COUNCIL AGENDA: 11/19/13
ITEM: 3.4

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Alex Gurza

SUBJECT: **Report on Retirement Board Governance Models**

DATE: November 7, 2013

Approved

Date 11/7/13

RECOMMENDATION

Acceptance of report and presentation on retirement board governance and direction to City staff on possible actions related to the report.

BACKGROUND

In 2009, the City engaged Cortex Applied Research, Inc., to review the Retirement Boards' governance structure and a report was issued. A January 26, 2010, Council memo entitled, "Retirement Board Governance," outlined the recommended changes to Board structure and explained two different policy alternatives for City Council to amend the ways in which Board members were appointed. In 2010, the Council approved the "3-3-1" structure for the Federated City Employees' Retirement System Board and the "4-4-1" structure for the Police and Fire Department Retirement Plan Board based on the February 4, 2010 supplemental memo. These changes were considered Phase I in that they did not address all of the recommendations made by Cortex in their initial report.

The Retirement Boards separately engaged Cortex in 2012 to provide an update on the consultant's initial report. Cortex conducted an analysis of the Board's governance models which included reviewing other public plans and interviewing Board members, staff, City Council and labor representatives. The resulting report provides 15 recommendations, based on the following categories:

- Authority of the Federated and Police and Fire Boards
- Safeguards for stakeholders
- Transparency and disclosure
- Risk oversight
- Scale and efficiency

ANALYSIS

Attached is the most recent Cortex Report on Retirement Board Governance. Cortex will be present at the November 19th Council meeting to present a summary of their report and recommendations on retirement board governance. A full explanation of the consultant's recommendations is included in the report. Below is a brief summary of the 15 recommendations:

Expand the Authority of the Boards	Independence of the Boards, including the ability to: • Appoint, direct, evaluate and terminate staff • Set compensation levels and determine human resources policies • Appoint legal counsel • Establish procurement policies
Establish Additional Safeguards for Stakeholders	All Board members selected by the City should be independent
	75% of the Board's composition should be independent
	Role of the Board's should be clearly defined in statute to exclude advocating or taking positions on legislative actions that affect the benefits provided by Retirement Services
	Discourage the Boards from engaging in economically targeted investing
	Staff serving the Retirement Boards should not be entitled to receive benefits from either System
	Any independent Board member appointed by the City or active/retired members should have expertise and experience relevant to the administration of the Retirement Systems
	Ability to offer appropriate compensation to independent board members (approximately $20,000)
Transparency and Disclosure	Provide additional annual disclosures i.e. annual compensation for senior executives and independent report on the cost-effectiveness of the Systems
	Eliminate non-voting Board member
	Hold an annual general meeting that is accessible to the public
Sanctions	Enact provisions that allow for the removal of any Board member for their performance or conduct by appointing authorities
Risk Oversight	Conduct an external independent review of the Boards' fiduciary and management once every 5 years
	Establish an audit committee
Scale and Efficiency	Pursue consolidation of the two Systems under the oversight of one retirement board.

Currently, the Department of Retirement Services is a City department. The Director of the department is appointed by the City Manager and subject to confirmation by the City Council, pursuant to the City Charter. All employees in the Department of Retirement Services are City employees, almost all of which are unionized civil service positions. The pay and compensation of Retirement Services staff is determined by the City Council, primarily through labor negotiations with the City's bargaining units.

It is important to note that the first recommendation to give the boards full permanent authority to hire, evaluate and terminate retirement services staff, etc. would require a City Charter change through a ballot measure approved by the voters. This is because the City Charter grants appointing authority to the City Manager regarding certain employees, including those employed in the Retirement Services Department. The Charter would need to be revised to have the Retirement Services Department not under the City Manager's appointing authority (City Charter Section 701).

EVALUATION AND FOLLOW-UP

The City Administration will continue to evaluate the recommendations in the Cortex report and will bring forward any follow up actions to the City Council for approval.

PUBLIC OUTREACH/INTEREST

☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1,000,000 or greater. **(Required: Website Posting)**

☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This does not meet any of the above criteria but will be posted on the November 19, 2013, City Council Agenda.

COORDINATION

This memo has been coordinated with the Department of Retirement Services and the City Attorney's Office.

CEQA

Not a Project, File No.PP10-069 (a), a. Staff Reports / Assessments / Annual Reports / Informational Memos that involve no approvals of any City Actions

Alex Gurza
Deputy City Manager

For questions, please contact Jennifer Schembri, Deputy Director of Employee Relations, at (408) 535-8154.

Attachment

A Review of the Governance Models of

Police & Fire Department Retirement Plan

and

Federated City Employees' Retirement System

Prepared by:

Cortex Applied Research Inc.

For the Boards of:

Police & Fire Department Retirement Plan and

Federated City Employees' Retirement System

May 9, 2013

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I. DEFINED TERMS

For purposes of this report

1. "City" refers to the city of San Jose, California.
2. "City Council" refers to the City Council of the City of San Jose, California.
3. "Retirement Systems" or the "City Retirement Systems" refers collectively to the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System.
4. "Retirement Boards" or "City Retirement Boards" or "Boards" refer to the boards of trustees of the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System.
5. "P&F" refers to the Police and Fire Department Retirement Plan.
6. "FERS" refers to the Federated City Employees' Retirement System.
7. "City Manager" refers to the San Jose City Manager
8. "City Attorney" and "City Attorney's Office" refers to the San Jose City Attorney and San Jose City Attorney's Office, respectively.
9. "Municipal Code" refers to the San Jose Municipal Code
10. The "Director" or "Director of Retirement Services" refers to the senior executive of the Retirement Services Department of the City of San Jose.
11. "Cortex" refers to Cortex Applied Research Inc., the author of this report.
12. "Cortex's 2009 Report" or "the 2009 Report" refers to *A Review of the Governance Models of The Police and Fire Department Retirement Plan & The Federated City Employees' Retirement System*, prepared by Cortex Applied Research Inc. for the City of San José, California, June 23, 2009.

Other terms may be defined as needed throughout this report.

II. Executive Summary

Cortex assessed the governance models of the two City Retirement Systems relative to best practice criteria and general industry practices. The best practice criteria include the following:

1. Operational autonomy
2. Sufficient stakeholder safeguards, including:
    a. Balancing stakeholder representation and board independence
    b. Independence of retirement staff
    c. Board qualifications
    d. Other safeguards such as transparency, disclosure, and alignment of interests.
3. Organizational scale and efficiency

In considering industry practices, Cortex looked to governance models in California, across the United States, in Canada, and in Europe.

Cortex concluded that the governance models of the two City Retirement Systems fall short of best practices, and are relatively weaker than those of their industry peers in the U.S. and elsewhere. The two City Retirement Boards lack the operational autonomy necessary to effectively administer the Systems and carry out their fiduciary duties to members and beneficiaries. At the same time, Cortex finds there are insufficient safeguards in place that would protect all stakeholders from the inappropriate use of such authority.

Cortex has identified a number of recommendations to improve the governance of the City Retirement Systems.

At a minimum, Cortex recommends that the following (equally important) priority recommendations be adopted.

1. The City Retirement Boards should be granted full authority over the operations of their respective Retirement Systems. At a minimum, such expanded authority should include a) the authority to employ and compensate their own staff that are exempt from City Civil Service Rules, and b) the authority to independently hire their own legal counsel.

2. The independence of the Retirement Boards should be enhanced by requiring that active and retired plan members appoint independent persons of strong character to fill approximately 25% of the seats on each board, leaving only approximately 25% of board seats to be filled by active and retired plan members. The remaining 50% of board seats should continue to be filled by independent persons selected by the City.

3. The technical qualifications of the Board should be enhanced by requiring that all appointed, independent board members have relevant skills and experience, regardless of whether they are appointed by the City or by active or retired plan members.

Increasing the independence and qualifications of the Retirement Boards, as recommended above, should provide the City the confidence necessary to grant the Retirement Boards full authority to administer the Systems. The fact that, under Measure B, plan members will share in the funding risk of the Retirement Systems provides further support for true joint trusteeship of the Systems.

Cortex would like to stress that the above priority recommendations must be adopted simultaneously. The governance and management of the Systems will not be improved in the long run if stakeholders implement additional safeguards, but fail to grant the Retirement Boards full operational autonomy, or, conversely, grant the Boards full operational autonomy without also establishing the additional recommended safeguards.

It should also be noted that the Retirement Boards have no authority to implement the above recommendations. Instead, the above recommendations all require amendments to either the San Jose City Charter or the Municipal Code.

Additional recommendations are detailed in Section VI of the report. They relate to, among other things, increasing transparency and disclosure regarding the operations of the Retirement Systems, establishing additional stakeholder oversight mechanisms, and providing for the removal of board members. These recommendations are important and would benefit all stakeholders, but are less crucial than the priority recommendations noted above.

