

## SDCERS BOARD MEETING - January 20, 2006

*By Patricia Karnes*

(Notes do not necessarily follow the order of the meeting, they may be by subject. They are my understanding of what happened.)

Present: Murray, Sullivan, Flynn, Hebranks, Meyer, Prevolos, Thomson, Sheffler, Kipperman. James Hearty resigned at the Mayor's request.

SDCERS' attorneys: Roxanne Story Parks was Interim SDCERS Attorney, replacing Lori Chapin who is on paid administrative leave due to the Federal indictment

Larry Grissom, former SDCERS administrator has retired, also on Federal indictment.

### NON-AGENDA COMMENT:

Lynn Swanson supported Larry Grissom, Lori Chapin, and current Board.

Nancy Acevedo, President of City of San Diego Retired Employee Association, appreciated the efforts of the Board.

Jim Gleason brought a letter from Attorney Mike Conger expressing his interest in cooperating in changing the amortization rate stated in the Gleason settlement, so City could pay more into SDCERS. Gleason will do everything possible to amend the contribution rate that was chosen by the City in the settlement..

Phil Hart wanted to know why there was a 13th check, as clearly there were no good fortunes at this time. (Note: Mr. Hart didn't know the 13th check is an obligation of the Board, per a legal settlement.)

### CUSTODIAL BANK FINALISTS: Mellon Trust, Northern Trust and State Street Bank

State Street Bank, the current bank, during the last bidding process, was aggressive in giving SDCERS a good price to start business on the West Coast.

SDCERS has hired Callan Associates, consulting company, to negotiate with the banks. Bo is Senior Vice-President and Manager. He has been there for 19 years. He is a custodial bank business expert, and is researching and comparing fees, services, etc. Custodial banks keep track of the comings and goings of all investments and financial actions.

The first step is to determine the range of custodial services needed by SDCERS, including disaster recovery payments in event that the City doesn't process retiree checks. He prepared a 55 page RFP for custodial banks, of 100 questions, 15 pages on just fees. These three custodial banks are ranked by how they rated with investment managers. Investment managers do 85% of SDCERS trades. Included is a compliance-monitoring program to notify SDCERS if investment guidelines are violated.

Preliminary evaluation ranged from \$823,000 to \$119,000 if SDCERS will lend securities, and \$1 million to \$457,000 if there is no security lending. (Banks,

for example, may split the return on security lendings- 70% for SDCERS and 30% for the banks.) Bo said that some banks felt SDCERS financial strategy is too complex to do security lending. Prevolos asked if it was common for public pension funds to lend securities. Bo felt most do.

Bo said the Board must base their decision, not just on fees, but also on the bank's capability in other key areas. Fees can be further negotiated by Callan, especially as three banks are competing. Sheffler asked if there was a concern by any of the candidates about SDCERS separating financially from the City.

Hebrank's motion to proceed to interviewing the three banks, Murray seconded. Vote 9-0.

BANK INTERVIEWS OPEN TO THE PUBLIC AT SDCERS ON FEB. 14, 2006, 12:30p.m., for three hours. Prevolos formed a committee to interview: Flynn as Chair with Sullivan and Kipperman.

#### REAL ESTATE PERFORMANCE REPORT -TOWNSEND GROUP

Townsend reported that \$7 million is available for investing in real estate. The one year return has been 19.1%. Quarter ending Sept. 30, 2005.

#### STATUS REPORTS -Doug McCalla, Dawne Clark

December 2005- \$13 million for payments to retirees/beneficiaries, DROP distributions and withdrawals, and operating expenses.

January 13, 2006- \$24.9 million for higher rate of withdrawal of DROP account funds for those not keeping DROP funds at SDCERS.

Unaudited realized gains for first 5 months (41% of year) - \$147.2 million.

Unaudited unrealized gains -\$553 million.

Net assets at market- \$3.957 billion end of November.

(On Jan 11, 2006 it was \$4.133 billion.)

There were fee reductions to Pimco as a result of SDCERS using new guidelines per Mercer (consulting firm).

