Attachment 3

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

REVISED REPORT

September 2009

I. SUMMARY OF RECOMMENDED GOVERNANCE MODEL

Cortex recommends that the City establish a new governance model for its retirement systems that will support more effective governance and oversight for the benefit of the City and all other stakeholders. The recommended model would have the following features:

1) The Boards of each retirement system would continue to consist of seven members, with:
    a) Four members, being a majority of the Board, appointed by City Council. These individuals should be independent of the City and should possess strong knowledge, expertise, and experience relevant to the administration of public retirement plans.[1]
    b) Two members selected by active members. The selected members would not be required to be active members of the plans.
    c) One member selected by retired members, and not required to be a retired member.
2) If the above recommendation is implemented, thus providing an accountability safeguard for the taxpayers and the City, then the retirement boards should be granted broader authority to administer the retirement systems including:
    a) The authority to establish the operating budgets, including salaries, of the systems.
    b) The authority to hire and direct the Chief Executive Officer of the System, who in turn, should have the authority to hire and direct the necessary staff to administer the System.
    c) The authority to hire all service providers necessary to administer the System.
3) The governing statute would continue to state that the assets of the Trust Funds are to be held in trust for the sole benefit of members and beneficiaries of the plans and that the board members are to be held to strict fiduciary standards.
4) The role of each retirement board should be clearly defined and understood by all stakeholders as consisting solely of administering the benefits negotiated by the stakeholders, and should not include creating or changing the benefits, or advocating for improvements to the benefits. The process involved in changing plan benefits should reside solely with the plan stakeholders.
5) The governing statute should constrain economically targeted investing by, for example, requiring a super-majority vote of the retirement board in order to make such investments.
6) The governance model should require specific reporting to stakeholders on, at a minimum: performance relative to investment and funding objectives, compliance with benefit delivery policies and procedures, compliance with conflict of interest and ethics policies, results of internal audit findings and follow up efforts, and board member attendance, travel, and educational efforts.
7) Stakeholders should have the ability to remove individuals they have appointed or elected to the retirement boards for failure to act in accordance with their fiduciary duties or failure to carry out the requirements of governing legislation.

None of our recommendations would directly increase the operating costs of the retirement systems or the City, with the following possible exception:

- Should the City decide to compensate the four individuals it appoints to each of the retirement boards (see our recommendation on page 23), this would increase the operating costs of the system by the amount of such compensation.

[1] By independent we mean that the members should not be employees of the City or have significant, direct commercial relationships with the City.

II. SUMMARY ANALYSIS

The City of San José retained Cortex Applied Research to review the governance models of its two retirement systems: the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan. Based on our review of relevant documentation, interviews with stakeholders, and research into industry best practices, Cortex concluded that the governance models of the City's retirement systems do not support the long-term effective management of the systems and therefore do not effectively serve the interests of the key plan stakeholders. These include plan members, retirees, and taxpayers.

While the governance models of the two retirement systems have numerous weaknesses, two are particularly noteworthy:

1. The governance models do not ensure that the retirement boards on balance will possess sufficient and relevant expertise to effectively guide and oversee the retirement systems, and
2. The governance models do not ensure that the retirement boards will be free of significant conflicts of interest and able to focus freely on the administration of the systems and the best interests of the members and beneficiaries.

As a result of the above weaknesses and the lack of accountability safeguards they imply, the City has withheld from the retirement boards certain authorities involved in administering the retirement systems (e.g. the authority to hire the Director of Retirement Services).

While the City's actions are understandable, withholding such authorities from the retirement boards may undermine the long-term health and success of the retirement systems. Accordingly, a new pension governance model should be established in which the City is able to appoint a majority of retirement board members and select board members who are both independent and highly qualified. This would create the conditions under which the City could be comfortable granting broader administrative authority to the retirement boards, including the ability to establish an operating budget, hire and direct retirement staff, set staff compensation, and retain all necessary advisors and service providers. Granting such authority would better position the retirement boards to effectively administer the retirement systems by clarifying accountabilities, facilitating the recruitment of qualified board members, and strengthening stakeholder relations.

Given the combined size of the two retirement systems, their importance to the lives of City employees and retirees, and the impact they are forecasted to have on the finances of the City, Cortex believes the City should establish a new governance model for its retirement systems as soon as it is feasible.

Below is a description of the model Cortex recommends for the City's consideration. It reflects a number of fundamental governance principles and contains various safeguards to protect the City and other stakeholders. In addition, it is consistent with models found at other progressive institutional funds in the United States and elsewhere.

1. ***Recognition of all Stakeholders:*** The recommended governance model would recognize that the San José retirement systems affect multiple stakeholders, including:
   a) current and future plan members and retirees, who have or will contribute to the system; and
   b) current and future taxpayers, who contribute to the systems, guarantee the benefits, and are represented by their elected officials and public administrators.

2. ***Acknowledgement of Legitimate Stakeholder Interests:*** The recommended model would acknowledge that each of the stakeholders has legitimate interests in the retirement system that must be protected:
   a) Current members and retirees have a legitimate interest in ensuring that the benefits promised to them are secure and will be paid when due.
   b) Taxpayers have an interest in ensuring they do not bear unnecessary risk in guaranteeing the promised pension benefits.

3. ***Accountability Safeguards*****:** The recommended governance model would contain numerous safeguards to assure the City, members, and retirees that their interests will be managed and protected. Some of the safeguards would benefit *all* stakeholders, some would protect primarily the interests of the City and taxpayers, and others would protect primarily the interests of members and beneficiaries. In order to take effect, most, if not all, of the safeguards would require changes to the City Municipal Code.

   Recommended Safeguards to Protect the City and Taxpayers:
   a) The City would appoint a majority of the board members of each retirement board, reflecting the fact that the City is the ultimate guarantor of the pension benefits.

b) The City would be required to ensure that its appointees (a majority of each board) will have significant expertise and experience.
c) The City would be required to ensure that the individuals it appoints would be independent of all stakeholders.
d) Under the recommended governance model, the role of the retirement boards would be limited to administering current, promised benefits and would not include advocating for new or increased benefits.

Recommended Safeguards to Protect Members and Retirees:

a) The City would continue to serve as the final guarantor of pension benefits.
b) Board members would be subject to a fiduciary duty of loyalty, and therefore would be required to place the interests of members and beneficiaries as a group above all other interests.
c) The City-appointed board members would be independent of the City and should not have significant financial or other conflicts of interest involving the systems.
d) Active and retired members would have the *option* of selecting board members who have significant expertise and experience.
e) The retirement boards would be constrained in their ability to pursue economically targeted investment strategies that may benefit the local economy or the City at the possible expense of the retirement systems. For example, the Boards could be required to achieve higher decision-making hurdles, such as a super-majority vote, in order to implement such strategies.

Recommended Safeguards to Protect all Stakeholders:

a) Board members would be subject to strict fiduciary standards of prudence and care.
b) Stakeholders would have the ability to remove board members for breach of fiduciary duty or failure to comply with governing legislation.
c) The retirement boards would be required to establish detailed conflict of interest policies and procedures for board members and retirement staff that reflect the unique needs of public retirement systems, and that cover any relevant risks not already addressed by state and municipal legislation (e.g. the Fair Political Practices Act).
d) The retirement boards would be required to have an audit committee containing at least one independent board member with a strong accounting or audit background.

4. ***A Single Administrative Body:*** If the above safeguards are established – particularly the requirements that the City appoint a majority of the retirement board

members and that those board members be independent and highly qualified – then the City should grant the retirement boards broader authority to administer the retirement systems. This would include the ability to establish an operating budget, appoint and direct retirement system staff, set staff compensation, and appoint all necessary advisors and service providers. This is in contrast to the current San José governance model, in which administrative authority is split between the retirement boards, City Council, and the City Manager, with no one party having both the authority and resources to fully and properly administer the systems.

If proper safeguards are established, and the City nevertheless continues to limit the authority of the retirement boards, the following negative long-term consequences are likely:

- Fiduciary accountability would be weakened due to the fact that there will be three separate parties with fiduciary responsibility for the systems, and no party will have both the decision-making authority and the resources to properly administer the System. In effect, no party could effectively be held accountable for the performance of the retirement systems.
- It would make it difficult to attract high calibre, independent individuals to serve as board members, as such individuals would expect or demand to have broad administrative authority if they are to successfully achieve the investment and funding objectives established by the City, and accept the personal liability associated with being a fiduciary.
- It would create continuous dissatisfaction and mistrust among active and retired plan members, as they would assume that if the City insists on maintaining significant operational control of the retirement systems, despite the above safeguards, it may have an ulterior motive.

Further details about our findings and recommendations are contained in the main body of this report.

III. REPORT OF FINDINGS

The Mandate

Cortex Applied Research (Cortex) was retained by the City of San José to assess the governance models of the two retirement systems sponsored by the City for its employees. The two retirement systems include:

- The Federated City Employees' Retirement System
- The Police and Fire Department Retirement Plan

The City directed Cortex to compare the retirement systems' current governance models to industry best practices, with a focus on the following issues:

- The composition and required competencies of the retirement boards
- The appropriateness of residency requirements for board members
- Board member remuneration
- Board authority and constraints

In addition, if Cortex found that the current governance models fall short of best practices, Cortex was to recommend an alternative governance model that would better serve the interests of all stakeholders.

Cortex was not directed to review the processes for determining or changing plan benefits, evaluate the current plan design, or assess the manner in which the costs and risks of the retirement systems are shared by plan members and the City.

