarbanes-Oxley Act applies principally to publicly-traded companies, the Trust has nonetheless voluntarily adopted many provisions of the Sarbanes-Oxley Act as best practices, where such practices are cost-beneficial and appropriate given the Trust's business model. For example, the following actions have been taken with respect to Sarbanes-Oxley compliance:

- The Trust has adopted a written Audit Committee Charter specifying the roles and responsibilities of the Committee, which includes an annual self-assessment.
- The Trust has established a whistleblower hotline as a means for all NRRIT Trustees, employees, investment managers and service providers to report any suspected acts of fraud or other wrongdoing. The whistleblower hotline number is included in all NRRIT directories/phone listings and is published in the Trust's quarterly reports posted to the RRB website.
- The Trust has adopted a Code of Ethics Policy; adherence to the policy is affirmed on an annual basis by all staff and Trustees.

- The Trust has adopted a Document Retention Policy; adherence to the policy is affirmed on an annual basis by all staff.

- The Trust's Chief Executive Officer and Chief Financial Officer provide an annual financial statement certification with respect to the Trust's internal controls and financial reporting. These certifications are included in the Trust's Annual Management Report.

- Trust staff annually evaluates its independent auditor through the results of peer review reports issued pursuant to AICPA requirements as well as Public Company Accounting Oversight Board Inspection Reports. The results are shared annually with the Trust's Audit Committee.

Some non-profit organizations have adopted Section 404 of the Sarbanes-Oxley Act. Section 404 requires an audit of internal controls over financial reporting for certain SEC registrants above a certain size. A very important distinction to make is that due to the nature of its operations, the Trust qualifies as an investment company rather than an operating company and, as such, adheres to the financial reporting practices and U.S. Generally Accepted Accounting Principles ("GAAP") for investment companies. Unlike operating companies, which are primarily engaged in the production or sale of a product or service other than the investment of capital, the internal control of investment companies rests largely with the custodian (in NRRIT's case, Northern Trust). The SEC recognized this important distinction when it explicitly excluded registered investment companies from the scope of Section 404 of the Sarbanes-Oxley Act. While formal adoption of Section 404 is not appropriate for NRRIT consideration, the Trust does have several processes in place with respect to evaluation of its internal controls:

- Trust Independent Auditor: The Trust's independent auditor is required by professional standards to communicate certain items to the Trust's audit committee, including the reporting of any material weaknesses in internal control over financial reporting identified during the course of the financial statement audit. No such deficiencies in internal control have been reported.

- Custodian: The Trust's custodian maintains records of, and custodial accounts for, all of the Trust's investments. As such, internal controls in place at the custodian are an integral part of the Trust's internal controls over financial reporting. While not required, Trust staff has adopted a practice of annually evaluating the internal control of its custodian, by reviewing its Service Organization Controls (SOC) 1 Report. The SOC 1 Report has resulted in an unqualified opinion on the operating effectiveness of the custodian's internal controls. The results of the SOC 1 Report are shared with the Trust's Audit Committee annually.

- Performance Reviews: The Trust conducts performance audits triennially in accordance with an MOU signed with the RRB in 2014. The MOU lays out specific scope areas for consideration in these performance reviews, as agreed upon by both NRRIT and the RRB. One scope area covers "internal financial controls and management of operations." In 2012, the Trust engaged the Protiviti consulting firm to conduct a performance review of this area of Trust operations. No significant recommendations resulted from the performance review, and a summary of the results were shared with the RRB.

The OIG Report states that the 2002 MOU between NRRIT, RRB, Treasury and OMB references an obsolete financial system and has not been updated to reflect annual changes in OMB Circular A-11

reporting requirements. The 2002 MOU requires NRRIT to provide a monthly report of its basic financial operations, specifically "receipts and disbursement of funds, purchases and sales of assets, earnings and losses on investments, value of investments held, and administrative expenses incurred." These reports provide the government a means to monitor NRRIT without offering any direct mode of control, which is consistent with specific Congressional intent. NRRIT has faithfully provided the financial reporting set forth in the MOU for the past 15 years, and there is no indication that any of the other three parties are dissatisfied with NRRIT's reporting or compliance with the MOU. Thus, it is unclear what point the OIG is trying to make.

OIG Allegation: NRRIT's Investment Strategy Increases Risk and Expense, Potentially Resulting in Higher Taxes

The section of the OIG Report that criticizes NRRIT's investment strategy and performance is flawed in many respects, and these flaws are discussed in detail below. At the tail end of the 2007-2009 recession, a period that saw the S&P 500 lose approximately 50 percent of its value, the RRB Inspector General stated that "it is 'ludicrous' for the pension agency to be 'investing one dime into the stock market at any time.'"[13] Fast forward eight years to the issuance of the OIG Report in 2017, when the stock market is in the midst of an historic bull market, and the OIG argues that the Trust's investment returns would be significantly greater, taxes on employers and employees would be significantly lower, and the railroad retirement system would be on more solid footing if NRRIT had invested all of its assets in passive stock index funds, similar to various TSP funds, rather than the diversified asset allocation and active management decisions it made over the past several years.

Regarding the claims and arguments made in the OIG Report, the description of the Trust's "active management strategy" is incorrect, mischaracterizes the Trust's investment program and strategy, and demonstrates a general lack of understanding of the basic principles of institutional investment management.

First, the Trust's investment strategy and asset allocation have evolved over time. For many asset classes, including fixed income and non-U.S. equity, active management is commonly utilized throughout the investment industry because passive alternatives, while available, are typically considered less efficient and have generally underperformed active managers over the long term. The only asset class in which there has been considerable debate over the use of active management is U.S. equity, which comprises approximately 25 percent of the Trust's assets. Within U.S. equity, the Trust does utilize passive investments to a certain degree (currently 28 percent of the asset class), as these index funds provide the Trust with cost-effective exposure to U.S. stocks, particularly large cap equities, and can be a good source of liquidity. For other asset classes in which the Trust invests, including private equity, private real estate, and absolute return, there are no passive investment alternatives, so to characterize investing in those asset classes as pursuing an active management strategy is misleading. There will be more comment on active/passive management later.

OIG Allegation: NRRIT's Investment Results Have Not Surpassed Passive Benchmarks

The OIG's decision to compare NRRIT's performance to that of the OASDI and individual TSP index funds is perplexing and further evidence of the OIG's lack of an essential understanding of the basic principles

[13] Michael Kranish, "Pension stock loss may be lesson: Plunge in value comes amid investment debate," *The Boston Globe* (April 16, 2009).

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of investing and of the institutional investment industry. Unlike NRRIT, the OASDI does not invest in a diversified portfolio but rather only invests in "special issues" of the U.S. Treasury.[14] Given the significant differences in their respective investment portfolios, and the fact that the Trust is prohibited from investing in the same "special issue" securities held by the OASDI, any comparison of the investment performance of the OASDI and NRRIT is inappropriate and irrelevant.

The Federal Thrift Savings Plan (TSP) is the largest defined contribution plan in the U.S. As such, individual participants in the plan decide which funds to invest in, with the goal of maximizing returns over the long term to help fund their individual retirements. NRRIT, on the other hand, is in many ways structured similar to a defined benefit plan. Given NRRIT's statutory mandate to diversify investments so as to minimize the risk of large losses, it would be highly imprudent (in fact, illegal, in the Trust's case) for any defined benefit plan to invest 100 percent of its assets in any single investment or index fund, as suggested by the OIG's analysis. Rather, the Trust invests in a diversified portfolio consisting of multiple asset classes, which together have generated an attractive annualized return since the inception of the Trust (7.4 percent, net of all fees and expenses). To suggest that the Trust should have invested all of its assets in any single investment or fund, as the OIG does, violates the basic tenets of diversification and is inconsistent with best practices within the investment industry, as well as the Trust's explicit statutory mandate. The principles and benefits of diversification are essential in understanding the Trust's investment strategy and its long-term performance (and in understanding those of any defined benefit pension plan, for that matter). The OIG's flawed analysis is quite dangerous because it can lead to erroneous conclusions, as is the case with the analysis in its report.

Rather, the Trust believes the most appropriate way to analyze and evaluate its performance is to look at the portfolio's entire investment track record, net of all fees and expenses, and compare that to the Trust's investment expectations, the returns of the Trust's passive benchmark, and the returns of the Trust's peer institutional investors. As shown in the Introduction section to this response, the Trust has performed quite well in all of those comparisons.

The OIG Report states that, "[i]n order to assess NRRIT's active management strategy, [it] compared the results of NRRIT's investment outcomes to those that would have resulted had its assets and investment and administrative expenses instead been invested in the OASDI or the TSP index funds. The calculations assume NRRIT's net asset balance as of December 31, 2005 was instead invested in OASDI or passively managed individual TSP funds over a ten year period *and NRRIT's investment and administrative expenses were invested in these funds rather than expended*" (emphasis added). A footnote on the page further states that "NRRIT's administrative expenses include investment management fees, compensation and benefits, investment related fees and expenses, professional fees, network software and systems, occupancy, Trustee fees and expenses, custodial fees, and other expenses."

While the use of OASDI and TSP funds for comparison purposes is flawed in many respects, as discussed elsewhere in these comments, it is the italicized and footnote language that we draw your attention to at this time. Because this language indicates that all of the Trust's expenses were assumed invested in the OASDI and TSP funds, it assumes that the Trust's assets could have been invested over a ten year period with absolutely no administrative costs. Even if the OIG had applied the TSP funds' extremely low, subsidized administrative expense ratio in its calculations (and there is no indication that it did), it

[14] Social Security Administration Website, "Frequently Asked Questions about the Social Security Trust Funds," *available at* https://www.ssa.gov/oact/progdata/fundFAQ.html (last accessed Dec. 1, 2017).

would have falsely assumed that the Trust could have benefitted from the economies of scale available to an entity eighteen times its size, and the offsets and subsidies available to investors in the Federal Government's TSP funds. In reality, the Trust's expenses are actually below those of its true peers, and assuming, as the OIG does, that any such pension plan could be operated with zero costs is absolutely incorrect.

