

## Patti's Notes

SDCERS BOARD MEETING March 17, 2006

(Notes are my understanding of what happened. Some information is from SDCERS' monthly Board packets available at the back of SDCERS' meeting room, and at the SDCERS' reception desk.)

Present: Prevolos, Lamberth, Sullivan, Murray, Flynn, Hebrank, Meyer, Thomson, Sheffler. Kipperman was not present.

General Counsel: Roxanne Story Parks

Outside Counsel: Harvey Leiderman of Steefel, Levitt and Weiss

MORNING SESSION 8:30A.M.

OPERATIONS

GENERAL BOARD MEMBER REPRESENTATIVE ELECTED

Franklin Lamberth received 490 votes. Dennis James Boisvert received 410 votes.

COMMITTEE ASSIGNMENTS

Audit- Kipperman, Sheffler, Flynn

Litigation- Prevolos, Meyer, Sullivan

Health (HAC)- Flynn, Casey, Thomson, Meyer

Proxy- Sullivan, Meyer

Navigant Report- Sullivan, Kipperman, Hebrank, Sheffler

Disability- Sheffler, Sullivan, Meyer, Hebrank, Prevolos

BOARD MEMBER ENTERS DROP

John Thomson, Jr., Fire-Rescue Department, entered Drop.

NEW AUDIT COMMITTEE

(Proposed by Prevolos at the February 2006 Board Meeting.)

Purpose: To facilitate the outside independent audit process, as well as, conduct internal and external audits of, and for SDCERS. Reduce workload for Board.

Structure: 2 current SDCERS Board members

3 independent outside advisors.

Nominations: Board members' recommendations would be reviewed by the Executive Committee, or its successor and approved by a majority vote of the full Board.

Qualifications of independent outside advisors: The Board voted to reduce requirements from those required to be a SDCERS trustee. The qualifications still call for a College degree or other relevant professional degree or certification, minimum of 15 years of total experience in pension administration, pension actuarial practice, investment management, real estate, banking, accounting, law, or combination. The Boards' intent was to broaden the scope of education that would qualify.

Term and Limits: Serve 2 year terms, not to exceed 2 consecutive terms, or until a successor is appointed.

Responsibilities: Facilitate annual independent audit of SDCERS' financial statements and any other internal and external audits of, or for, SDCERS. Review and refer all audit results and Committee recommendations to the full Board for further action. Initiate the development, issuance and timing of RFP (Requests for Proposals) for selecting outside auditors, review RFPs before issuance, oversee the selection process and recommend candidate finalists to the full Board for further action. Ensure the adequacy of internal controls, subject to appropriate Board action. Perform other duties as directed by Board.

Discussion:

Thomson asked who would "vet" these outside advisors and pay for the vetting. Prevolos added that an interviewing panel would be needed. When Meyer inquired into training costs and reimbursement for legal counsel, Sullivan replied that those issues would be brought to the full Board.

Meyer asked what criteria and process would be used to remove outside advisors, if it became necessary. Outside counsel, Harvey Leiderman suggested adding "serving at the will and pleasure of the Board, etc." Would there be a problem with indemnification? asked Meyer. Harvey advised that the Board is limited in providing indemnification, but could use insurance coverage, which is different from the Board's and employees' indemnification.

Flynn noted that it was like adding three more members to the Board, making the total 16, instead of the current 13. Hebrank found it positive to have three more people from the outside with Sarbanes-Oxley's impact. (SDCERS' Board has tried to go with Sarbanes-Oxley, even though it was designed for private businesses.)

Prevolos repeated his February comments that this offers a first time for taxpayers to have a window to what is going on at SDCERS. He said he has received impressive resumes from those interested. Vote 8-1 (Thomson).