III. Background

In 2009, Cortex completed a review of pension governance best practices for the City, which resulted in numerous recommendations for improving the governance and management of the two City Retirement Systems. The 2009 recommendations related to two general topics:

- ***Granting the Retirement Boards Greater Authority***: Cortex recommended that the City should allow the Retirement Boards greater authority in a number of areas in order that they may better administer their respective Retirement Systems and properly carry out their fiduciary duties.

- ***Instituting Additional Safeguards to Protect Stakeholders***. Cortex recommended that, if the Retirement Boards were to be granted expanded authority, various safeguards should be established to further protect the interests of stakeholders from the inappropriate use of such authority.

The City implemented only a few of the 2009 Cortex recommendations. It increased the level of independence on each of the Retirement Boards by requiring that a certain number of board members be independent of the City. It also increased the level of pension knowledge on the Retirement Boards by requiring that the independent board members have relevant experience and expertise. The City did not however grant the Retirement Boards any additional authority that would enable them to administer the Retirement Systems more effectively.

In 2012, the Retirement Boards retained Cortex to conduct a follow-up analysis of the Retirement Systems' governance models and to provide additional recommendations for improvement. The Retirement Boards indicated they seek to further enhance their ability to operate effectively and ensure they are even more accountable to stakeholders for their performance.

This report contains the results of Cortex's follow-up review.

Methodology

Cortex's follow-up review included the steps listed below:

a. Interviews with board members on the Retirement Boards.
b. Interviews with representatives of employee associations.
c. Interviews with several members of the City Council.
d. Interviews with members of the City of San Jose executive team.
e. Review of literature concerning pension governance best practices and standards.
f. Review of literature and survey data concerning governance structures and practices in the United States and other jurisdictions.

g. Identification of the structures and practices of certain public pension plans, which Cortex believes represent noteworthy governance models; this was done by reviewing the plans' websites or governing statutes and, in some cases, contacting the pension plans directly.
h. Preparation of a draft presentation of findings, in PowerPoint format, which was delivered to a joint governance committee of the Retirement Boards, and subsequently to each of the Retirement Boards in public session.
i. Preparation of this final report.

IV. BEST PRACTICES ANALYSIS

CRITERIA

In assessing the governance models of the two Retirement Systems, Cortex considered the following best practice criteria and the extent to which they are reflected in current industry practice:

1. Operational autonomy
2. Sufficient stakeholder safeguards, including:
    a. Balancing stakeholder representation and board independence
    b. Independence of retirement staff
    c. Board qualifications
    d. Other safeguards such as transparency, disclosure, and alignment of interests.
3. Organizational scale and efficiency

1. Operational Autonomy

Background

The first best practice criterion Cortex considered was the operational autonomy of a public plan. An effective public plan should have a governing board with full authority to administer all aspects of the plan. Such authority should include the power to establish an operating budget, appoint and direct staff, set staff compensation, and appoint all necessary advisors and service providers. Without such authority, the governing board will be severely constrained in its ability to administer the plan, and stakeholders will not be able to properly hold the board accountable for performance.

The need for operational autonomy is well recognized and supported throughout the pension industry and in the academic literature. A study published by the World Bank stated that pension boards should have the authority to hire and fire the organization's chief executive officer.[1] In

[1] Impavido, G. (2002). On The Governance Of Public Pension Fund Management. *The World Bank.*

addition, The Clapman Report suggests that, "A governing body should have the authority to select or dismiss key staff and independent advisors and counsel." [2]

Industry Practices

Though widely accepted as best practice, Cortex's research and experience have found that few public plan boards in the United States possess complete authority over the administration of their plans.[3] One experienced public plan executive commented on industry practices as follows:

> *"Statutory provisions in some states do not empower retirement boards in ways that truly allow them to fulfill their fiduciary obligations. For example, it might be possible for a board to assure that an essential function is carried out by internal staff at a fraction of the cost of using an outside service provider. However, this will only be possible if they are not hamstrung by a state pay and classification system that precludes them from attracting and retaining the internal professionals needed. The board then could be forced into making a bad business decision because it effectively has been restricted from use of a less expensive, but constructive, alternative."*
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> Gary Findlay, Executive Director, MOSERS, P&I Magazine, December, 2003.

In Cortex's experience, some of the more significant types of constraints imposed on public plan boards are briefly described below.

- Many public plan boards do not have the authority to approve their own operating budgets. Instead, they must recommend an operating budget to the sponsoring authority (i.e., a state, county, or municipal legislative body), which in turn approves the budget. A recent survey of 54 U.S. state public plans found that only 26% of the governing boards had budget approval authority.[4]

- Many public plan boards lack independent authority to set compensation for their staff and, instead, are subject to civil service rules governing recruitment practices, salary levels, and incentive compensation practices. Cortex's experience working with dozens of public plans suggests that the lack of authority over compensation has made it difficult for many public plans to attract and retain the types of staff they require, particularly in the investment area.

- Many public plan boards also lack authority to appoint certain independent advisors. For example, the boards of the San Francisco Employees' Retirement System (SFERS) and the Los Angeles City Employees' Retirement System (LACERS) do not have independent

[2] *The Committee on Fund Governance Best Practice Principles,* issued by the Stanford Institutional Investor's Forum, 2007, and also known as The Clapman Report.

[3] Public funds in some U.S. states appear to operate with relatively higher levels of authority; e.g. Missouri, Texas, and Colorado.

[4] Survey conducted by the National Association of State Retirement Systems (NASRA) in 2010.

authority to hire their own legal counsel, but must instead obtain outside legal services through their respective city attorneys. The Board of SFERS faces a similar constraint with respect to retaining financial audit services, and must work through the City Controller's Office to obtain such services.

One area in which most public plan boards do appear to have the requisite level of authority concerns the ability to appoint their chief executive officers. In California, for example, the boards of all 20 county pension plans governed by the County Employees' Retirement Law of 1937 have such authority. The boards of CalPERS and CalSTRs also have such authority, as do the boards of certain California municipal retirement systems.[5] Cortex's experience and research in other jurisdictions found similar results.

Assessing the San Jose Retirement Systems

The City Retirement Boards are more constrained than most public plan boards. They lack many of the authorities necessary to operate effectively and carry out their fiduciary duties including the following:

i. While the retirement staff are required by law to provide services to the Retirement Boards, neither of the Retirement Boards has the authority to hire, direct, evaluate, or terminate the retirement staff. Instead, the retirement staff are hired by and directed by the City Manager. In the case of the Director of Retirement Services, the decision of the City Manager is also subject to confirmation by City Council. In effect, the retirement staff report to three different parties: the City Manager and the two Retirement Boards. This has led to an inefficient and challenging working environment for all parties.

ii. On a related point, the Retirement Boards lack the authority to set the compensation levels to be paid to the retirement staff. Such compensation levels are subject to civil service rules established by the City. Cortex believes this arrangement is in large part responsible for the difficulties the Department of Retirement Services has experienced in attracting and retaining investment staff in recent years.

iii. While the Retirement Boards have the authority to approve their own operating budgets, such authority is somewhat hollow in that, again, they do not have the authority to approve the addition of any retirement staff positions, which normally constitute one of the largest items in a public plan's operating budget.

iv. The Retirement Boards lack the authority to appoint their own independent legal counsel. Such authority rests with the City Attorney, and the Retirement Boards must work through the City Attorney's Office to obtain all legal services;

[5] Two California municipal pension plans that do not have the authority to appoint their executive director are Los Angeles City Employees' Retirement System and City of Los Angeles Fire and Police Pensions. In both cases, the appointment of the executive director is subject to confirmation by the Mayor and City Council of the City of Los Angeles.

v. The authority of the Retirement Boards is somewhat constrained with respect to certain routine operating procedures. The Retirement Boards are required to follow city procurement policies and processes, and are expected to use any services for which the City has already entered into contracts, such as printing and mail services. Cortex understands that the City also influences routine issues such as where Retirement Board meetings may be held.

On the other hand, the City Retirement Boards do have the authority to hire the most significant service providers and advisors (with the exception of legal counsel). These include but are not limited to custodians, investment consultants, actuaries, investment managers, and other general consultants. The Retirement Boards also have the authority to hire their own financial auditor, but have not exercised this authority, as to date they have used the same financial auditor as the City.

In summary, the City Retirement Boards have significant constraints on their authority, more than most other public plan boards Cortex is aware of.