There are many other significant problems with the OIG's investment performance analysis in the report. First, by limiting the analysis to the 10-year period ended September 30, 2015, the OIG only uses a portion of the Trust's investment track record in the analysis and gives no explanation as to why a full five years of performance was excluded. Any thorough analysis of investment performance should include all available information and time periods in order to ensure the validity and fairness of the analysis. Otherwise, the analysis is subject to selection biases in terms of the time periods chosen and does not present a complete and accurate picture of what is being measured. Had the Trust's entire investment track record been utilized, rather than one specific limited time period, the comparisons and the resulting conclusions would have been much different, as shown in the Trust's since-inception performance comparisons in the Introduction section of this response.

Another basic, and quite troubling, error in the OIG's analysis is that, in comparing the returns of NRRIT with those of the various TSP funds, the OIG uses different time periods for each in doing so. Inconspicuously in a footnote on page 5 of the report, the OIG notes that it used fiscal year returns for NRRIT but calendar year returns for the TSP and OASDI passive index funds. Thus, the analysis compares NRRIT's 10-year return through September 30, 2015, with the 10-year return of the index funds through a different ending date, December 31, 2015. The quarter (4Q 2015) that was excluded from NRRIT's returns but included in the TSP funds' returns was an excellent one for equites, with U.S. stocks (as represented by the Russell 3000 Index) up 6.27 percent, thus unfairly boosting the TSP funds' returns in the comparison. The quarter (4Q 2005) that was included in NRRIT's returns but excluded from the TSP funds' returns also was a good one for U.S. stocks (up 2.21 percent), but to a much lesser degree. In using these time periods that do not match, the OIG's analysis is flawed to such an extent to render the analysis worthless in the first place.

The OIG suggests in his analysis that NRRIT's assets could have been greater, in some cases significantly, had the Trust invested solely in one of several TSP funds. Of course, as noted earlier, such a concentrated investment approach would be imprudent and in violation of NRRIT's statutory mandate to invest in a diversified portfolio so as to minimize the risk of large losses. There are also numerous flaws with the analysis, as noted earlier, rendering the numbers cited meaningless. The OIG points specifically to the TSP S fund as an example of a fund in which the Trust could have invested its entire portfolio and cites an erroneous amount by which the Trust's assets could have increased had it invested only in TSP S. The TSP S fund consists solely of small and medium-sized U.S. stocks, with a risk level described on the TSP web site as "moderate to high." [15] To suggest that the Trust, or any large institutional investor for that matter, should put all of their assets in one fund, particularly one investing exclusively in highly volatile small-cap stocks, is imprudent. Moreover, such an action would certainly not be considered passive investing, as the TSP S fund is not representative of the equity market universe but rather a very small sub-component of it.

[15] Thrift Savings Plan website, "Funds Comparison Matrix," *available at* https://www.tsp.gov/InvestmentFunds/FundsOverview/comparisonMatrix.html (last accessed Dec. 1, 2017).

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The OIG also mischaracterizes the TSP funds as purely passive index funds, when in fact most of the TSP funds have active management components built into their strategies. Most of the TSP funds have actually outperformed their passives benchmarks, in some cases by a fairly wide margin, due to various active management practices. The below table shows the returns of several TSP funds versus their applicable passive benchmarks through December 31, 2016.[16]

TSP Fund	1 Year	3 Years	5 Years	10 Years
F Fund				
Net return	2.91%	3.49%	2.59%	4.59%
Bloomberg Barclays U.S Aggregate Index	2.65%	3.03%	2.23%	4.34%
Return variance	***0.26%***	***0.46%***	***0.36%***	***0.25%***
I Fund				
Net return	2.10%	-1.27%	6.87%	1.02%
EAFE Index	1.00%	-1.60%	6.53%	0.75%
Return variance	***1.10%***	***0.33%***	***0.34%***	***0.27%***
S Fund				
Net return	16.35%	6.78%	14.84%	8.13%
Dow Jones U.S. Completion TSM Index	15.75%	6.36%	14.38%	7.91%
Return variance	***0.60%***	***0.42%***	***0.46%***	***0.21%***

Such large return variances are common with actively-managed funds, but not with passive index funds, so the OIG's characterization of the TSP funds as purely passive index funds is inaccurate and misleading. There are several examples of active management used by the TSP funds gleaned from the Federal TSP website, and there also may be others used by the funds' investment manager (Blackrock). Most of the TSP funds engage in securities lending, which is the practice of lending shares owned by the fund to others, typically to investors who would like to short the applicable stock.[17] Securities lending can add to the returns of a fund (as appears to be the case with most TSP funds), but the practice also entails risks, including liquidity risk, as was demonstrated during the financial crisis when many lenders of shares could not retrieve them from their borrowers when needed. In addition, several of the TSP funds do not even aim to fully replicate their applicable benchmark indices but rather use a form of active management in order to more efficiently manage the fund.[18] *To be clear, this is not a criticism of the*

[16] See Thrift Savings Plan Website, "Investment Fund Information," *available at* https://www.tsp.gov/InvestmentFunds/FundOptions/fundPerformance_F_Perf.html (last accessed Dec. 1, 2017).

[17] *Id.*, "Funds Comparison Matrix," *available at* https://www.tsp.gov/InvestmentFunds/FundsOverview/comparisonMatrix.html (last accessed Dec. 1, 2017).

[18] *See id.*, "F Fund Information as of December 31, 2016," *available at* https://www.tsp.gov/PDF/formspubs/FundF.pdf (last accessed Dec. 1, 2017); "S Fund Information as of December 31, 2016," *available at* https://www.tsp.gov/PDF/formspubs/FundS.pdf (last accessed Dec. 1, 2017)

TSP funds, as they appear to have performed well versus their benchmarks, but rather of the OIG's misrepresentation of the TSP funds as purely passive index funds for comparison purposes with NRRIT.

Moving to fees and expenses, the OIG compares NRRIT's total costs of 27 bps to that of OASDI (22 bps) and the average TSP index fund (which the OIG incorrectly cites as 4 bps, as noted earlier in our comments). These are not good comparisons, and NRRIT believes its total costs are reasonable and indeed lower than the costs of the Trust's true peers. Moreover, the Trust has been able to deliver attractive rates of return over the short and long term, while also outperforming passive benchmarks, net of all fees and expenses.

The OIG's comparison of NRRIT with the OASDI is inappropriate given the significant differences in the two organizations' sizes and investment strategies, but nonetheless the Trust looks quite favorable in such a comparison. The OASDI manages assets of over $2.8 trillion, which is more than 100 times the size of NRRIT, and yet the OASDI's costs are only 6 bps lower than those of NRRIT.[19] Given the economies of scale that it enjoys, and the fact that it invests in a quite limited opportunity set (only special issues of the U.S. Treasury), this small difference is surprising. Moreover, in U.S. dollar terms, the difference is quite striking. NRRIT operates much more efficiently than the OASDI, as the latter appears to have total costs exceeding $6.1 billion compared to NRRIT's FY 2016 costs of $68 million, based on the numbers provided in the OIG report.

There also are several problems associated with the OIG's comparison of NRRIT's costs to those of the average TSP fund, as previously discussed. First, the comparison itself is inappropriate, as NRRIT is not a defined contribution plan. It would be more appropriate to compare the total costs of NRRIT with other defined benefit plans, not the TSP funds, which are individual index funds within the largest defined contribution plan in the U.S. In addition to being a completely different type of plan, the Federal TSP is enormous, with assets more than 18 times greater than those of NRRIT. Given its size, the TSP funds should benefit from economies of scale and thus be able to negotiate lower fees than smaller investors. In short, comparing NRRIT's costs in basis points to those of a much larger defined contribution plan is not an appropriate comparison.

Notwithstanding the above, the OIG's reported average expense ratio for TSP funds of 4 basis points is understated and misleading. As already noted, the 4 basis points is, in fact, a net fee amount, after certain fees are offset by various items. The TSP funds are subsidized by taxpayers, and most of the funds also engage in securities lending, which can boost returns, but such activity also can increase risks and has led to higher costs, which fees were omitted from the OIG's fee calculations for each TSP fund. The actual gross fees for TSP funds thus are much higher than those reported by the OIG.

As noted above, NRRIT believes that a more appropriate analysis would be to compare the Trust's costs with those of other defined benefit plans. Using the expense ratio range of 15 basis points to 40 basis points of private defined benefit pension funds provided in the OIG report, the Trust's expense ratio of 27 basis points falls squarely in the middle of that range, indicating that the Trust's cost are reasonable compared with peers. However, the study utilized in the OIG Report is a bit dated (2010), includes information mostly from the 1990s, a time period in which the Trust did not even exist, and is otherwise

[19] Social Security Online, "Trust Fund Data," *available at* https://www.ssa.gov/cgi-bin/investseries.cgi (last accessed Dec. 1, 2017).

not presented honestly.[20] Looking at more recent industry data and surveys, the Trust's costs actually are much lower than other defined benefit plans. Based on a CIEBA (Committee on Investment of Employee Benefit Assets) survey conducted in 2016, the average total plan expense ratio was 66 basis points, excluding PBGC premiums.[21] Thus, NRRIT's expense ratio of 27 basis points is much lower than peers based on current industry data.

OIG Allegation: NRRIT's Investment Strategy Potentially Increased Tier II Taxes and Railroad Retirement Program Expenses

This section of the OIG Report, which argues that Tier II taxes paid by rail employers and employees have been higher due to NRRIT's investment strategy, is entirely based on the OIG's faulty conclusion that NRRIT would have earned significantly better returns had it invested its assets in passive index funds similar to various TSP funds. Since that argument is refuted elsewhere in these comments, there is little to respond to here. Nonetheless, it bears mentioning that the reform of the railroad retirement system that created NRRIT in 2002 has resulted in billions of dollars in tax savings and benefit improvements for the rail industry, and is widely considered to be a resounding success.

Specifically in this section, the OIG Report states that it "estimate[d] that NRRIT's current ten year AABR was between 0.4 and 2.2 points lower than if NRRIT funds had been invested in OASDI or TSP funds, *excluding the G Fund which invests only in Treasury securities*" (emphasis added). The OIG gives no explanation for why its calculation did not include the G Fund, unless its exclusion assumes that NRRIT does not invest in Treasury securities, which is not the case. NRRIT, like almost every defined benefit plan, owns Treasury securities, as such bonds are an essential component of a diversified portfolio. The reality is that more TSP assets are invested in the G Fund than in any other fund -- $0.45 of every TSP dollar. If anything, the G Fund not only should have been included in the OIG's calculations, but its returns, which are significantly lower than NRRIT's over every time period, should have accounted for 45 percent of the calculations.