#### MUNICIPAL CODE AND ORDINANCE CHANGES IRS' VOLUNTARY CORRECTION PROGRAM (VCP) TAX DETERMINATION LETTER (TDL)

Voluntary Correction Program filed July 12, 2005. Operational review is underway. Tax counsel was here December 6-8 and will be here again March 21-23 to work on operational compliance of the TDL and VCP. All divisions of SDCERS' staff are participating in this project.

Parks delivered information on needed changes to the Municipal Code and ordinances to the Mayor's office. These changes are most important, according to tax attorney Ice Miller.

Municipal Code Amendments:

1. Tax Compliance Ordinance (Technical amendments to confirm SDCERS' compliance with key tax laws.)
2. Domestic Partner Ordinance (To comply with State law.)
3. Gleason Settlement Ordinance (To comply with State law.)
4. Resolution Clarifying Eligibility of Certain Beneficiaries to Corbett Retiree

Benefit.

## 5. Technical Corrections Ordinances.

### UNION PRESIDENTS BENEFIT CALCULATION FOR JUDY ITALIANO, JAMES FARRAR AND GARY COLLINS

These applicants have requested active member DROP benefits.

Retirement calculations have been on hold, for up to 3 years, as tax attorney Ice Miller opined differently from the SDCERS administrator. They disagreed that SDCERS could present and begin retirement benefits for Union Presidents, pending future IRS review.

Steps include:

- An audit report is in process, for the purpose of reviewing union presidents' creditable service records.
- A unique union presidents' salary schedule needs to be created in accordance to the Plan Sponsor's ordinances.
- Forward audited salaries, a confirmation to the CEO and Labor Relations Chief.
- Calculate retirement benefits.
- Board approval of retirement benefits.
- Determine a basis for accepting and crediting monies into DROP accounts.
- Also legal staff will be consulted on possible under/over contributions, as well as, the collection or refund of any monies as requested.

Gary Collins, past president of P.O.A., was already concerned about what is used to calculate the union president benefit and requested that he see what it is used, before it is approved by the Board.

### ANNUAL REQUIRED CONTRIBUTION (ARC)

Gene Kalwarski (FSA, MAAA, EA), of Cheiron, was introduced as one of the nation's leading actuaries. (Sheffler has the same initials, plus more.) Gene briefly used interactive simulation software which he created. He plans to return during the next year to work with the Board on stress-testing the interaction of possible actuarial assumption changes on SDCERS' funding ratio with his lap top.

There was a presentation hand out, "San Diego City Employees' Retirement System, Actuarial Valuation Presentation as of June 30, 2005" presented by Gene and dated March 17, 2006.

However, many of us, beside Don McGrath, who was attending as an individual and not officially from the City Attorney's office, would have liked a handout of each of the Power Point screens that Gene flashed in a quick demonstration, if for no other reason than it was difficult to read the numbers from the back of the room. (It was a very well attended presentation.)

Gene covered the basic plumbing of doing valuations, SDCERS historical trends, and July 1, 2004 and 2005 principal valuation results. He drew the Board's attention to:

- The projected unit credit funding method.
- Future amortization schedule changes:

2006-28%

2007-27%

2008-15%

- Trend of investment returns to go below 8% assumed rate of return.
- Doing away with the concept of "surplus" (nothing to cover the years, such as 2001-4, where earnings are less than 8%).
- Liabilities in excess of 415 benefit limits.
- Possible inclusion of 13th Check and Corbett payments in the unfunded liability.
- Use of book value for asset smoothing.

He wanted the Board to look at the interaction of many assumption changes, and not at pieces individually. Gene was reluctant to speculate on projected numbers and recommended staying with what he described as "the flawed baseline assumptions" until the Board had time to stress test options. He said the real challenge of this system was the investment volatility. He appeared to be working toward a predictable yearly ARC for the City in future years.

Sheffler was concerned that the current 28 year amortization is not covering interest of the unfunded liability. Gene said the Board would have to go to 20 year amortization, instead of the current 28 year amortization, if they wanted the 2006 City's annual payment to cover the interest.