2. Stakeholder Safeguards

Background

The second best-practice criterion Cortex considered is the need for adequate stakeholder safeguards. The need for stakeholder safeguards is closely related to the operational authority of pension boards. If pension boards are to have full authority to administer their pension plans, safeguards are needed to ensure the boards exercise that authority appropriately. Some argue that pension boards are subject to fiduciary duties, the strictest standards in law, and that stakeholders are therefore well protected and should not be overly concerned about the risk of boards using their authority inappropriately. Cortex's discussions with stakeholders of the City Retirement Systems and Cortex's work in other jurisdictions suggest otherwise; fiduciary duty alone does not appear to provide stakeholders with the level of assurance they feel is necessary, resulting in a) ongoing attempts by sponsors to manage their financial risk exposure by maintaining excessive control over the operations of public plans, and b) plan members becoming mistrustful of plan sponsors' actions. If public plans are to be effective, trust law needs to be augmented by other appropriate safeguards. Examples of such safeguards are discussed below.

A. Stakeholder Representation & Board Independence

Key stakeholders of a defined benefit public plan include plan members and taxpayers.[6] Active and retired plan members contribute to the plan and therefore need to be confident that the benefits promised to them are secure and will be paid when due. Taxpayers have an interest in ensuring they do not bear unnecessary financial risk, given that they must fund any pension deficits that arise through either tax increases or reductions in public services.

[6] Future generations of taxpayers and plan members are also important stakeholders; for simplicity however we have not addressed them herein.

An effective pension governance model must reflect the fact that the above stakeholders have a legitimate interest in the effective administration of the pension plan. It should also promote the ability of plan fiduciaries to act independently of stakeholders and to focus on the sole best interests of the plan beneficiaries, as required by trust law. The composition of a public plan's governing board is key to achieving both of the above objectives. For example, if stakeholders share equally in the financial risk of the pension plan, they should be equally represented in the composition of the governing board.

Governance models differ however on is whether stakeholders should serve on public plan boards directly, or whether they should instead appoint independent persons to serve on the boards in their place.[7]

Under the Interested Board Model, major stakeholders in a public pension plan (i.e. active and retired plan members, and elected officials or civil servants representing taxpayers and citizens) serve directly on the governing board; i.e. the governing board includes elected officials, civil servants, and active and retired plan members. This occurs despite the fact that such individuals face significant conflicts of interest with respect to the management of the plan. For example, elected officials and civil servants may find themselves in a conflict on issues involving social and economically targeted investments or funding matters. Elected officials are especially conflicted by the short-term nature of their office versus the long-term nature of pension benefit obligations. Similarly, plan members serving on public plan boards may face conflicts of interest when they make determinations concerning funding or investments; or when they take positions on benefit levels or design.

In effect, the Interested Board Model results in systemic conflicts of interest. The Model assumes however that because board members are subject to the fiduciary duty of loyalty, they will be able to set such conflicts aside and act solely in the best interests of the members and beneficiaries of the system.[8]

While the Interested Board Model may be appealing to many, best practices suggest it does not serve the long-term best interests of members, beneficiaries, or taxpayers because it often fails to support truly independent decision-making. [9]

An alternative model calls for stakeholders to select independent persons of strong character and reputation to serve on pension boards in their place. This approach allows stakeholders to play an important role in determining the composition of the pension board, while significantly enhancing the independence of the board and its ability to act in the sole best interests of

[7] In any event, board members must administer the pension plan in the sole best interests of the plan beneficiaries and cannot act in the interests of any stakeholder.
[8] The duty of loyalty is the obligation to act for the exclusive benefit of the plan participants and beneficiaries. In carrying out their duties, the trustees must put the interest of all plan participants and beneficiaries above their own interests or those of any third parties.
[9] Eaton and Nofsinger; The Effect of Financial Constraints and Political Pressure on the Management of Public Pension Plans, Journal of Accounting and Public Policy, 2004.

members and beneficiaries. Such independence will also better support the long-term sustainability of the plan.

The importance of ensuring that pension boards are able to act independently is perhaps best stated in the Uniform Management of Public Employee Retirement Systems Act:

> *"Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations. In the absence of independence, trustees may be forced to decide between fulfilling their fiduciary obligations to participants and beneficiaries or complying with the directions of others who are responding to a more wide-ranging (and possibly conflicting) set of interests."*
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> UMPERSA, Section 5

Industry Practices

With respect to stakeholder representation and independence on public plan boards, common industry practice does not reflect best practices. The Interested Board Model critiqued above is the most common governance model at public plans in California and throughout the United States. In a recent study of 84 state-level pension plans, the composition of all but four pension boards included direct representation by multiple key stakeholders of the system (i.e., the plan sponsor and active and retired plan members). The exceptions were Delaware SEPP, Florida Retirement System, New York Employees' Retirement System, and the North Carolina Retirement System. In each of these exceptions, only the plan sponsor is represented on the governing boards, usually by one or more ex-officio, elected officials.[10]

The Interested Board Model is also common in Canada. Canadian public retirement systems tend to have active and retired plan members on the board (though they seldom have elected officials). A small number of leading Canadian public funds, however, have moved much closer to best practices in that their boards do not include elected officials or civil servants, and include few if any active or retired plan members.[11]

Assessing the San Jose Retirement Systems

Prior to 2011, the composition of the City Retirement Boards followed the Interested Board Model, as the Retirement Boards included elected officials, and active and retired plan members. Cortex had recommended in its 2009 Report to the City that the model be changed such that the elected officials would be replaced by independent persons not connected with the City, and that active and retired members would have the option of selecting independent persons to serve on the Retirement Boards in their place.

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[10] *Characteristics of Large Public Education Plans*, National Education Association, 2010.

[11] For example, the Public Sector Pension Investment Board, Canada Pension Plan Investment Board, and the Ontario Teachers' Pension Plan.

Cortex's 2009 recommendations were only partially adopted. The Municipal Code was changed to require that elected officials be replaced by independent persons not connected with the City, but active and retired plan members continue to make up approximately half the members of each City Retirement Board.

Furthermore, since 2011, each City Retirement Board includes a non-voting board member, which is not required to be filled by an independent person. In fact, the positions are currently filled by a member of the City Council.

In summary, while the composition of the City Retirement Boards has improved, it continues to lack the necessary level of independence that all stakeholders require.

B. Independent Retirement Staff

Cortex believes that it is also best practice for pension staff to be independent. That is, they should not be members of the pension plan they administer. If they are, they will face a conflict of interest whenever they are required to provide information, analysis, or recommendations concerning benefit changes or administration that may affect their own personal benefits.

Industry Practices

With respect to the independence of pension staff, common industry practice again appears to be inconsistent with best practices. In reviewing this issue, Cortex attempted to determine how prevalent it is for pension staff to be members of the same plan they administer. Such arrangements appear to be the norm in the United States. Cortex identified only one U.S. public plan in which the staff are not members of the same plan: the Missouri Local Government Employees Retirement System.[12] Only three such plans were identified in Canada: Ontario Teachers' Pension Plan, Ontario Municipal Employees' Retirement System, and the Public Sector Pension Investment Board.

Assessing the San Jose Retirement Systems

The staff who currently administer the day-to-day operations of the City Retirement Systems are independent of the P&F but not of FERS, due to the fact that the retirement staff are members of FERS. As such, they may occasionally be required to provide analysis and recommendations to the Board of FERS or to other stakeholder on matters that affect their own personal pension benefits. From the perspectives of the City and taxpayers, this arrangement is less than ideal and falls short of best practices.

C. Board Qualifications

Best practices suggest that a public pension board should possess deep knowledge, expertise, and experience directly relevant to the oversight of a pension plan. At a minimum, a pension board should include individuals who:

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[12] There may in fact be other such systems, as we did not perform a comprehensive review. Our findings suggest however that situations where staff are not members of the plan they administer are rare.

- Possess in-depth knowledge of asset/liability management, pension finance, accounting, auditing, actuarial science, risk management, and law.

- Have significant senior executive or board-level experience with large organizations, particularly in the financial services, health and welfare, or benefits industries.

- Have demonstrated a capacity for strong judgment, strategic thinking, and leadership.

Due to the growing complexity of modern pension plans, highly qualified boards are increasingly viewed as critical to the success of public pension plans. Pension governance guidelines from around the world, as well as academic research, agree on this point.[13]

Industry Practices

Most public plan boards lack strong pension and investment expertise. Governing statutes are mixed in terms of requiring board members to possess financial, investment, and other relevant expertise.[14] This is in large part due to the prevalence of the Interested Board Model noted earlier in this report, which favors placing elected officials and active and retired plan members on pension boards, who typically do not have the requisite technical expertise. As a result, most pension boards have at most one or two board members with investment or other relevant pension knowledge.

Academics have also conducted research into the levels of knowledge on pension boards and found that they often lack the necessary qualifications to properly consider and oversee complex investment, funding, and statistical matters.[15]

Assessing the San Jose Retirement Systems

Since 2011, the City Retirement Systems have moved closer to best practices on the issue of board qualifications. The City is now required to appoint members to each Board (four to P&F and three to FRS), who are not only independent of the City, but who also possess specific and relevant knowledge and experience. Despite this change, approximately half of each City Retirement Board continues to be comprised of individuals who are not required to have expertise relevant to the governance of the Retirement Systems.