Methodology

In conducting its review, Cortex undertook the following steps:

1) We reviewed governance-related documentation provided by City Administration or available on the City website.
2) We conducted face-to-face or telephone interviews with various individuals representing the stakeholders of the systems.[2]
3) We developed pension governance principles for use in assessing the current governance models and for recommending an alternative model.
4) We prepared a Report of Findings.

[2] See Appendix B for a list of interviewees and a summary of the interview findings.

5) We sought feedback from City Administration on the accuracy, clarity, and scope of the Report of Findings.
6) We finalized the Report of Findings for submission to City Council and release to other stakeholders.

Background[3]

The Federated City Employees' Retirement System ("Federated") and The Police and Fire Department Retirement Plan ("Police & Fire") are defined benefit retirement Plans serving the employees and retirees of the City of San José, California. Both pension plans use investment income and employer and employee contributions to provide eligible retirees with defined-benefit pensions based on their years of service and highest compensation. The plans also provide medical benefits, survivor benefits, and permanent disability benefits to qualified members and their beneficiaries. The two plans differ from each other in their eligibility requirements; employer and employee contribution rates; eligibility for benefits for retirees' spouses, dependents, and beneficiaries; pension benefits and other related retiree benefits.

The Federated Board of Administration consists of seven members: two members who are members of the Plan, one member who retired under the retirement plan provisions, two San José City Councilmembers, one member from the Civil Service Commission, and one member with banking or investment experience.

The Police & Fire Board of Administration consists of seven members: one Police employee and one Fire employee who are members of the Plan, one member who retired under the retirement plan provisions, two San José City Councilmembers, one member from the Civil Service Commission, and one member from City Administration.

Operating under the San José Municipal Code, the two pension plans are managed and administered by their respective Boards of Administration. The Boards' specific duties include: consideration of requests for retirement, administration and investment of the retirement funds, determining eligibility for membership in the pension plans, and determining employees' eligibility for retirement benefits. In fulfilling their fiduciary responsibilities, the Boards enlist outside consultants for a variety of professional services. The Boards possess broad and flexible investment authority, and they also possess the authority to make reasonable rules for the administration of the pension plans.

[3] Source: City of San José website.

Under the City of San José Municipal Code, the Director of the City of San José Department of Retirement Services is the Secretary of the Boards of Administration for both Plans and is responsible for supporting both Boards. The Director is an employee of the City, who reports to the City Manager.

Investment Performance & Contribution History

The city retirement systems combined have 11,612 active members, retirees and beneficiaries (as of June 30, 2008) and have approximately $3.2 billion in assets (as of March 31, 2009). The financial performance, health, and security of the systems are important to the lives of plan members and their beneficiaries, as well as to the citizens of San José. Given the size of the assets involved, the investment performance of the systems has a significant impact on the finances of the City. As background, the following tables summarize current funding and contribution levels for the two systems, as well as recent investment performance.[4]

Table I - Funded Status of the City of San José Retirement Systems

	Federated	P & F
Pension Funding Ratio @ June 30, 2007	82.8%	99.7%
Pension Projected Funding Ratio @ June 30, 2009	Roughly 60%	76.0%

Table II - Current Contribution Rates As At June 28, 2009

	Federated		Police		Fire	
	City	Employee	City	Employee	City	Employee
Pension	18.31%	4.28%	21.61%	8.18%	24.12%	8.62%
Health	5.70%	5.07%	5.28%	4.78%	4.19%	3.78%
Total	24.01%	9.35%	26.89%	12.96%	28.31%	12.40%

[4] All data was provided by City Administration.

Table III - Recent Investment Performance				
	Police & Fire Department Retirement Plan		Federated City Employees' Retirement System	
	Market Value	Net Rate of Return (1 yr.)	Market Value	Net Rate of Return (1 yr.)
June 30, 2008	$2.561 Billion	-18.4%	$1.774 Billion	-17.0%
June 30, 2009	$2.047 Billion		$1.434 Billion	
Total Decline in Market Value Return	$514 Million		$340 Million	
Total Decline During the 1 year Period	$854 Million			

City Administration also provided us with forecasted contribution rates for the Police and Fire Pension Plan for fiscal years 2009/10 to 2014/15, as prepared by the system's actuary. The data indicate that City contributions are forecasted to rise to 50% of payroll (from the current rate of 28.31%) under optimistic assumptions and are forecast to rise to 60.9% of payroll under baseline assumptions.

The above tables and information suggest that pension contributions represent a sizeable portion of the City's operating budget and are forecasted to grow considerably in the coming five-year period. Even small variations in contributions can dramatically impact the City's operations. Accordingly, it is clearly in the best interests of the City that the systems be strongly positioned from a governance perspective to effectively manage the financial risks of the systems and achieve strong performance. This is also true from the perspective of members and retirees, for, while the City serves as the ultimate guarantor of pension benefits, such a guarantee only has value to beneficiaries if the City remains solvent.

Analytical Framework

Most North American public retirement systems were established in the early or mid-twentieth century, and their fiduciary governance models understandably reflected then prevailing circumstances which included:

- A relatively simple investment industry where available investments were largely limited to publicly traded domestic stocks and bonds.
- Most public retirement funds invested only in U.S. treasury securities. Some public funds were initially unfunded, and therefore had no assets at all.[5]
- Stakeholders were primarily focused on ensuring that plan members received the benefits they were entitled to. Fiduciary oversight of investment programs likely received less consideration, apart from the application of basic trust law concepts.
- Professional and academic knowledge of pension finance was rudimentary, having not been fully developed until the 1970s.

Apart from common law, the stakeholders who designed the initial governance models of today's public retirement systems likely had few standards to guide them. Today, however, in reviewing the governance models of the San José retirement systems, Cortex was not only able to rely on its own experience working with dozens of public retirement systems, but also on principles and criteria drawn from a number of sources published around the world in recent decades. These include:

- Employee Retirement Income Security Act (ERISA) (U.S.)
- The Uniform Management of Public Employee Retirement Systems Act (UMPERSA) and the Uniform Prudent Investor Act (UPIA) (U.S.)
- The Clapman Governance Principles (U.S)
- The OECD Guidelines for Pension Fund Governance (OECD)
- The Myners Report on Governance (U.K.)
- CAPSA Pension Governance Guidelines (Canada)

The principles we used to assess the governance models of the San José retirement systems are described below:

[5] An unfunded plan can be a pay-as-you go plan, in which benefits to retired members are paid with contributions received from active members (e.g. Social Security). Alternatively, the fund may in effect hold promissory notes issued by the sponsoring government entity.

Principles of Effective Governance

A pension governance model must satisfy four fundamental principles. These include:

1) ***Recognition of Multiple Stakeholders:*** The model must recognize that there are multiple stakeholders in a public retirement plan. These typically include:
   a) Current and future active plan members and retirees.
   b) Current and future taxpayers, as represented by their elected officials and public administrators.

2) ***Acknowledgement of Legitimate Interests:*** The model must acknowledge that each stakeholder group has legitimate interests in the retirement system that need to be protected in order for the retirement system as a whole to be successful.
   a) Current active and retired plan members contribute to the retirement system and therefore need to be confident that the benefits promised to them are secure and will be paid when due.
   b) Taxpayers have an interest in ensuring they do not bear unnecessary risk to guarantee the promised pension benefits, given that they must fund pension deficits through either tax increases or reductions in public services.
   c) Future plan members and taxpayers are unable to express or defend their interests in the retirement plans. However, they have a legitimate interest in receiving equitable treatment in respect of the retirement systems. This is sometimes referred to as intergenerational equity; and is a primary concern in the effective management of endowment funds.[6] It is, however, also important for public retirement systems. If a retirement system is well managed, current and future plan members should receive similar pension benefits at comparable costs, and current and future taxpayers should pay comparable amounts and bear comparable risk with respect to the pension benefits of their City employees.

      In the case of San José, we understand that a two-tier benefit system is being contemplated, which would suggest that future employees may not, in fact, receive the same level of benefits as current employees. And given expected future contributions to the city retirement systems, it also appears that future taxpayers may have to pay more towards the pensions of City employees than current and past taxpayers. While there may be many reasons behind the potential failure of the City's retirement systems to achieve intergenerational

[6] See Appendix A-1 – Yale University Endowment Fund, for details about the Yale Endowment Fund's governance structure.

equity, the current governance model is almost certainly one of them and needs to be changed to prevent further inequities in the future.

3) ***Accountability Safeguards:*** A pension governance model must provide effective safeguards to assure all stakeholders that their interests in the retirement system will be adequately protected. If the governance model fails to provide such safeguards, stakeholders will likely seek to protect their interests in other ways, which will inevitably lead to ineffective organizational and decision-making structures, contentious relationships among stakeholders, and poor performance by the retirement systems. For example, sponsors may attempt to retain significant authority to administer the retirement systems (e.g. approval of operating budgets and hiring retirement system staff), thus severely weakening fiduciary accountability for the retirement systems. Similarly, plan members and retirees may scrutinize and question all investment and benefit decisions to a far higher degree than they would otherwise, thus potentially straining stakeholder relations and unnecessarily diverting the attention of the retirement boards from their fiduciary duties. (Note that Cortex is not suggesting that public retirement boards should not be subject to the scrutiny of members and retirees. On the contrary, we would suggest that constructive scrutiny on the part of members and retirees is highly beneficial.)

   Accountability safeguards should include the following:

   A) The governance model should recognize that the assets of a retirement system are held in trust solely to secure the benefits already promised to members. And furthermore that the members are entitled to the protections afforded under trust law to maximize the likelihood that they will receive the benefits promised. A governance model should clearly designate the members of the retirement board as fiduciaries, subject to fiduciary standards and duties, which are among the most stringent under the law.