Gene had prepared the ARC according to the legal requirements that included the Gleason Settlement (the City had insisted on keeping the longer amortization, not Gleason).

Hebrank asked the effect of going to a 15 amortization, Gene responded that it would be 6% of payroll. Gene reflected several times on recommending a "rolling" 15 year amortization in the future.

Gene told Sheffler that including the cost of the interest on the UAAL would be 32 or 33% of payroll.

Sheffler said he was concerned that the City's and SDCERS' payroll figures are not reconcilable.

Gene agreed with Sheffler, that in the short term, when systems shut out new hires from retirement benefits, that their contributions to their retirement fund went up.

Gene will work with the Board in developing a definition of "actuarial soundness", as recommended by the Navigant Report, in subsequent meetings.

Harvey Leiderman, outside counsel, said what the Board needed, to do today, was to be sure that the Board is not exposing the system to risk.

Prevolos suggested forming a committee, including representatives from the City as they are a major stakeholder, to study Cheiron's concepts. This committee would co-ordinate with the Navigant Report Committee and report back to the Board. Meyer suggested the Business & Procedures Committee.

Meyer and Gene discussed that it is important to compare actual contributions to the projections of contributions, so the numbers don't get buried. Sheffler and Meyer discussed the annual statements of contributions by members.

Meyer advised the Board not to be seen as co-operating with the City sponsor, as some people are now under indictment as a result of this appearance. In contrast, Prevolos and Murray felt the Board must be in a joint

walk with the City.

Sullivan asked Gene if the UAAL crisis was manageable. Gene felt there was a challenge and need for discipline, SDCERS' good investments would help and he had seen worse survive. Gene told them that Cheiron will work it all out in the future and the UAAL will be much smaller in 30 years.

What a suspenseful atmosphere when Gene finally announced the City's bill was \$162 million. It was less than last year, allowed the UAAL to grow, and used Roeder's figures (the actuary being sued) from June 30, 2004. It didn't count UAAL interest, didn't count contingent benefits, etc.

Gene said, he had only been hired three months ago and there had not been time to do more. He explained that he did what was legally required. A final, written report would follow in the months ahead he added.

Don McGrath asked Gene if he didn't need another 11% (making the total number \$220 million) more from the City, as employer, for the employee and employee pick-up. Didn't the number seem low, asked McGrath. Gene responded that McGrath should expect the UAAL to decrease in the future, but increase next year and the UAAL interest was not included in this bill.

Prevolos thanked Gene for coming up with the numbers a month earlier than April, so the City could have a figure.

SDCERS staff/board seemed unprepared for public and media reaction. There were many questions asked in the reception area outside the meeting room.

## INDEMNIFICATION

Harvey Leiderman, replaced Parks, for the discussion of Grissom and Chapin's 3rd request for indemnification for defense in a Federal criminal proceeding. He said findings must be made for each of the following four points, and none of them can be ignored:

1. Within scope of employment.
2. In interest of members.
3. Good faith/ no malice.
4. Acted in apparent best interest of system.

If it turns out the reason to grant indemnification was incorrect, the Board can go back to Grissom and Chapin for reimbursement.

Sullivan asked if the Board was prepared to vote based on reading the Navigant Report and the indictments. Harvey said that they must be aware of the allegations in order to vote.

### Public Comments:

There were several speakers that were friends of Chapin.

Retired Assistant City Attorney Kaheny advised the Board to think about future employees, "Respect well the people who guard you while you sleep."

Don McGrath asked how much \$2 million, (the estimated cost of two infemnifications) would earn in 20 years?

Attorney Mike Conger pointed out that not all members wanted to pay for Chapin and Grissom's defense. He added that by voting for approval, each Board members would become personally responsible and they could explain their vote

to a jury.

Retiree Dave Wood said it was impossible to know because of secret meetings, and he thought Chapin had malice toward him. How can indemnification be in the best interest of the system, he asked.

