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March 29, 2007

Council President Scott Peters
The City of San Diego
202 C Street, MS #10A
San Diego, CA 92101

Re: Item 203, City Council Meeting of March 5, 2007, Proposal to Eliminate the Concept of the "Waterfall" ("Waterfall Ordinance")

Dear Council President Peters:

I am writing on behalf of the San Diego City Employees' Retirement System ("SDCERS") to express our concern about the wording of the above-referenced proposed Waterfall Ordinance that was considered by the Council on March 5, 2007. While our actuary supports the elimination of the surplus earnings concept upon which the "Waterfall" is based and has reflected the associated "contingent liabilities" in the June 30, 2006 SDCERS valuation liabilities, the wording of the proposed ordinance would result in SDCERS' *inability to pay* the annual supplemental benefit (13th check) and the *Corbett* settlement amounts.

1. **Annual Supplemental Benefit (13th Check)**

SDMC section 24.1503(a) sets out the criteria SDCERS must use to determine who is a "Qualified Retiree" eligible to receive the 13th Check, and section 24.1503(b) provides the process SDCERS must use to determine the amount of the benefit to be paid to a Qualified Retiree each year:

- (1) identify all the Qualified Retirees on the payroll in October, then
- (2) determine the number of years of service credit each identified Qualified Retiree has, then

- (3) add the years of service credit for all identified Qualified Retirees together to determine the sum of the "Qualified Creditable Years," then
- (4) divide the Surplus Undistributed Earnings by the Qualified Creditable Years.

The outcome of steps (1) through (4) is the "per annum dollar value for each creditable year," (SDMC 24.1503(b)), subject to specified caps (which differ depending on the year the member retired). The Waterfall Ordinance removes step (4) above, thus eliminating from the Municipal Code all direction on how to determine the value of each creditable year that is needed to determine the benefit amount to be paid. Absent such direction, SDCERS *cannot determine or pay* this benefit.

The Waterfall Ordinance also removes the statement that no annual supplemental benefit will be paid in a fiscal year in which there is less than \$100,000 to pay them (pursuant to the formula that is now being removed). (See SDMC § 24.1502(a)(6)).

Deputy City Attorney Gersten told the Council on March 5 that SDCERS has the authority "to determine when the benefits should be paid," regardless of whether the plan describes how and when the benefit is to be paid. Later during the Council meeting, the City Attorney told the Council that once the concept of Surplus Undistributed Earnings is removed from the plan:

"Then that means that SDCERS has to administer the pension plan based upon fiduciary duties that are set forth in the state constitution and the fundamental principles of fiduciary law, which governs the operation of any trust.

And that means that they're going to have to figure out how to deal with it [the 13th Check]. It doesn't mean that the benefits aren't going to be paid. It just means that the way in which they're going to be paid is left up to CERS."

These statements of the law are incorrect. SDCERS operates the City's retirement plan as a tax-qualified governmental plan under Internal Revenue Code section 401(a), which requires that a defined benefit plan provide an express formula for calculating each benefit to be paid to each member or beneficiary. (IRC section 401(a); Rev. Rul. 74-385; Treas. Reg. § 1.401-1(b)(1)(i).) The SDCERS Board has confirmed its duty to administer

the plan in compliance with federal tax law and with the express terms of the plan document, as set forth in SDMC Chapter 2, Article 4, and will not administer benefits that have not been enacted by Council ordinance as required by City Charter sections 143.1 and 146. (Board Resolutions 06-05, 07-01, attached).

Therefore, contrary to the City Attorney's representations, the Municipal Code cannot simply "leave up to SDCERS" the specifics of when the benefit will be paid and how the benefit amount will be determined. If the Waterfall Ordinance is adopted as currently drafted, SDCERS could not pay the 13th Check without jeopardizing the plan's tax-qualified status, which we will not do.

In further accord with this view is Judge Barton's decision in the *SDCERS v. Aguirre* litigation. At Page 28 of his Statement of Decision, Judge Barton observed that:

"The evidence and the City Charter and California Constitution define the duties and responsibilities of SDCERS. It is the administrative body for the pension system created by the City (cit. omitted). SDCERS' responsibility is to administer the system and pay the benefits the City sets. It invests the pension assets and provides annual accountings. It does not set benefits and has no power to either set or rescind benefits. The power to create or modify benefits rests with the City."

By placing SDCERS in the position of determining when benefits should be paid and to whom, the position of the City Attorney's office would result in the usurpation of the City's sole authority either to set, modify or rescind benefits.