   B) The composition of a retirement board must reflect the relative risk/reward exposure of active members, retired members, and taxpayers. Where risks and rewards are shared equally, equal representation by stakeholders on the retirement board is appropriate. Where one party bears a disproportionate share of the risk involved, it should have majority representation on the fiduciary board.

   C) The governance model should allow stakeholders the ability to remove their respective appointees from the retirement board for failure to act in accordance with their fiduciary responsibilities or to meet the requirements of the governing legislation.

D) The governance model should ensure that the fiduciary board will, as a whole, possess substantial knowledge, expertise, and experience that are directly relevant to the oversight of a public retirement system. At a minimum, the City should ensure that the individuals it appoints to the retirement boards are strongly qualified for the position and should include individuals who as a group:
   i. Possess in-depth knowledge of asset/liability management, pension finance, accounting, auditing, actuarial science, risk management, and law.
   ii. Have significant senior executive or board level experience with large organizations, particularly in the financial services, health and welfare, or benefits industries.
   iii. Have demonstrated a capacity for strong judgment, strategic thinking, and leadership.

E) The governance model should minimize the existence of, or potential for, conflicts of interest on the fiduciary board. Conflicts involving one's stakeholder interests can be just as detrimental to the proper functioning of a retirement board as conflicts involving personal financial gain from investments or other financial transactions.

   Accordingly, both types of conflicts should be minimized in order to best position the fiduciaries to focus fully and freely on the administration of the System in the best interests of the members and beneficiaries as a group. Conflicts are reduced or mitigated by:

   i) Separating to the extent possible fiduciary functions and settlor functions. All fiduciary responsibilities should rest with a designated fiduciary board (i.e. the retirement boards) and all settlor functions should reside solely with the stakeholders (the sponsor, taxpayers, plan members, and retirees) and be resolved outside the fiduciary arena.
   ii) Selecting board members who are less likely to have opportunities to profit personally from their position on the board, and yet still have the requisite knowledge and expertise to perform the duties of a trustee.
   iii) Discouraging economically targeted investing.
   iv) Requiring stringent conflict of interest policies and disclosure provisions for both retirement board members and staff.

F) The governance model should require the retirement board to provide comprehensive and regular reporting to stakeholders on, at a minimum:
   i. Performance relative to investment and funding objectives.
   ii. General investment performance with attribution analysis.
   iii. Compliance with policies, particularly those pertaining to conflicts of interest, ethics, and travel.
   iv. Compliance with investment and benefit delivery policies and procedures.
   v. External and internal audit findings.

4) ***A Single Administrative Body:*** If the above safeguards are established to protect the interests of the plan sponsor – in particular, that the plan sponsor will be able to appoint a majority of retirement board members and will be able to appoint individuals who are independent of stakeholders and highly qualified for the position – then the fiduciary boards should be granted broad authority to administer the retirement system, including the ability to establish an operating budget, appoint and direct retirement system staff, set staff compensation, and appoint all necessary advisors and service providers.[7]

Assessment of the Current San José Pension Governance Models

This section of the report contains the results of our assessment of the San José pension governance models relative to the principles set out above.

Cortex concluded that the current governance models of the City of San José retirement systems have numerous weaknesses. In particular, the models provide numerous safeguards for plan members but very limited safeguards for taxpayers and the City. As a result, the City has instituted a decision structure in which the City retains significant authority to administer aspects of the retirement systems, rather than granting such authority to the retirement boards. Such a structure does not support the long-term health and success of the retirement systems.

The safeguards that are in place are primarily intended to protect plan members and include:

[7] The fiduciary board would be free to retain the services of City departments to meet some or all of the needs of the retirement system, as the fiduciary board deem appropriate, but would not be required to do so.

- The benefits must be funded in accordance with actuarial standards, and the assets of the retirement systems are held in trust and may only be used for payment of promised benefits to beneficiaries and reasonable administrative expenses. Section 3.28.350 of the City Municipal Code states that:

  > "The assets of the retirement plan are trust funds and shall be held for the exclusive purposes of providing benefits to members of the plan and their beneficiaries and defraying reasonable expenses of administering the system."

- The pension plans and funds are administered by separate retirement systems. These systems are governed by retirement boards consisting of individuals who are fiduciaries and, as such, are subject to fiduciary duties and standards. Section 3.28.350 of the City Municipal Code imposes a prudence person fiduciary standard on the members of the city retirement boards. It states:

  > "The board shall discharge its duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims."

The governance models lack a number of accountability safeguards that would protect taxpayers and further protect plan members. These are discussed below:

1) The City is not able to select a majority of the members to the retirement boards, despite being the final guarantor of the benefits.

   The City and taxpayers of San José bear the ultimate funding risk associated with the retirement plans. That is, in the event of negative investment or liability experiences, the City would be required to fund any shortfall that arises in the Systems. One might argue that if the City were ever required to make additional contributions to the systems due to funding shortfalls, it would likely attempt to recover such contributions during future salary negotiations. While this may be true in the case of relatively minor shortfalls, experience suggests it would be highly unlikely, if not impossible, in the event of extraordinary losses. Accordingly, the City and taxpayers do serve as the ultimate guarantor of the pension benefits, and members are only at risk in the event the City should enter bankruptcy protection.

2) The retirement boards are not currently required to have a substantial number of board members with relevant expertise or experience.

   Currently, the City Municipal Code requires that the Board of the Federated City Employees' Retirement System have only one member with relevant experience, specifically in banking or investments. Similarly, the Board of the Police and Fire Department Retirement Plan is required to have only one member with relevant experience, specifically someone who holds a position in the City Administration at a level of Deputy Department Head or higher and who has experience in the investment or management of public funds, retirement funds, institutional funds, or endowment funds.

3) The composition of the retirement boards is not sufficiently free of conflicts of interest, as demonstrated by the following features of the boards:
   a) Only the Board of the Federated City Employees' Retirement System is required to have even a single board member who is independent of the stakeholders. This is insufficient to ensure an independent board.
   b) Both retirement boards are required to have Council Members serving on them. When acting in their fiduciary capacity as retirement board members, these individuals inevitably must decide on matters in which the interests of the retirement system and those of the City conflict. For example, when setting policies affecting contributions, Council Members must potentially decide between the City's desire for lower contributions on the one hand and members' desire for benefit security on the other.
   c) Both boards are also required to have board members who are active or retired members of the plans. When acting in their fiduciary capacities, these individuals are also inevitably required to make decisions where the interests of the System conflict with those of the City. For example, when setting the asset allocation of the Fund, the interests of the System and the retirees are in conflict. An asset allocation policy with greater expected risk and return characteristics may generate excess returns and therefore support benefit payments from the Supplemental Retiree Benefit Reserve (SRBR). If, however, the decision yields negative returns, the City would be required to fund the resulting deficit.

   Cortex is not alone in making the above observations. During our interviews, we found that some stakeholder representatives from each of the stakeholder groups were similarly concerned about the conflicts of interest that are inherent in the current board structures.

4) Members and retirees do not have the ability to remove board members they elected to the boards for breach of fiduciary duty or failure to comply with the City Municipal Code. In the course of our interviews, this concern was shared by at least one interviewee representing plan members.

5) Though under the Municipal Code the retirement boards appear to have responsibility for administering the retirement systems, such responsibility is in fact shared among three parties: the retirement boards, the City Manager, and City Council. This shared accountability arises because the City Manager hires and directs the Director of Retirement Services who is responsible for administering the daily operations of the retirement systems, and the City Council approves the operating budgets of the systems. From an organizational perspective, this situation is problematic for the following reasons:

   a) Fiduciary accountability is weakened due to the fact that there will be three separate parties with fiduciary responsibility for the systems: the retirement boards, the City Manager, and City Council. No party will have both the decision-making authority and the resources to properly administer the System. In effect then, no party can truly be held accountable for the performance of the systems. Should the performance of either retirement system fall short of expectations, it is quite possible that the City may claim the retirement boards are at fault, while the retirement boards in turn may claim that the City is at fault for not allowing the boards the autonomy to make decisions or spend necessary resources.

      During our interviews with stakeholders, the fact that the retirement boards currently do not have full authority and resources to administer the retirement systems was repeatedly raised as a significant concern. Members and retirees appeared to be most concerned with the boards' lack of authority to hire and direct the Director of Retirement Services.

   b) The current organizational structure makes it difficult to attract high calibre, independent individuals to serve as board members, as such individuals would expect or demand to have broad administrative authority if they are to successfully achieve the investment and funding objectives and accept the personal liability associated with being a fiduciary.

c) It creates the potential for continuous dissatisfaction and mistrust among active and retired plan members, as they would assume that if the City insists on maintaining significant operational control of the retirement systems, despite the above safeguards, it may have an ulterior motive.

Recommended Governance Model

Cortex recommends the following alternative governance model, which we believe better supports effective governance and oversight of the retirement systems and contains the safeguards necessary to assure all stakeholders that their interests will be protected.

1) The governing statute would continue to state that the assets of the Trust Funds are to be held in trust for the members and beneficiaries of the plans, and as such are not to be directed to any other use. Furthermore, the members of the retirement boards should continue to be held to fiduciary standards of care and loyalty.