#### CURRENT EMPLOYEE CONTRIBUTIONS-Bob Wilson

Sullivan requested the status of the off-set reserve for employees. Wilson replied that it will be depleted Feb. 24, 2006. The following pay period the rate adjustment will be made and employee contributions will be increased.

Questions regarding additional \$18 million in employee contributions collected by the City to pay down the unfunded liability. Currently they are being held by the City and earnings are credited to that account. Sullivan said that if the \$18 million is not given to SDCERS, then SDCERS becomes part of the police lawsuit. The police don't have a contract and this was City imposed and not "meet and confer". Some of the Board believed the \$18 million should be deposited at SDCERS. Sheffler wondered if it was only funded by City "IOUs". Sullivan was concerned that active DROP members equivalent pay-drop was used to put into this unfunded liability account.

## FUNDING RATIO AND STATUS OF CAFR AND

BROWN ARMSTRONG -Bob Wilson

Will SDCERS' annual auditors, Brown Armstrong, accept the Navigant Report as an adequate "illegal acts investigation" and release the last two years of SDCERS' Comprehensive Annual Financial Reports (CAFR)? Wilson will contact Brown Armstrong on Monday, January 23rd, for a 6 to 8 week scheduling for release of the two CAFRs for June 30, 2004 and June 30, 2005. (At past meetings, there had been mention that Brown Armstrong might wish to have Board members sign off on audit.) Prevolos asked to be notified as to the date of the release, as he will need a special SDCERS Board meeting for a discussion of the CAFRs when they come out.

SDCERS funding ratio for 2003-2004 and 2004-2005 can then be compared to media's figure of 60 (something)%.

## NAVIGANT CONSULTING, INC. REPORT PRESENTED

Prevolos announced that the "illegal acts" report will be available on the web site.

The report was in two parts: 115 pages of investigation conclusions and details and 127 pages of legal analysis and conclusions. The courts were left to determine criminality. City issues were not covered. Attachments: word definitions, engagement letter, objectives and scope of the investigation, status of those interviewed (50 people) -or not interviewed (39 people), search terms of 134,000 documents, and time-lines of Board trustee terms in office. Navigant said that their work plan was developed after they worked with SDCERS staff and the Board.

The investigation and report preparation took place between August 30, 2005 and January 20, 2006. Sheffler noted the cost was \$2,700,000 and Navigant took about 1/6 the time and 1/10 the time of Kroll's investigation. This despite the City's lack of response regarding sharing information from Kroll, and Vinson and Elkins.

Provolos's introductory remarks referred to taxpayers' interests, and the need for the SDCERS' new April 2005 Board, which retained only Steve Meyer from the previous Board, to be educated as to reasonableness, before waiving attorney-client privilege. He said Council President Scott Peters was "his friend". Prevolos was concerned that the City Council decided it wasn't proper for the City Council to ask the State of California, or Kroll, to come in and do the audit. After the presentation, Prevolos found the report "sobering". He announced that SDCERS staff and Board will be reviewing the report and seeing if they disagree with it.

As the presentation began, Donna Frye arrived. The mayor's office and City Attorney's office were represented. Also, Toni Atkins' and Scott Peters' aides were present, as well as media. VanDeerlin was there. Many, many men in suits were there.

Reports were handed out from boxes, unseen or not discussed with the SDCERS Board before distribution to the Board or those attending. The report covered as early as 1991, focusing on 1995 to 2002, and some events

subsequent to 2002.

Navigant's Steve Stanton and Amanda Massucci presented the findings, plus Reish, Luftman, Reicher & Cohen's attorney, Bruce Ashton, presented the legal viewpoint.

Stanton and Massucci covered conclusions, on page 5, of the first section and recommendations, on page 109, on the big screen. Ashton started with legal conclusions on page 9 of the Legal section and the recommendations starting on page 124.

### INVESTIGATION CONCLUSIONS

Navigant's report began with saying that SDCERS current retirees benefits can be met, based on 2004 data. There was no mention of a cut-off date for active employees. ( NOTE: This data will be two years old on June 30, 2006. This statement was also used by Grissom and Saathoff previously, they also reversed the statement, telling the active employees that they were covered, but not retirees.)