Since the Trust invests in a diversified portfolio consisting of stocks, bonds, and other asset classes as mandated by law, and as is the common practice of nearly all defined benefit plans, any legitimate

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[20] In citing the dated 2010 study, the OIG states that the study "indicates that private defined benefit pension fund investment fee expense ratios range from .15 percent to .40 percent." What the study *actually* states is that its analysis pertains to "pension fund cost levels *for their domestic equity investments,*" and that for these, there is "a median annual cost of 27 basis points for defined benefit funds." Bauer, Rob and Cremers, Martijn and Frehen, Rik, "Pension Fund Performance and Costs: Small is Beautiful" (April 29, 2010) at 4 (emphasis added). The cost levels cited by the OIG only apply to one asset class (US stocks, which generally tend to be lower-cost mandates than those in most other asset classes). Moreover, they appear to be only investment management fees and thus do not include any other administrative expenses that all defined benefit plans incur (and which are included in NRRIT's administrative expense ratio). That's not all. The ".15 percent to .40 percent" is not the full range, as the OIG represents. The study states that "the *average* annual cost levels for the smallest and largest 30% of domestic equity investments of defined benefit funds equal 40 and 15 basis points, respectively." Id. (emphasis added). So for defined benefit plans reviewed in the study, the smallest 30% of U.S. equity investments had an average annual cost level of 40 basis points, and the largest 30% of U.S. equity investments had an average annual cost level of 15 basis points. That means there were cost levels greater than 40 basis points and lower than 15 basis points. Despite all of these mischaracterizations, NRRIT, with its administrative expense ratio that includes *all* of its expenses, still manages to land squarely in the cited median.

[21] Committee on Investment of Employee Benefit Assets, Inc. (CIEBA), U.S. Defined Benefit and Defined Contribution Plans Membership Profile 2016 (Oct. 18, 2017) at 18.

comparison to the TSP funds would have to compare the Trust's returns to those of a mix of TSP funds representing a more diversified portfolio. Using the actual dollars invested in the various TSP funds provided in the OIG's report to represent such a diversified portfolio, the Trust has handily outperformed the TSP portfolio over the 15-year period ended September 30, 2017. For that 15-year period, the Trust has generated an annualized return of 7.80% versus an annualized return of 6.73% for the TSP funds' portfolio, for an outperformance of 107 bps, net of all fees and expenses.

OIG Allegation: Academic Studies Find Active Management Unsustainable

While there has been considerable debate over the merits of active management, that discussion typically has occurred only within the context of public equities, in particular U.S. large-cap equities. As noted elsewhere in this response, the Trust's portfolio is much broader than just public equities, so the active/passive debate only has relevance for a portion of the Trust's portfolio. There are no passive investment alternatives for many of the asset classes in which the Trust invests, including private equity and private real estate. In addition, very few (if any) academic studies argue for the use of passive investment strategies in fixed income. Also, equity markets outside the U.S. have proven to be less efficient, and active management generally has performed better in those markets. That leaves only U.S. equities, which currently account for approximately 25 percent of Trust assets, for which this debate is relevant. Indeed, as noted above, the Trust does utilize passive investment strategies within U.S. equities, particularly large-cap, to a certain degree.

At the total portfolio level, the Trust's use of active management is in line with industry peers. As of September 30, 2017, the Trust had approximately 89 percent of the portfolio allocated to active investment strategies. According to a 2016 CIEBA survey of U.S. pension plans, the average percentage allocated to active investment strategies by the survey participants was 88 percent.[22] Much of the information in the OIG Report to the contrary is of limited relevance because (1) it is focused on retail mutual fund flows and (2) it appears to pertain to only one asset class, U.S. equities.

There are valid arguments on both sides of the active/passive debate, so the broad statement in the OIG Report regarding active management being "unsustainable" is incorrect and only presents part of the picture. For every academic study pointing to the pitfalls of active management, there are others touting its benefits, including better risk management, outperformance in down markets, and avoidance of concentration of risk to large/mega-cap stocks. Moreover, there are several inconsistencies and important omissions regarding some of the research cited by the OIG in support of his argument for passive investing.

The OIG Report first cites a 1970 article written by Eugene Fama, developer of the Efficient Frontier Hypothesis, that was based on research performed in the 1960s. The 47-year old article is cited in support of the OIG's argument for passive investing, however, in keeping with the OIG's theme of leaving out important parts of the story, the report conveniently failed to mention Fama's later academic research, which led to the Fama-French three-factor model.[23] This subsequent work by Fama concluded that active investors can indeed beat passive benchmarks by focusing on several key factors, including overweighting inexpensive and small-cap stocks. Moreover, Fama currently is a Director at one of the largest active investment managers in the U.S., Dimensional Fund Advisors (DFA), whose

[22] *Id.* at 14.

[23] *See* Eugene F. Fama and Kenneth R. French, "Common risk factors in the returns on stocks and bonds," *University of Chicago Journal of Financial Economics* 33 (1993).

active strategies are based in large part on Fama's academic research.[24] Needless to say, Fama himself likely believes there are some merits to active management.

Next, the OIG cites a Schwab Center study from 2001, which is more recent than the 1970 article but still quite dated and irrelevant given the changes in the industry over the last 16 years. The study relies on mutual fund data at a time when active retail mutual fund fees were over 1 percent on average.[25] The Trust does not operate in the retail mutual fund space, and the fees that the Trust pays to its public market investment managers are much lower than those used in this study.

There have been many studies in support of active management, and trying to list all of them here would be futile. For example, much research has been done in the field of behavioral economics, demonstrating the inefficiencies in markets, including by recent Nobel Prize winner Richard Thaler. There is one fairly recent academic study (2013) by Antti Petajisto published in the Financial Analyst Journal that found that "the most active stock pickers have been able to add value for their investors, beating their benchmark indices by about 1.26 percent a year after all fees and expenses."[26] Also noteworthy is a 2013 paper published by Vanguard, one of the world's largest managers of passive index funds, which concluded that "low-cost active talent can achieve outperformance; and that investors, to the extent they stick with a disciplined approach, can be successful using actively managed funds."[27]

The key to being successful in active management is being able to find good managers with sound organizational structures, talented and stable investment teams, and disciplined and consistent investment processes, and then to negotiate appropriate economic terms that make sense for the investor (i.e., low fees, including, ideally, fee structures that are tied to performance). Throughout its history, the Trust has been able to do this, and the best proof of the benefits of active management lies in the actual performance of the Trust, net of all fees and expenses. The below table shows the annualized net-of-fee performance of each of the major public market asset classes within the Trust's portfolio for multiple time periods through September 30, 2017.

[24] *See* U.S. Dimensional Fund Advisors Website, "About Us," *available at* http://us.dimensional.com/about-us/who-we-are (accessed Dec. 1, 2017).

[25] Morningstar, U.S. Fund Fee Study, "Average Fund fees Paid by Investors Continued to Decline in 2016" (May 23, 2017) at 3, Exhibit 1.

[26] Antti Petajisto, "Active Share and Mutual Fund Performance," *Financial Analysts Journal*, Vol. 69 No. 4 (July/August 2013).

[27] Daniel W. Wallick, Brian R. Wimmer, CFA, and James D. Martielli, CFA, "The case for Vanguard active management: Solving the low-cost/top-talent paradox?" *Vanguard Research* (Jan. 2013), *available at* https://www.vanguard.com/pdf/s356.pdf (last accessed Dec. 1, 2017).

Global Asset Class	1 Year	3 Years	5 Years	Since Inception
Public Equity				
Net return	21.30%	9.15%	11.86%	8.94%
Benchmark return	19.22%	8.11%	10.95%	8.84%
Net excess return	**2.08%**	**1.04%**	**0.91%**	**0.10%**
Fixed Income				
Net return	3.21%	3.00%	2.95%	4.83%
Benchmark return	-0.19%	2.13%	1.36%	3.93%
Net excess return	**3.40%**	**0.87%**	**1.58%**	**0.90%**
Real Assets				
Net return	-0.83%	-3.51%	-2.30%	-0.66%
Benchmark return	0.23%	-5.21%	-5.19%	-1.87%
Net excess return	**-1.05%**	**1.70%**	**2.89%**	**1.21%**
NRRIT				
Net return	13.38%	6.48%	8.47%	7.36%
Benchmark return	12.33%	5.98%	7.76%	7.23%
Net excess return	**1.05%**	**0.50%**	**0.71%**	**0.13%**

As shown in the table, at the total portfolio level, NRRIT has generated positive excess returns over every time period, including since inception, net of all fees and expenses. In addition, the outperformance has been widespread among the portfolio's public market asset classes, with all asset classes outperforming over every time period, with only one exception (real assets underperformed for the trailing one-year period). Clearly, the Trust's active management strategy has worked over both the short and long term.

OIG Allegation: Officer and Director Compensation Exceeds Pension Industry Norms

The OIG Report alleges that NRRIT employee compensation, when considering the value of assets under management, exceeded that of its industry counterparts. The Report goes on to state that the compensation paid to NRRIT's former CEO/CIO exceeded that of the CEO's responsible for the largest pension funds, both nationally and globally. As an initial matter, it is difficult to directly address the OIG's allegations because the OIG Report includes very limited information about what is included in the cited compensation paid to the executives of other funds that are used for the comparison. Nonetheless, there are significant errors and misrepresentations that are obvious with respect to NRRIT officer and director compensation.

