

PATTI'S NOTES

SDCERS BOARD & COMMITTEE MEETINGS and Channel 24.

AUGUST 19TH AND 20TH, 2010

My Notes are by subject. They are my understanding of what happened. I attended the full Board meeting, Investment and Business & Governance Committees.

Thank you to Mark Hovey, SDCERS' CEO, and his staff for checking my facts.

TRUSTEE FRANKLIN LAMBERTH RESIGNING. SDCERS Board President Mark Sullivan announced Franklin, a general employees' representative, is leaving due to increased professional and personal responsibilities which no longer leave time for his thorough focus on SDCERS. Franklin will be recognized at SDCERS' October Board Meeting.

VOTING TO CHANGE A BENEFIT

Definition of MAJORITY Vote:

Challenging the City Attorney's interpretation of "majority", Elaine Reagan clarified that the voting practice of the last 70 years was a simple majority of who had voted, not the majority of all members.

If the change of benefits involved retirees, retirees would be the voting members. Retirees are not voting as this is an active employee issue.

In accordance with the City's proposed ordinance, Active Members will be VOTING TO remove the option to enter DROP for certain current unclassified and unrepresented employees, increase the entry age for DROP for certain groups of current employees, and remove the DROP annuity option for certain groups of current employees. SDCERS is required to hold this election because the City Council imposed a labor agreement by Ordinance that included DROP changes for current employees. The **City Charter Section 143.1 requires that "no ordinance amending the retirement system which affects the benefits of any employee under such retirement shall be adopted without the approval of a majority vote of the members of said system."** So active employees will be voting "all or nothing" on six changes, said SDCERS Board President Mark Sullivan at the Business and Governance Committee.

The Board was concerned that active members understand the consequences of their votes. Eliminating the option to enter DROP for certain categories of employees and to increase the age at which other certain groups of employees could enter DROP will save the City money over time. However, the change to eliminate the annuity option will increase the City's Annual Required Contribution by \$2 to \$9 million over the next 15-30 years.

Trustee Steve Meyer was also concerned about the wider implications of eliminating benefits under contract law. SDCERS' fiduciary counsel responded that member's rights would be strongest under contract law if their plan did not have ability for members to alter the plan.

SDCERS ASSETS:

JULY

Investment staff reported SDCERS **July 31st unaudited market value as reported by the custodial bank as \$4.61 billion.**

SDCERS' CEO Mark Hovey noted July's cash infusion included Annual Required Contributions (ARC) from the City of \$225 million (still owes \$4 million), plus \$12 million from the Port, and \$4 million from the Airport.

JUNE AND MAY

The Executive Summary of Staff Reports says-

The **unaudited market value of net assets as of June 30, 2010** "as reported by the custodial bank was **\$4,162,069,727.**"

May 31st net assets were \$4,237,910,559.

FISCAL YEAR INVESTMENT RETURNS

From SDCERS' new investment consultant, ENNISKNUPP's report entitled "Investment Committee Discussion dated August 18, 2010, Steve Voss, Satya Kumar"

"The market value of the **Total Fund increased \$456.4 million during the fiscal year ending June 30, 2010** - The cumulative result of \$90.7 million in net withdrawals and \$547.1 million in investment earnings." (page 20)

Fiscal year Investment Results (page 19)

2010: 13.1%

2009: negative -19.1%

2008: negative -4.7%

2007: 16.5%

2006: 12.8%

2005: 10.8%

2004: 20.3%

2003: 5.3%

2002: negative -2.4%

2001: negative -1.2%

2000: 14.8%

1999: 9.5%

LONG TERM RETURN TRENDS

ENNISKNUPP, SDCERS' new investment consultant reported SDCERS' 15 year average gross investment return rate of 7.1% and SDCERS' net return rate as 6.7% compounded long term on page 17 of their report titled "Asset Liability Study for the San Diego City Employees' Retirement System" August 19, 2010.

At the Investment Committee, according to Mr. Rowland Davis from ENNISKNUPP, **the City's ARC as a percent of payroll, is 28.3% for Fiscal Year 2010 and 48.8% in Fiscal Year 2018** on page 26 of the above report

Their report showed the results of 1000 different computer investment scenarios. Page 20 has a note that there is a **52% probability of an average 7.75% return to SDCERS in 40 years**. The Board noticed that they had set their assumed rate of return on target.