The second finding was that the strong stock market may have been a factor in the previous Board decision to agree to contribution reductions.

(Diane Shipione already called Navigant's report another white wash, see [www.voiceofsandiego.org](http://www.voiceofsandiego.org) "Retiring the Doubt" by Andrew Donohue and Evan McLaughlin, January 21, 2006. Regarding the first two conclusions, "I think the report could have been written by the retirement system's staff ....", Diann said.)

Other conclusions included:

- MP I and MP II did not make economic sense.
- The Board relied on surplus earnings to pay for administration of SDCERS and certain ongoing benefits.
- SDCERS was obligated to evaluate the City's ability to pay SDCERS when they became a lender to the City.
- Navigant suggested that the Board consider strategies in the event that the City can not pay.
- Board approved underfunding despite warnings.
- Dual roles of Board trustees.
- SDCERS was placed in the middle of the City's benefit policy.
- SDCERS' staff assisted the City in the reduction of contributions.
- SDCERS' Comprehensive Annual Financial Report contained misleading statements/or omitted disclosures regarding the funding of the System.
- Annual actuarial valuations were misleading.
- The Board changed how contributions were calculated to a not generally accepted method. Salary increases were not incorporated. Board requested Corbett benefits, granted to retirees, be excluded from the actuarial valuation.
- Technical violations of IRS regulations, such as Union presidential leave, etc.

### HISTORY

The City linked their savings on contributions to giving more benefits in 1991. The premise was that investment returns of over 8% would cover the costs. In 1995, the City tried to use excess earnings to pay the City contributions, but there were not enough earnings. This set the stage for 1996's MPII. Board

Members, Terri Webster and Ron Saathoff had unique benefits under MPII. In June 2002, the funding ratio was 77.3%, and the Board had discussions. SDCERS' actuary, Rick Roeder, expressed concern but drew no conclusions. The Board did not share the depth of the situation to outside attorneys, when requesting outside opinions.

#### CAUSES OF THE UNDERFUNDING:

39% Benefit improvements.  
12% Increase in assets held outside the plan: DROP \$185million, COLA, etc  
11% Net investment losses.  
9% Purchase of service costs.  
7% MPI and MPII contribution lower than "actuarially funded contribution" (ARC).  
7% Actuary assumption changes.  
15% Other actuary gains and losses.  
100% total.

#### SOME INVESTIGATION RECOMMENDATIONS:

(Page 109 is start of the complete list.)

- Develop a definition of actuarial soundness.
- Ask the City to pay the real bill, because to the extent that the contribution is not at the right amount, the unfunded liability is growing.
- Understand fiduciary responsibilities.
- Update, annually, information on Board rules and legal requirements.
- Establish a standing governance committee to self-assess duties, skills, oversight, integrity, and characteristics of Board members. Provide consistent training for new members. Re-evaluate the committee structure. Appoint a compliance officer role.
- SDCERS' legal counsel reporting directly to the Board rather than head administrator. There should be many direct sources of information to the Board.
- Autonomy from the City. This is achieved by steps.
- Eliminate the use of "reserves" to fund benefits to the extent possible.
- Review treatment of disability benefit payments in connection with the Corbett Settlement. (Impacts 150 people.)
- Consider hiring employees without prior involvement with the City so there are no existing relationships.
- Consider expanding the number of internal audit tests..
- Retiree Health issues.

Navigant offered to return to discuss the report, as it is long and needs to be read and studied first. They said that they can continue to be engaged, if the Board wishes to add: Vinson & Elkin Report, Brown & Armstrong, KPMG, Kroll. Data was limited from the last week of the pre-trial in progress.

#### LEGAL ANALYSIS

Bruce Ashton, relied on Navigant's findings. He said that members have the right to an adequately funded and actuarial sound system. Ashton did not attempt

to address criminal issues, not conflict of interest, or impact of conflict of interest, or validity of benefits; those were for the courts to decide. He said there were wrong-doings and individuals on previous Boards made bad decisions. Navigant can help the Board do better in the future.