Attorney presentation:

Chapin's attorney pleaded that Chapin had recused herself from advising the Board on the MPIO vote. He said that the only thing she had done was not tell the Board about Saathoff's presidential leave benefit, beside, only the City Council could approve the presidential leave benefit. He concluded, noting that the Board should remember that loyalty goes both ways. (Note: The indemnification would give a paycheck to her attorney.)

Discussion:

Sullivan continued to support indemnification, but didn't feel he must go with the best defense that money can buy. He didn't believe that members would support millions of dollars for this "circus", and suggested two safety valves: Control of dollars and acting if there were billing abuses observed.

Harvey said one of the charges was fraudulently concealing information from the Board so it would approve MPIO ( see Indictment, Paragraph 31e) and there was more than just isolated acts as Chapin's attorney and Grissom's attorney were presenting. Harvey pointed out that Grissom's name is listed 8 times in the indictments. Harvey was not encouraging indemnification and argued against Chapin's and Grissom's attorneys' perspective to give the Board balance.

Hebrank believed that MPIO was not in the best interest of the system.

Flynn pointed out that the Board was not bound by City guidelines or private business guidelines. He knew that there was a great divergence of opinion on this issue, and he must balance individuals' and the system's interests. He believed that three more previous Board members will request indemnification if Chapin's and Grissom's indemnification were approved. (Later someone commented that now the Board could save the City millions on indemnification of the former employee trustees, who the City can't muster up enough votes to indemnify.) Flynn could not support the leap from civil to criminal indemnification.

Meyer said that it was not a character issue, sadly to say. The decision came down to what Chapin and Grissom were expected to do: they were directed to work with the City leadership. Could we direct staff to do their job, he asked. He argued that the same Plan documents are still in effect. Any new officers would ask for protection. He did not believe this was to defend criminal acts and he moved for indemnification.

Sheffler said to the best of his knowledge that they pass the four tests. New information could change his opinion, he added. He said that the Board should ask for some collateral. SDCERS needed the best and the brightest new employees. He seconded the motion to indemnify.

Murray found no good in this for retirees, but voted to indemnify anyway.

Thomson planned that if he is sued later, he would need indemnification, so he had better vote to indemnify.

Hebrank asked if it possible to cap the rate at the amount that SDCERS pays Seltzer?

Prevolos found these issues high impact, complex, serious, and precedent setting. He recommended reaching deep, right and fair for this organization and members. If SDCERS fails to have qualified people run this organization in the future it will affect members. He conditioned that legal counselor's hourly rates not to exceed rates paid to SDCERS' outside counsel, that all counsel comply with all billing guidelines of the SDCERS system and include appropriate collateral to be provided by indemnified employees.

Passed 7-2 (Hebrank and Flynn)

#### EXECUTIVE SEARCH FOR RETIREMENT ADMINISTRATOR

Executive Leadership Solutions continues the search. Twenty-one additional applicants have been screened since Gary Findlay rejected the offer of CEO/Retirement Administrator of SDCERS. Executive Leadership said that they now have two more possible interviewees: one is from the public pension industry and the other would come up to speed quickly.

In their report, they said that they will continue to screen applicants. They noted that the situation is even more difficult since the indictment of the former CEO. Qualified individuals have been completely unwilling to consider SDCERS or to make referrals, saying they do not know anyone so foolish to risk a career by getting involved with SDCERS.

CLOSED SESSION (and a brought in lunch) was held later, about 1:30 to 2:30, as the meeting ran late.

NOTE: The Operations Meeting will move back at 1:30p.m. on April 21, 2006.

AFTERNOON SESSION noticed for 1:30P.M.  
FINANCE AND INVESTMENT

Non-agenda comment:

John Casey advised the SDCERS' Board, "Do not trust the City." Samples: City took 21% discount on general members' contributions and 7% on safety members' contributions. City Council use of "surplus earnings" for benefits. He said to have everything in writing and three attorney opinions.