2) The Boards of each retirement system would continue to consist of seven members[8], however:
   a) Four members, a majority of the Board, would be appointed by City Council, reflecting the fact that the City and taxpayers bear the ultimate financial risk associated with the funding of the retirement systems. These individuals should:
      i) Be independent of the City. By this we mean that they should be neither employees of the City nor have significant, direct commercial relationships with the City.
      ii) Possess high levels of knowledge, expertise, and experience relevant to the administration of a public retirement plan. While there may be a need to emphasize investment and funding matters, it is important that the boards also possess members with relevant knowledge of benefits, accounting, operations, law, and human resource management. Examples of individuals with relevant backgrounds include:
         (1) Senior executives of insurance or banking companies with asset/liability management experience.
         (2) Senior executives or professionals with audit, accounting, legal, actuarial, investment, or risk management backgrounds.
         (3) Academics in the fields of finance, actuarial science, law, or accounting.
         (4) Senior executives in financial services, health and welfare, or benefit delivery organizations with technology, operational, or custody backgrounds.
   b) Two members would be selected by active members.
   c) One member would be selected by retired members.

   The board members selected by active and retired members could be members of the Plan, but this would not be a requirement. Similarly, they could have relevant

[8] See Appendix A-3 – San Diego City, which recently implemented a similar structure.

expertise similar to that possessed by the City appointees, but this also would not be a requirement. Given, however, the complexity involved in effectively overseeing a multi-billion dollar retirement system, we believe that active and retired members will recognize the value of being able to select independent and highly qualified individuals to serve on the retirement boards, an option not available to them under the current governance model.[9]

The process for recruiting candidates to serve on the retirement boards should be in-depth and rigorous. Stakeholders should not rely solely on a candidate's credentials, but should undertake comprehensive due diligence including interviews, background checks, and references, and most importantly, ensure that candidates fully understand what is expected of them. Many of the stakeholders we interviewed suggested, and Cortex fully agrees, that a candidate's commitment, attitude, integrity, and judgement are as important as their knowledge and expertise. These characteristics cannot be discerned simply by reading a résumé. Some of the more progressive retirement systems we are aware of, in fact, establish independent nominating committees to recruit and recommend candidates for appointment to the retirement board.[10]

3) If the above safeguards protecting the City's interests are established, the City should grant the retirement boards broader authority to administer the retirement plans including:[11]
    i) The authority to establish the operating budget of the system, including salaries;
    ii) The authority to hire and direct the Chief Executive Officer of the System, who in turn should have the authority to hire and direct the necessary staff to administer the System;
    iii) The authority to hire all service providers and advisors necessary to administer the System. The boards, however, could retain the services of the City Attorney and other City departments to meet some or all of the needs of the retirement systems, but would not be required to do so.

4) To enhance stakeholders' ability to recruit trustees who are qualified, independent, committed, and have the necessary time to devote to the retirement boards:

[9] For examples of other institutional fund with strong professional boards, see Appendix A describing the boards of Yale, the United Mine Workers, Delaware Retirement System, CPP Investment Board, Ontario Teachers Pension Plan, and the National Railroad Retirement Investment Trust.
[10] See Appendix A-8 Canada Pension Plan Investment Board.
[11] See Appendix A-4 Ontario Teachers' Pension Plan and A-8 CPP Investment Board.

a) Residency requirements for board members should not be overly restrictive; i.e. residency should not be limited to San José, but should be expanded to include the Bay Area, the State of California, and perhaps the western region of the United States. Finding candidates who meet the criteria set out in our report will be a challenge. Establishing a reasonably large pool of potential candidates to choose from would therefore be advisable.

b) Board members who are not members of the plan should be compensated for their service to the Board at levels commensurate with the significant responsibilities, time commitment, and personal liability associated with the position. Compensation to board members of U.S. public sector funds is typically limited to certain out-of-pocket expenses and what might be considered an honorarium. At large institutional funds in other sectors or countries, however, examples can be found where board member compensation better reflects the nature of the duties, responsibilities, and risks involved. Table IV describes compensation amounts paid to board members of the Canada Pension Plan Investment Board and the Ontario Teachers' Pension Plan Board. We understand that some Taft Hartley Plans pay similar levels of compensation, but the data is not publicly available.

Table IV:
Board Compensation at the Canada Pension Plan Investment Board and the Ontario Teachers' Pension Plan

	Annual Retainer	Annual Retainer for Committee Chairs	Attendance Fee Per Board Meeting	Attendance Fee Per Committee Meeting
CPP*	$25,000	$7,500	$1,500	$1,250
OTPP**	$24,000	$3,750	Approx. $1,300	Approx. $1,300

* Source: CPPIB Compensation Policy
**Source: OTPP 2008 Annual Report

Cortex has included the above tables for information purpose only and is not providing a recommendation on the levels of compensation that should be paid to board members of the San José retirement boards. The two systems above differ from the systems in San José in a number of respects, not the least of which is their significantly larger size. Specific compensation levels for San José should reflect the circumstances and needs of San José.

5) The role of each retirement board should be clearly defined and understood by all stakeholders as consisting solely of administering the benefits negotiated by the

stakeholders; the Board's role should not include the authority to create or change the benefits; or advocate for, or take positions on, benefit improvements.[12]

Members and retirees of public retirement systems seldom fully appreciate that the role of a retirement board is not to advocate for benefit enhancements but rather is to prudently and faithfully administer those benefits that have already been agreed upon. Our interviews with the stakeholders of the San José systems revealed a similar finding. Nevertheless, we would suggest that a governance model that clearly separates fiduciary and settlor functions, and is supported by education and communications, will enhance stakeholders' understanding of the various roles involved in the retirement systems.

6) Plan members should be able to have confidence that the assets of the systems will be allocated to investment opportunities that best meet the interests of the systems and its members, and are within the risk parameters established by the City. This concern was shared by at least one of the stakeholder groups we interviewed during our review. Accordingly, the City Municipal Code should discourage investments in ventures that may benefit the City or economy of San José at the expense of the systems. For example, such investments could require a super-majority vote of the retirement board or be subject to other relatively high approval hurdles. Examples of such investments may include real estate investment strategies intended to provide concentrated exposure to the local economy; or infrastructure strategies specifically intended to favor or target local infrastructure projects.

7) The governance model should require specific reporting to stakeholders on, at a minimum, the following issues:
   a) Reporting on the Boards' success at meeting the investment and funding objectives.
   b) Investment performance and attribution.
   c) Compliance with conflict of interest and ethics policies.
   d) Compliance with benefit delivery policies.
   e) Results of external and internal audit findings and follow up efforts.
   f) Board member attendance, travel, and educational efforts.

   With respect to reporting on fund performance relative to liabilities, there is currently an important debate among professionals in the actuarial field as to the correct

[12] See Appendix A-4 Ontario Teachers Pension Plan, A-6 Maryland State Retirement System, and A-8 Canada Pension Plan Investment Board.

method for valuing liabilities. The current methodology values the liabilities independently from the assets, making risk management difficult. Another methodology normally associated with Liability Driven Investing values both assets and liabilities under the same methodology, greatly facilitating the risk management process. Until this debate is resolved, we would recommend that the retirement boards provide reporting to the stakeholders using both methods for valuing liabilities. Once again, as the ultimate guarantor of the pension benefits, it is important that the City, with the support of a designated department within the City, become highly knowledgeable of this important issue in order to fully understand the implications for the City's finances.

8) The governance model should provide members and retirees the ability to remove individuals they have appointed or elected to the retirement boards for failure to act in accordance with their fiduciary duties or failure to carry out the requirements of the governing legislation. If the retirement boards are to be granted broad authority to administer the retirement systems and affect stakeholders' interests, stakeholders require the ability to remove, for cause, any individual they have appointed or elected to the boards. While most U.S. public fund governance models lack such a provision, it is found at other types of institutional funds (e.g. Taft-Hartley benefit plans).[13]

[13] See Appendix A-2 United Mineworkers Retirement Trust.

APPENDICES

Appendix A
Industry Best Practices

Cortex believes that due to historical and other reasons noted in this report, the public fund governance models commonly found in North America are inconsistent with the tenets and principles we have applied in our analysis and recommendations.[14] Nevertheless, there are examples of progressive public retirement systems and other institutional funds that do comply with some of the tenets and principles we have put forward in this report.

It should be noted that, in most cases, these progressive systems were established or re-designed in the last 20 years. In some cases, the systems had, until recently, been unfunded and administered directly by the plan sponsor without a fiduciary board.[15] In other cases, the system or the retirement board underwent a major negative experience that caused the stakeholders to review and significantly change the governance model of the system. In both situations, the stakeholders were able to take a fresh look at their fiduciary governance models and apply all available knowledge and experience accumulated to date in designing the most effective governance model possible.

In the following pages, we briefly describe relevant features of the governance models of a number of funds we believe are consistent with at least some aspects of Cortex's recommended model. The examples include public retirement systems, multi-employer union systems (i.e. Taft-Hartley plans), and a highly regarded university endowment fund. The examples are drawn from the United States with the exception of two large and highly regarded Canadian public retirement systems.

The systems are listed below in reverse alphabetical order along with key features. More detailed overviews of each fund can be found in the following pages.

[14] There are thousands of public retirement systems in the United States; Cortex is familiar with at most several hundred large and medium sized systems. Accordingly, while we cannot claim to have first hand experience with every system in the United States, we believe the funds we are familiar with are reasonably representative of the broader universe of public funds.

[15] Such systems might be funded on a "pay-as-you go" basis or are essentially funded by non-marketable loans issued by the sponsoring government entity.

