CITY OF FORT PIERCE - OFFICE OF THE CITY ATTORNEY

M E M O R A N D U M

TO: Thomas K. Perona, Chair, Fort Pierce Retirement System

FROM: James T. Walker, Assistant City Attorney

RE: Report on 2015 NAPPA Conference

DATE: July 23, 2015

This memo is intended to serve as thanks to the Board of Trustees for the Retirement System of the City of Fort Pierce for authorizing my attendance, once again, at the Annual Educational Conference of the National Association of Public Pension Attorneys (NAPPA). Such conference ran from June 23 thru June 26, 2015. My participation in that event was inspired by awareness that "The more extensive a man's knowledge of what has been done, the greater will be his power of knowing what to do." – Benjamin Disraeli.

I am further mindful that, as one Margaret Fuller put it, "If you have knowledge, let others light their candles in it." My sense of appreciation is therefore expressed by offering in what follows a summary of some of the highlights of what I myself found most interesting. It is done with a qualification: one of the features that distinguishes this particular conference from some others is that each speaker's presentation is accompanied by an extensive outline. There must be over a thousand pages of material. There were many speakers and numerous breakout sessions, some of which ran concurrently with each other, meaning that some were attended and some were not. With all this in mind, it is impossible to attempt here a summary of anything more than a small portion of what was actually given out. But a memory stick is to be provided to each of our board members which contains the entire record of proceeding. If the material there raises questions on anything not covered here, I'll be happy to address it or, if I can't, will find someone who can.

With that, let me begin. The opening day of the Conference focuses on basic principles of retirement law, aimed at new members and practitioners. I always find this a beneficial reminder of what should be known or recalled but maybe wasn't, and usually pick up new bits of information. Indeed, each of our board members will find it a useful exercise by themselves paying particular attention to the opening outlines—each such outline is felt to be well crafted and worth the time spent in reviewing them. The initial outline, by Bill Akerman, reviews the fiduciary status of governing board members, creation of fiduciary duties, characteristics of the fiduciary and how the standard of care borne by a fiduciary is much higher than what is typically expected of an individual in normal daily living. Mr. Akerman reviewed areas of fiduciary

responsibility including fund management and administration, communication and education, investment-related activity, and selection of consultants and advisors. He also discussed fiduciary responsibilities in relation to litigation, and breach of fiduciary duty, and best practices.

One Brian Goodman of the Virginia Retirement System presented "Benefits Basic for Governmental Defined Benefit Plans". He identified major sources of federal law governing a Plan, other than the immediate plan documents, including the US Constitution, Art. I, sec. 10 ("No State shall pass any… law impairing the obligations of contracts."), the Uniformed Services Employment and Reemployment Rights Act (USERRA), Title II of the Employment Retirement Security Act of 1974 (ERISA), the Age Discrimination in Employment Act (ADEA) and Americans with Disabilities Act (ADA). He presented the basic formula for benefit entitlement, one which our board members is undoubtedly familiar with: AFC (average final compensation) x months/years of service x a "factor/multiplier". He also addressed remediation of errors made in administration of benefit entitlement.

A particularly helpful outline is supplied by Lisa Harrison, entitled "Are you Qualified? Protecting the Systems Qualified Status and Providing the Best Tax Treatment for Members' Benefits". It pointed out that governmental plans are maintained and qualified under IRC sections 401(a) and 414(a) and those sources controlling requirements for their qualification include IRS regs, Treasury regs, revenue rulings, revenue proceedings and notices, as well as private letter rulings. Proper qualification of the Plan is necessary so that employer contributions are not taxable to members, that earnings income is taxed to neither the Trust nor members, which distributions receive favorable tax treatment that employers don't pay employment taxes when employer contributions are made or benefits paid. Moreover, governmental plans are exempt from most (but not all) ERISA requirements do not have to make premium payments to the Pension Benefit Guaranty Corp. (PBGC) and are entitled to certain other IRC exemptions for premium payments. Normally Plan eligibility receives IRS confirmation through submission of IRS Form 5300, but the IRS is moving away from issuance of Letters of Determination after this 2015 approval Cycle. Ms. Harrison further discussed the Exclusive Benefits Rule—see sec. 401(a)(2), prohibited transactions—see sec. 503(b), limits on contributions—see sec. 415(c), limitations on benefits—see sec. 415(b), limits on service purchases—see sec. 415(n), limits on compensation—see sec. 401(a)(17), required benefit payments—see sec. 401(a)(9) and rollovers—see sec. 401(a)(31).