#### FINANCIAL STATEMENTS FOR JANUARY 2006

For seven months, ended Jan. 31, 2006, manager fees were \$4.1 million, Navigant billed for \$2.6 million, and Reish, Luftman was \$700,000 plus.

#### CALLAN CAPITAL MARKET OVERVIEW /ASSET ALLOCATION

Presentation:

Jay, from Callan, presented the financial education. He asked what do we know now, that we didn't know last year, and that causes us to make changes? He said we don't want to overreact. The most dangerous words are: "This time it is different."

Bottom line: Expect low inflation, low interest rate, low return environment.

Inflation was 3.4% last year. Core inflation remains at 2%, if we don't eat or drive. Interest rates will peak in 2006, as a possible repeat of the recession. After subtracting for inflation, the real return on cash invested at 4%, is 1.25%, but there is only 1% increase for taking on long term debt. Long term interest rates have a higher demand, and therefore, are cheaper, but earn less than shorter term interest rates.

Thirty-five percent of all mortgages are interest only. Companies have been using their money to make shareholders better off. There is an entrenched desire to keep the USA's current trade deficit at the current level. We are importing deflation.

Returns, from 60% stocks and 40% bonds, are expected to be 7.4% over the next 5 years. Bond returns are set at 5%, good if there is another recession and interest rates drop. Real Estate returns are expected to be 5%. International investments are no longer such a bargain. At least, one more, good year is left in the economy, until a slowing next year.

Value can be added by active money managers, Jay said. To push up return, push up equity. Alternate sources of return include hedge funds, high yield, etc. Jay added that the only area left, for SDCERS, to allocate is private equity.

Discussion:

Prevolos responded to the "venture capital" pitch. He said that SDCERS wouldn't be able to get capital back out of the investment very easily. Others on the Board were not interested in long term capital investments either, as Callan pushed their concept of super performing venture money managers.

Jay said, yes, there is no return in the early years and capital is tied up in the early years. Jay went on to the idea of re-structuring allocations to TIPS (poor returns in deflationary and rising interest rate environments), commodities, real assets, leverage, etc. Another approach involved complex re-structuring of more risky asset classes and more active management. And finally, Jay offered cutting edge strategies related to the explosive growth of derivatives, as well as, financial engineering to tailor investments.

## WAIVE REAL ESTATE REQUIREMENTS

Due to a fall in returns, the Board approved relaxing their real estate guidelines in order to purchase a property for investment:

- Initial cash return.
- Initial capitalization.
- Total real rate of 5% net.

Prevolos asked why real estate managers were handcuffed, and he would rather broaden guidelines than have monthly exceptions. The Board approved the very modest waive of guidelines and asked staff to return in 90 days with comprehensive approach to more flexible guidelines.

## CUSTODIAL BANK INTERVIEWS- Chaired by Joe Flynn

Sub-committee scheduled for March 23, 2006 to interview the three finalist banks. The banks will make a 30 minute presentation. Joe Flynn expects the sub-committee to have the results at the April Board meeting.

State Street's contract was extended to August 31, 2006.

#### COMMENTS

Lease of space for SDCERS at 4th & B

Prevolos announced that the lease of the SDCERS' current location on 4th floor, plus an executive style upper floor, at the Wells Fargo Bldg expires July 2007. (The high cost of the current location has been the subject of comment. Prevolos only commented that SDCERS did not own its building.)

The Board needs to oversee a new lease. Doug has prepared a list of lease property available and an RFI is in process to find a local firm for tenant representation, or a broker, or an agent to find and close a new lease.

Separation of Port assets

Doug has been exploring a method to do a plan accounting basis to track Port. etc. assets in a multi-employer plan, such as SDCERS.

NOTE: Finance and Investment meeting moves back to 8:30a.m. on April 21, 2006 at 8:30a.m. (Revised 4-06-2006)

*Submitted by Patricia Karnes*