Then Mr. Davis presented graphs demonstrating how increasing SDCERS' investment risks would counter the City's underfunding. On page 43, SDCERS' risk is reported at 78% allocation at the lower end of the comfort zone. But Trustees responded that they would not be basing investment choices on the basis of funding status (funding ratio). **Trustee Herb Morgan noted SDCERS Board was not interested in shifting to more risk.**

On page 52, "In 26% of the stimulated outcomes, the funded ratio at June 30, 2015 is below 50%. In almost all of these cases the average 15 year employer contribution ratio is over 50% of payroll."

The Board is now requesting clarification from SDCERS staff on **how investment returns are being calculated** so they may compare older data from their previous investment advisor, **Callan's (gross returns)** and newer data from **ENNISKNUPP (net returns)**. Hovey also noted that the actuary and the investment consultants look at the numbers differently.

DERIVATIVES in FINANCIAL STATEMENTS:

Assistant Investment Officer Jamie Hamrick wrote on August 4th that the new GASB 53 rule "...gives financial statement users the information needed to evaluate the inherent risks that derivative instruments potentially can pose...including how their value and cash flow change over time." "...all of SDCERS derivative instruments will be reported as investment derivative instruments, and not as a hedging instrument."

"According to the definition presented within GASB 53, SDCERS has five portfolios that are impacted by this new disclosure statement- PIMCO, TCW/Met West, Rogge, Allianz Convertibles and The Clifton Group."

"SDCERS will be implementing GASB 53 for the first time in FY 2010 CAFR."

SDCERS BUDGET ENDING JUNE 30, 2010

Hovey wrote on August 6th:

"Total budgeted expenditures (Administrative and Investment Management) were \$36.8 million, or **\$1.9 million under budget.**"

Outside legal costs for current litigation was \$1.3 million over budget.

Actuarial costs were \$0.2 million over budget, "...primarily associated with non-retainer work on the substantially equal City Charter language and associated contribution rate work. Savings in salaries, data processing, and disability processing costs were able to offset much of the overruns in legal and actuarial costs."

Hovey noted at the August 19th Business and Governance Committee that the City had made actuarial requests that cost SDCERS between \$50,000 to \$60,000. The City had re-paid SDCERS approximately 80% of the City's bills at this time.

Hovey also pointed out six months of savings from the open Chief Financial Officer

position that is now being filled.

(This next section is long and you may wish to skip to LEGAL below.)

PURCHASE OF SERVICE CREDIT (PSC) "CORRECTION"

Is this a "little thing" of great importance?

This impacts approximately 16% of members. SDCERS needs \$20 to \$30 million dollars to cover under priced PSC contracts. If affected members sued, the cost of a legal settlement with members may exceed the underfunding.

Issues Overview:

(Patti's Note and not part of the SDCERS meetings: The City Council apparently had created a particular purchase of service ordinance about 1996-1997 which SDCERS widely advertised as an opportunity. Perhaps stock market returns from PSC cash were expected to cover the City's share of pension costs, and part of the members' PSC costs, as the City was underfunding SDCERS in order to cope with their structural deficits and political projects.)

Regarding the Fourth District Court of Appeals ruling on June 7, 2010, Hovey reported that SDCERS may not use SDCERS' investment returns to cover the miscalculated part of a member's share of costs for PSC contracts, as that would increase the City's unfunded actuarial liability (UAL).

Meanwhile, members claim detrimental harm if they are charged the "corrected" amount of the PSC contracts.

The IRS does not itself structure the correction plan. That is up to SDCERS. The IRS's function is to approve the proposed plan. Once the plan is developed by SDCERS and approved by the IRS, then SDCERS has 150 days to implement the plan. The City Council may need to complete a corrective PSC Ordinance to meet IRS requirements within this limited time period.

What Happens Next:

Dave Hall, Chair of SDCERS PSC Ad Hoc Correction Committee, announced free parking at an additional stakeholders meeting on Sept. 16, 2010 at the Balboa Park Ballroom from 9:30 AM to Noon.