Table V:
Peer Funds and Relevant Features

Fund	Relevant Feature
Yale Corporation Investment Fund (U.S)	• An example of a fiduciary body whose composition contains a very significant proportion of independent, expert members. • It is also a good example of a governing fiduciary body that is truly focused on policy; i.e. the Investment Committee meets only quarterly and focuses on investment policy, strategy, and monitoring; and does not get involved in the operational and due diligence aspects of fund management.
United Mine Workers of America Combined Benefit Fund (U.S)	• An example of a fiduciary body whose composition contains a high proportion of independent experts.
San Diego City (U.S.)	• An example of a plan sponsor that recently reviewed the composition of its retirement board. The new composition is similar in structure to that being recommended by Cortex.
Ontario Teachers' Pension Plan (Canada)	• A good example of fiduciary board comprised of a high number of independent highly qualified individuals. • A strong reputation for being highly focused on managing assets so as to maintain a close relationship to the plan liabilities. • The Board has full authority to administer all aspects of the System including budget authority and the authority to hire staff and establish their compensation. • Board members also receive significant compensation in line with the scope and nature of their duties.
National Railroad Retirement Investment Trust (U.S)	• An example of a trust that is: o designated as independent of the sponsors o contains a high proportion of independent experts o Governing legislation provides that the Railway Retirement Board (the entity on behalf of which the Trust manages assets) may bring a civil action to enjoin any act or practice of the Trust that violates the provisions of the Act or to enforce any provision of the Act.
Maryland State Retirement System (U.S)	• An example of a board with some experts and with independent, qualified advisors to support it, particularly on investment matters. • Noteworthy provisions include: a. Board prohibited from advocating for benefits b. Statutory minimum levels of continuing education c. The legislation provides for an incentive compensation program and the CIO has corresponding statutory authority to select investment managers.
Delaware Retirement System (U.S)	• An example of a fiduciary body with a high proportion of independent experts
Canada Pension Plan Investment Board (Canada)	• A good example of fiduciary board comprised of a high number of independent highly qualified individuals. • The Board has full authority to administer all aspects of the System including budget authority and the authority to hire staff and establish their compensation. • Board members also receive significant compensation in line with the scope and nature of their duties. • Required by statute to have an audit committee and an investment committee.

Appendix A-1
Yale University Endowment Fund

The Yale University Endowment Fund had total assets of $22.9 billion as of June 30, 2008. Yale Corporation, which is the senior policy-making body for Yale University, has established an Investment Committee which is responsible for oversight of the Endowment Fund, incorporating senior level investment experience into portfolio policy formulation.

Yale Corporation Investment Committee

The Yale Corporation Investment Committee consists of at least three Fellows of the Corporation and ten other persons who have particular investment expertise. The Committee meets quarterly, at which time members review asset allocation policies, Endowment performance, and strategies proposed by Investments Office staff. The Committee approves guidelines for investment of the Endowment portfolio, specifying investment objectives, spending policy, and approaches for the investment of each asset category.

The 13 members of the Investment Committee are:

Douglas A. Warner, Chairman	Former Chairman, J.P. Morgan Chase & Co.
G. Leonard Baker	Managing Director, Sutter Hill Ventures
Joshua Bekenstein	Managing Director, Bain Capital
Jeffrey Bewkes	Chairman and CEO, Time Warner Inc.
Shauna King	Vice President Finance & Administration, Yale University
James Leitner	President, Falcon Investment Management
Richard C. Levin, Ph.D.	President, Yale University
Henry F. McCance	Chairman, Greylock Management
William I. Miller	Chairman, Irwin Financial Corporation
Ranji Nagaswami, MBA	Senior Managing Director and Chief Investment Officer, AllianceBernstein Investments
Honorable Barrington Parker LLB	Judge, United States Court of Appeals for the Second Circuit
Dinakar Singh	CEO and Founding Partner, TPG-Axon Capital
Fareed Zakaria	Editor, Newsweek International

Appendix A-2
United Mine Workers of America Combined Benefit Fund

The UMWA Combined Benefit Fund was established by federal law under the Coal Industry Retiree Health Benefit Act of 1992 (Coal Act). Effective February 1, 1993, the UMWA 1950 Benefit Plan and Trust and the UMWA 1974 Benefit Plan and Trust were merged into the Combined Fund.

Board of Trustees

The board of seven trustees who are the plan administrator makes all major policy decisions for the Combined Fund and draft Plan and Trust documents. The duties of the trustees include collecting premiums and other funds owed to the Combined Fund, interpreting the provisions of the plan to pay benefits and investing the assets of the trust.

As required by the Coal Act, the UMWA appoints two trustees, the Bituminous Coal Operator's Association (BCOA) appoints one trustee and the three largest coal operators which were formerly signatory to the National Bituminous Coal Wage Agreements (previous to the National Bituminous Coal Wage Agreement of 1988) appoint one trustee. The remaining three trustees are selected by the other four.

The current Board members are:

- Michael H. Holland (co-chair) and Michael W. Buckner - appointed by the UMWA
- Elliot A. Segal (co-chair) and Daniel L. Fassio - appointed by the BCOA
- William P. Hobgood, Carl E. Van Horn and Gail R. Wilensky - the three additional trustees, one a former head of US Health Care Financing Administration (Medicare and Medicaid), another a former Congressman who had served 20+ years on Health and Human Services Committee, and the third a former United Airlines executive and Under Secretary of Labor who had resolved major strikes in the mining industry.

Appendix A-3
The City of San Diego

Readers may be aware of the financial and pension crisis that became evident in the City of San Diego in the early part of this decade. The details of the crisis and the eventual outcomes are complex, voluminous, and outside the scope of Cortex's report. Some of the events involving the San Diego crisis, however, involved the fiduciary governance model of the San Diego City Retirement System and are instructive for the City of San José.

In April 2001, the Mayor Richard Murphy appointed a Blue Ribbon Committee consisting of nine private citizens to assist the Mayor and City Council in evaluating the fiscal health of the City of San Diego. One of the issues the Committee decided to address was the City's pension system.

The Committee issued its final report of findings in September 2004. Among the many recommendations were several regarding the governance of the City retirement system:

The Committee concluded that while both employees and the City make contributions to the Plan, "only the City acts as the final guarantor of all benefits paid by the Plan. This ultimate guarantee of the Plan's ability to pay the agreed-upon benefits means that he primary, if not the sole, stakeholder in the operations of the Plan itself are the citizens of the City of San Diego."

The committee expressed two concerns about the governance of the City's retirement system, one involving the independence of retirement board members and the other involving the qualifications of board members: First, the composition of the retirement board members made it possible for the City to fund its current operating budget at the expense of the retirement plan as long as the ramifications to the Plan were not severe over the short-term. Second, the composition of the Board did not ensure the Board would possess the necessary technical skills to understand the complex issues that are present in the administration of the Plan and ask meaningful questions of the trained professionals hired or retained to administer the Plan.

The Blue Ribbon Committee concluded that the Plan, the beneficiaries, and the City would be better served by a Board composed of qualified professionals who have no vested interest in the Plan.

The Committee recommended that the composition of the Retirement Board should be changed to "seven members appointed by the City Council. The members would serve with staggered terms of four years each, with a two consecutive term maximum. Such appointees will have the professional qualifications of a college degree and/or relevant professional certifications, fifteen years experience in pension administration, pension actuarial practices, investment management (including real estate), banking, or certified public accounting. Such appointees will be U.S. Citizens and residents of the City of San Diego but cannot be City employees, participants (direct or indirectly through a direct family member) of the SDCERS, nor a union representative of employees or participants, nor can such appointees have any other personal interest which would be, or create the appearance of, a conflict of interest with the duties of a Trustee."

In August 2006, a report of the Audit Committee of the City of San Diego (the Kroll Report) was completed and delivered to the City of San Diego.

The Kroll Report addressed a wide range of issues involving the City of San Diego pension crisis and the operation of the City's retirement system, including recommendations on the governance of the retirement system. The Kroll report believed that the recommendations of the Blue Ribbon Committee concerning board composition were substantially correct. The Kroll Report agreed that the Board should be composed of qualified professionals with experience in the management of investment funds, as well as an understanding of and a commitment to the fiduciary responsibilities owed to the System's retirees and employees. At the same time, the Kroll report argued that the employees and retirees, whose contributions helped build the System's assets, have a direct financial interest in the System's welfare and that interest is deserving of respect. Accordingly, the Kroll report recommended that the composition of the Board of Administration of SDCERS should consist of nine members, including five members who should be appointed by the Mayor and confirmed by the City Council. The Report recommended that the Mayoral appointees meet similar educational and professional backgrounds as recommended by the Blue Ribbon Committee.