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[13] See the Clapman Guidelines, *The Governance of Public Employee Post-Retirement Benefits Systems*, issued by the Government Finance Officers Association (hereinafter the "GFOA Governance Guidelines"), the *OECD Guidelines for Pension Fund Governance*, issued by the OECD Working Party on Private Pensions (hereinafter the "OECD Governance Guidelines"), and the The Canadian Association of Pension Supervisory Authorities' *Pension Governance Guidelines* (hereinafter the "CAPSA Governance Guidelines"); and the GFOA Guidelines in the U.S., guidelines issued by the OECD, and the CAPSA Guidelines (Canada). See also Hess, David.

[14] Fitzpatrick, T. J., & Monahan, A. B. (2012). Who's Afraid of Good Governance? State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform. *Federal Reserve Bank of Cleveland.*

[15] See *Pension fund trustee competence: decision-making problems relevant to investment practice* (2006). Gordon L Clark, Emiko Caerlewy-Smith, and John C Marshall, University of Oxford, Oxford, United Kingdom.

D. Other Safeguards

Many other safeguards exist that would provide further checks on the authority of governing boards, and would protect stakeholders.[16] Such safeguards generally include:

- *Transparency and disclosure of fiduciary decision-making.* This involves allowing stakeholders to observe the fiduciary decision-making process first hand and to have access to various types of information relating to plan and fund administration.

- *Alignment of interests among stakeholders.* By aligning the interests of stakeholders, plan sponsors are more likely to allow governing boards the necessary operational authority to properly carry out their fiduciary duties. Aligning stakeholder interests is also more likely to result in better long-term investment and funding performance and in intergenerational equity among stakeholders.

- *Independent risk oversight.* Best practices suggest that rather than interfering in the operations of public pension plans by withholding authority from governing boards, stakeholders should require periodic independent assessments of public plans and their boards. This may also support continuous improvement in plan operations.

- *Removal of Board Members.* No matter how strong a governance structure may be, there is always a possibility that at some point an ineffective or unethical board member will serve on a governing body. Best practices would suggest that there should be mechanisms to remove such board members from office.

- *Board member compensation.* Best practices suggest that independent members of pension boards should receive compensation from the pension plan that reflects the value of their technical expertise, the time commitment involved, and the risk associated with the position. Without such compensation, it may be difficult to attract and retain sufficiently qualified individuals to serve. This may be particularly important for plan member stakeholder groups, which may have more difficulty than the plan sponsor in attracting suitable individuals to serve as board members.

- *Constraints on Board Action and Policy.* To help ensure public boards do not stray from their fiduciary mandate to focus solely on administering promised benefits in the sole best interest of beneficiaries, Cortex believes it may be appropriate to place certain types of limits on board actions, if they facilitate more effective fiduciary decision-making. One example would be to limit or discourage a pension board's ability to engage in social or economically targeted investing. Another example would be to limit a board's ability to advocate for legislation that would change benefit levels or design and impose material costs on stakeholders.

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[16] See UMPERSA

Industry Practices
Below we review industry practices in each of the areas noted above:

Transparency: In looking at industry practices, Cortex found that U.S. public pension plans have considerable transparency in their governance and decision-making. In fact, they demonstrate much more transparency than peers in other countries. (For example, Canadian pension plans typically do not make board meeting minutes publicly available, and do not allow the public to attend board meetings; several recently-created public plans, however, hold annual general meetings for the public.) U.S. public plan boards typically must hold all their meetings in open session, and can discuss very few subjects in closed session. Many U.S. public plans post their meeting minutes on their web-sites and some even broadcast their meetings over the Internet. Most U.S. public plans publicly disclose considerable amounts of information about their activities, and issue comprehensive annual financial reports. They also often make their policies and procedures readily available on their websites.

Another positive feature of U.S. public plans is that members of the public usually may address the board at board meetings on any agenda item. The duration of such addresses can be limited at the board's discretion and the board generally is not required to respond.

Alignment of Interests: Stakeholder interests are not generally aligned in traditional public sector defined benefit plans, in which the plan member receives a promised benefit that is defined in advance using a formula based on years of service and some measure of final pay. Any funding shortfalls that arise with respect to the promised benefits are generally the responsibility of the plan sponsor and ultimately the taxpayers.[17] In a small number of U.S. public plans, the plan sponsor and the plan members share in the financial risk of the plan. The Wisconsin Retirement System is one example of a plan that has such an arrangement.

In Canada, and particularly in the Netherlands, sharing of funding risk is more common. Virtually all Dutch pension plans are target defined benefit plans, in which the plan aims to provide a defined benefit, but the benefits are adjusted downwards if insufficient assets are on hand, and adjusted upwards if the funded status subsequently improves.

Independent Risk Oversight: Examples of independent risk oversight mechanisms include requirements to undergo special management or fiduciary audits, and the establishment of stakeholder oversight bodies.

Cortex has identified a number of U.S. public plans that are required by law to undergo independent third-party management or fiduciary audits. These include, but are not limited to, all three retirement systems sponsored by the City of Los Angeles, all public plans in the state of Ohio, and the New York State Common Retirement Fund. These audits are generally very broad in scope and are aimed at assessing the governance practices of the plan fiduciaries, the investment performance of the funds, the asset allocation policies of the plans, and sometimes

[17] It can be argued that plan members may bear some funding risk in that plan sponsors may attempt to recoup unexpected pension funding costs through wage negotiations.

the cost effectiveness of the operations. The audits are commissioned by the plan sponsor and the costs are borne by the plan sponsor.

Cortex also identified examples of public plans that are subject to oversight by a stakeholder oversight body; e.g. a committee of the legislature. The Maryland State Retirement System ("Maryland SRS") is one such example; representatives of Maryland SRS must appear periodically before a legislative committee to review the performance of the plan and any other issues of interest.

Board compensation. It is uncommon for public plans to pay their board members anything other than a nominal honorarium plus re-imbursement of expenses incurred in attending meetings. Cortex did identify public plans in other countries that do pay compensation to board members comparable to that paid to directors of private sector corporations. These plans are very large, but may nevertheless provide some perspective on board member compensation. See Appendix 3 for details.

Constraints on Board Action or Policy: Cortex identified one example of governing legislation that imposes reasonable constraints on board actions to facilitate fiduciary decision-making. In Texas, pension plans are prohibited by law from engaging in lobbying activities to influence legislation that affects benefit design. While trust law and ERISA would appear to prohibit self-dealing, we did not find any governing statutes that prohibit public plans from engaging in economically targeted investment strategies; we did not however perform a comprehensive review of this issue.

Assessing the San Jose Retirement Systems

The City Retirement Systems already have a number of the additional safeguards discussed above, but both systems could benefit from having further safeguards in place.

Transparency and Disclosure. Both City Retirement Systems are already highly transparent. They are subject to open meeting laws and any member of the public may therefore attend board and committee meetings and obtain meeting materials. The Retirement Systems go further than many of their peers in that they broadcast their meetings on the internet in video and/or audio format. They also post a considerable amount of information on their websites including, but not limited to, investment policies and performance reports, meeting minutes, and the annual comprehensive financial report.

While meetings of the Retirement Boards are open and accessible to the public, the meetings are designed to allow the Retirement Boards to conduct their regular business. They are not specifically designed to educate and inform the general public about the workings and performance of the Retirement Systems.

Alignment of Interests. With the recent passing of Measure B (Article XV-A of the City Charter), Cortex understands that members of the Retirement Systems may be required to share in the funding risk of the Retirement Systems, unless they voluntarily opt into a new Voluntary Election

Program. Measure B is being challenged in the courts, but if upheld, it introduces a sharing of financial risk, and a stronger alignment of the interests of plan members and taxpayers.

The plan membership understandably views Measure B negatively. Cortex cannot comment on the appropriateness of Measure B, but Cortex does believe it offers a benefit from a governance perspective. Because of Measure B, the City should now be more willing to grant the Retirement Boards full operational authority over the Retirement Systems, given that the City is no longer fully responsible for funding shortfalls.

Independent Risk Oversight. The Retirement Boards are currently not subject to monitoring by a stakeholder body specifically constituted for such purpose. Instead, as mentioned previously, the composition of each Retirement Board includes a non-voting board member selected by the City Council to act as a conduit between the Retirement Boards and the City Council. The non-voting board member may attend and participate in all meetings of the Retirement Boards, including educational meetings, but may not vote. The position is intended to benefit City Council by keeping the Council informed of the activities of the Retirement Boards. The other stakeholder groups (i.e. active and retired members) have no similar mechanism available to them.