In the introductory paragraph of this section, the OIG Report states that it is evaluating "compensation *paid* to NRRIT's former CEO/CIO," however, in Table 4 in this section it reports a dollar figure much larger than the amount that was paid to this individual in the cited year. While the Report states that

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the CEO/CIO was paid $916,968 in FY 2015, that amount includes amounts that were not actually paid to the CEO/CIO that year. Both deferred compensation paid and deferred compensation earned in that year are included in the total reported by the OIG. The Trust has in place for Directors and Officers a deferred compensation plan that is used as a retention tool. Under the plan, a portion of one's annual bonus is deferred for five years and, if the individual is still employed by the Trust five years after it is earned, it vests and the individual receives that amount, with interest. To include both deferred compensation earned and deferred compensation paid in one's annual compensation is a misrepresentation that results in double counting. In this case, the total amount of compensation that NRRIT's CEO/CIO was actually paid in FY 2015 was $697,641 (versus the $916,968 reported by the OIG). Similarly, the reported amounts in Table 4 for other NRRIT positions are significantly higher than the amounts that were actually paid: NRRIT's Senior Managing Director – Investments was actually paid $408,603 (versus the $540,761 reported in Table 4); NRRIT Senior Administrative/Accounting Officer (Average) was actually $306,546 (versus the $418,103 reported in Table 4); and NRRIT Investment Director (Average) was actually $248,502 (versus the $324,009 reported in Table 4). As you can see, the compensation paid to NRRIT Officers and Directors was significantly overstated by the OIG.

Another problem with the OIG Report is that it states amounts paid to similar positions at other pension funds, without citing the source of the information or describing what is included in the reported compensation for those positions. Thus, it is unlikely that the OIG has made apples-to-apples comparisons, and its attempt at a comparison to NRRIT compensation is meaningless.

For years NRRIT has had a compensation structure in place that does benchmark staff compensation against the compensation earned at peer organizations, and the compensation it pays is comparable to its peer group. Around 2007, hiring and staff retention in the investment community had become extremely competitive, and NRRIT realized this first hand after losing staff to other entities. As a result, the Administrative Committee and Board engaged the Watson Wyatt consulting firm to provide advice with respect to the compensation structure of NRRIT"s investment staff, including base pay, incentive compensation, and benefits. Watson Wyatt performed a detailed review of investment industry compensation practices and comparability data for different types of potential peer pension plans, and its advice was a significant resource in the Board's development of a compensation and benefits structure. That compensation structure has been continually reviewed and, where appropriate, revised by the Board in an effort to have in place a structure that appropriately incentivizes and promotes retention of key staff. As part of the Board's effort to continually review and update the compensation structure, the Administrative Committee and Board engaged the Mercer consulting firm in 2013 to assist with the review and update of the staff compensation structure.

Because NRRIT is a unique organization with elements of a corporate pension plan and elements of a public pension plan, overall compensation for senior staff (base compensation and bonus) is evaluated by reference to compensation paid for similar positions in corporate and public plans, with a higher weight being giving to the compensation of public plans. Updated data is obtained regularly from independent organizations that track pension industry compensation data and trends, and evaluated in the annual year-end compensation process.

The current staff bonus structure contains both quantitative and qualitative criteria. The quantitative calculations assess (i) total Trust performance against its benchmark, and (ii) its risk adjusted return. These two determinants are measured over three and five year performance periods to ensure that incentives are focused on long term performance. In addition, following its consultation with Watson Wyatt, the Board determined to institute a deferred compensation structure for senior staff (noted

earlier) in order to promote retention of these individuals. Such deferred compensation amounts for officers and senior staff are calculated as a percentage of the annual bonus earned for a year but do not vest until five years after the year in which they are earned and, thus, act as an effective retention tool.

Another point made in the OIG Report is that "[c]ompensation paid to NRRIT's officers, directors, and key employees can also be influenced by the choice of investment strategy. While NRRIT engaged a consultant to conduct an independent study to determine the appropriate levels of compensation, an active management strategy requires the payment of greater compensation and bonuses than a passive index strategy as it requires an investment staff with heightened knowledge and expertise." The OIG is absolutely correct on this account and, as demonstrated above in these comments, the Trust's highly qualified staff with heightened knowledge and expertise, has consistently generated excess returns net of fees and expenses. Another benefit of having such a highly qualified staff is that, unlike many other pension funds, NRRIT does not hire outside consultants to conduct its manager searches – the Trust's investment staff handles this entirely in house. Thus, the Trust does not incur costs for consultants that many of its peers incur. Given the level of expertise possessed by NRRIT's investment staff, the Trust's Board believes the compensation it pays is very appropriate.

OIG Allegation: Executive Bonuses Are Not Consistent with NRRIT Performance

The OIG Report states that executive bonuses reported to the IRS did not correlate with NRRIT's investment returns and often exceeded 30 percent of base compensation in years when NRRIT yielded negative returns. This argument is flawed in multiple respects.

First, the IRS Form 990 instructions require NRRIT to report compensation paid in the calendar year ending within the fiscal year for the respective report. Because NRRIT has an October 1 – September 30 fiscal year, the compensation reported on NRRIT's Form 990 in a given year relates to the compensation earned with respect to the prior year's performance (e.g., the 2015 Form 990 contains compensation information earned in calendar year 2014 and any incentive compensation included is with respect to FY 2014 performance). The OIG Report does not account for this and, therefore, does not accurately assess compensation levels in relation to the Trust's performance in a given year.

A second flaw in the OIG's argument is that it suggests that bonus compensation is earned for one-year performance. This is not the case. NRRIT's staff bonus structure measures quantitative criteria over three and five-year performance periods to ensure that incentives are focused on long term performance.

A third flaw in the OIG's argument is that it suggests that bonus compensation should only be earned in years in which the Trust earns positive returns. This is a naïve view of the investment industry and the value that a highly skilled staff can provide. NRRIT's bonus structure contains quantitative criteria that assesses total Trust performance against its benchmark, and its risk adjusted return. Such a structure is common in the investment industry and recognizes that investment staff can provide tremendous value even in down markets (e.g., if the Trust's benchmark is down three percent for a given period and the Trust's performance is down one percent for the same period, there is tremendous tangible benefit in the 200 basis points by which NRRIT outperformed its benchmark), and that there is great benefit to generating returns without taking on excessive risk. The bonus compensation earned by NRRIT staff reflects its excellent performance in these areas.

OIG Allegation: Independent Trustee Compensation and Responsibilities Are Not Fully Disclosed

NRRIT's statute states that the Board of Trustees shall have seven members, with three representing the interests of rail labor, three representing the interests of rail management, and one shall be an independent trustee selected by the other members of the Board. The members of the Board who represent rail labor's interests and rail management's interests participate on NRRIT's Board of Trustees as part of their employment responsibilities within the industry and are compensated by their employers for doing so. In contrast, the Independent Trustee has no connection to the rail industry and must be compensated for his or her service by the Trust. That is why the legislative history of the statute creating NRRIT and NRRIT's bylaws provide for reasonable compensation to be paid to the Independent Trustee.

In 2002, the Trust retained the Russell Reynolds executive search firm to manage a nationwide search for the Independent Trustee. As a result of the extensive search process, Russell Reynolds associates and NRRIT's Board identified candidates, all of whom were well qualified in the area of pension fund investments, and the Board eventually hired its initial Independent Trustee. This individual had many years of experience in managing large pools of investment assets, including service as an executive for multiple pension funds. This significant experience proved to be a tremendous asset, especially in the formative years of the Trust.

At the time of this search, the Board also sought advice from Russell Reynolds with respect to the appropriate level of compensation for a qualified individual to serve as the Independent Trustee. Based on this advice, the Board set the Independent Trustee's compensation. The Independent Trustee's compensation remained unchanged for a number of years, until the other six Trustees determined that it should be increased to a level more commensurate with the overall contribution provided by the Independent Trustee to the work of the Board. Important to note is that, unlike many other Trusts, NRRIT's Independent Trustees have not been involved in decision making related to their own compensation.

In 2010, the Independent Trustee informed the Board that he would not be continuing in the position upon the expiration of his current term at the end of January 2011. As a result, the Board retained the Heidrick & Struggles executive search firm to manage a nationwide search for a new Independent Trustee. Similar to the earlier process, an extensive search was performed that identified several highly qualified candidates and resulted in the hiring of the current Independent Trustee, who began service on the Board in February 2011. The Trustees determined at that time to maintain the Independent Trustee's compensation at the current level, with the expectation that the responsibilities and the commitment required, as well as the contribution that would be provided would remain unchanged. During his first two terms, the current Independent Trustee provided invaluable contributions to the Trust, served on both the Audit and Administrative Committees, and served multiple terms as Chair of the Board. In short, NRRIT and its Board have benefited tremendously from the expertise and leadership abilities of its Independent Trustees, and have compensated them fairly and commensurate with their contributions, and in line with the compensation earned by trustees and directors at other funds.

One thing pointed out in the OIG Report is that NRRIT stopped reporting the Independent Trustee's hours worked on its IRS Form 990 after fiscal year 2009. This omission from subsequent Forms 990 was not intentional, and we believe it is not a material one. The time dedicated to the Trust by the Independent Trustee remained relatively unchanged from FY 2009 until Trust year 2012 (which

coincides with the Trust's FY 2013) when, in recognition of his particular acumen and leadership abilities, the Board of Trustees appointed him as Chairman. As Chairman, the Independent Trustee's responsibilities increased, primarily due to the Chairman's role as the primary liaison between the Board and NRRIT staff and counsel, especially in between Board meetings. The Independent Trustee's time commitment also increased, to approximately 3-3.5 days per month. The Independent Trustee was similarly appointed Chairman in Trust years 2013, 2015, and 2016. For each of these years, the Independent Trustee's time commitment remained relatively the same, though it increased slightly in 2016 with the promotion of the new CEO/CIO, as the Independent Trustee spent additional time mentoring the new CEO on management leadership issues, interacting with the Trustees, and investment issues related to asset classes he hadn't previously overseen. For all of these years, the base compensation and meeting fees remained unchanged. Going forward, NRRIT will ensure that it includes the Independent Trustee's average hours worked on all Forms 990 filed by the Trust.

OIG Allegation: NRRIT's Office Space Usage and Rental Expense Lack Transparency

The OIG Report states that "In 2003, NRRIT began leasing 7,000 square feet of Class A office space at 1250 I Street in Washington, DC. During August 2012, NRRIT commissioned an architectural design firm to redesign this office space. We were unable to determine the cost of this redesign or rationale for conducting the redesign." This redesign was not for the existing office space as indicated in the report, but rather for the Trust's new office space at 2001 K Street in Washington, DC. The cost of the redesign was reimbursed fully by the landlord of the new office space. Trust staff negotiated a tenant improvement allowance to be "used to pay the 'hard' and 'soft' costs of the initial improvements (including all architectural, engineering and permit fees)." The redesign employed several of the best practices identified in the General Service's Administration ("GSA") *Workplace Standards Benchmarking* report, such as more open workstations with no cubicle walls, thus facilitating collaboration and the exchange of concepts and ideas. In addition, the design involved the recycling of materials from the existing office space, such as glass doors and light fixtures.