#### LEGAL CONCLUSIONS

(page 9 of the legal section):

Basically there were violations of funding laws, violations of the Board's fiduciary responsibilities, violations of the IRS tax-qualifications and violations of Grissom's obligation to determine and present facts to the Board.

"Funding arrangements agreed to by the Board in 1996 and 2002, in MPI and MP2,... failed to assure the 'competency' of the Retirement System assets as required by the state Constitution."

They "...violated the contract clauses of the state and federal Constitutions...."

They "...violated the state Constitution's restriction on political interference in the administration and funding of SDCERS."

They violated State Constitution, Government Code, City Charter and Municipal Code.

SDCERS failed to "conduct an proper investigation of relevant facts", "determine long term funding", "adequately supervise and monitor the SDCERS staff and experts", "assess the concerns expressed by their fellow board members and their experts", "obtain opinions from the System actuary on the ...long-term impact of the proposals."

Board engaged "in activities beyond the scope of its responsibilities" and violated the "intent of Prop. 162 by entering into a contract that coupled increased benefits with reductions in funding."

Board did not "determine the proper timing of the owed amount, how the liability will be satisfied, and if appropriate, secured."

SDCERS subject "to potential disqualification as a tax-qualified plan" due to MPI, MP2, Corbett Settlement, Presidential Leave Benefit, and SDCERS paying directly for health benefits program rather than the City.

"Larry Grissom had an obligation to determine facts and circumstances of special benefits being given to board members and failed in his legal duty to fully disclose this information to the Board."

#### LEGAL RECOMMENDATIONS

(page 124 of the legal section of Navigant's report):

Formal fiduciary training for Board members so they understand funding of the plan.

A written report each year discussing "actuarial requirements under each of the Constitution, State and Municipal law" and if each of those laws were complied with for the preceding year", delivered to an open session SDCERS Board (with comments by the actuary), a copy to the Mayor, Council and posted on SDCERS website.

The formal annual bill for City's "actuarially funded contribution (ARC)" be submitted by January 31st of each year.

Discussion of possible Municipal Code and Charter changes regarding the Board.

SDCERS General Counsel should report directly to the Board and not the head administrator. Concerns about potential political pressure of City Attorney on SDCERS actuary.

Essential for Board to know if benefits are legal in order to determine payments.

"Board should analyze, with the assistance of its actuary and independent counsel, the best way to recoup" shortfalls in funding and what to do in case of City bankruptcy. Consider asking the City for security on the shortfall.

Work with IRS' remedial correction program to retroactively correct tax qualification issues. Add items to the pending corrections.

#### BOARD RESPONSE TO NAVIGANT:

President Prevolos indicated that this report is not the end, but the beginning of the journey.

Prevolos gave his personal opinion on PROP 162(eliminating political control of public retirement boards). He said that it was important for Mayor Sanders not to make this political, in order to do what he wants. He requested that the Mayor not set a bad precedent, criticize the SDCERS Board and set up MP 3. Prevolos supports the Mayor and will resign as he was requested, just not right now!

In his view, Prevolos, saw the underfunding of MP 1 and MP 2 as City interference and the sacrifice of members to the City's interests. He would keep going to protect the tax payers. Projects that he has started, needed to be completed before he resignations. He invited other Board members to stay.

Sullivan (police representative) was disappointed that there was no criminality review. He said that who declined to be interviewed, speaks volumes. He wondered if Navigant had an opinion of the City placing individuals into dual

roles: such as SDCERS' former City Manager representative (Cathy Lexin) who was asked to represent the City in negotiating with unions while sitting on the SDCERS Board, and the former City Auditor representative (Terri Webster, who reviewed City and SDCERS numbers). Bruce Ashton, Navigant's legal counsel, responded that yes, there was a serious conflict and it was difficult to deal with.

Sullivan asked if some board members were not adequately informed on the impact of their vote on MP 2? Navigant's Steve Stanton replied that the information was there, but probably they did not have enough information to understand the implications, but enough to ask questions.

Meyer asked if there were any people directing, at any time, the outcome of this investigation. Navigant replied, no.