3. Organizational Scale & Efficiency

Though not strictly a matter of governance, scale and efficiency in operations were also considered by Cortex as a best practice criterion. Pension administration, particularly with respect to the investment function, is subject to significant economies of scale. Economies of scale, along with efficient organizational structures, can have a major impact on whether a public plan achieves its long-term performance objectives.

Best practices would suggest that an efficient organizational structure is a linear structure (i.e. every level of the organization is accountable to one higher-level body; has minimal redundancy; contains clear lines of communication, authority, and accountability; and makes efficient use of board, staff, and external resources.

For public pension plans, economies of scale are most relevant for the investment function, though they may also exist, to a lesser extent, in the benefit administration function. Economies of scale in investment management arise when the incremental average cost of managing an additional dollar of assets decreases as the assets under management grow. Academic research has found that economies of scale are relevant for pension plans, as the investment performance of larger funds generally exceeds that of smaller funds, net of costs.[18] This outperformance is due to a number of factors:

[18] See: Dyck and Pomorski, Is Bigger Better? Size and Performance in Pension Plan Management, 2011; and CEM Study.

- Larger funds (e.g. over $10 billion) are able to justify in-house asset management which is much less costly than using external investment managers. They also enjoy lower costs through volume purchasing.

- Larger funds can invest efficiently in alternative asset classes which may enhance the risk/return characteristics of the total fund. Smaller funds often cannot access these asset classes, or must do so at a prohibitively high cost.

Industry Practices
Growing recognition of the advantages large plans have over smaller plans has caused plan sponsors in many jurisdictions to seek economies of scale by consolidating small plans, or by allowing them to outsource their assets to larger public plans. For example:

- In 2011, the Indiana Teachers Retirement Fund merged with the Indiana Public Employees' Retirement System to create a single $26 billion public plan, thus facilitating greater economies of scale in both the investment and the benefit administration functions.

- Massachusetts has established legislative provisions whereby smaller funds that fail to meet certain investment performance benchmarks are required to transfer their assets to the state investment board (Massachusetts Pension Reserves Investment Management Board).

- Governing legislation of the Ontario Municipal Employees' Retirement System and the Ontario Teachers' Pension Plan was revised in recent years to enable these organizations to manage the assets of smaller public funds. In addition, the government of the Province of Ontario has indicated it intends to require most public funds in Ontario to be amalgamated into a single fund with the express goal of achieving cost savings.

- In the Netherlands, All Pension Groups (APG) manages the assets of all government and education sector pension plans, and recently also the pension assets of the construction industry (totalling over one third of all Dutch pension assets). Furthermore, APG is free to manage additional assets of other pension plans.

With respect to the efficiency of pension plans' organizational structures, the great majority of structures involve a pension board supported by a single, dedicated staff with assistance from external advisors and vendors such as investment consultants, actuaries, and investment managers. An alternative, but relatively rare, structure is one in which a retirement staff supports multiple boards. The city retirement plans of Fresno City and New York City are examples of such a structure. Another example can be found in the province of Alberta, Canada, where there is a single public administrative entity that provides benefits administration services to five provincial public plans and their boards. Those same public plans rely on the investment staff resources of a single pension investment agency, the Alberta Investment Management Corporation.

Assessing the San Jose Retirement Systems

The organizational structures of the City Retirement Systems do not meet the criteria of scale and efficiency. The Retirement Systems are fairly unique in that they are governed by two distinct boards, despite carrying out similar activities and functions. They share the same staff and (through separate contracts) employ the same actuarial and legal firms and custodian. They also attempt to employ common investment managers when their respective investment strategies allow. On the other hand, they employ different general investment consultants and specialty investment consultants.

While having separate City Retirement Boards may result in each Board being more in tune with, and responsive to, its respective plan members, combining the two Boards would also have some advantages, including:

- More effective and efficient use of staff resources: Currently, staff must serve and respond to two boards, approximately eight committees, and sixteen board members. They must prepare for and attend a large number of meetings throughout the year.

- Clear accountability: Clearer governance and accountability with respect to the authority to hire, direct, evaluate, and potentially terminate the Director of Retirement Services.

- Improved net investment performance: Combining the assets of the Retirement Systems, and eliminating redundant service providers would enhance economies of scale, reduce investment costs, provide improved or more cost-effective access to additional asset classes and investment opportunities, and ultimately lead to potentially higher net investment returns. Admittedly, the economies of scale would not be dramatic due to the fact the Retirement Systems already share resources and co-ordinate efforts to some extent. Cortex estimated that if the key advisor contracts were consolidated (i.e. general investment consultant, actuary, legal, audit, and proxy voting) combined fees might be 25% to 33% lower, resulting in annual cost savings of approximately $700,000. This estimate does not however include potentially lower investment manager fees that might accrue if the investment programs were consolidated, which could potentially exceed the above amount. (See Appendix 4 for more detail concerning the above estimates).

Cortex does believe that combining the two Retirement Systems would significantly improve the efficiency and effectiveness of current staff resources, resulting in a more efficient and effective decision process.

V. NOTEWORTHY PENSION GOVERNANCE MODELS

The previous sections of this report found that few public pension plans display all of the best practice criteria identified in this report, and that the governance models of the two City Retirement Systems are relatively weaker than their industry peers. Cortex did, however, identify a small number of public plans or pension models that display many if not all of the best practice criteria. They are:

- San Bernardino County Employees' Retirement Association (SBCERA)
- Missouri State Employees' Retirement System (MOSERS)
- Texas Teachers' Retirement System (Texas TRS)
- Ontario Teachers' Pension Plan (OTPP)
- The Dutch Pension Model

These noteworthy plans/models may be instructive to San Jose and other public plans wishing to enhance their governance models. The above list includes public plans from California and other U.S. states, as well as from Canada and Europe. They also include public plans that range in size from under $10B to over $100B, suggesting that strong governance models can be, and have been, established for public plans of virtually any size.

A short overview of why Cortex considers the above public plans to be noteworthy and how their governance structures might be informative follows. More details about each public plan may be found in Appendix 2.

San Bernardino County Employees' Retirement Association (SBCERA)
SBCERA was selected because it meets a number of the best practice criteria, though not all of them. It is also of particular interest because it recently underwent fundamental changes that brought it into line with certain best practice criteria. How it implemented these changes may be particularly instructive for San Jose. The fact that SBCERA is a California public plan is helpful, as it demonstrates that certain best practices can readily be achieved within California.

Like many public plans, SBCERA has complete authority to invest the assets of the plan, subject to prudent person standards, and it has the authority to hire any external advisors it deems necessary. SBCERA stands out from industry peers, in California and elsewhere, in that it has the authority to hire, direct, compensate and terminate its own staff. That is, SBCERA has the legal authority to hire virtually any specialized staff it requires to administer the Association[19]:

> *The SBCERA board may appoint an administrator, assistant administrator, chief investment officer, subordinate administrators, senior management employees next in line to subordinate administrators, supervisors and*

[19] Other California county systems that have similar, though not quite as extensive, authority over human resource matters include the retirement systems of Orange County and Los Angeles County.

> *employees with specialized training/knowledge in pension benefit member services, investment reporting compliance, investment accounting, pension benefit tax reporting, pension benefit financial accounting, pension law, and legal counsel.*[20]

Furthermore, SBCERA's governing legislation provides that:

> *The above employees may not be county employees but shall be employees of SBCERA, subject to terms and conditions established by the SBCERA Board.*[21]

The boards of most California city and county pension plans may only hire the executive director and certain other senior level executives in at-will positions. All other employees must be city or county employees subject to city or county civil service system rules.

While SBCERA may hire its own staff, it falls short of certain other important governance criteria. The composition of the SBCERA Board must include, by statute, a number of individuals who are inherently conflicted, including active and retired members of the system and the county treasurer and tax collector. As well, there is no requirement that any board members have specialized expertise relevant to the administration of the plan. Furthermore, SBCERA employees are not independent, as they are members of SBCERA.

Missouri State Employees' Retirement System (MOSERS)

Similar to SBCERA, the MOSERS board has a high degree of independent authority to administer the plan, including the authority to invest the assets of the plan, to appoint any necessary advisors, and to appoint an executive director. Other employees of MOSERS are chosen only upon the recommendation of the executive director. In addition, the Board may determine the salaries of MOSERS employees.

MOSERS however falls short of best practices in a number of respects. Similar to SBCERA, MOSERS's staff are members of MOSERS, and therefore not independent. More importantly, the board of MOSERS has a low level of independence, consisting largely of ex-officio and other elected officials, active plan members and a retiree. Two board members are appointed by the Governor; the governing statute does not specify that these individuals must be unconnected to state government. Like SBCERA, there is no requirement that MOSERS board members possess relevant expertise and experience.