The OIG Report states that "[I]n October 2012, NRRIT established a new lease agreement less than a mile away for approximately 9,200 square feet at 2001 K Street, Washington D.C., where its offices are currently located. An approximate nine month lease overlap occurred during which NRRIT potentially incurred additional rental expense estimated at more than $300,000." The lease for the Trust's new office space was executed in October 2012, however, the Trust did not occupy the space until May 2013. While the Trust's lease at 1250 I Street did not end until July 31, 2013, there was no lease overlap resulting in additional rental expense. Trust staff negotiated an abatement of monthly rent for the 1st year of the 2001 K Street lease. Therefore, the Trust did not make any rental payments on any lease for a period of nine months, from August 2013 through April 2014. The new lease resulted in a net savings to the Trust of approximately $330,000 through the negotiated rent abatement, rather than additional rental expense as claimed in the report.

The OIG Report states that "[t]he new lease increased NRRIT's office space expense by 69 percent, while the number of NRRIT employees increased by 43 percent, from 14 in fiscal year 2007 to 20 in fiscal year 2015." As an initial matter, for its comparison purposes, the OIG inexplicably uses NRRIT's 2007 employment number (four years after the initial lease began). Setting that aside, the OIG's claims are otherwise flawed. The Trust's rent expense increased by 52 percent (not 69 percent), from 2007 to 2015. This increase is reasonable based upon the 43 percent increase (using 2007, as the OIG did) in the number of employees as the Trust's professional staff was built out, combined with modest increases in Washington, DC commercial real estate rental rates. The Trust's 2001 K Street lease resulted in an

increase in rent per square foot in line with expectations, from $41.21 to $46.48, driven by increases in rental rates over the 10-year period from 2003-2013.

The OIG Report states that "NRRIT's current office space is undergoing Trophy Class renovation with expected completion in 2017 at a cost of approximately $275,000." It is not clear where the OIG obtained this information, but it is false. The common area of the building occupied by the Trust is currently undergoing renovations that are outside of the Trust's control. NRRIT's office space is receiving no upgrades or modifications associated with the renovations (and has not been renovated or upgraded since the Trust moved into the space). Likewise, NRRIT is not responsible for any of the costs of the renovations. It is unclear how the $275,000 cost of the renovations cited in the OIG report is derived, however, the Trust's lease remains unchanged with no modifications or changes to the rent schedule resulting from the renovations.

The current lease at 2001 K Street was entered into during a period of favorable market conditions for tenants in the Washington, DC commercial real estate market, and the Trust negotiated very attractive terms on the space. As a result, the Trust is paying rent well below current market rates for similar office space.

DC Area Rental Rates	Colliers[28]	JLL[29]	Cresa[30]	2001 K St. Comp[31]	Average	NRRIT	% Diff (NRRIT vs. Average)
Trophy Class	N/A	$85.31	$69.07	N/A	$77.19		(40%)
Class A	$60.16	$69.28	$56.36	$56.50	$60.82	$46.48	(24%)
Class B	$45.61	$50.18	N/A	N/A	$47.90		(3%)

It is illustrative to point out that one recent comparable lease was signed in the same location as the Trust. The lease, signed in February 2017, was entered into with full knowledge of the current renovations (which the OIG refers to as Trophy Class) taking place at 2001 K Street. Even with this knowledge, this comparable aligns much more closely with Class A asking rents than Trophy Class rents. While the current renovations to the common areas and exterior of the building may result in some characteristics of Trophy Class office space, and while the developers of the project may attempt to publicly position the building as "Trophy Class" and market it as such, the renovated building will more closely resemble the characteristics of Class A space. The recent comparable in the building supports this. In any event, NRRIT's annual rent of $46.48 per square foot compares favorably with current rents for Trophy Class, Class A, and even Class B space in the area.

[28] Colliers International, *District of Columbia Office Market Report* (Q3 2017).

[29] JLL Research, *Washington, DC Office Observations* (Oct. 2017).

[30] Cresa Market Research, *DC Rent Comparison* (Q1 2016).

[31] There is one comparable lease at 2001 K Street of which we are aware that has been signed since the announcement of the "Trophy Class" office renovations. Source: Cushman & Wakefield Lease Comparables.

The OIG Report states that, "[s]ince its inception, NRRIT office lease expense averaged $26,176 per employee. By comparison, in the District of Columbia, the average office rental expense is $9,008 per federal employee." It further states that, "we estimated the average office space per NRRIT employee exceeds 500 square feet. The industry standard is 200 usable square feet per employee and the federal benchmark is 190 usable square feet per employee…."

The OIG's calculations of average office rental expense of $9,008 per federal employee and $26,176 per NRRIT employee are flawed in several respects.

First, as is noted in the GAO report cited in the OIG's calculation, its "analysis of average lease costs did not account for the ratio of rentable square feet ("RSF") to usable square feet ("USF") because this information is not available in the GSA lease inventory data. Therefore, these costs do not consider the 'add-on' factor commonly used to compare building space."[32]

Second, and more importantly, all per-person GSA benchmarking metrics define headcount as follows: "Headcount: The total number of employees, including full-time, part-time, interns, and contractors, that work at a designated office location."[33] Any calculations that exclude NRRIT Trustees, Trust auditors, Information Technology managed services personnel, and other contractors from the analysis dramatically overstate the Trust's Space Allocation Rate.

While the GSA's general recommendation of a 200 USF per-person ratio referenced in the OIG report is a starting point, several important factors must be considered in order to accurately and fairly evaluate the Trust's office space efficiency.

Benchmark Flaws and Lack of Authoritative Status: By its own admission, the *GSA Facilities Standards* do not advocate a one-size-fits-all approach. Because the Federal Government is a collection of diverse agencies with differing missions, the GSA's most recent benchmark study does not, and was not intended to, "develop a government-wide standard for office workspace use per-person for all agencies."[34] The report acknowledges that the published benchmark report lacks authoritative status and is presented "to the entire Federal community with the hope that it leads to a more effective, efficient workspace environment that accommodates individual work styles and alternative workplace strategies to reduce office workspace costs."[35] The standards set design criteria and policy for new buildings and major/minor alterations in the programming, design, and documentation of GSA buildings. "The *Facilities Standards* is not a guideline, textbook, handbook, training manual, or substitute for the technical competence expected of a design or construction professional."[36]

Code of Federal Regulations Prevails: In fact, "over the past decade, the Federal government has moved away from strict hierarchical space use standards based on pay grade or associate position. The Federal

[32] U.S. Government Accountability Office, GAO-16-434, "Federal Real Property Commodity Futures Trading Commission Needs Better Leasing Guidance to Improve Cost-effectiveness," (April 2016).

[33] U.S. General Services Administration, "Workspace Utilization and Allocation Benchmark," Effective July 2012.

[34] *Id. at* 7.

[35] *Id. at* 4.

[36] U.S. General Services Administration Website, "Facilities Standards Overview," *available at* https://www.gsa.gov/real-estate/design-construction/architecture-engineering/facilities-standards-p100-overview (last accessed Dec. 1, 2017).

government now follows the Code of Federal Regulation's ("CFR") recommendations for space planning based on organizational needs. Current workplace regulations state that 'Executive agencies must provide a quality workplace environment that supports program operations, preserves the value of real property assets, meets the needs of the occupant agencies, and provides child care and physical fitness facilities in the workplace when adequately justified. An Executive agency must promote maximum utilization of Federal workspace, *consistent with mission requirements*, to maximize its value to the Government.'"[37] We believe the Trust's current office space design fulfills these objectives as they are defined in the CFR.

Consideration of Trust mission: As noted in the CFR, it is important to consider the Trust's mission and the nature of operations as a "manager of managers." Trust staff does not manage assets in-house, but rather engages outside asset management firms to invest portions of Trust assets. Whereas in-house management would require additional full-time staff, the outsourcing of this work means that additional conference rooms are necessary to accommodate visiting investment managers. The Trust has adopted an Investment Procedures Manual that requires rigorous due diligence of prospective investment managers, and ongoing monitoring of existing investment managers. During calendar year 2016 alone, the Trust held 274 meetings in its 2001 K Street office with current or prospective managers. This excludes onsite Board of Trustee meetings and other meetings with external parties held in the normal course of business, not to mention meetings among NRRIT staff members. NRRIT also must provide accommodations for its Auditor, whose staff spends a significant amount of time onsite at the Trust's offices.

In the design of its new office space and with the Trust's mission in mind, "the office was split into two separate areas, with the front containing meeting areas and board rooms, and the back filled with open workspaces and offices."[38] Any analysis of Trust office space efficiency must take into consideration the Trust's office configuration as necessitated by its mission. Accordingly, relevant USF per-person calculations are more meaningful when applied to the open workspaces and offices in the back area of the Trust's office space.

Economies of scale: With a staff of approximately 20 employees, NRRIT is unable to take advantage of the same economies of scale enjoyed by larger organizations with respect to common areas. Common areas such as the Trust's supply cabinet, reception area, IT/server room, and pantry are allocable only to the Trust's limited staff. The average federal agency in the Executive Branch has over 7,000 employees.[39] With a staff of only 20 employees, the Trust's economies of scale are very different than that of the average Federal agency.

Teleworking: As noted above, a primary function of the Trust's core mission involves regular meetings with outside investment managers. Thus, the Trust staff professionals hold face-to-face meetings with outside visitors routinely and are not eligible for teleworking. Many federal agencies that were able to achieve relatively low utilization rates were able to benefit from alternative work arrangements such as

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[37] "Workspace Utilization and Allocation Benchmark," jointly issued by the U.S. General Services Administration Office of Government wide Policy and Office of Real Property Management Performance Measurement Division, issued July 2011, with benchmark data as of July 2012 (emphasis added).

[38] CallisonRTKL Website, "National Railroad Retirement Investment Trust," *available at* https://www.callisonrtkl.com/projects/national-railroad-retirement-investment-trust/ (last accessed Dec. 1, 2017).