There was discussion of the federal legislative climate. Not much of anything is likely to happen this year, for a couple of reasons. For one thing, public pensions generally are doing much better these days, taking the steam out of reformist impulses. The 2015 Wilshire Report on State Retirement Systems makes good reading this year. It shows that the funding ratio for public systems was about 80% on average in 2014, up from 74% in 2013. Public pension asset valuation is now up above the previous 2007 peak. As of 9/30/14, state and local plans held $3.7T in assets. For another, the mere fact of an approaching election season in 2016 makes it unlikely there will be any significant political pressure to disrupt pensions before the end of 2016. One bill that has been hanging on from previous years, the Public Employee Pension Transparency Act (PEPTA), which makes it "voluntary" for public plan sponsors to report funding information annually to Treasury using market values, is going nowhere fast. No hearings are scheduled on it, and the number of sponsors is way down, only two in the Senate

and ten in the House. But the speakers warn that things could heat up after the election. Pensions remain a tempting target for conservative budget cutters: from 2012-16 retirement security incentives cost Treasury $654.3B dollars, $198.9B of which is attributed to DB plans. Enemies of public DB plans remain many and strong. There is, for instance, the Arnold Foundation, which holds $1.4B in assets and is mounting an aggressive nationwide campaign in favor of DC and "cash balance" plans as a substitute for the traditional security afforded by defined benefit plans.

A panel reviewed benefit litigation around the country. Either of two legal tests has been used by the courts nationwide in weighing benefit challenges. First, there is a contractual "per se" test. If the benefit in question (COLAs are frequent subjects of litigation, for instance) is part of the contract existing between employer and employee and entitlement is vested, that pretty much ends the court's review. Benefit entitlement is upheld. But a second test was enunciated by the US Supreme Court in **US Trust Co. of New York v. New Jersey,** 431 US 1 (1977). It determined that a contractual benefit term may be set aside upon application of a three-prong inquiry: is there a contract? If so, was the contract substantially impaired? If it was, is the impairment reasonable and necessary to serve a legitimate public purpose? Here in Florida, intermediate District Courts generally have applied the "per se" test. The question of which test the Florida Supreme Court might find controlling remained unsettled until it handed down **Scott v. Williams,** 107 So.3rd 379 (Fla 2013). **Scott** was the only Florida case discussed by the panel. There, our board members may recall, the Court upheld legislation which converting the Florida State Retirement System from a noncontributing system by employees to contributing. This was attacked as an unconstitutional impairment of contract. But the Court chose to adopt the **US Trust** standard and, after working its way thru the three-prong test held that the legislature may eliminate prospective benefits going forward, "… so long as any benefits tied to service performed prior to the amendment date are not lost or impaired." pg. 389. Hence, employees could thereafter be required to contribute to the plan.

One presentation was entitled "Role of the General Counsel in Investment Transactions: Perspective from internal and external legal counsel and an investment professional". Funds with billions of dollars in assets are heavily committed to direct decision-making involving their investments. They have in-house staffs of management, financial, investment and legal administrators, consultants and advisors. This lecture was primarily for their benefit as it involved use of legal expertise in making their investments.

A perennial panel that appears at most annual conferences is The Small/Medium Fund Affinity Group Workshop. This is a group which leads a discussion by attendees on several different topics of presumed special interest to smaller funds. Remember that for purposes of this national conference, including such participants as CalPers, a billion dollar fund is small beans. "Small" is definitely relative here. So some of what is discussed in the workshop is transferable to our own Fort Pierce situation while some is not. The first discussion topic was entitled "Alternative Investments—What does your board know and what should they know?" We know that Funds look increasingly beyond the traditional world of stocks and bonds to other forms of investment in an effort to grow their yields. This is particularly true of Funds which, unlike the Fort Pierce System, possess resources permitting them to do their own direct investing. The panelists identified several such alternative vehicles, including private equity, hedge funds and direct