Texas Teachers' Retirement System (Texas TRS)

The Texas TRS governance model meets a number of best practice criteria. At least five of the nine board members are required by law to have financial expertise, have worked in private business or industry, and have broad investment experience, preferably in the investment of pension funds. With respect to personnel matters, the TEXAS TRS board also has the authority

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[20] S. 31522.7 of the County Employees Retirement Law of 1937.

[21] Ibid.

to appoint its own staff. While staff are state employees, they serve at will. Texas TRS has the authority to establish its own human resource and compensation policies. This has allowed Texas TRS to successfully recruit highly qualified investment staff. With respect to investments, the Texas TRS board has the authority to invest the assets of the system, subject to fiduciary standards.

Texas TRS's governance model includes features that are intended to serve as a check on the authority of Texas TRS and thus protect the interests of stakeholders:

- The Texas Constitution provides that the Texas Legislature may restrict the pension board's investment discretion if it deems necessary. The Texas Legislature has exercised this authority in the past with respect to other state investment entities though, to Cortex's knowledge, not with respect to Texas TRS. Cortex understands the rationale behind this provision, but believes that more effective and appropriate safeguards exist.

- Texas TRS is required to submit its operating budget to the Texas Legislature for review and approval, even though Texas TRS has constitutional authority to exceed any budget so approved if the board believes its fiduciary duty requires it do so.

- Texas TRS is prohibited by law from lobbying the Texas Legislature with respect to benefits.

- Texas TRS is required to report annually on its performance to committees of both the Texas Senate and the House of Representatives.

A large proportion of the Texas TRS board is not fully independent, as four of the nine members are required to be active or retired plan members.

Ontario Teachers' Pension Plan Board (OTPP)
OTPP is often touted as an example of the "Canadian Pension Model". This term, however, generally refers to the strategy of a small number of Canadian plans that have built in-house capabilities in asset management and direct investment, which results in lower costs and better fund performance. The Canadian Pension Model is made possible because of the governance models in place to support it. The OTPP has complete authority to administer all aspects of the plan, from investing plan assets to adopting its own budget and hiring and compensating staff and advisors. There are also many safeguards in place to serve as a check on OTPP, including:

1. Joint Trusteeship - OTPP is governed by a jointly trusteed board consisting of equal numbers of board members appointed by the Province and the teachers' union.

2. Risk Sharing - Unlike most U.S. public sector pension plans, OTPP is jointly sponsored and the Province and the membership are jointly responsible for addressing surpluses and shortfalls.

3. Independence - OTPP demonstrates a high degree of independence:
   a. No elected officials or civil servants serve on the board.

b. No more than two of the nine board members may be plan members.
c. Staff members are not members of OTPP but, rather, of a separate pension plan.

4. Board Qualifications - Though governing legislation does not specify qualifications for the board members, in practice board members are highly experienced professionals and executives and are drawn from the fields of management, finance and investments, actuarial science, economics, accounting, and education.

The Dutch Pension Model

All Dutch industry-wide pension plans are target defined benefit plans, rather than traditional defined benefit plans typically found in the United States public sector. As such, Dutch public plans target, or aim, to provide their members with a retirement benefit of 70% of final or average wages, and there is no guarantee as to the exact amount of benefits. Benefits and/or contributions are adjusted, up or down, annually based on the funded status of the plans. Dutch pension funds are independent financial institutions with their own governance administrative structures separate from that of the employer, which allows them a significant degree of operational autonomy. As a result, employers are less able to dominate pension fund management. Given that employers are also not fully responsible for funding shortfalls, they are generally comfortable allowing such autonomy. The risk sharing in these models is also reflected in the composition of the governing boards, as employers and employees are equally represented.

All Pensions Group (APG) is a Dutch pension administration entity that reflects a number of best practices. The pensions of all government and education workers in the Netherlands (approximately 2.7 million workers) are managed by APG. The public plans are administered by APG through a service level agreement, and the pension clients have a 100% ownership stake in APG. In 2008, APG merged with Cordares, another pension administration entity, which manages pensions primarily for the construction industry. APG now manages the pension assets of approximately one third of all pension assets in the Netherlands. It serves four million members and is free to serve other clients, as well.

Conclusions Regarding Noteworthy Pension Governance Models

The public plans discussed above compare favorably to the best practice criteria identified and discussed earlier in this report. In particular, the boards of these public plans all have relatively high degrees of operational authority, which is necessary if they are going to effectively administer their plans and carry out their fiduciary duties. There is much more variation among the models with respect to safeguards, with OTPP and the Dutch Model being relatively stronger.

VI. RECOMMENDATIONS

This section of the report contains Cortex's recommendations for improving the governance of the City Retirement Systems. The recommendations flow directly from the above analysis and fall into three categories:

1. Recommendations pertaining to expanding the authority of the City Retirement Boards.
2. Recommendations to establish additional safeguards to protect the Retirement Systems' stakeholders. These recommendations can be further classified as those intended to a) enhance fiduciary independence, b) enhance the qualifications of the Retirement Boards, and c) provide other protections to stakeholders.
3. Recommendations to increase the scale and efficiency of the Retirement Systems.

The recommendations combine many of those submitted to the City in Cortex's 2009 Report along with new recommendations prepared for the City Retirement Boards in this 2013 report. With respect to the 2009 recommendations, Cortex has noted whether or not the recommendation was implemented.

It should also be noted that Cortex's recommendations are intentionally general in nature. This is because there are many ways to implement the recommendations, and Cortex believes stakeholders will wish to jointly consider and agree upon the details of implementation.

Expand the Authority of the Retirement Boards

1) Cortex recommends that the authority of the City Retirement Boards be expanded in order that they may better administer all aspects of their respective Systems and better fulfill their fiduciary duties. As discussed earlier in this report, the City Retirement Boards currently lack independent authority in a number of important areas. To rectify this, Cortex recommends that the Retirement Boards be granted full authority to administer their Systems including but not limited to:

    a) The authority to appoint, direct, evaluate, and, if necessary, terminate their own staff;
    b) The authority to set compensation levels and determine other human resource policies in connection with their staff.
    c) The authority to appoint legal counsel.
    d) The authority to establish their own procurement policies.

    If the above recommendations are accepted, retirement staff would no longer be hired by or accountable to the City Manager and would not be subject to the civil service rules of the City.

Similar recommendations were included in Cortex's 2009 Report, but were not implemented. Cortex however continues to believe that expanded authority in the above areas is critical to the long-term success of the Retirement Systems.

Establish Additional Safeguards for Stakeholders

Increase the Independence of the Retirement Systems

2) Cortex recommended in 2009 that the level of independence on the Retirement Boards be increased. More specifically, all board members selected by the City should be independent and not connected with the City. This would allow such board members to be more objective in their decision-making, and to focus solely on the best interests of members and beneficiaries, without being influenced by the interests of the City.

   The above recommendation was accepted by the City and implemented in 2011 via a change to the municipal code.

3) Cortex recommended in 2009 that the independence of the Retirement Boards be enhanced by eliminating the requirement that active and retired plan members serve on each board. Cortex recommended instead that active and retired members should have the option of selecting independent individuals to serve on the retirement board to represent them. Such individuals should not be active or retired members of either Retirement System nor should they be employees of officers of the respective employee or retiree associations.

   The above recommendation was not implemented by the City and approximately half of each Retirement Board is still required to consist of active or retired plan members. Active and retired plan members continue to have no ability to select independent, qualified individuals to serve on the Retirement Boards.

   As a result of the current review, Cortex now recommends that, for each City Retirement Board, the proportion of the Board that must consist of active or retired members be reduced to approximately 25%. Furthermore, approximately 25% of each Board should consist of independent persons appointed by active and retired plan members. Under this recommendation, the composition of each Board would be as follows:

   a) Approximately 50% of the board members would continue to be independent persons appointed by the City Council.[22]
   b) Approximately 25% of the board members would be independent persons appointed by active/retired members.[23]
   c) Approximately 25% of the board members would continue to consist of active/retired members selected by active/retired members.

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[22] i.e. Independent at a minimum should be defined to mean the board member is not connected with the City, not an active or retired member of either City retirement system, and not an employee or officer of the respective employee or retiree association.

[23] Ibid.

d) One independent board member would continue to be selected jointly by the board members selected in a) through c) above.

Procedures would need to be developed for nominating and appointing the above board members, along with clear criteria defining independence

The above recommendation is intended to ensure that plan members and the City will each be able to select 50% of the board members, while also significantly increasing the independence of the Retirement Boards. The above recommendation also provides that a proportion, albeit a smaller one, will continue to consist of active and retired plan members. In this manner, the decision-making processes of the Retirement Boards can benefit from the involvement of actual plan members. Academic research suggests that having plan members on a public plan board can help performance, provided plan members make up a small proportion of the board.[24]

4) Cortex recommended in 2009 that 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 will enhance the Retirement Boards' ability to act independently and to focus solely on the best interests of the members and beneficiaries of the Retirement Systems.