[39] Calculated from various sources: *Fed Figures Federal Workforce Statistics*; FOIA.gov, and Federal Register Index.

telework and hoteling, which reduce the demand for physical office space. Public sector organizations in the GSA's benchmarking study averaged 1 seat per every 1.23 personnel. This is another factor that must be considered in evaluating the GSA's benchmark of 200 USF per-person. In 2015, 20 percent of all federal employees teleworked. Of those employees that teleworked, 31 percent did so 3 or more days per week.[40] These figures are significant and must be considered in evaluating the applicability of the GSA's 200 USF per-person benchmark to NRRIT.

Makeup of Trust staff: Fifty percent of the Trust's staff functions at the Executive or Director level. By contrast, only 31 percent of Federal Government employees are classified as Executive or Senior Level (defined as GS-13 positions up to and including Senior Executive Service).[41] The GSA provides prevailing standard workplace averages per staff position based on their benchmarking research, ranging from a low of 40 USF at the Clerical level to a high of 400 USF at the Executive level. The Trust's staff makeup is atypical when compared with the average government agency included in the GSA benchmarking statistics, and would lend itself to a higher USF per-person than that reflected in the benchmark report.

Peer Comparison: In 2007, the GAO conducted a study of the administrative expenses of the Federal Retirement Thrift Investment Board (FRTIB), which administers the TSP. As it relates to workplace utilization, a GSA official told the GAO that, "based on FRTIB's mission, [its] space needs are likely similar to a model that proposes 368 rentable square feet per person." At the time the report was drafted, "FRTIB's headquarters provided more than 670 square feet per person." The similar mission of the FRTIB and the Trust make comparisons across the two organizations more meaningful than comparisons against the GSA's benchmark.

In contemplation of the organization-specific factors described above, we believe the Trust adheres fully to the guidance prescribed in the Code of Federal Regulations. In short, the Trust promotes maximum utilization of its workspace, consistent with mission requirements, to maximize its value to its stakeholders.

While calculation methodologies differ across user organizations, as described in detail in the GSA's benchmarking report, the Trust's internally derived USF per-person ratio falls within the industry specific ranges reflected in the GSA report.

The OIG Report states that "[t]hese upgrades to rental space, relocation, square footage, and leasing expense details were not disclosed in NRRIT's financial statements or by other means to inform the impacted railroad community."

NRRIT's financial statements disclose all required information with respect to the Trust's lease in accordance with U.S. GAAP.

The OIG Report states that "NRRIT's bylaws state that the principal office of NRRIT shall be fixed and located at such address as NRRIT shall determine. NRRIT is granted full power and authority to change said principal office from one location to another. NRRIT's bylaws established Washington DC as its principal office space; but, there is no indication that the Trustees provided a location analysis or strategy identifying any specific benefits of the location to RRB." The OIG is incorrect.

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[40] U.S. Office of Personnel Management ("OPM"), "Status of Telework in the Federal Government," Report to Congress, (FY 2015).

[41] Partnership for Public Service, *Fed Figures – Federal Workforce*, 2014.

The Trust's governing statute establishes Washington, DC as its principal location.[42] The bylaws of the Trust reflect adherence to the statute.

The Trust performed extensive research on the new office space (and other options) prior to signing the lease in October 2012. The former space at 1250 Eye Street was a Class B building and the Trust's rent was approximately 5 percent above market rates for that category of office space. Alleviating safety concerns as well as finding a location with numerous hotels nearby to accommodate visiting Trustees and investment managers were important factors in deciding on a new location. The 2001 K Street office offered improved safety for employees and visitors, and sufficient number of hotel rooms within walking distance to accommodate the regular onsite visitors.

It is worth noting that at the time the decision was made to move to the new location, there were no plans to renovate the building's common areas and the Trust had no knowledge of any such plans in the future. The plans to renovate the common areas were announced by the property manager in November 2015, more than 2 years after the Trust signed its lease at 2001 K Street. As noted earlier in our response, the current renovations to the common areas of 2001 K Street are entirely outside of the Trust's control. The project will have no impact on the office space covered under the Trust's lease, and all work is being performed at no cost to the Trust.

The OIG Report also states that "NRRIT did not disclose a change in its principal location that presumably occurred between October 2012 and January 2015. District of Columbia trust laws require that beneficiaries be notified 60 days prior to a change in principal location." The cited District of Columbia Code section requires a Trust to notify its beneficiaries of such a move in the event that it moves to another jurisdiction (i.e., outside the District of Columbia). The Trust remained in the District of Columbia. Moreover, the Trust does not have beneficiaries to notify even if it had located to another jurisdiction. This is one more example of the OIG irresponsibly alleging that the Trust has violated the law when it is in fact not the case.

OIG Allegation: NRRIT Investments Are Not Fully Disclosed

The OIG Report states that "NRRIT only publicly discloses the 50 largest holdings in its investment portfolio. The largest holdings within each asset class, including those exceeding 5 percent of net assets, are presented in NRRIT's Condensed Schedule of Investments." The Trust prepares its financial statements in accordance with GAAP for Investment Companies. Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 946, *Financial Services – Investment Companies*, includes the disclosure requirements for the Condensed Schedule of Investments. The Trust specifically identifies all holdings that are required to be disclosed as such under the FASB guidance.

The OIG Report goes on to state that, "NRRIT provides no explanation for this disclosure limitation." The Trust's explanation for its financial reporting practices is included in the footnotes to its financial statements. The Trust's footnote on Significant Accounting Policies states that "[t]he accompanying financial statements were prepared in accordance with accounting principles generally accepted in the United States of America (GAAP), including but not limited to ASC 946."[43] Furthermore, the Trust's Condensed Schedule of Investments is characterized as a "disclosure limitation" in the OIG report. On

[42] Section 105 of the *Railroad Retirement and Survivors' Improvement Act of 2001* states that the Trust "is hereby established as a trust domiciled in the District of Columbia…."

[43] NRRIT Audited Financial Statements, Fiscal Year 2016.

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the contrary, the Trust has voluntarily adopted the requirements of registered investment companies in its Condensed Schedule of Investments. The disclosure requirements for non-registered investment partnerships are less restrictive and require less disclosure than is provided by NRRIT.

Figure 2 on page 26 of the OIG report shows a trend of increasing "undisclosed" NRRIT Assets by fiscal year. Acknowledging first that these assets are not "undisclosed" as the OIG suggests (this is explained below), this trend is a natural and expected outcome of the Trust's statutory mandate to construct a diversified portfolio. As the Trust has become fully built out since its inception, individual holdings have become an increasingly smaller percentage of the total investments of the Trust. The result is that a smaller percentage of assets are required to be disclosed in the Trust's financial statements. While Figure 2 seems to imply a greater degree of risk, in actuality the opposite is true. A more concentrated portfolio would require a larger percentage of investments to be specifically identified under GAAP. A diversified portfolio, with no single investment unduly impacting Trust performance, results in a smaller percentage of investments required to be specifically identified under GAAP.

It is important to differentiate between the terms "specifically identified" and "disclosed." One hundred percent of Trust assets are disclosed in its financial statements. There are no "undisclosed" or off-balance sheet assets excluded from the financial statements. The OIG's references to "undisclosed" assets refers to those assets not required to be "specifically identified" within the Condensed Schedule of Investments under GAAP.

OIG Allegation: NRRIT's Offshore Investments Introduce Risks

The OIG's description of the small portion of the Trust's investments that are through offshore investment vehicles is inaccurate and simply a scare tactic based on a fundamental misunderstanding of what is common practice in the investment industry. The Trust has several investments, primarily in alternative asset classes, for which the most appropriate and cost-effective legal structures for the investments are through funds that are domiciled in other countries. These investment vehicles are perfectly legitimate legal structures and are used widely within the institutional investment industry. In opting for these particular structures, the Trust seeks to maximize its net returns, while also balancing the associated risks.

The allegation in the OIG's report that the "types of investments" in these offshore vehicles are unknown is simply not true. NRRIT's investment staff knows quite well the types of investments in each of its accounts, irrespective of the fund's legal jurisdiction. The Trust receives regular investment reports from each of its managers on a monthly or quarterly basis containing the holdings, key exposures, and/or portfolio characteristics for each applicable fund, as well as updated investment performance information. Also, none of the events contained in the OIG's list of "known risks of offshore investments" have occurred since NRRIT's inception, as the Trust's thorough manager due diligence and monitoring process minimizes the likelihood of such events. The Trust conducts due diligence on all of its managers prior to hiring, including those utilizing offshore investment vehicles, following the comprehensive process laid out in the Trust's Investment Procedures Manual. In addition, NRRIT actively monitors each of its managers, including a thorough review of periodic investment reports and quarterly calls or meetings with each manager on NRRIT's roster.

The OIG also states in this section that, because NRRIT is tax exempt, its offshore investments are not required to be reported to the IRS. This contention is incorrect. On an annual basis, NRRIT reports

relevant contributions to, and ownership of, the Trust's offshore investment vehicles on IRS Forms 926, 5471, and/or 8865 as required.

OIG Allegation: NRRIT Administrative Expenses Are Rapidly Increasing

Regarding the OIG's criticism of NRRIT's expenses, two important points are worth considering:

(1) NRRIT's expense ratio of 27 bps is significantly lower than its defined benefit plan peers (66 bps on average); and

(2) NRRIT's portfolio has outperformed its passive benchmark, net of all fees and expenses, over the trailing 1-year, 3-year, and 5-year time periods through September 30, 2017, as well as since NRRIT's inception in 2002.

The percentage increases cited by the OIG may appear high on their face, but the starting point for these increases was the early days in the Trust's history when there were only a few staff members and the Trust had not yet fully developed its investment strategies and asset allocation. Thus, these percentage increases are artificially inflated due to the unsustainably low expenses incurred during the Trust's initial years of existence and, while eye-catching, are essentially meaningless. The Trust's costs did increase, as expected, in those early years as the portfolio was gradually built out, but expense levels have plateaued as the Trust has matured over the last decade. Indeed, as shown in the OIG report, the Trust's costs actually have declined slightly over the last ten years, going from $75 million in FY 2007 to $68 million in FY 2016. NRRIT's total expenses have been fairly consistent and range-bound over the last decade, ranging from $64 million to $83 million in each fiscal year from FY 2007 through FY 2016.