2. **Corbett Settlement – 7% Increase**

By striking section 24.1502(a)(7), the Waterfall Ordinance removes the only authority in the Municipal Code that allows SDCERS to pay the 7% increase to retirees and beneficiaries covered by the *Corbett* Settlement Agreement. On March 5, Deputy City Attorney Gersten told the City Council that the Waterfall Ordinance merely eliminates the waterfall as a funding source for this benefit, and that it does not affect the *Corbett* benefits because "the benefits are actually payable pursuant to the [*Corbett*] settlement agreement."

This is incorrect. The authority to pay the benefit *must* be in the Municipal Code, the governing plan document. The Waterfall Ordinance would remove the only reference in the Municipal Code to the *Corbett* Settlement Agreement, therefore eliminating the argument that the settlement agreement is incorporated by reference.

Later in the March 5 Council meeting, the City Attorney suggested that the *Corbett* benefit is non-contingent, and with the removal of the waterfall, would be paid every year. In reality, the Waterfall Ordinance would have the exact opposite effect. The removal of the only authority in the City's Plan document that directs payment of the 7% *Corbett* increase would prevent SDCERS from paying the increase going forward, as such a payment would no longer be authorized by the plan document. Again, SDCERS would jeopardize its status as a qualified plan if it made distributions that were not specifically described in its governing plan document, and we will not do so.

3. Supplemental COLA

By eliminating the concept of "surplus earnings," the Waterfall Ordinance would strike from section 24.1504(c)(3) the basis for determining when the Board credits interest to the reserve used to pay for the Supplemental COLA benefit. All that would be left is an instruction that the reserve be credited with interest annually "if sufficient funds are available." As such, if the ordinance is adopted there would be neither a specified source from which to credit the reserve nor a methodology to determine the amount of the credit. Unless an alternative source of funding and methodology is identified in the ordinance, no further amounts will be credited to the reserve for the supplemental COLA and upon the depletion of the reserve no further supplemental COLA payments could be made.

4. Employee Contribution Rate Reserve

The Waterfall Ordinance would strike from section 24.1507(c) the basis for determining when sufficient funds are available to credit the Employee Contribution Rate Reserve. As a practical matter, this has no effect on SDCERS as this reserve no longer exists. Section 24.1507 could be stricken in its entirety.

5. Summary

In summary, absent significant changes in the Waterfall Ordinance, effective with its enactment SDCERS would lack the authority under the Municipal Code, which constitutes our governing plan document, to pay either the Annual Supplemental Benefit (13th Check) or the *Corbett* settlement-7% increase. Further, SDCERS will lack authority to credit any amount to the reserve for the supplemental COLA. Upon depletion of that reserve, no further supplemental COLA payments could be made.

With substantial revisions, the Waterfall Ordinance can be amended to achieve the results that are being sought by City without creating the myriad of problems that would result from the enactment of the ordinance in its present form. We would be pleased to work on the necessary language with the appropriate City representatives.

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I understand that the proposed ordinance has been calendared for the Council meeting on April 9. Please do not hesitate to contact me with any questions concerning the above matters.

Sincerely,



Christopher W. Waddell
General Counsel
SDCERS

Attachments

cc: Honorable Mayor Jerry Sanders
Honorable Councilmembers
Ronne Froman, Chief Operating Officer
Jay Goldstone, Chief Financial Officer
Andrea Tevlin, Independent Budget Analyst
Peter Preovolos, SDCERS Board President
SDCERS Board Members
David Wescoe, SDCERS Retirement Administrator

BOARD RESOLUTION NO. R 06-05

ADOPTED ON July 21, 2006

**A RESOLUTION OF THE BOARD OF ADMINISTRATION FOR THE
SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM
REQUIRING ALL AMENDMENTS TO CITY RETIREMENT PLAN
BE ENACTED BY ORDINANCE SPECIFICALLY DESCRIBING
THE BENEFITS SDCERS IS TO ADMINISTER**

WHEREAS, the San Diego City Employees' Retirement System (SDCERS) was created by ordinance pursuant to Section 141 of the Charter for the City of San Diego ("Charter"); and

WHEREAS, Charter section 141 empowers the City Council to establish, by ordinance, the retirement benefits for City employees participating in SDCERS; and

WHEREAS, Charter section 143.1 provides that no ordinance affecting the benefits of any City employee participating in SDCERS may be adopted without the approval of a majority vote of the City members; and

WHEREAS, Charter section 143.1 also provides that no ordinance affecting the vested defined benefits of any City retiree may be adopted without the approval of a majority vote of the affected retirees; and