Meyer asked if any one, or agency, not help in a significant way? Stanton said it would have been nice to talk with Vinson & Elkin. Ashton said V & E indicated that they needed a release from the City, as a client. As far as Ashton knew, no permission was given.

Prevolos inquired about the temperament of the meeting with Aguirre? Navigant said they spent about 15 minutes with Aguirre, who provided a list of items to consider, some outside of Navigant's investigation. They spoke with others in the City Attorney's office for 1 ½ hours.

Hebrank asked if they used old Board meetings? Navigant responded that they also used minutes, interviews of previous Board members, and e-mails.

Hebrank asked if the previous Board really believed in the 8% return on SDCERS investments? Navigant said a lot of people believed in 8% returns, but Navigant could not say what was in the Board members' heads.

When Hebrank asked if the Board was independent? Stanton replied that SDCERS is getting there. It is a state of mind. It confusing, however, when SDCERS uses City staff. He added that many people think that this is a City department. Hebrank asked if the independence was in the Bylaws? Ashton said yes, you can sue and be sued.

Hebrank asked if the City of SDCERS could use the "reserves"? The answer- It is your operation to run as you please, but it is based on the source of the reserve, was it City or SDCERS? Stanton added that the reliance on surplus earnings is not good and not an appropriate action. Reserves were rationalizations. It is hard to believe that staff or the Board could understand reserves. The City may have participated in discussions, but SDCERS set them up. Some reserves are legal, some are discretions, recommend that in the future make sure that there is economic substance to having reserves.

Flynn asked if Board member had the same, or different information? Stanton answered that the Board members had the same information, and if they were not at the meetings then they had the monthly Board packets, but there was little financial implications on MPI and more on MP 2 and that the Board had failed to exercise proper oversight.

Murray blamed Wall Streets' sentiment that there was no stopping the stock market in 1996. He also noted the republican convention. When in a fiduciary capacity, a trustees always want more, he added. This is where "compassionate stupidity" comes in, he ended.

## WAIVING NAVIGANT WORK PAPERS AND FUTURE PLANS

Board voted to waive attorney client privilege on work papers.

Preovolos had no comment on the unread report. He said the unread report, the Pension Reform Committee report, Operational reviews, etc. will be used to guide SDCERS. Adjourned for lunch.

## AFTERNOON SESSION 1:30p.m.

### NON-AGENDA SPEAKERS

Four more speakers in favor of indemnification of Lori Chapin. One reference to Aguirre and his well-connected friends' political and financial assault for control of SDCERS funds.

April Boling, Chair of the Pension Reform Committee, spoke about not growing the deficit. She was concerned that the "real bill" be given to the City. She asked that SDCERS administrative overhead no longer come out of return on the investments, only investment costs should come out of the returns. Either include the 13th check and Corbett in the annual funded ratio or adjust the rate of return. Don't adopt any sort of negative amortization, the City needs to start paying off interest annually. How did SDCERS ever come to the current interpretation of City codes regarding the 50-50 split? The Board should resolve this with the actuary, she recommended.

Mike Conger, Attorney for retirees, said that the Gleason Settlement does not prohibit changes in amortization.

Judy Italiano referred to 500 letters of thanks from MEA member to the Board.

Ann Smith argued that Aguirre wants to re-constitute the Board to change SDCERS' view of its litigation. And he had told the judge that a new Board would be in place in February with a different attitude to his being SDCERS' attorney. She recommended reading the Prop. 162 voter education booklet to clarify understanding of Prop.162.

Ann said the testimony she is hearing in court recently is different than the Navigant report. The soul of the City to some extent is hanging in the balance as we scapegoat a few people when many people had a role. Example: the City Council had seven lawyers in Closed Session in the fiscal failure of the City. She explained that Rob Butterfield had explained why Presidential Leave is not an IRS tax qualification problem.