   This recommendation was not implemented. Cortex continues to support it.

5) Cortex recommended in 2009 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. This will enhance the Retirement Boards' ability to act independently and to focus solely on the best interests of the members and beneficiaries of the Retirement Systems.

   This recommendation was not implemented. Cortex continues to support it.

6) 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. Instead, the Retirement Boards should have the authority to seek out and provide alternative benefit arrangements for their staff. This will help ensure any analysis and recommendations put forward by staff are as objective as possible.

Recommendations to Enhance the Qualifications of the Retirement Boards.

7) Any independent board member appointed to the Board by City Council or by active/retired members should be required to have expertise and experience relevant to the administration of the Retirement Systems. Specific criteria for determining a prospective board member's

[24] Hess, D. (2005). Protecting and Politicizing Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices. *US Davis Law Review*, November 2005.

qualifications should be developed as part of the nominating and selection procedures noted in recommendation 3 above,

Cortex made a similar recommendation in its 2009 Report. That recommendation was partially implemented by the City through a change to the Municipal Code. The independent board members appointed by the City are now required to possess relevant expertise. The recommendation could not be fully implemented to apply to all board members, because the remaining board members consist of active and retired plan members.

8) To help recruit and retain qualified, independent board members, the Retirement Boards should have the ability to offer appropriate compensation for independent board members (i.e., those selected by the City and/or the plan membership). It is difficult to provide an estimate of what would constitute appropriate compensation and there can be many approaches to compensating board members (fixed retainer, per diems, committee fees, chair fees, etc.), but Cortex believes annual board member compensation of approximately $20,000 would not be unreasonable and that board and committee officers should receive additional compensation.

   Cortex also made this recommendation in its 2009 Report. The recommendation was not implemented. Cortex continues to support it.

Other Stakeholder Safeguards

Transparency & Disclosure

9) Cortex noted in its analysis that the Retirement Systems are already highly transparent to the public with respect to their operations. Cortex would nevertheless recommend that the Retirement Boards be required to make certain additional annual disclosures including:

   a) Total annual compensation, benefits, and incentive compensation earned by each of the senior executives of the Retirement Systems.
   b) Total annual payments made to each board member including compensation and reimbursement of expenses.
   c) Independent annual reporting of the risk-adjusted performance of the retirement funds relative to appropriate benchmarks.
   d) Independent reporting on the cost-effectiveness of the administration of the system relative to appropriate benchmarks (at least every three years and including trends).
   e) Summary annual report of board member education efforts and related travel.
   f) Summary annual report of board member meeting attendance (board and committee meetings).

   The above disclosures should be clearly made on the Retirement Systems' websites and in their comprehensive annual financial reports.

A number of the above recommended disclosures are particularly relevant if the Retirement Boards are granted broader authority in areas such as appointment and compensation of staff.

10) The position of non-voting board member should be eliminated. As noted in this report, this position is currently filled by a member of the City Council and is intended to serve as a liaison for the City Council. Cortex recommends that the non-voting board member be replaced by a stakeholder committee for each Retirement System. The Retirement Systems should be required to meet with their respective stakeholder committee at least annually and such committees would have no discretionary authority. Instead they would serve as an additional public forum for key stakeholder groups to exchange information and perspectives amongst each other and with the Retirement Systems; and to review the performance of the Retirement Systems.

    Each stakeholder committee might consist of at least six members and might include individuals appointed by, for example, the City Council, the Mayor, the City Manager, and the employee and retiree associations.

11) Each Retirement System should be required to hold an annual general meeting that is easily accessible to the public, whereby board members and senior retirement staff will inform and educate the public about the performance and activities of the Retirement Systems and engage in questions and answers. The format and agenda of such annual general meetings would be different from those of regular board meetings, in that they would be designed to serve the education and information needs of the general public, as opposed to the regular business of the Retirement Boards.

Sanctions

12) Provisions should be established in the governing legislation to allow for the removal, by the appropriate appointing authorities, of any board member for reasons relating to their performance or conduct (e.g. poor meeting attendance or ethical breaches). Furthermore, governing legislation should provide that the Retirement Boards may recommend removal of an appointed board member to the party that appointed the board member.

    Cortex also made this recommendation in its 2009 Report. The recommendation was not implemented. Cortex continues to support it.

Risk Oversight

13) Cortex recommends that the City Retirement Systems be subject to an external independent review of their fiduciary and management practices once every 5 years. The reviews could, for example, focus on the reasonableness of the asset allocation policies and practices of the Retirement Boards, the success and reasonableness of any active investment management that is undertaken, the fiduciary practices of the Board, staff, and advisors; and the cost-effectiveness of plan and fund administration. This review would be separate and apart from any internal or external audits commissioned by the Retirement Systems themselves. To keep the costs of such audits to reasonable levels, the scope should be carefully defined.

14) Cortex recommends that each Retirement Board be required to establish an audit committee to help further ensure adequate Board oversight of the financial assets and risks of the Systems.

This recommendation was included in Cortex's 2009 Report but was not implemented. The Retirement Boards however have nevertheless implemented them on their initiative.

Scale & Efficiency

15) While perhaps not specifically related to governance, Cortex 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. This would improve the efficiency and effectiveness of staff, generate cost savings, and potentially result in improved risk-adjusted investment returns.

If the Retirement Boards are consolidated into a single board, the newly constituted board should meet all of the best practice criteria set out in this report. To meet the criteria, particularly the requirement that stakeholder interests be properly reflected in the composition of the board, the size of the consolidated board may need to be larger than either of the current Retirement Boards.

Priority Recommendations

While all of the above recommendations would enhance the governance of the Retirement Systems, some of the recommendations are more important than others. At a minimum, Cortex suggests that the following (equally important) priority recommendations should be adopted:

- Granting the Retirement Boards full authority over the operations of the Retirement Systems by expanding their authority in the areas noted in the report. This would include, among other things, allowing the Retirement Boards to employ their own staff who are exempt from City Civil Service Rules.

- Enhancing the independence of the Retirement Boards by requiring that active and retired plan members appoint independent persons of strong character to fill approximately 25% of the seats on each board, while continuing to allow approximately 25% of the seats to be filled by active and retired plan members.

- Enhancing the technical qualifications of the Board by requiring that all appointed, independent board members have relevant skills and experience, regardless of whether they are appointed by the City or by active or retired plan members.

Cortex would like to stress that the above priority recommendations must be adopted simultaneously. The governance and management of the Systems will not be improved in the long run if stakeholders implement additional safeguards, but fail to grant the Retirement Boards full operational autonomy, or, conversely, grant the Boards full operational autonomy without also establishing the additional recommended safeguards.

The above changes all require amendments to either the San Jose City Charter or the Municipal Code. The Retirement Boards have no authority to address the above recommendations.

Remaining Recommendations

The following recommendations are less urgent than those listed above. If accepted, however, they would also require amendments to the City Charter or Municipal Code:

1. Allowing the Retirement Boards the authority to establish alternative benefit arrangements for their staff.
2. Elimination of the non-voting board member positions.
3. Mechanisms for the removal of board members.
4. Allowing the Retirement Systems the ability to offer meaningful compensation to independent board members.
5. Requiring the Retirement Systems to make the additional disclosures set out in Cortex's recommendations.
6. Requiring the Retirement Boards to hold annual general meetings for the public.
7. Discouraging or prohibiting economically targeted investment policies.
8. Prohibiting the Retirement Systems from engaging in advocacy to change or improve benefits.
9. A requirement to establish stakeholder committees and for the Retirement Systems to hold annual meetings with them.
10. A requirement that independent fiduciary audits be performed every 5 years.
11. A requirement that each Retirement Board establish an audit committee.

Cortex has recommended that the above provisions be codified in the City Charter or Municipal Code so that they will have the force of law. If the Charter and Municipal Code are not changed to reflect the above recommendations, the Retirement Boards may nevertheless implement the recommendations voluntarily. In fact, given that it may take more than a year for the Stakeholders to study and address the recommendations, the Retirement Boards may wish to consider adopting the recommendations in the very near future.

Cortex's recommendation concerning the scale and efficiency of the Retirement Systems are independent of Cortex's other recommendations. That is, they may or may not be adopted, regardless of whether the other recommendations are adopted.

Implementation Issues

There will undoubtedly be many issues that arise when attempting to implement the above recommendations. A few of them are discussed below:

1. *Exempting retirement staff from the civil service system.* As noted elsewhere in this report, the staff of most public plans are subject to civil service system rules, and it is rare to find public plans that have undertaken a process to exempt their employees from such systems. Accordingly, the City Retirement Boards have few examples to refer to. As discussed previously, however, Cortex has identified another California public plan that has recently gone through such an exercise, the San Bernardino County Employees' Retirement Association (SBCERA). Cortex contacted SBCERA to discuss the experience and learned that SBCERA made offers of employment to all of its incumbent staff members. If they accepted the offers, the staff would no longer be county employees subject to civil service. Only three employees elected to remain county employees working in the retirement office. Over time, however, all SBCERA staff will be employees of SBCERA. Please refer to Appendix 2 for further details about SBCERA.