SDCERS Board may vote on action on October 1, 2010 at 8:30 AM at SDCERS.

(Trustees Mark Sullivan, Steve Meyer and Gregory Bych recused as they fall into this correction.)

Urgency is a factor for those members impacted, as they face issues of serious financial planning and the physical toll of emotional stress. Some retirees would appear to be disqualified from retirement if they have no remaining funds to re-purchase the time they already bought. SDCERS' credibility is at issue for them.

SDCERS is proceeding as quickly and accurately as possible in researching the facts for SDCERS tax attorney firm, Ice Miller, and the IRS.

SDCERS Member Services Director Cynthia Queen was in action at the Board meeting, facilitating members' input to the Board.

The good news from Terry:

SDCERS' tax counsel Ice Miller's Terry A.M. Mumford and Katrina M. Clingerman took notes of members asking for more creative options. Terry said the IRS would be more flexible than the Board originally thought on solving the PSC correction.

The IRS takes into account the obstacles. The solution must be possible legally under State of California laws protecting members, as well as, matching up with the Fourth District Court of Appeals.

Terry said the more facts SDCERS and members present, the easier an IRS will be able to find an agreeable solution allowing SDCERS to remain tax-qualified. All SDCERS members' contributions would remain untaxed until paid out in pensions. There were comments about "grouping members" into various solutions.

Comment:

Impacted members noted that SDCERS did not acknowledge that contracts were under litigation when these irrevocable contracts were signed.

Dick Wilken of AUE heard applause when he questioned the intentions of SDCERS' process that first appeared to lock in a rigid idea of charging members. He urged SDCERS to evaluate the feasibility of pursuing malpractice litigation and recovering some of the shortfall via insurance.

Several other speakers questioned the motivation of a previous SDCERS Board to push members to purchase under-priced contracts.

SDCERS was encouraged to go to the City Council. Members also questioned the City's motivation in allowing this to continue, with interest (not market rate, but SDCERS' 7.75% assumed rate of return) on the unpaid contributions, over three years.

Ann Smith said contracts cannot be "corrected". MEA talked about the contract law a basic between employees and the City.

Jack Canning retired after "15 years of mental brutality" at the City, used his life savings to purchase retirement credits. He would not have the time to keep his retirement. His wife commented "No where in SDCERS duties did it say to harm us." She didn't believe SDCERS could stand up to the political pressures.

Mike Conger noted it was SDCERS actuary Cheiron, whose numbers were the basis of the court decision. Conger suggested that those Trustees who were appointed, ask the Mayor, that if current Trustees make a mistake in voting, would the Mayor back them up with indemnification for previous Boards' mistakes? If, not, then appointed trustees should consider quitting as a group, because trustees don't have enough insurance for the decisions they make.

Joan Raymond of 127 said the Board would be picking members' pockets for the error made by SDCERS and the City.

Another speaker pointed out that there are always "windows". She noted that at the time of this window, SDCERS was under-staffed and months behind in processing PSCs, and why was this window illegal?

An Airport member failed to understand why this is the responsibility of employees.

Another speaker said that employees are hated by communities and threatened by the City, and now the Board is threatening members also. SDCERS should take the blame, another speaker added.

Others noted their financial hardship. One member had used 93% of her retirement savings to purchase time. Another had taken out a second mortgage on her home in order to purchase PSC and wondered if she would lose the house. This was not a short-term impact. There was no time for members to adjust their lives to this loss. If the Board approved charging members or deleting time credited, it would have a detrimental impact on the rest of members' lives.

Board discussion:

Trustee Mark Oemcke asked how "whole" did SDCERS need to become, 100%, 80%? Ice Miller said that the IRS would look at all the circumstances once the voluntary compliance program is filed. Terry stressed that the solution must be really available to SDCERS Board, legally and practically. Legal ramifications may prevent the fund from being made whole.

Trustee Richard Tartre inquired to the consequences of not meeting an IRS approved solution? Terry emphasized that the IRS does not want to take SDCERS to a disqualification on this type of problem.

Hovey said he would tell the City what the members' situations are and ask for City cooperation.