investment in such fields as agriculture and real estate. They briefly reviewed the different structural formats of each alternative vehicle and the respective duties of care to the Fund. There may or may not be any fiduciary care required of them in the exercise of their obligations. They may only be bound to exercise ordinary care. The board members need to understand what level of care applies to each such alternative service provider. If the alternative vendor commingles assets of multiple different Funds or investors that can create its own set of issues. Where there is investor commingling, it limits a Funds ability to negotiate over the terms of the relationship. There may be an investors' committee within the Fund which makes the actual investment decisions, such committee including only the larger investors, while the rest are merely along for the ride. A good example of this is our own board's recent involvement with a real estate fund. Such real estate entity commingles our monies with the monies of other, much larger investors. While we were able, with some assistance from outside counsel, to negotiate an investment contract bearing on terms limited strictly to Florida and local concerns, such as venue for any litigation involving only our own Fund, there isn't much leverage for negotiating beyond that. We depend on the real estate fund to make the actual choices on how to place its real estate money. A second discussion topic was "Succession planning in the event of the loss of key staff members". The Fort Pierce Retirement System Trust Fund has no full-time staff members, as such. Instead, it relies on city staff resources. But larger Funds retain full-time executive directors, investment managers, informational resource managers, operations/benefit managers, their own fully dedicated legal departments. For those Funds, problems can arise when key people suddenly leave. The ED may be fired. There may be contractual issues over severance, there may be a question about an interim successor's authority. There are several reasons for advance planning regarding this, relating to the board's duty as fiduciary, simple prudence, and the positive image it projects for plan stability. Such planning includes identification of the key people, naming early successors, while arranging contractual tie ups and incentives. Of course there always remains the existential question of whether anyone is ever truly indispensable. A third topic of discussion was called "Forming alliances and working successfully with stakeholders, participants, plan sponsors and other agencies of government". This involved the decision-making process, the first step of which is to identify effected stakeholders. Thereafter the issue should be defined, a process of resolution established, and goals fixed. There should be a means of facilitation, as by involvement of a mediator, with consensus as the objective, followed by finalization and implementation, while preserving existing alliances. For a fourth topic of discussion, there was "Advising your board on plan sponsor initiated benefit cuts". While we hope this will never become a concern in Fort Pierce, where the sponsors remain fully committed to the integrity and maintenance of the retirement system, nevertheless it can and does happen that a sponsor may seek to take a position about termination or modification of benefits that is at odds with the beneficiaries, leaving a board caught in the middle. In such an instance the board must remember its role as fiduciary and study the matter carefully. It should assure that both sides are well-educated on the issues and ramifications and assist them in resolving their differences if possible, as through mediary processes, providing advise from independent sources, even seeking opinions as necessary from the state attorney general. For a last resort the board may even choose to take sides. This can be an extremely complex, difficult situation.

Ethics is always an important part of the Conference agenda. This year it was called "Preventing Runaway Ethics". There were several excellent presentations. The first speaker reviewed ethics

in a psychological context of behavioral context and cognitive primary, with ABA Model Rule 1.13 (Organization as Clent) in the background, which obliges counsel to take action where a person within the organization may be engaging in acts of commission or omission which are like to result in substantial injury to the organization. There are often perverse incentives built into organizational practices and policies which can be recipes for disaster as by, for instance, rewarding results over high-quality decision-making. Opportunities for fraudulent/unethical conduct need to be identified and there needs to be readiness in questioning the status quo. A particularly interesting speaker, seen often in previous years, was James Salvie, General Counsel to the Massachusetts Teachers' Retirement System. He spoke on "It's Only a Game: Ethical Lessons from Sports". He spoke about three common areas of cheating in pension administration: accepting things of value from someone who can benefit from your actions; representing interests of the "day job" on the board; and self-dealing, or taking actions to benefit those close to you. He spoke of the rationales that can lure otherwise well- meaning individuals into such conduct.

Actuarial policy is another area routinely included in the Conference. The presenter this year was one Paul Angelo, whose lecture was "Funding Policies in a Post-GASB World of New Rules and Emerging Guidance". The focus was on actuarial funding policies. He identified some of the major players in this field. There is the Governmental Accounting Standards Board (GASB), which is the source of generally accepted accounting principles in use by state and local governments. But actuarial funding policies emanate from such groups as the Actuarial Standards Board, which puts out Actuarial Standards and Practices (ASOPs), the Academy of Actuaries, and its Public Plans Subcommittee, the Society of Actuaries, which publishes the "Blue Ribbon Panel Report", and the Conference of Consulting Actuaries Public Plans Communities, which puts out a "White Paper" (see Oct. 2014 issue). There is general consensus among these groups on these basic policies to be followed: there should be funding of the expected cost of all promised benefits and 100% of the unfunded actuarial liability; the cost of benefits should be matched up with the years in which the benefits emerge; (i.e. manage contributions volatility); balance competing funding policy objectives as by focusing on balancing demographic matching against contributions volatility; and actually fund the "actuarially determined contribution". These include the following specifics: use of the Entry Age Cost Method; a 5 year period of asset smoothing; and preference for a 15 to 20 year UAAL amortization schedule. Every board member should know this basic funding formula: contributions plus investment income equals benefit payments and expenses (C + I = B + E).