WHEREAS, SDCERS has historically conducted the membership elections required by Charter section 143.1; and

WHEREAS, under Charter section 144, the SDCERS Board of Administration (Board) has the sole authority to manage SDCERS, invest the SDCERS Trust Fund, and determine the rights to benefits under SDCERS that have been established by the Council by ordinance; and

WHEREAS, under federal tax law, SDCERS must satisfy the "definitely determinable requirement," such that the benefits for each participant can be computed as expressly provided in the plan, as contained in Chapter 2, Article 4 of the San Diego Municipal Code (SDMC); and

WHEREAS, in order for SDCERS to properly administer the retirement benefits established by the City for its employees, and to satisfy its duties under federal tax law, all retirement benefit changes affecting City employees must be enacted by ordinance amending SDMC Chapter 2, Article 4; and

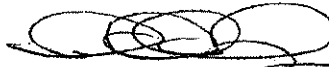
WHEREAS, in order for SDCERS to properly administer the retirement benefits established by the City for its employees, and to satisfy its duties under federal tax law, all such ordinances must clearly describe each amendment to the plan, identify the employees covered by each amendment, and provide the effective date of each amendment; and

WHEREAS, in order for SDCERS to properly administer the retirement benefits established by the City for its employees, and to conduct elections required by Charter section 143.1, SDCERS must receive advance notice from the City Council before any such ordinance is docketed for introduction; and

NOW, THEREFORE, BE IT RESOLVED, that the Board will administer the retirement benefits of City employees and retirees in accordance with the terms of the City's retirement plan, as set forth in SDMC Chapter 2, Article 4, and will not implement any benefit changes that have not been enacted by an ordinance amending the plan and, where required, a majority vote of the SDCERS membership; and

BE IT FURTHER RESOLVED that the Board hereby requests the City Council to provide the Retirement Administrator written notice before any ordinance amending the benefits under SDMC Chapter 2, Article 4 is placed on the City Council docket for introduction.

ADOPTED: July 21, 2006



Peter E. Prevolos, President
Board of Administration, San Diego City
Employees' Retirement System

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**BOARD OF ADMINISTRATION
SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM**

RESOLUTION NO. 07-01

ADOPTED ON FEBRUARY 16, 2007

A RESOLUTION OF THE BOARD OF ADMINISTRATION OF THE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM APPROVING THE AMENDED TECHNICAL TAX COMPLIANCE ORDINANCE TO BE SUBMITTED TO THE INTERNAL REVENUE SERVICE WITH THE TAX DETERMINATION AND VOLUNTARY CORRECTION PROGRAM APPLICATIONS

WHEREAS, the City Council has the sole authority to establish and define the terms and conditions of the retirement benefits available under the San Diego City Employees' Retirement System (SDCERS) through the promulgation of general ordinances; and

WHEREAS, the Board of Administration for SDCERS (the Board) has the sole authority to administer SDCERS, invest its Trust Fund and determine the eligibility for the right to collect benefits under the ordinances enacted by the City Council; and

WHEREAS, the Board has consistently and continuously administered SDCERS as a qualified governmental plan under the Internal Revenue Code (IRC) since inception; and

WHEREAS, the Board has never obtained a Tax Determination Letter (TDL) confirming its qualified status from the Internal Revenue Service (IRS); and

WHEREAS, although a TDL is not required for public retirement plans to qualify for tax-favored status, it is a prudent practice because it ensures preservation of a retirement plan's qualified status; and

WHEREAS, upon the advice of its tax counsel, the Board unanimously approved the filing of an application for a TDL on April 15, 2005; and

WHEREAS, SDCERS staff and Tax Counsel worked together to prepare a Technical Tax Compliance Ordinance to amend the San Diego Municipal Code (SDMC) to add specific references to the IRC; and

WHEREAS, in May 2005, the Board adopted Resolution 05-01 approving the submittal to the City Council of a Technical Tax Compliance Ordinance amending section 24.1010 of the San Diego Municipal Code (SDMC) to add a "Guidepost Section," setting forth the IRC provisions with which SDCERS must comply; and

WHEREAS, Resolution 05-01 also confirmed the Board's intention to administer the SDCERS plan in accordance with the Technical Tax Compliance Ordinance, pending its adoption by the City Council; and

WHEREAS, the SDCERS staff forwarded the proposed Technical Tax Compliance Ordinance to the City in May 2005 for placement on the Council Docket for action; and

WHEREAS the City Charter requires the City Attorney's approval of an ordinance before the Council may act upon it; and