2. *Separate benefit plans for retirement staff.* Once again, SBCERA serves as an example of a public plan that attempted to have its employees participate in a separate pension plan not administered by SBCERA. SBCERA investigated various options, but, for reasons of cost-effectiveness, ultimately decided to contract back to the County for its employee benefits.

3. *Nomination procedures.* As mentioned in recommendation 3, it will be important to establish clear procedures for appointing members to the City Retirement Boards. In developing the procedures, the City should consider the use of independent nominating committees, detailed nomination procedures, and clear criteria to determine if a candidate is truly independent and possesses the necessary qualifications.

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APPENDIX 2: INDUSTRY LEADERS PROFILES

San Bernardino County Employees' Retirement Association (SBCERA)

General Information

	SBCERA
Plan Type	Defined Benefit
Plan Assets	$6.4 B (at 11/30/2012)
Funded Status	79.2%
Assumed actuarial rate of return	7.75%
Investment performance to 11/30/2012	9.9% (3 year) 7.4% (10 year)

Asset Allocation (07/05/12)

Asset Class	Target (%)
Domestic equities	13
International equities	13
US fixed income	17
Global fixed income	16
Real estate	9
Private equity	16
Real assets	7
Absolute return	7
Cash	2

Board & Staff Independence

Board Composition

- Nine board members:
  - San Bernardino County Treasurer (ex officio member)
  - 4 members appointed by San Bernardino County Board of Supervisors
  - 2 members elected by "General" members;
  - 1 member elected by "Safety" members (along with an Alternate)
  - 1member elected by "Retired" members (along with an Alternate)

- Staff are members of the pension plan.

Board Qualifications

- No requirement for board members to have expertise and experience relevant to pension plan and fund administration.
  - Ex-officio member is highly likely to have financial background.
  - Board of Supervisors likely to attempt to appoint members with relevant expertise and experience.
- Recent changes to 1937 Act established minimum educational requirements for trustees.

Board Compensation

- Board members receive $100 per meeting (CERL 31521) to a maximum of 5 meetings per month.

Missouri State Employee's Retirement System (MOSERS)

General Information

	MOSERS
Plan Type	Defined Benefit
Plan Assets	$8.1 B (at 06/30/2011)
Funded Status	77.2% (as 06/30/2011)
Assumed actuarial rate of return	8.5%
Investment performance to 06/30/2011	3.9% (3 year) 7.1% (10 year)

- Top performing state fund over past 10 years

Asset Allocation (06/30/11)

Asset Class	Target (%)
Domestic equities	19.2
International developed	19.6
Emerging markets	6.2
Core fixed income	10.0
TIPS	10.0
High yield	5.0
Market neutral	5.0
Real Assets	15.0
Private Investments	10.0

Board & Staff Independence

Board Composition

- Board consists of 11 members:
  - State Treasurer (ex officio member)
  - Commissioner of Administration (ex officio member)
  - 2 members of the senate
  - 2 members of the house
  - 2 members appointed by the Governor
  - 2 elected active members
  - 1 elected retiree

- Staff are members of the pension plan.

Board Qualifications

- No requirement for board members to have expertise and experience relevant to pension plan and fund administration.
  - Governor likely to attempt to appoint members with relevant expertise and experience

Teacher Retirement System of Texas (Texas TRS)

General Information

	Texas TRS
Plan Type	Defined Benefit
Plan Assets	$111.4 B (at 06/30/2012)
Funded Status	81.9% (as 06/30/2012)
Assumed actuarial rate of return	8.0%
Investment performance to 06/30/2012	11.2% (3 year) 7.4% (10 year)

Asset Allocation (06/30/12)

Asset Class	Target (%)
Public Equity	50.0
Private Equity	12.0
Fixed Income	13.0
Short-term	1.0
Hedge funds	4.0
Global inflation linked bonds	5.0
Real Assets	13.0
REITs	2.0

Board & Staff Independence

Board Composition

- 9 members all appointed by the Governor:
  - 3 trustees direct appointees of the Governor
  - 2 trustees nominated by State Board of Education (subject to senate confirmation)
  - 2 active members nominated by public school district employees
  - 1 active member nominated by higher education employees
  - 1 retiree nominated by TRS retired members

- All staff are members of the pension plan.

Board Qualifications

- At least five board members are required by law to have financial expertise, have worked in private business or industry, and have broad investment experience, preferably in the investment of pension funds.

Ontario Teachers' Pension Plan (OTPP)

General Information

	OTPP
Plan Assets	$117 B (at 12/31/11)
Funded Status	94.4% (as 01/01/12)
Assumed actuarial rate of return	5.05%
Investment performance to 12/31/12	4.2% (4 year) 8.0% (10 year)

- Plan members and the Province share funding gains and losses.
- Jointly sponsored plan by Ontario Government and Ontario Teachers' Federation (partners committee)

Asset Allocation (12/31/2011)

Asset Class	Target (%)
Equity	44
Fixed Income	48
Commodities	5
Real Estate	22
Absolute return	11
Money market	-30*

* Money-market activity provides funding for investments in all asset classes, and is comparable to a treasury department in a corporation.

Board Composition

- 9 board members:
  - 4 appointed by the Ontario Government
  - 4 appointed by Ont. Teachers' Federation (OTF):
  - OTF by-laws require at least two OTF appointments may not be plan members.
  - The 9th member (board chair) is selected by the 8 other board members
  - Composition is not set out in legislation, but in the plan document negotiated by plan sponsors

Board Qualifications

- Governing legislation does not specify educational requirements for trustees
- In practice, all members are highly experienced professionals
  - Board member are drawn from fields of business management, finance and investment management, actuarial science, economics, education, and accounting

Board & Staff Compensation

	Annual Compensation
Board Chair	$165,000
Each Board Member (not the Chair)	$65,000
Chair of a board committee	$15,000 additional
Board members appointed to more than 3 committee OR are in their 1st year of tenure	$5,000 additional

Staff Position	Base Salary	Annual Incentive	Long-term Incentive	Total Compensation for 2012
President & CEO	25%	37.5%	37.5%	$4,252,285
SvP & CFO	45%	27.5%	27.5%	$1,111,192
EvP, Investments	25%	37.5%	37.5%	$3,555,039
SvP, Fixed Income & Alternative Investments	27%	33%	40%	$2,398,785
SvP, Public Equities	27%	33%	40%	$2,010,954

APPENDIX 3: BOARD COMPENSATION FOR CANADIAN PENSION BOARDS

Table 1: Board Compensation for Canadian Pension Boards

	Annual Retainer	**Annual Retainer for Committee Chairs**	**Attendance Fee per Board Meeting**	**Attendance Fee per Committee Meeting**
Canadian Pension Plan Investment Board[25]	$32,500	$10,000	In person: $1,500 Teleconf.: $750	In person: $1,500 Teleconf.: $750
Ontario Teachers' Pension Plan[26]	Member: $65,000 Chair: $165,000	$15,000	nil	nil
Public Sector Pension Investment Board[27]	Member: $30,000 Chair: $150,000	$10,000	$1,500 <1hour: $500	$1,500 <1hour: $500
Alberta Investment Management Corporation[28]	Member: $20,000 Chair: $50,000 Vice-Chair: $10,000	Audit: $10,000 Others: $7,500	$1,000	$1,000

[25] Source: CPPIB Compensation Policy – February 14, 2013
[26] Source: OTPP 2012 Annual Report
[27] Source: PSP By-Law No.2 – June 8, 2012
[28] Source: AIMCo 2012 Annual Report

APPENDIX 4: KEY SERVICE PROVIDERS – POTENTIAL COST SAVINGS

The following table contains estimates of potential savings that may arise from consolidation of certain professional services currently engaged by the City Retirement Boards. The estimated savings discounts were arrived at through discussions with retirement staff and some of the service providers. We believe the estimated savings discounts are reasonably conservative. The table does not include estimated savings for investment management services.

Services	Estimated Savings Discount	Combined Annual Costs: P&F and Fed City[29]	Estimated Annual Savings
Custodian	25%	$ 399,304	$ 99,826
Investment Consultant	33%	$ 1,097,926	$ 362,316
Actuarial Services	25%	$ 485,906	$ 121,477
External Legal Services	25%	$ 382,488	$ 95,622
Financial Audit	33%	$ 113,018	$ 37,295
Proxy Voting	33%	$ 49,983	$ 16,494
Total Estimate			**$ 733, 030**

[29] Based on average of FY2011 and FY2012 annual fees.