The OIG's analysis included at Table 8 of the report also contains inaccuracies. The table is represented as an analysis of NRRIT financial statement data for fiscal years 2002 through 2015. While Trust staff were not able to review the details of this analysis, it appears that the analysis actually covers the Trust's financial statements through FY 2016, not FY 2015. Therefore, while the table indicates that the Trust incurred $807 million of expenses over a 14-year period, these expenses were actually incurred over a 15-year period. If this had been accurately represented, each of the annual averages in Table 8 would have been less than the amount reported by the OIG.

Finally, the methodology used by the OIG in arriving at the figures in Table 8 includes a full 15 years of data for some captions, but as few as 2 years of data for other captions. It is important to understand that the Trust's financial statements follow GAAP for investment companies. GAAP for investment companies requires separate disclosure of each expense exceeding 5 percent of total expense.[44] Therefore, the expense captions reflected in the Trust's Statement of Operations will vary from year to year, as the amount of these expenses will vary over time. Similarly, the specific expenses included in the "Other Expenses" caption will vary each year. The OIG's computation of average annual "Other Expenses" of $2.8 million in Table 8 results in a meaningless figure that is not a reasonable basis for evaluating Trust expenses.

In this section, the OIG's use of investment income as a metric in evaluating the Trust's costs is uncommon and puzzling. First, the Trust, like most defined benefit plans, does not explicitly target increasing investment income as an investment objective but rather seeks to maximize total risk-

[44] *See* 17 C.F.R. § 210.6-07.

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adjusted returns. Returns can be generated from capital gains or investment income, and given the Trust's tax-exempt status, NRRIT is indifferent between these two sources of returns. While the Trust's investment income may not have increased over the last decade, the Trust's returns have increased, as the portfolio has generated attractive net of fee returns over multiple time periods (as demonstrated elsewhere in this response). The fact that most of the Trust's returns have been generated via capital gains rather than investment income is only relevant for financial reporting purposes.

The most common method in the investment industry for measuring a pension fund's costs is to divide the fund's total expenses by its assets, resulting in an expense ratio, and that measure also is cited in the OIG report (as discussed in this response). Using investment income rather than assets is not a common practice in the investment industry, particularly when evaluating a pension fund's expenses, and for good reason. Most pension funds, like NRRIT, do not explicitly target investment income, but rather seek to maximize total returns. Also, most of the costs incurred by a pension fund are tied much more closely with total assets, as opposed to income, as most investment managers are paid fees, at least in part, based on the amount of assets under management. The OIG did not evaluate the Trust's expenses as a percentage of investment income (the OIG's preferred methodology) within the context of broad pension fund surveys or other industry data. This likely is due to the fact that such information does not exist because the methodology is so unusual and considered largely irrelevant within the industry.

Interestingly, if one was to calculate the Trust's administrative expense ratio as a ratio of net income rather than as a ratio of net assets, as the OIG advocates, the Trust's administrative expense ratio would have been significantly higher in its early years, when the Trust's portfolio was mostly passively managed: 23.04 in 2004 versus 16.14 in 2016. Thus, the OIG's methodology either supports active management as being more cost efficient than passive management or, as we suggest, it demonstrates that the OIG's methodology is meaningless.

<u>OIG Allegation: NRRIT CEO/CIO Conflict of Interest Not Reported</u>

The OIG Report states that a conflict of interest involving NRRIT's former CEO/CIO occurred and that this conflict of interest was not disclosed to the RRB until after the OIG brought it to the RRB's attention. In reality, NRRIT's Board was confronted with a personnel situation that it handled swiftly, decisively, and appropriately, including its notification to the RRB about what had occurred.

At NRRIT's December 2015 Board meeting, the Trust's then CEO/CIO asked for permission to serve as a compensated director of a number of BlackRock closed-end mutual funds. These are not funds that NRRIT invests in or would consider investing in, however, NRRIT's Board declined the request for various reasons. On February 9, 2016, NRRIT's Board learned that, notwithstanding the Board's decision, the then CEO/CIO had accepted the BlackRock position, to be effective July 1, 2016. That same week, members of NRRIT's Board of Trustees, together with counsel, met with the then CEO/CIO to confirm this. Once confirmed, NRRIT's Board began the process of terminating this individual's employment, consistent with terms in the employment contract. Importantly, the individual's employment contract provided ten days for the individual to remedy the situation giving rise to termination. Once those ten days elapsed, on February 23, 2016, and sufficient remedy was not provided, the members of the RRB and the RRB General Counsel were notified about what had occurred. Given what transpired, NRRIT's Board handled the situation as swiftly as possible and, to this day, believes the matter was handled correctly.

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The timeline of events related to the former CEO/CIO's departure presented at Table 10 of the OIG Report is dubious and relies heavily on information supposedly provided by the RRB's former General Counsel, who has since retired and is not available to corroborate the information attributed to him in the report. Nonetheless, an email dated February 29, 2016 from the RRB's former General Counsel to NRRIT's counsel indicates that the OIG brought this issue to his attention on that day, following its discovery of a brief article regarding the matter in Pensions & Investments Online.[45] Moreover, neither the former General Counsel nor the RRB Members ever indicated that the issue involving NRRIT's former CEO/CIO had been brought to their attention by the OIG prior to February 23, 2016, when they were informed of the matter by the Trust.

The OIG Report goes on to claim that NRRIT and its former CEO/CIO did not observe a cooling off period following the individual's departure from the Trust, and that this somehow resulted in a conflict of interest. This allegation is predicated on the OIG's misreading of material it cited from Institutional Shareholder Services, Inc. ("ISS"), which states that, "[f]or the Canadian market, ISS' 2015 policy changes affect proposals to adopt or amend an advance notice bylaw or board policy and its definition of independence, whereby a former CEO will be subject to a five year cooling off period to serve on the board or any key board committee to be classified as independent." What this ISS statement speaks to is the cooling off period required for a former CEO of a company to be considered an independent director/trustee of the same company.[46] In other words, a former CEO of Company A would have to observe a five-year cooling off period before he or she could be considered an independent board member of Company A. This is completely irrelevant to the scenario involving NRRIT's former CEO/CIO. In fact, we are unaware of any cooling off requirements that would relate to this situation. If they exist, we imagine the OIG would have cited actual authority, rather than citing to a consultant's changes to its policy affecting the Canadian market. In any event, the former CEO/CIO has not been in contact with NRRIT staff regarding Trust business, and has had no involvement with NRRIT since departing the Trust.

OIG Allegation: NRRIT's Trustee Term Limits Are Not Effective and May Not Comply with RRSIA

The OIG Report states that "NRRIT Trustee term limits are not enforced and several Trustees have served beyond their initial three year term. RRSIA states that each member of the Board of Trustees shall be appointed for a three year term, and shall continue to serve until a successor is appointed. However, RRSIA does not specify if each member may be reappointed indefinitely after their term has expired. While RRSIA's three year term is not clear, its instruction on the selection of a successor implies the establishment of a three year term limit rather than a recurring three year term cycle."

As an initial matter, there are no term limits stipulated in NRRIT's governing statute or its bylaws. While the statute does establish a term period (three years) for each member of the Board of Trustees and

[45] The February 29, 2016 email from the RRB's former General Counsel to NRRIT's counsel contained an email he received from the OIG that same day. In that email, the OIG inquired about issues related to the former CEO/CIO's departure, and attached a brief article, dated February 26, 2016, related to the departure and the Trust's appointment of an interim CIO. Given the significance of the February 29, 2016 communications between the OIG and the former General Counsel, they are conspicuously absent from the OIG's timeline of events on the matter.

[46] "Independent director" means a person other than an executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer's board of directors, would interfere with the exercise of independent judgement in carrying out the responsibilities of a director. *NASDAQ Marketplace Rule 4200(a)(15) – Definition of "Independent Director," available at* http://media.corporate-ir.net/media_files/irol/87/87823/corpgov/nasdaq_marketplace_rule_4200.pdf (last accessed November 29, 2017).

includes a provision that dictates that any Trustee shall continue to serve until a successor is appointed, it does not prohibit the reappointment of the same individual upon the expiration of his or her term.[47] Further, to the extent that the statute is silent on whether a member may be reappointed after the expiration of the initial term, the D.C. Nonprofit Code is instructive.[48] The D.C. law provides no limit on the number of terms an individual may serve as a director for a nonprofit (i.e., 501(c) organization) domiciled in the District of Columbia.[49] Finally, the District of Columbia Retirement Board's ("DCRB") Board of Trustees is illustrative of the common practice of reappointment of experienced Trustees. For example, a majority of the DCRB's current board members have served multiple consecutive terms – including several who were first appointed in the mid-1990s and have remained on the Board.[50] As such, this continuity and retention of institutional memory is common practice, and serves to strengthen the Board's function. NRRIT is not required by law to impose term limits and, more significantly, has benefited from the longer tenures of some of its Trustees.

OIG Allegation: NRRIT Investment Managers Lack Required Experience and Qualifications

The OIG Report states that, "as of fiscal year 2015, two of the three senior investment staff members with investment responsibilities had not achieved the Chartered Financial Analyst (CFA) designation and the former CEO/CIO had not earned a Master of Business Administration (MBA) degree, as required by NRRIT. Of the fourteen remaining investment staff with investment responsibilities, one did not have significant investment experience, nine had not earned their MBA degree, and five had not achieved their CFA designation."

Citing a sentence that appeared only in the Trust's 2002 annual management report as a Trust requirement is irresponsible. In 2002, in its year of inception, NRRIT's Board of Trustees identified general criteria for its hiring of initial investment professionals, which included the expectation that they would possess either an MBA degree, a CFA designation, or equivalent investment knowledge and experience. That expectation was noted in the Trust's very first annual management report in 2002, however, the Trustees soon realized that it was neither necessary nor realistic to require all investment staff to have obtained each of these degrees and/or certifications. Since that time, the Board has undergone numerous cycles of hiring investment staff, and some of these individuals have attained their MBAs or CFAs while others have not. This result justifiably captures the Board's better understanding of the talent pool and the requirements for various investment staff since 2002. Significantly, it is worth reporting that, as set forth in NRRIT's 2016 Annual Management Report, all NRRIT senior staff have a CFA or MBA, and ten of the eleven investment staff possess either a CFA or an MBA,[51] and the eleventh person is making progress toward achieving the CFA designation. In short, the Trust's investment staff is very highly qualified.