The City Council appears to have implemented a board governance model resembles that recommended by the Kroll Report. The current composition of the Board is:

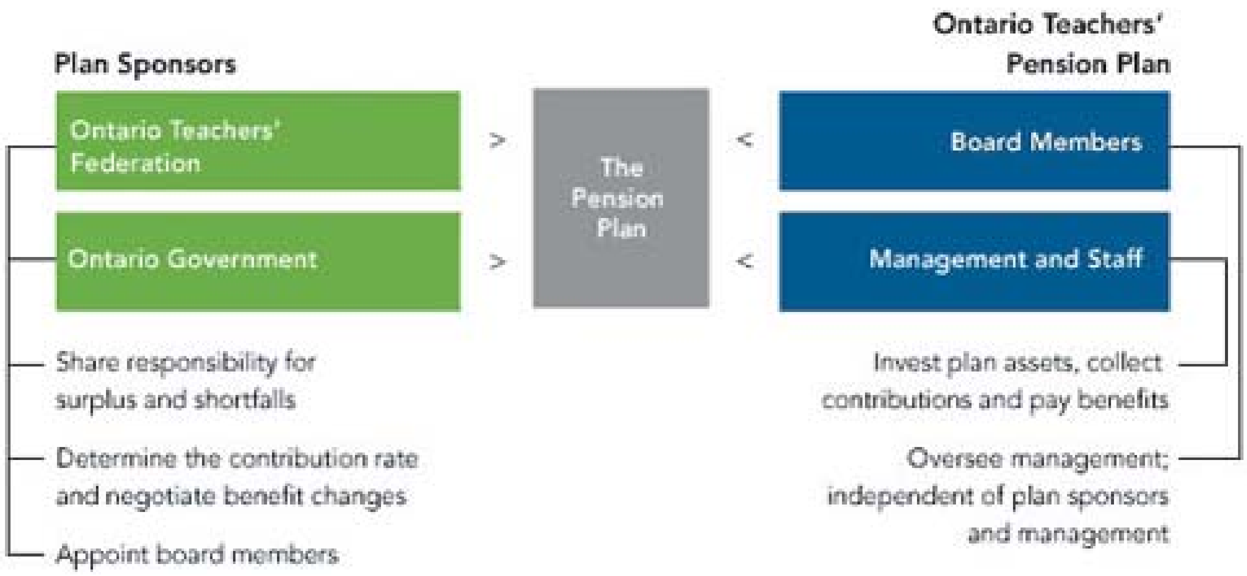
7 Members	Appointed by Mayor and confirmed by City Council
1 Active Fire Safety Member	Elected by Active Fire Safety Members
1 Active Police Safety Member	Elected by Active Police Safety Members
2 Active General Members	Elected by Active General Members
1 Retired Member	Elected by Retired Members
1 City Management Employee	Appointed by Mayor

Appendix A-4
Ontario Teachers' Pension Plan

With $87.4 billion in net assets at December 31, 2008, the Ontario Teachers' Pension Plan (Teachers') is the largest single-profession pension plan in Canada. An independent corporation, it invests the pension fund's assets and administers the pensions of 284,000 active and retired teachers in Ontario.

Plan Governance

The Ontario Teachers' Pension Plan Board is an independent corporation (without share capital) established on December 31, 1989, by the Teachers' Pension Act (Ontario). This Ontario statute requires the corporation to administer the pension plan, manage the pension fund, and pay members and their survivors the benefits promised.



Plan Sponsors

The pension plan is sponsored by the Ontario Teachers' Federation (OTF), representing teachers, and the Ontario government, which matches teachers' contributions. Under the Teachers' Pension Act (Ontario), the plan sponsors are jointly responsible for ensuring the plan remains fully funded over the long term and for setting plan benefits and contribution levels. In addition to making plan funding decisions, the plan sponsors also appoint the pension plan's board members.
The Teachers' Pension Act (Ontario) provides for the joint management of the pension plan by the Ontario government, through the Minister of Education, and the executive of the Ontario Teachers' Federation ("the partners").

Signed by the plan sponsors as partners, an agreement signed by the partners effective January 1, 1992, sets out the terms of joint management. The partners are jointly responsible for plan losses and gains. A six-member partners' committee is responsible for changes in plan design and benefit levels. The agreement deals with appointments of board members and delineates the board's powers and duties other than those set out in legislation. The members of the partners' committee are not members of the board.

Board of Directors

Before 1990, the plan was administered by the Ontario government and restricted to investing in non-marketable Government of Ontario debentures. In 1990, the government established the Ontario Teachers' Pension Plan Board as an independent corporation overseen by a nine-member board, appointed equally by the plan sponsors, the OTF and the Ontario government. The board is required to act independently of both the plan sponsors and the plan's management, and to make decisions in the best interests of all beneficiaries of the plan.

Eileen Mercier, Chair	A management consultant and the former senior vice-president and chief financial officer of Abitibi-Price Inc. She holds an MBA and is a Fellow of the Institute of Canadian Bankers and the Institute of Corporate Directors.
Jill Denham	Former vice-chair, CIBC Retail Markets. The Financial Post named her one of the Top 50 Most Influential Women in Canada for three consecutive years and, in 2004, U.S. Banker named her the eighth most influential female banking executive in North America.
Helen M. Kearns	President of Bell Kearns & Associates Ltd. and sits on numerous not-for-profit boards. She is a former president of Nasdaq Canada and served two terms as a director of the Toronto Stock Exchange.
Hugh Mackenzie	Runs an economic consulting business and has worked as an economist in the public, non-profit and trade union sectors for more than 30 years.
Louis Martel	Managing Director & Chief Client Strategist for Greystone Managed Investments Inc. He is a fellow of the Society of Actuaries, a fellow of the Canadian Institute of Actuaries and a Chartered Financial Analyst.
Guy Matte	Former Executive Director of the Association des enseignantes et des enseignants franco-ontariens.
Sharon Sallows	Partner in Ryegate Capital Corp. A former executive at the Bank of Montreal and MICC Properties, Ms. Sallows sits on the board of RioCan Real Estate Investment Trust and is Chair of the Board of Executive Risk Services. She has more than 30 years of business experience.
Bill Swirsky	Chartered Accountant and independent consultant. He is a former executive of the Canadian Institute of Chartered Accountants and a Fellow of the Institute of Chartered Accountants of Ontario.
Jean Turmel	President of Perseus Capital Inc. and former president of Financial Markets, Treasury and Investment Bank for the National Bank of Canada.

Board Committees

The board has established five standing committees: Investment Committee, Audit & Actuarial Committee, Human Resources & Compensation Committee, Governance Committee, and Benefits Adjudication Committee.

Appendix A-5
National Railroad Retirement Investment Trust

The National Railroad Retirement Investment Trust (NRRIT, or "the Trust") was established pursuant to Section 105 of the Railroad Retirement Survivor's Improvement Act of 2001 (the "Act") that was signed into law on December 21, 2001. The Act set February 1, 2002 as the date that the Trust was to become effective. The sole purpose of the Trust is to manage and invest Railroad Retirement assets. The Act authorizes the Trust to invest the assets of the Railroad Retirement Account in a diversified investment portfolio in the same manner as those of private sector retirement plans. Prior to the Act, investment of Railroad Retirement Account assets was limited to U.S. government securities.

The Trust has no powers or authority over the administration of the benefits under Railroad Retirement. Responsibility for administering the railroad retirement program, including eligibility determinations and the calculation of beneficiary payments, remains with the Railroad Retirement Board (RRB). The Trust is a tax-exempt entity independent from the federal government.

Railroad Retirement Board

The Railroad Retirement Board (RRB) is an independent agency in the executive branch of the Federal Government. The RRB's primary function is to administer comprehensive retirement-survivor and unemployment-sickness benefit programs for the nation's railroad workers and their families, under the Railroad Retirement and Railroad Unemployment Insurance Acts.

The RRB is headed by three members appointed by the President of the United States, with the advice and consent of the Senate. One member is appointed upon the recommendation of railroad employers, one is appointed upon the recommendation of railroad labor organizations and the third, who is the Chairman, is appointed to represent the public interest.

The RRB and the National Railroad Retirement Investment Trust

The Trust and the RRB are separate entities. The RRB remains a federal agency and continues to have full responsibility for administering the railroad retirement program, including eligibility determinations and the calculation of beneficiary payments. The Trust has no powers or authority over the administration of benefits under Railroad Retirement. Under the Act, the Trust is required to act solely in the interest of the RRB, and through it, the participants and beneficiaries of the programs funded under the Railroad Retirement Act. The Act does not delegate any authority to the RRB with respect to day-to-day activities of the Trust, but the Act does provide that the RRB may bring a civil action to enjoin any act or practice of the Trust that violates the provisions of the Act or to enforce any provision of the Act.

Board of Trustees

The Board is comprised of seven Trustees, three selected by railroad labor unions and three by railroad companies. The seventh Trustee is an independent Trustee selected by the other six Trustees.

As of February 1, 2009, the Trustees selected by the rail labor unions are:

George J. Francisco, Jr.	President of the National Conference of Firemen and Oilers - SEIU;
Joel Parker	Special Assistant to the President and International Vice President, Transportation Communications International Union (TCU/IAM);
Walter A. Barrows	International Secretary-Treasurer of the Brotherhood of Railway Signalmen.

The Trustees selected by the railroad carriers are:

Bernie Gutschewski	Vice President for Taxes, Union Pacific Corporation;
James A. Hixon	Executive Vice President, Law and Corporate Relations, Norfolk Southern Corporation;
William Sparrow	CSX Corporation (Retired).

The Independent Trustee is John MacMurray, a pension fund professional with 30 years of experience in the field.

Appendix A-6
Maryland State Retirement and Pension System

The Maryland State Retirement and Pension System administers death, disability and retirement benefits on behalf of more than 350,000 active and former State employees, teachers, State police, judges, law enforcement officers, correctional officers and legislators. The State of Maryland is the primary sponsor of this multi-employer defined benefit system; over 100 local eligible governmental agencies voluntarily participate in the System as well.

Board of Trustees

The System is managed by a 14 member Board of Trustees, with 6 members appointed by the Governor, 5 elected by members, and 3 ex-officio members. The Board directs the management of a multi-billion dollar investment portfolio, adopts the actuarial assumptions necessary to properly fund the System, approves all disability retirements, and adopts rules, regulations, policies, and procedures necessary to administer the various plans.

