

ADDENDUM TO
REVIEW OF THE GOVERNANCE MODELS OF POLICE AND FIRE
DEPARTMENT RETIREMENT PLAN AND FEDERATED CITY
EMPLOYEES' RETIREMENT SYSTEM

Subsequent to issuing our draft report entitled *Review of the Governance Models of Police and Fire Department Retirement Plan and Federated City Employees' Retirement System dated May 9, 2013 (the "Report")*, Cortex followed up with various stakeholders to obtain comments and feedback. Based on these follow up discussions, it was apparent that some confusion existed concerning our report and recommendations. Accordingly, Cortex has prepared this addendum to clarify various aspects of the Report. Specifically, this addendum attempts to clarify:

- Our proposed governance model.
- Our recommendations for implementing the proposed governance model.
- The extent to which our recommendations were intended to be implemented concurrently as a package.
- The implications the recent Measure B judicial decision may have for our recommendations.³⁰

A. PROPOSED GOVERNANCE MODEL

Cortex's proposed governance model provides that the governance structure of a public retirement system should meet the following general criteria or principles:

1. Fiduciary Autonomy

The governing board of a public retirement system requires full and clear autonomy to administer the retirement system. Without such autonomy, a governing board will not be able to function effectively or efficiently and the performance of the system, both in the investment and member service areas, will suffer. Furthermore, if the authority to administer the system is shared between the governing board and other parties, it will be difficult if not impossible to establish clear accountability for the performance of the system.

2. Stakeholder Confidence

As a general principle, the key stakeholders of a public retirement system need to be reasonably confident that the retirement system will be administered effectively, efficiently, and in the best interests of members and beneficiaries, and that the governing board will exercise its autonomy prudently and appropriately. If such confidence does not exist, stakeholders are unlikely to support granting the governing board the necessary degree of autonomy.

3. Safeguards and Protection

The best method for promoting confidence among stakeholders is to establish sufficient safeguards and protections that will guard against the inappropriate use of autonomy by the governing boards and that will promote effective administration of the retirement system.

The most important safeguards and protections generally include the following:

³⁰ See Santa Clara County Superior Court Judge Patricia Lucas's decision on Measure B filed December 20, 2013.

- a) There must be appropriate representation of stakeholders on the governing board, i.e. the composition of the governing boards must reflect the key stakeholders of the retirement system.
- b) The governing board must be sufficiently independent so as to be able to engage in objective decision-making on behalf of all members and beneficiaries.
- c) The governing board must be sufficiently qualified to make the complex decisions involved in administering the system and overseeing the advisors and agents of the system.
- d) The operations and decisions of the governing board should be highly transparent to stakeholders and there should be strong mechanisms for communication between the governing board and stakeholders.

In designing *specific* safeguards and protections, the relative risk exposures of the different stakeholders need to be carefully considered. Any stakeholder that bears significantly more risk relative to other stakeholders may be justified in expecting greater protections or safeguards. If risks are borne approximately equally by all stakeholders, then no stakeholder group should expect additional safeguards or protections over and above those provided to the other stakeholder group(s).

B. RECOMMENDATIONS FOR IMPLEMENTING THE PROPOSED GOVERNANCE MODEL

The above discussion describes the *general* model proposed by Cortex. In the Report, Cortex also identifies 15 recommendations for implementing the proposed model.³¹ Below, we attempt to clarify each recommendation, confirm which recommendations are of primary importance, and which recommendations should be implemented concurrently.

Primary Recommendations

The following three recommendations are of primary importance and should be implemented concurrently:

1. The authority of the two San Jose retirement boards should be expanded to include among other things the authority to hire, direct, evaluate, and terminate their own staff; to set necessary compensation levels to attract and retain staff; and to directly appoint independent legal counsel.³²

For greater clarity, in making the above recommendation, Cortex intended that the retirement staff should be employees of the retirement systems rather than of the City, that they should report to the retirement boards rather than to the City Manager, and that they should be exempt from City civil service rules.

2. The proportion of each City Retirement Board that must consist of active or retired members should be reduced to approximately 25%. Furthermore, approximately 25% of each Board should consist of independent persons appointed by active and retired plan members.³³

For greater clarity our recommendation originally intended that:

- a) The City and the members/retirees be equally represented on each Retirement Board.³⁴
- b) Plan members and retirees would have the ability to directly appoint those board members they selected, as opposed to the current structure in which members and retirees may only nominate to City Council the individuals they wish to represent them on the boards.