WHEREAS, on June 6, 2005, Councilmember Donna Frye sent a Memorandum to the City Attorney requesting that he review the proposed Technical Tax Compliance Ordinance "as soon as possible"; and

WHEREAS, the proposed Technical Tax Compliance Ordinance has never been placed on the Council Docket for action; and

WHEREAS, SDCERS filed its application for a TDL from the IRS on July 12, 2005; and

WHEREAS, the passage of the Pension Protection Act of 2006 required amendments to the proposed Technical Tax Compliance Ordinance; and

WHEREAS, the necessary changes have been made to the attached revised Technical Tax Compliance Ordinance; and

WHEREAS, it is now necessary to provide the attached revised Technical Tax Compliance Ordinance to the City with a request that it be docketed as soon as possible; and

WHEREAS, the proposed tax amendments contained in the revised Technical Tax Compliance Ordinance are crucial to SDCERS' ability to obtain a TDL for the City's retirement plan; and

WHEREAS, one purpose of this Board Resolution is to indicate that the Board intends to administer the SDCERS plan in accordance with the revised Technical Tax Compliance Ordinance, pending its adoption by the City Council; and

WHEREAS, the concept of temporarily administering a plan in accordance with tax law requirements before the Council adopts a formal plan amendment is an accepted concept by the IRS; and

WHEREAS, in July 2004, the City of San Diego ("City") and the Board of Administration ("Board") for the San Diego City Employees' Retirement System ("SDCERS"), entered into a settlement of the following lawsuits: *Gleason v. San Diego City Employees' Retirement System, et al.*, San Diego Superior Court Case No. GIC 803779, a class action lawsuit; *Gleason v. San Diego City Employees' Retirement System*, San Diego Superior Court Case No. GIC 810837; and *Wiseman v. Board of Administration for the San Diego City Employees' Retirement System*, San Diego Superior Court Case No. GIC 811756 (collectively, "the Gleason Actions"); and

WHEREAS, the Settlement Agreement in the Gleason Actions requires the City, within 120 days of the Court's entry of a final order approving the Settlement Agreement on July 26, 2004, to "repeal those portions of the San Diego Municipal Code section 24.0801 enacted November 18, 2002, which specify the rates the City pays [to the Retirement Fund on behalf of City employees] are as agreed to in the governing Memorandum of Understanding between the City and SDCERS"; and

WHEREAS, in July 2004, the City Attorney's Office prepared an ordinance to amend San Diego Municipal Code section 24.0801 pursuant to the Gleason Settlement Agreement ("Gleason Ordinance"), but it was never placed on the Council Docket for action; and

WHEREAS, the 120-day period to amend section 24.0801 expired on November 24, 2004; and

WHEREAS, on May 20, 2005, the SDCERS Board adopted a Resolution directing SDCERS staff to work with the City to have the Gleason Ordinance placed on the Council Docket; and

WHEREAS, the proposed Gleason Ordinance was never placed on the Council Docket for action; and

WHEREAS, Municipal Code section 24.0801 must be amended to conform to the Gleason Settlement Agreement; and

WHEREAS, section 24.0801 must also be amended to remove the provision stating that the portion of the City's employer contribution that the City "designates for the 401(h) Fund or the Health Trust, to be used for retiree health benefits under Division 12, is not a deficiency within the meaning of this section," because: (1) the City no longer funds these benefits from a 401(h) or Health Trust Fund, and (2) SDCERS has been advised by its Tax Counsel that Retirement Trust Funds may not be used to pay retiree health benefits; and

WHEREAS, the attached Ordinance will not affect any SDCERS-administered benefits for active or retired members of SDCERS, and thus no vote is required under Charter section 143.1; and

WHEREAS, it is now necessary and appropriate to amend the SDMC to provide for the above-recited changes; NOW, THEREFORE,

BE IT RESOLVED, the Board will continue to administer SDCERS as a qualified governmental plan under IRC section 401(a); and

BE IT FURTHER RESOLVED, the Board intends to administer the SDCERS plan in accordance with the attached Ordinance, pending its adoption by the City Council; and

BE IT FURTHER RESOLVED, the Board directs SDCERS staff to work with the appropriate employees and officials of the City of San Diego to have the City Council adopt the attached Ordinance; and

BE IT FURTHER RESOLVED, the attached Ordinance will be submitted to the Internal Revenue Service for its review as part of the TDL application filed by the Board.

ADOPTED: February 16, 2007



Peter E. Prevolos, President
Board of Administration, SDCERS

ATTEST:



David B. Wescoe
Retirement Administrator

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