Additional PSC correction information:

Board agenda item VII. # 3. Update on Staff Progress Regarding PSC Correction Measure (by Mark Hovey, dated August 5, 2010, "**Approximate number of contracts requiring correction: 3,650....Approximate number of members with contracts requiring correction: 2,100Members retiring on or after November 20, 2007 that bought PSC at the old rates after August 15, 2003 are subject to correction.**")

Member Service Director, Cynthia Queen, wrote on July 30th that 5,500 letters were sent to members who may be affected by the court decision on PSC out of an approximate total of 19,000 members, including active, retired, continued, and active.

Agenda item VII. #4. **Presentation On Acceptable IRS Correction Method....
POWER POINT PRINT-OUT FROM ICE MILLER, SDCERS' TAX COUNSEL**

Ice Miller Report ...on Correction of PSC Pricing Issues, August 20, 2010
Terry A.M. Mumford and Katrina M. Clingerman

Step 1: "Determine Scope of Issue"

("Actuarial review by Cheiron has identified other instances of PSC underpricing." "Determine extent of correction...." "Very detailed information will be necessary in order to craft a correction....")

Step 2: "Prepare IRS submission for Voluntary Correction Program" (VCP)

("Available for operational failures.")

Options include: "Collect additional contributions from members to fully fund purchases.

Rescind the contract. Modify the contract to reduce the amount of service granted."

"...may identify other options as we proceed.")

("Correction method may require tailoring by group. Deceased members. DROP participants. Disability retirees. Domestic relations orders. Other groups may be identified.")

Set 3: "IRS Review of VCP" ("Any plan amendments or corrective action will be brought back to the Board and/or City for appropriate approval.")

Step 4: "Negotiate and Agree on Compliance Statement with IRS" ("IRS will issue a compliance statement after completing its review of the VCP filings. The Compliance Statement will be presented to the Board for review and approval.")

*"THE IRS WILL NOT TREAT THE PLAN AS FAILING TO MEET QUALIFICATION REQUIREMENTS DUE TO FAILURES COVERED IN COMPLIANCE STATEMENT."
"...must be implemented within 150 days."

Step 5: "Implement Correction as required by Compliance Statement"

Step 6: "Report to IRS that Correction Accomplished"

LEGAL UPDATE-

Closed Session Legal Reporting Out:

Mark Sullivan announced the **SDCERS Board would not be appealing the court decision on the MOU.**

At the Business and Governance Committee, Elaine Reagan noted that **Ron Saathoff was appealing a favorable decision for SDCERS.**

Also there were large data requests from SDCERS for the City Attorney and the San Diego Union-Tribune.

Below are selected items from SDCERS General Council Elaine Reagan's August 2010 legal report:

1)BARTON CASE

(Reagan's chart page 1)

SDCERS v. City of San Diego and City Attorney Mike Aguirre

SD Superior Court Case No. GIC 841845

Consolidated with: SDCERS v. City of San Diego, GIC 851286

Judge: Hon. Jeffrey Barton

SDCERS Complaint: **Declaratory Relief on Right to Employ Counsel**

City's Cross Complaint: Validity of MPI and MPIL and certain retirement benefits.

SDCERS' Cross-Complaint: Recovery of monies owed by City to SDCERS but not paid because of MPIL.

Current Status... "Intervenors and City currently negotiating resolution of complaints in intervention after which judgement will be entered on entire action."

Upcoming Hearings: **"Upcoming Hearings on Motion to Bifurcate or Sever Complaints in Intervention or Otherwise Dispose of Case."**

2) **PRESIDENTIAL LEAVE BENEFIT- Judith Italiano**

SDMEA; Judith Italiano v. City of SD;

SDCERS SD Superior Court Case No.: 37-2008-00096145-CU-BC-CTL

Judge: Pressman

"...on now-discontinued 'Presidential Leave' retirement contribution program."

Dispositive Rulings- "SDCERS' Motion for Summary Adjudication granted as to all claims except emotional distress and breach of fiduciary duty.

City Motion for Summary Adjudication granted as to all claims except breach of contract.

August 27, 2010: Case Management Conference.

October 8, 2010: Cross-Motions for Summary Judgement on Breach of Contract Claim against City."