Due to the judicial decision concerning Measure B, however, these two elements of our recommendation were re-examined. (See Section C of this Addendum for details.)

3. Any independent board member appointed to the Board by City Council or by active/ retired members should be required to have relevant expertise and experience relevant to the administration of the Retirement Systems.³⁵ This recommendation would result in approximately 75% of the members on each retirement board being required to have

³¹ For purposes of this Addendum we ignore Recommendation 2 on page 24 of the Report (i.e. that City representatives should be independent of the City), as it has already been implemented by the City.

³² See Recommendation 1 on page 23 of the Report.

³³ See Recommendation 3 on page 24 of the Report.

³⁴ See the final paragraph of Recommendation 3, on page 25 of the Report.

³⁵ See Recommendation 7 starting on page 25 of the Report.

relevant expertise (currently just over 50% of each board is required to have relevant expertise).

Cortex believes the above recommendations are closely connected and should therefore be implemented concurrently. Our reasoning is as follows:

- Stakeholders will likely not be confident enough in the governance of the Systems to support granting full autonomy to the governing boards, unless reasonable minimum safeguards and protections exist, namely the following:
 - a) The boards are sufficiently independent.
 - b) The boards are sufficiently qualified.
 - c) There is sufficient stakeholder representation on the boards.
- On the other hand, adding the above safeguards and protections without also granting the governing boards full autonomy will lead to dissatisfaction and frustration among the board members and will not lead to improved investment performance or member service quality.

The above recommendations (i.e. that approximately 75% of each board should consist of independent and qualified board members) reflect Cortex's views as to what constitute reasonable and appropriate safeguards to support board autonomy, and are based on Cortex's experience and research. Cortex recognizes however that stakeholders may have different risk tolerance levels and may demand stronger or weaker safeguards (i.e., a lesser or greater number of independent and qualified board members). Accordingly, it may be beneficial for the City and the members/retirees to discuss the above recommendations to determine the precise parameters that will provide the necessary degree of stakeholder confidence in San Jose.

Please see Exhibit I for an overview of the composition of each board based on Cortex's recommendations.

Secondary Recommendations

While worthy of consideration, Cortex considers the other 11 recommendations in the Report to be of secondary importance and does not view them as absolutely necessary for implementing our proposed governance model. Below we summarize the reasons why:

- a) Recommendation 4 in the Report (page 25) states the role of the Retirement Boards should be clearly defined in statute to exclude advocating for, or taking positions on, legislative changes affecting the nature or cost of the benefits provided by the Retirement Systems. This recommendation is not necessary to implement our governance model, as legislation already exists that limits boards from engaging in inappropriate political activities.
- b) Recommendation 5 in the Report (page 25) states that governing legislation should discourage the Retirement Systems from engaging in economically targeted investing, and should prohibit the City from promoting such investments to the Retirement Systems. We

recognize however that laws already exist to discourage pension fund fiduciaries from pursuing economically targeted investment strategies. We nevertheless included this recommendation in response to concerns raised by members and retirees during past outreach discussions.

- c) Recommendation 6 in the Report (page 25) states that the staff serving the Retirement Boards should be independent in that they should not be entitled to receive benefits from either of the City Retirement Systems. While we believe this is desirable, we recognize it may be difficult to implement and that a new benefit program may not be as cost-effective as the current program.
- d) Recommendation 8 in the Report (page 26) states essentially that independent board members should be provided higher levels of compensation reflecting the amount of time, effort, and risk involved in the position. While we have classified this as a secondary recommendation, Cortex strongly recommends that it be adopted, as it is intended to facilitate the implementation of two primary recommendations (i.e. it will support the recruitment and retention of qualified and independent board members.).
- e) Recommendations 9, 10, 11, 13, and 14 in the Report (page 26-28) contain numerous recommendations intended to either increase transparency in the operations of the board and the systems, or enhance communications between the boards and the stakeholders. For retirement systems in certain other jurisdictions, these recommendations might potentially be very important. Given, however, that the San Jose retirement systems are already very transparent, and that there is ample opportunity for communication among stakeholders and the boards, Cortex believes these recommendations are of secondary importance.
- f) Recommendation 12 in the Report (page 27) states that provisions should be established in legislation to allow for the removal, by the appropriate appointing authority, of any board member for cause. We suspect the ability to remove board members for cause is implicit in the ability to appoint them and we understand if stakeholders may feel this does not need to be formalized.
- g) Finally, recommendation 15 of the Report (page 28) recommends that the City consider enhancing the operational scale and efficiency of the Retirement Systems by pursuing consolidation of the two systems under the oversight of a single retirement board. We have classified this as a secondary recommendation because it is unrelated to our proposed governance model, which is the focus of our analysis; i.e., combining the retirement boards is neither a safeguard nor a protection against granting autonomy to the retirement boards. Instead, it relates to the issues of organizational scale and efficiency.