Nancy K. Kopp	Chairman, State Treasurer, Chairman of the Board of Trustees of the Maryland Retirement and Pension Agency, Ex Officio since February 14, 2002
Peter Franchot	Vice Chairman, State Comptroller, Ex Officio since January 22, 2007
David S. Blitzstein	As Special Assistant for Multiemployer Plans for the United Food & Commercial Workers International Union (UFCW), Mr. Blitzstein currently serves as a trustee on five Taft-Hartley pension funds and two health funds representing a quarter of a million plan participants.
William D. Brown	Elected in 1997 by the Maryland State Teacher System membership, both active and retired, and will serve in his current term until 2009. Active in national teacher affairs, Mr. Brown is on the Administrative Committee of the National Council on Teacher Retirement, where he chairs the Research and Development Committee.
John W. Douglass	Chosen in a special election to be an Employee Systems representative by state employees to fill an un-expired term that ended in 2007. He was subsequently reelected to a full four-year term. Most recently, Mr. Douglass was Deputy Director of the Maryland Department of Assessments and Taxation from 1995 to 2003.
T. Eloise Foster	Secretary of Budget and Management, Ex Officio since January 17, 2007
James M. Harkins	Former Harford County Executive and two-term member of the Maryland House of Delegates, is the Director of Maryland Environmental Service. A gubernatorial appointee to the Board, he was re-appointed in July 2006 as the local government representative.
Sheila Hill	Elected by state employees in October 2004. She has served as president of AFSCME Local 1319 at the Patuxent Institution since 1997.

F. Patrick Hughes	A gubernatorial appointee to the Board of Trustees. Mr. Hughes was President and Chief Executive Officer of Mid-Atlantic Reality Trust (MART), a New York Stock Exchange listed company, headquartered in Baltimore.
Morris L. Krome	First elected to the Board by members of the Maryland State Police Retirement System in 1998. A career officer with the State police.
Theresa Lochte	Represents active and retired members of the Teachers' Retirement and Pension Systems.
Robert W. Schaefer	A gubernatorial appointee to the Board. He received his B.S. degree from the University of Baltimore and his M.B.A. from Loyola College. He also is a Certified Public Accountant. Mr. Schaefer spent 45 years with the First National Bank of Maryland (now Allfirst), the last 35 years as its senior financial officer.
Harold Zirkin	A gubernatorial appointee to the Board. Mr. Zirkin is President of Zirkin-Cutler Investments, Inc., a firm which provides investment management services for individuals, pensions, retirement accounts, foundations and charitable organizations.

Thurman W. Zollicoffer, Jr. - A partner in the Baltimore-based law firm Whiteford, Taylor & Preston, is a gubernatorial appointee to the Board.

Board Committees

The Board has established three committees: an Investment Committee, an Administrative Committee, and an Audit Committee.

Public Advisors to the Investment Committee - Selected for 3 year term by the Board of Trustees with approval of Board of Public Works:

Wayne H. Shaner	Managing partner of Rockledge Partners, LLC located in Bethesda, Maryland. In his prior position, Mr. Shaner was managing director of the Lockheed Martin Investment Management Company, a wholly owned subsidiary of the Lockheed Martin Company where he managed the Bethesda based parent corporation's consolidated employees' retirement and saving plan assets. He earned an M.B.A. from the Wharton School, University of Pennsylvania and awarded a CFA in 1983.
Brian B. Topping	Since 1997, Mr. Topping has served as Vice-Chairman of Mercantile Safe Deposit and Trust Company (MSDT). In addition, he is a consultant to the Wealth and Investment Management Division and co-manager of the Mercantile Growth and Income Fund. After receiving a BA degree from the University of Pennsylvania, he was awarded an MBA from the Wharton Graduate Division in 1965.
Larry E. Jennings, Jr.	Senior Managing Director & a founder, TouchStone Partners; formerly a principal of Carnegie Morgan Partners ("CMP"), a financial advisory firm to state and local governments. Prior to forming CMP, Mr. Jennings spent over 7 years as an investment banker at Legg Mason Wood Walker, Inc. rising to Managing Director. Mr. Jennings received a BS in Mathematics and Economics MBA at Carnegie Mellon University.

Appendix A-7
Delaware Public Employees' Retirement System

The State of Delaware Board of Pension Trustees administers the Delaware Public Employees' Retirement System. The System consists of nine retirement plans and three commingled pension funds. Each plan has a separate membership and differs accordingly.

Board of Pension Trustees

Established by Chapter 55, Title 29, Section 8308, and is responsible for the general administration of the Delaware Public Employees' Retirement System which has control and management of the state pension funds.

Philip S. Reese, Chair	Former Vice President, Corporate Development and Treasurer, Conectiv
Jan M. King	Former Vice President and Treasurer, Hercules, Inc.
Robert W. Allen	President, Allen Petroleum
Nancy M. Shevock	Former Director, Delaware Transit Corporation
Helen R. Foster, J.D.	President, CTW & Consulting, Assoc., L.L.C.
Gary Pfieffer	State Secretary of Finance, ex-officio
Ann Visalli	Office of Management & Budget Director, ex-officio

Board Committees

The board has established three committees: an *Investment Committee* made up of two trustees and four outside members, a *Medical Committee* of nine doctors, and an *Audit Committee* with one trustee and five outside members.

Appendix A-8
Canada Pension Plan Investment Board

The Canada Pension Plan Investment Board is a professional investment management organization based in Toronto, Canada. Its purpose is to invest the assets of the Canada Pension Plan which currently totals approximately $105.5 billion. The CPP Investment Board was incorporated as a federal Crown corporation by an Act of Parliament in December 1997 and made its first investment in March 1999.

Mandate and Objectives
The mandate of the CPP Investment Board is set out in its legislation:
- To invest in the best interests of CPP contributors and beneficiaries
- To maximize long-term investment returns without undue risk, taking into account the factors that may affect the funding of the Canada Pension Plan and its ability to meet its financial obligations
- To provide cash management services to the Canada Pension Plan so that they can pay benefits.

The CPP Investment Board cannot conduct any business or activity that is inconsistent with these objectives.

Independence
The CPP Investment Board is a professional investment management organization, operating in the private sector world of financial markets, with strong public sector accountability. It operates independently of the Canada Pension Plan and at arm's length from federal and provincial governments that are jointly responsible for the CPP.

Oversight of the CPP Investment Board is provided by an independent board of directors. This board, not governments, approves investment policies and makes critical operational decisions, such as the hiring of the president and chief executive officer and the setting of executive compensation. The board hires the president and CEO who, in turn, hires and leads the management team. These investment professionals make portfolio decisions within policies agreed to by the board of directors.

Accountability
While the CPP Investment Board operates at arm’s length from governments, it is subject to very rigorous accountability requirements, some examples of which include:
- Annual report is tabled in Parliament by the federal minister of finance
- Annual audits by an independent external audit firm
- Review of the CPP and the CPP Investment Board by the federal and provincial finance ministers every three years
- Special examination of our records, systems and practices every six years.
- If deemed necessary, the finance minister also has the power to appoint a firm of accountants to conduct an audit at any time
- Public meetings in each participating province every two years

Board of Directors
The board is responsible for the stewardship of the CPP Investment Board, including oversight of management. As fiduciaries, the directors are required to act honestly and in good faith in the best interests of CPP contributors and beneficiaries. They must

exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Directors must use their specialist knowledge in carrying out their duties and are subject to higher standards of care in areas that relate to their expertise.

Robert M. Astley	Chair. Former president of Sun Life Financial Canada, former president and CEO of Clarica Life Insurance Company. Director of the Bank of Montreal and Chair of its human resources and management compensation committee. Qualifications include extensive senior management experience in pension and life and health insurance financial services.
Ian A. Bourne	Retired executive vice-president and CFO of TransAlta Corporation, a power generation company, and president of TransAlta Power L.P. Thirty-eight years of experience in senior finance roles at TransAlta, General Electric and Canada Post Corporation. Qualifications include expertise in finance in major corporations and international experience in Paris and London.
Robert Brooks	Was the Vice Chairman of the Bank of Nova Scotia before retiring on October 31, 2008 after a 40-year career with that bank. During his career Mr. Brooks carried out wide-ranging responsibilities for risk management, treasury functions and various international operations. Mr. Brooks obtained a Bachelor of Science at the University of Manitoba in 1965 and a Master of Business Administration at the University of Western Ontario in 1968.
Pierre Choquette	Chairman, Methanex Corporation since 2003. Former CEO of Methanex, serving for 10 years and credited with globalizing the company’s asset base. Former President and COO, Novacorp International and former President of Polysar Inc. Former chair of Gennum Corporation. 25 years of senior management experience, concentrated in the natural gas and chemical industries.
Germaine Gibara	President & CEO of Avvio Management Inc., a management consulting firm specializing in strategic planning and commercialization of technology. Served in senior positions with Caisse de dépôt et placement du Québec, TAL Global Asset Management Inc. and Alcan Aluminum Ltd. Director of Sun Life Financial, Cogeco Cable Inc., Cogeco Inc., Agrium Inc. and Technip. Qualifications include expertise in public pension plan investments with responsibility for private equity at Caisse de dépôt, in management of an international organization as former president of Alcan Automotive Structures and in governance as former chair, governance committee at Clarica Life Insurance Co.
Michael Goldberg	Former Chief Academic Officer, Universitas 21 Global, an online graduate school initiated by Universitas 21, an international network of 20 research-intensive universities. Professor Emeritus and former Dean of the University of British Columbia’s Sauder School of Business, with 37 years on the UBC faculty. Ph.D. (Economics) from the University of California at Berkeley. Qualifications include expertise in global real estate investments and urban infrastructure and experience on boards as a director serving on audit and compensation committees.