3) **SPLITTING INVESTMENT LOSSES WITH CITY EMPLOYEES**

Elaine's introductory comment: "...**interpretation of the substantially equal requirement in City Charter (section #143). An amended Demurrer was filed on August 2, 2010. The hearing on the Demurrer is scheduled for September 24, 2010, The hearing on the Petition is scheduled for November 19, 2010 at 8:30 a.m.**"

(Reagan's chart page 7)

City of San Diego v. SDCERS, Case No. 37-2010-00091207-CU-WM-CTL

(Substantially Equal)

Judge: Joan Lewis

"Write of Mandate action seeking an order compelling the Board to calculate employee contributions including "substantially equal" share of cost of actuarial losses, including investment losses."

Current Status:"Writ filed and served on May 3, 2010. SDCERS' Demurrer filed on July 2, 2010. An amended Demurrer was filed on August 2, 2010."

4) **RETIREE HEALTHCARE**

Randon Levitt v. City of San Diego, Case No.: 37-2010-00094272-CU-OE-CTL; filed 06/15/2010

Plaintiff's Counsel: Mike Conger

"A declaratory relief action challenging the cap the City put on retiree healthcare last year"

UPDATE ON CONTRIBUTION RATE FOR EMPLOYEES

At the City Rules Committee on July 21, Hovey was asked to explain the background for the SDCERS Board changing the contribution rate for Safety employees. Hovey wrote on August 6th: "At the conclusion of the presentation, the **Committee voted 3-2 to direct the City Attorney to prepare an ordinance for the City Council's approval amending the Municipal Code to have the City pay an increased share of disability costs.**"

In the meantime, the new rates, which were set to start in July 2010, "...were not implemented by the City Controller's staff as required by the San Diego Municipal Code." Hovey went on to write: "A letter was sent to the Mayor and Council President requesting the City immediately implement the new rates as legally required...as set by the Board."

DISABILITY AND POLICE On "ACCOMODATION"- Good News

Trustee Dave Hall, Chair of the Disability Committee, recognized SDCERS General Counsel Elaine Reagan for her work with the Police Department regarding the meaning of "temporary" work assignments, so that department's intentions don't result in "good deeds gone awry".

Elaine Reagan reported at the Business and Governance Committee, that the Police will not be making permanent accommodation.

BOARD'S ETHICS TRAINING UPDATE, Part Two

* Statements of Economic Interests, recent and potential changes, including gifts to spouses of Board members, and conflict of interest codes.

* "New California laws re: cross-selling, two-year post-retirement board/staff 'time out', and 'placement agent' disclosures." "Bans on sales of investment products by all California public retirement system board members and staff to any California retirement system."

* "New SEC rule to curtail 'pay to play' by investment advisors"

Restricts political contributions, bans certain third-party solicitors, bans solicitations of contributions, and also restricts indirect contributions and solicitations."

Register and Use SDCERS Web-portal for the latest news and update your file.

My Notes are by subject. They are my understanding of what happened. For exact happenings:

1) **SDCERS Web site**- Watch delayed Board meetings, with subject access. Simply log-on to the City of San Diego or www.SDCERS.org and look for the button that links to Channel 24. The Board's back-up materials are also available on PDF.

2)**Television**- If you live in the city limits, Board meetings are on City Channel 24

usually at 6pm following meeting days, and usually repeat on the weekend. Schedule on Channel 24's web-site, under the City of San Diego.

3) **Official CDs** of SDCERS' committees and Board meetings are available through the Board Secretary; visual recordings are available through City Channel 24. Motions and votes are in SDCERS monthly summaries of Board meetings.

SDCERS Board meets approximately every 6 weeks.

Board meetings are at 8:30 a.m. Mark your calendars:

No meeting in September. Next meeting: October 1, November 5, and December 17, 2010.

Special meetings may be scheduled as needed with 72 hours notice.

Committee meetings, not televised yet:

on the Thursday before the regularly scheduled board meeting:

Disability Committee will meet from 8:30 am - 10:00 am

Business & Governance will meet 10:30 am - 12:00 PM

Investment Committee will meet 1:30 PM - 4:00 PM

Audit Committee will continue to meet quarterly on Wednesdays at 9:00 am. on Sept 29, and December 15, 2010