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[47] *See* 45 U.S.C. § 231n(j)(3)(C).

[48] *See* D.C. Code § 29–406.05.

[49] *See id.*

[50] *See* DCRB Website, "Board Members," *available at* https://dcrb.dc.gov/page/dcrb-board-members (last accessed Nov. 27, 2017).

[51] *See* FY2016 NRRIT Annual Management Report at Appendix M. This number excludes the four administrative and operations staff.

OIG Allegation: Acceptability of Travel and Other Expenses Is Not Monitored

The OIG Report states that the "Acceptability of Travel and Other Expenses is Not Monitored." Procedures have been put in place demonstrating that the acceptability of travel and related expenses is, in fact, monitored. NRRIT Trustees review and approve the Trust's travel budget annually. Staff presents an analysis of total travel expenses versus budget on a quarter-to-date and fiscal-year-to-date basis to the Trustees each quarter.

In addition, all staff travel requests require written pre-approval by each staff member's supervisor. For travel requests for which the expected total cost of the trip exceeds $5,000, completion of a separate pre-approval form is required, including a detailed breakdown of expected costs, and the approval of either the Trust's CEO/CIO or Chief Financial and Operating Officer. The specific details, including total costs, of trips exceeding $5,000 are reported to NRRIT Trustees quarterly. Such trips are rare and generally involve overseas travel as part of prospective manager due diligence or existing manager monitoring.

Finally, NRRIT's Trustees review details of all staff travel throughout the course of the year. Trustees are provided with a detailed travel report on a quarterly basis. This report is included in materials provided to the Trustees in advance of each meeting, and includes the following:

- Meeting Date(s)
- Staff member(s) in attendance
- Asset class
- Investment manager or Conference name (if applicable)
- Location (Specific offsite location or NRRIT offices)
- Relationship (e.g., Current Manager, Prospective Manager)
- Meeting Type (e.g. Due Diligence Meeting, Introductory Meeting, LP Annual Meeting)

As described earlier in this response, the Trust has adopted an Investment Procedures Manual that requires rigorous due diligence of prospective investment managers and ongoing due diligence of existing managers. These due diligence requirements were developed to promote the effective and efficient achievement of the Trust's mission.

While NRRIT is not subject to the requirements of the OMB with respect to travel, the Trust nonetheless meets the spirit of the OMB's guidance. In a November 25, 2016 memorandum to the heads of executive departments and agencies,[52] OMB Director Shaun Donovan wrote that, "[a]s each agency reviews its travel and conference-related activities, it is critical to continue to recognize the important role of mission-related travel and conferences in supporting operations. Given the unique travel and conference needs of each agency, there are circumstances in which physical co-location is necessary to complete the mission." Implementing the Trust's investment strategy as required by statute does require a certain amount of staff travel. The travel procedures described above are designed to ensure that the acceptability of travel and related expenses are, in fact, monitored.

[52] Memorandum from Shawn Donovan, Office of Management and Budget Director, "Amending OMB Memorandum M-12-12, *Promoting Efficient Spending to Support Agency Operations*," (Nov. 25, 2016).

OIG Allegation: NRRIT Has Not Established Social and Geopolitical Investment Policy

The OIG Report criticizes NRRIT for not establishing a policy for investing in socially and economically responsible funds. The irony of this criticism is that the OIG advocates that NRRIT should be doing exactly what Congress did not want it to do – make investment decisions based on social or political preferences rather than for the sole purpose for which the Trust was established. NRRIT's statute states that the Trust and each member of the Board of Trustees "shall discharge their duties (including the voting of proxies) with respect to the assets of the Trust solely in the interest of the Railroad Retirement Board and through it, the participants and beneficiaries of the programs funded under this Act - for the exclusive purpose of providing benefits to participants and their beneficiaries; and defraying reasonable expenses of administering the functions of the Trust." Congress did not provide the Trust with flexibility to invest assets for the purpose of achieving social or political goals. Rather, Congress directed the Trust to invest the assets solely for the benefit of the railroad retirement system, free from political interference. The OIG Report suggests that NRRIT should develop investment policy that violates its statute.

The OIG also states in the Report that it has identified 26 socially responsible investment funds that outperformed NRRIT over the 10-year period ending September 30, 2015. We have no way of verifying this claim because the OIG simply cites to the web site SocialFunds.com -- it does not provide the names of the funds that supposedly outperformed NRRIT or indicate how they were identified, nor does the OIG indicate what percentage of socially responsible investment funds outperformed NRRIT. It is entirely possible that there are some socially responsible investment funds that have outperformed NRRIT, however, cherry picking such funds in no way indicates that social investment would have improved the Trust's performance.

The OIG Report also states that under District of Columbia common law, pension funds are prohibited from investing in companies that do not abide by international law or that involve geopolitical risks, for example, investments linked to Northern Ireland and Iran's political factions. The District of Columbia legal requirements that are cited, and which the OIG says NRRIT is subject to, do not in fact apply to NRRIT. District of Columbia Law 17-337 and District of Columbia Code § 1-907.01 detail prohibitions on the investments of certain D.C. Government pension plans and are not applicable to NRRIT. This is yet another example of the OIG not understanding a legal requirement.

Committee Structure May Violate RRSIA and Hinder Effective NRRIT Management

This entire section of the OIG Report is based on the OIG's faulty understanding of what the term "independent director" means with respect to SEC requirements. As discussed earlier, an independent director is essentially a person other than an executive officer or employee of the company (or, in this case, the Trust). By this definition, all of NRRIT's Trustees are independent – none of them are employed by the Trust. The term "Independent Trustee" as used by NRRIT (or "independent member" as set forth in NRRIT's statute) has nothing to do with the SEC's definition of independent director. It simply indicates the Trustee who is not affiliated with rail management or rail labor. Thus, the arguments made in this section of the OIG Report with respect to independence concerns, which are based on SEC final rule 33-8220 related to independent directors of listed companies, are irrelevant.

It also is worth noting that this section contains misrepresentations about NRRIT committee structure and how NRRIT's decisions are made, including quorum and voting requirements. These have been addressed earlier in these comments. Lastly, this section of the report alleges that NRRIT's committee

structure and responsibilities may create conflicts of interest if the committees are not properly formed. This allegation includes a mention of the Administrative Committee's control of retention of legal counsel and suggests that a conflict of interest may occur as the Administrative Committee may influence decisions involving legal counsel through their retention authority. We have been unable to decipher what the OIG means by this and, therefore, have not addressed this allegation.

Conclusion

The thorough comments provided throughout this document not only expose the numerous errors, misrepresentations, and flaws contained in the OIG Report, they also demonstrate that NRRIT has been a resounding success and, because of its creation and its performance, the railroad retirement system is on extremely sound footing.

The Trust created by Congress in 2001 has succeeded at shoring up the solvency of the railroad retirement system for the foreseeable future, improving benefits for railroad retirees, and reducing taxes on rail workers and employers. NRRIT's success is, in no small part, due to the governance and accountability structures that Congress established for the Trust and its ability to manage the assets of the Trust free from government influence and interference. The sound processes established by NRRIT's Trustees and staff, and the expertise that NRRIT has assembled will contribute heavily toward the Trust's success for years to come.

Appendix IV – Conflict of Interest Notification

February 9, 2016 12:09 PM redacted email from RRB OIG's Supervisory Auditor to RRB's General Counsel regarding NRRIT's CEO's appointment to BlackRock's Board of Directors.

Tue 2/9/2016 12:09 PM

RRB OIG Supervisory Auditor

NRRIT CEO Appointed to BlackRock

To RRB General Counsel

Cc RRB OIG Auditors

Message 12-31-board-changes.pdf

RRB General Counsel ,

Attached is the BlackRock notice we discussed. Please let us know what impact this will have on the NRRIT.

Thank you.

RRB OIG Supervisory Auditor
Office of Inspector General
U.S. Railroad Retirement Board

The Office of Inspector General's email included the following attachment which served to formally notify the RRB's General Counsel of the appointment.

BLACKROCK

Contact:
1-800-882-0052

BlackRock Closed-End Funds Announce Changes to their Board of Directors/Trustees

New York, December 31, 2015 –- The BlackRock registered closed-end funds (each a "Fund" and collectively, the "Funds") announced today that and will retire from their positions on the Board of Directors/Trustees (the "Board") of each Fund, effective December 31, 2015.

In addition, the Funds announced today that the Board of each Fund has taken steps towards filling the vacancies created by and retirements. The independent directors/trustees of the Board nominated and the full Board appointed as a director/trustee effective April 1, 2016 and **NRRIT's CEO** as a director/trustee effective July 1, 2016. and **NRRIT's CEO** have each agreed to serve as an independent director/trustee of each Fund as of their respective effective date.

Acronyms

AABR	Average Accounts Benefit Ratio
ABR	Accounts Benefit Ratio
BOMA	Building Owners and Managers Association
CEO	Chief Executive Officer
CFA	Chartered Financial Analyst
CFO	Chief Financial Officer
CIO	Chief Investment Officer
DCRB	District of Columbia Retirement Board
DFI	Dimensional Fund Advisors
DI	Disability Insurance
Dow Jones	Dow Jones U.S. Completion Total Stock Market (TSM)
ERISA	Employee Retirement Income Security Act of 1974
FRTIB	Federal Retirement Thrift Investment Board
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GSA	General Services Administration
IRS	Internal Revenue Service
ISS	Institutional Shareholder Services Inc.
MBA	Master of Business Administration
MSCI EAFE	Morgan Stanley Capital International Europe, Australasia, Far East
MOU	Memorandum of Understanding
NRRIT	National Railroad Retirement Investment Trust
OASDI	Old Age, Survivors, and Disability Insurance
OASI	Old Age and Survivors Insurance
OIG	Office of Inspector General
OMB	Office of Management and Budget
PBGC	Pension Benefit Guaranty Corporation
RRA	Railroad Retirement Act
RRB	Railroad Retirement Board
RRSIA	Railroad Retirement Survivors' Improvement Act of 2001
RUIA	Railroad Unemployment Insurance Act
RSF	Rentable Square Feet
SEC	Securities and Exchange Commission
S&P 500	Standard and Poor's 500
TSP	Thrift Savings Plan
U.S.	United States
USF	Usable Square Feet