As background, it is our understanding that the two retirement boards have reviewed Cortex's secondary recommendations and have already committed to implementing them to the extent

they have the authority to do so.³⁶ More specifically, the boards have implemented, or are in the process of implementing, recommendations 4, 5, 9, 11, 13, and 14.

To summarize, only Cortex's primary recommendations are intended to be implemented concurrently. Cortex views the remaining recommendations to be worthy of consideration, but not absolutely necessary for implementing the proposed governance model. If however the stakeholders of the San Jose retirement systems determine that the safeguards contained in our primary recommendations are insufficient, they may wish to consider the additional safeguards contained in our secondary recommendations.³⁷

³⁶ The boards of course do not have the authority to enshrine the recommendations in the City Charter or Municipal Code, as recommended by Cortex. Instead, where possible, the boards have agreed to implement the recommendations using board policy.

³⁷ Note, Cortex does not consider combining the boards to be safeguards or protections, but rather a possible method of enhancing economies of scale and achieving efficiencies.

C) IMPLICATIONS OF MEASURE B DECISION

The degree to which financial risk is shared among stakeholders has important implications for how our recommended governance model is implemented. As stated above, if one stakeholder bears relatively more risk, then it is reasonable for that stakeholder to expect greater protections or safeguards. If stakeholders bear risk approximately equally, then the governance model can be viewed as a true partnership and no stakeholder should require greater protections or safeguards relative to the other stakeholders.

In the case of San Jose, our understanding of how risk is to be shared among stakeholders has changed over time due to various developments.

When preparing the Report, we assumed that the passage of Measure B implied that the financial risk of the system would, over time, be shared approximately equally between the City and the members/retirees. Accordingly, we recommended in the Report that the City and the members/retirees should be represented equally on the two retirement boards; i.e. the City should select and appoint half of the members of each board and the members/retirees should select and appoint the other half. (The members of each board so appointed could also then select one additional member.)

A recent judicial decision concerning Measure B now suggests however that risk will be shared equally only with respect to new plan members, and that the City will bear the majority of financial risk with respect to current liabilities. This suggests that our recommendations need to be modified somewhat.

Under our proposed model it would be reasonable for the City to expect relatively greater protections or safeguards to compensate for the greater risk it bears. Two reasonable solutions are as follows:

1. Change the balance of power on the boards so that the City selects and appoints a majority of the members of each board; or
2. Maintain equal representation on the two boards, but allow the City to retain the final authority to appoint all board members.

Of the above two options, Cortex recommends the second. We believe that maintaining equal representation on the boards, but having the City maintain final authority over all board appointments, promotes a spirit of partnership in fiduciary decision-making while recognizing the greater risk borne by the City.

We trust the above provides helpful clarification concerning the Report. If any board member or stakeholder has further questions, Cortex would be pleased to discuss them.

EXHIBIT 1: BOARD COMPOSITION UNDER CORTEX'S RECOMMENDATIONS

EXCLUDING 9TH AND 7TH MEMBERS

	Police & Fire		Federated	
	Number of Board Members	Percentage of Board (excl. 9 th member)	Number of Board Members	Percentage of Board (excl. 7 th member)
Independent Board Members Selected by the City	4	50	3	50
Independent Board Members Selected by Members/ Retirees	2	25	1	16.7
Members/Retirees	2	25	2	33.3
Total Board Members (excl. 7th & 9th members)	8	100	6	100
Board Members representing the City	4	50	3	50
Board Members representing Members/Retirees	4	50	3	50

INCLUDING 9TH AND 7TH MEMBERS

	Police & Fire		Federated	
	Number of Board Members	Percentage of Board (incl. 9 th member)	Number of Board Members	Percentage of Board (incl. 7 th member)
Independent Board Members Selected by the City	4	44.4	3	42.9
Independent Board Members Selected by Members/ Retirees	2	22.2	1	14.3
Members/Retirees	2	22.2	2	28.6
Independent board member selected jointly by above	1	11.1	1	14.3
Total Board Members	9	100	7	100
Board Members representing the City	4 + ½	50	3 + ½	50
Board Members representing Members/Retirees	4 + ½	50	3 + ½	50