An absolutely fascinating panel discussion was presented under the heading of "DB v. Alternative Plans, Part II—A Discussion on the Pros and Cons". Hank Kim, Executive Director and General Council for the National Conference on Public Employee Retirement Systems (NCPERS) presented the case well for defined benefit plans. He identified the following reasons for why they are superior to defined contribution plans or hybrid alternatives: DB plans cost state and local governments less; DB plans provide disability and survivor benefits; DB plans enhance ability of state local governments to attract and retain qualified employees; DB plans help state and local governments manage their work force; DB plans earn higher investment returns and pay lower investment management fees; DB plans reduce overall cost of providing lifetime retirement benefits by pooling risk; DB plan investment earnings supplement employer and

employee contributions; DB plans provide predictable security for retirement benefits; DB plans help sustain state and local economies through the income streams provided to retirees. Mr. Kim's written outline, found within Thursday's schedule, was outstanding and our board members are urged to acquaint themselves with its contents. But present in the panel for dour counterpoint was Chuck Reed, Mayor of San Jose, California. That city was forced to close its DB plan after a ten year period of budgetary deficit accompanied by a 28% reduction in labor force. Eventually the city could no longer sustain the cost of its retirement system. Also on hand was William Fornia, President of Pension Trustee Advisors (PTA). He showcased a study, updated from 2008, by the National Institute of Retirement Security (NIRS), a research group based in Washington, D.C. Mr. Fornia's outline, too, is excellent and is likewise "required" reading by board members. The study shows that there are three reasons for why DB plans save money compared to DC plans: first, DBs pool the longevity risks of large numbers of individuals, providing each the security of a lifetime pension without the risk of outliving individual savings; second, DBs are "ageless" and therefore can perpetually maintain an optimally balanced investment portfolio rather than the typical individual strategy of down-shifting over time to a lower risk/return asset allocation; and third, DBs achieve higher investment returns as compared to individual investors because of professional asset management and lower fees. For equivalent benefits through "self-insurance" by means of a DC plan, the beneficiary would have to set aside $600,000.00, and, based on an 80th percentile of life expectancy, there is still a one out of five chance he or she will outlive savings, while contributions would have to be made by the employee at a rate of 19.6% of payroll. The case for DB plans is strong. But dissent was nevertheless offered by one Michelle Welch, who sat in for the Laura and John Arnold Foundation. She presented the Arnold Foundation's case against DB plans. She argued that DB plans, through a vesting requirement, short-change early to mid-career employees who may not remain in their employment sufficiently long to earn any benefit. She argued that workers and taxpayers are exposed to risk when plan sponsors fail to make sufficient payments, or the plan takes on too much investment risk, or makes incorrect assumptions about factors like life expectancy. She advocated alternatively for DC/Cash Balance plans which leave the employee with limited lump sum payments and annuities upon retirement. Her remarks were received politely. There, also, an outline will be found with the other materials.

There was also a "Municipal Bankruptcy Working Group Panel Discussion" , led by a federal bankruptcy judge, the former general counsel for CalPers, and several attorneys involved in bankruptcy proceedings of the City of Stockton, CA, Detroit, and Jefferson County, Alabama. Hopefully this is a topic which will continue to remain of only academic interest to the Fort Pierce Retirement System.

Finally, there was a review of "Significant Public Pension Decisions" from around the country. None of these involved any Florida cases. But a perusal of the case summaries is nevertheless advantageous to our board members who will thus acquire a sense of all the things that can go wrong for even the best-run of pension systems. Let us hope that our own system continues to remain free of such litigation concerns. Our consultant, Callahan Consultants, wisely stresses how well the system continues to do by maintaining a patient, steady course through the ups and downs that are normally to be expected in the usual course as the economy swings through cycles of boom and bust, with an outlook that must span decades. The temptation to respond with panicky overreaction to current developments can be great. Speaking strictly for myself, it is

admitted that I've often thought back to those who were Commissioners. Supporting city staff members, City Attorney John Brennan, and independent consultants when the system was first being established, and I've given them a silent prayer of thanks for the excellence of the work that so well stood the test of time! Thanking this board once again for giving me the opportunity to attend such an informative conference, I am and shall ever continue to remain, as always,

Most Cordially and Respectfully Yours,

James T. Walker, Esq.
Assistant City Atty/Board Counsel

s/ James T. Walker
James T. Walker, Esq.
Assistant City Attorney

/mlp
Attachment
cc: Robert V. Schwerer, City Attorney