Sullivan pursued his questions regarding the increased percent that the City is putting aside from employees checks (to pay off a mechanism to add funds to SDCERS, otherwise that money is to be returned to the employees). Ann said that on July 1, 2005, that employees picked up 3% of what the City was paying, of what would be a 50/50 split. On July 1, 2006, another 1% will be picked up by employees. Ann added that the money is entrusted to the City auditor, not to be spent. The City has always picked up the retrospective costs of benefit increases, and the 50/50 split only covers forward costs of benefit increases. Preovolos announced this item would be put on the February agenda.

## DISABILITY

In December, a new committee was formed for disability approval. This Disability Committee met January 6, 2006 at 10:00a.m. They will meet again February 3, 2006 at 10:00a.m.

## DROP DISTRIBUTION SCHEDULES SELECTED BY RETIREES

By tremendous effort, SDCERS' staff have processed 568 DROP retirees' distribution selections. There are 17 that have complications and 5 have not responded, so their funds are being held for roll-over or lump-sum distribution.

## INTERVIEWS FOR RETIREMENT ADMINISTRATOR

No recommendation at present. There were few candidates that the Board felt were qualified.

Gary Findlay, Missouri State Employees Retirement System, was the favored candidate and he declined, but sent a letter to the Board on the situation as he saw it and also the areas a retirement administrator can't fix. Prevolos read his letter aloud. Findlay listed:

- City Attorney appears to want seats on both sides of the legal table.
- Loyalty of Sander's replacements to the Board would be questioned.
- Influence peddling persists, deflecting blame, instead of solving problems.
- If power brokers do not get their way, the Board will face on-going legal challenges to no avail.
- Less than arm's length between the City government and the Board.
- Unions and management need to re-design the plan. Benefits need to be examined.
- Responsible funding plan.
- Review and modify legal documents, as well as investments and actuarial assumptions.
- System actuary to provide needed expense flow.
- Citizen group to witness progress on problems.
- Some areas need independence.
- Establish a business model of who is responsible for what.

Sheffler wondered if Findlay would come if the current Board did not resign, and Aguirre was not its attorney.

(Some of these recommendations would require changes in the Municipal Code or Charter.)

## INTERIM GENERAL COUNSEL

Thomson requested notice for February's agenda for out of class pay for Roxanne Parks, who formerly worked under Lori Chapin. This was referred to outside counsel as Parks would be in conflict of interest. Will be discussed in a future Closed Session.

Parks will be reporting to the Board exclusively and not to SDCERS administration.

An RFP is out for a General Counsel. January Closed Session agenda shows discipline/dismissal/release of general counsel.

In February, Parks will update the Board on the IRS' private letter ruling on purchase of service.

Updating of court dates per Trustee packet (check before you go down):  
SD Police Officer's Assoc. vs. Aguirre, et al.

Hearing Feb. 6, 2006, 10:30 Court 13- Federal Court, Judge Marilyn Huff  
SDCERS asking to be dismissed.

People of the State of California vs. Lawrence Grissom, et al.

Demurrer and motion to strike to be heard on Feb. 17, 2006 at 10:30a.m.  
Judge Steven Denton, Case Management conference also scheduled for Feb.  
17, 2006.

#### BOARD COMMENTS

Prevolos shared his thoughts:

He is concerned about taking on the expenses of environmental issues, if the City gives (contaminated) property in lieu of cash. Would this be a breach of fiduciary responsibility? Referred to attorneys.

The votes, against indemnification, affects staff morale.

Restore integrity to the Board.

Train Board members in fiduciary responsibilities. Draft a document/agreement of full responsibility for trustees to sign in the future.

Amend Board Rules per Navigant's recommendation.

Bill the City for their real contribution to SDCERS, with no room for negotiating a lower amount.

Work with the City ethics commission to establish ethical rules and standards for Board and staff.

Use the Navigant Report as a plan for change.

Sheffler wanted to see that changes, of the amortization schedule in the Gleason Settlement, were taken to the City Council for approval.

#### COMMITTEE TO USE NAVIGANT REPORT AS GAME PLAN

Chair: Mark Sullivan; Kipperman, and Hebrank. It ultimately will merge with Sheffler's audit committee.

SPECIAL FULL BOARD MEETING to review Navigant Report on January 30th at SDCERS.