Peter K. Hendrick	Former executive vice-president of investments and chief investment officer of Mackenzie Financial Corporation. Former vice-president and director of CIBC Wood Gundy Securities Inc. (now CIBC World Markets) in the Corporate Finance, Institutional Equity and Capital Markets divisions. Former lecturer at the Graduate School of Business Administration at Harvard University in the area of management and financial accounting relating to financial controls. Qualifications include experience in equities trading, due diligence reviews, securities regulation, derivatives, hedging, risk analysis, and performance measurement.
Nancy Hopkins	Partner at McDougall Gauley where she practices law, with an emphasis on taxation law and corporate governance. She currently serves as a Director of a number of corporations. She chairs the Audit Committee on the Board of Cameco Corporation. Ms. Hopkins chairs the Governance Committee and is Vice-Chair of the Board of the Saskatoon Airport Authority. As a member of the Board of Governors of the University of Saskatchewan, she chairs the Governance Committee and is Vice-Chair of the Board.
Elaine McKinnon	Chief Financial Officer and Chief Operating Officer of Brovada, a Saint John, New Brunswick-based software provider. Previously, she served in a number of executive roles with the telecommunications firm, Bell Aliant. Ms. McKinnon obtained a Bachelor of Business Administration at the University of New Brunswick in 1982 and completed the Senior Management Program of the American Management Association in 1995. She is also a Certified General Accountant.
Helen Sinclair	CEO of BankWorks Trading Inc., a business television and webcasting company. Former president of the Canadian Bankers Association, and former senior vice-president of Scotiabank. Qualifications include extensive experience in senior management roles at financial institutions and on boards of financial institutions.
Ronald E. Smith	Part-time CFO and director of Immunovaccine Technologies Inc. Former senior vice-president & CFO of Emera, Inc., a Halifax-based energy company. Former CFO of Aliant Telecom Inc. and its predecessor, Maritime Telephone & Telegraph Inc. Former partner Ernst & Young. Extensive experience in investment, finance and compensation from various CFO roles.
D. Murray Wallace	Chairman and CEO of Park Street Capital Corporation, a personally-owned investment and corporate advisory firm. Former president of Axia NetMedia Corporation. Director of Western Surety Ltd., Terravest Income Fund and Critical Outcome Technologies Inc. Former Deputy Minister of Finance and Deputy Minister to the Premier for the Government of Saskatchewan. Qualifications include expertise as a chartered accountant, senior-level financial experience, experience in public pension plan management and interface with government.

Board Committees
The board has four standing committees. The Investment Committee and the Audit Committee are required by governing statute.

APPENDIX B
SUMMARY OF STAKEHOLDER INTERVIEWS

As part of our review, Cortex conducted interviews with a number of stakeholders of the two city retirement systems (see listing below). The purpose of the interviews was to enable stakeholders to share any concerns, observations, or suggestions about the governance of the city retirement systems. As our review is not intended to be an audit or investigation of any sort, we did not prepare detailed records or transcripts of the interviews. As a record of the interviews, however, we have prepared the following summary of key issues raised during the interviews.

List of Interviewees

Members of Federated Board of Retirement:
David Busse
Pete Constant, Councilmember
Ash Kalra, Councilmember
Matt Loesch
Ed Overton
Jeff Perkins
Patrick Skillsky

Members of Police and Fire Board of Retirement:
David Bacigalupi
Bill Brill
Rose Herrera, Councilmember
Sam Liccardo, Councilmember

Representatives of the City
Rick Doyle, City Attorney
Debra Figone, City Manager
Alex Gurza, Director of the Office of Employee Relations
Chuck Reed, City Mayor
Christine Shippey, Assistant City Manager

Retiree Representatives
Representatives of Police and Fire Fighters Association
- Bruce DeMers;
- Jay Wendling.

Representatives of Federated Retirees Association
- Bob Leininger;
- Anita Pennington; and others.

Employee Group Representatives
Bobby Lopez, President POA
Randy Sekany, President IAFF, Local 230
Frank Crusco, IBEW
Bill Pope, OE3
Tom Reilly, OE3

As one would expect, stakeholders displayed a wide range of views on most of the topics discussed during the interviews. We did however identify some issues where consensus existed. Below we have attempted to summarize areas of consensus and issues where divergent views were evident.

Board Composition
Virtually all interviewees were at least somewhat receptive to the possibility of restructuring the composition of the retirement boards. At least some interviewees suggested that the current board composition and governance structure do not appear to effectively protect the interests of all stakeholders. For example, some suggested that the current board composition emphasizes representation of stakeholders at the expense of effective decision-making.

All interviewees agreed that the composition of the retirement boards should continue to reflect the interests of stakeholders; i.e. active members, retired members, and the City should continue to be somehow represented on the boards.

A number of interviewees representing members or retirees expressed dissatisfaction with the fact that members and retirees do not have the authority to elect representatives to the retirement boards. Instead, City Council currently must appoint individuals elected by the membership and may choose not to.

Direct versus Indirect Representation

Opinions differed however as to whether board members needed to be stakeholders themselves (i.e. active members, retired members, Councilmembers, or City administration) or whether instead they could be independent individuals appointed or elected by the stakeholders (i.e. indirect representation).

While most interviewees were at least somewhat comfortable with the idea of indirect representation, others felt strongly that stakeholders needed to be directly represented on the boards. This strong sentiment among certain stakeholder groups stemmed from either a) a belief that only direct representation could effectively serve their interests, or b) a belief that they needed direct access to other stakeholder groups, namely City Council, and that this could only be satisfied effectively by having Councilmembers themselves serving on the boards.

Expert Board Members
Most interviewees were of the opinion that the effectiveness of the retirement boards would be improved by having additional board members with specialized expertise, particularly investment expertise. Opinions varied however on some of the specifics involved:

- Some interviewees were of the view that it was unnecessary for *all* board members to be experts.
- Some interviewees were sceptical of the value of investment expertise, citing the failure of many investment experts to foresee the financial crisis that began in 2008.
- Some interviewees expressed concern that investment experts appointed to the boards might conflict with professional staff on technical matters.
- Some interviewees suggested that focusing strictly on investment expertise was misguided, as the boards also require members with expertise in areas such as benefits and disabilities.

Objectives and Risk Exposure
Interviewees generally held similar views on the objectives and risks associated with the retirement systems from the perspectives of plan members and the City.

With some exceptions, interviewees recognized that given the defined-benefit nature of the pension plans and the fact that the City is ultimately responsible for funding shortfalls, the plan members bear little financial risk. To the extent there is financial risk to plan members it arises only under extraordinary, though not inconceivable, circumstances where the pension plan is underfunded and the City is bankrupt and unable to fund the shortfall, in which case members would receive less than the promised benefits. It is important to note that only some interviewees appeared to be aware that there is always a risk that a City, even one as vibrant as San José, could find itself in bankruptcy where the viability of the pension plans would be called into question.

During the interviews we also attempted to identify the specific objectives of the City in connection with the pension plans. In addition to human resource objectives of attracting and retaining qualified employees, most respondents indicated that the City's primary financial objective was to minimize the volatility of contributions to the pension plans, as opposed to minimizing the long term absolute level of contributions necessary for the City to fund the plans, as volatile contributions are likely to have a greater negative impact on the City's ability to maintain consistent and quality services to the residents of the City.

Board Member Skills and Experience
Interviewees recognized that the job of a board member is complex and that the Boards would benefit from having members with various skills, experience, and personal qualities. Below is a summary list of comments we received in this regard:
- Free of conflicts of interest
- Understand and be committed to the concept of fiduciary duty
- An ability to manage one's fiduciary and stakeholder roles
- An understanding of the role of the Board and individual board members
- Have an interest and commitment
- Balanced perspective
- Analytical
- Mature
- Diligent
- Investment expertise
- Knowledge of non-investment issues pertaining to pensions
- Be engaged
- Have the time and ability to prepare for and attend meetings

Other Issues and Concerns
Other issues and concerns raised during the interviews include:
1) Virtually all interviewees expressed concern with either the current capital markets or the performance of the retirement trust funds, or both. They recognized that continued poor performance in either of those areas would affect the long-term health and viability of the retirement systems.
2) Some interviewees indicated that it is important that all stakeholders clearly establish and acknowledge that the assets of the retirement systems are not public assets but

exist to secure the benefits promised to beneficiaries of the systems, and cannot be diverted directly or indirectly to any other use. This would include investing the assets of the trust in assets or projects that benefit either the City or employee groups rather than assets or projects that best serve the interests of the beneficiaries.

3) Concerns exist involving the independence and authority of the retirement boards; in particular there was some debate over the meaning, implications, and applicability of Article 16, Section 17 of the California Constitution. Specifically the debate involved:
   a) The authority of the retirement boards to hire their own retirement administrator and staff;
   b) The authority of the retirement boards to hire their own legal counsel
   c) Whether the City or the retirement board has the authority to make certain administrative decisions; for example determining the "lowest cost plan".

   It was suggested that the lack of clarity surrounding the above issues can lead to power struggles between the retirement boards and the City.
4) Members are concerned that the City intends to introduce tiered benefits (i.e. a new, lower cost benefit for future employees) in order to reduce the City's benefit costs.
5) Interviewees representing retired members suggested that retired members need to be well represented at the retirement boards because decisions can arise that might benefit active members at the expense of retired members.
6) Some interviewees indicated that there has historically been a poor understanding among some board members as to the nature of one's fiduciary duties to the members and the retirement system, and the requirement (when serving in the capacity of a retirement board member) to place one's fiduciary duties ahead of all other duties one may have to other stakeholders. In short, fiduciaries are not there to represent one group of stakeholders but have a responsibility to represent all members as a group.
7) Only a few board members acknowledged the need for the retirement systems to ensure intergenerational equity is maintained among current and future plan members and current and future taxpayers. That is, the cost of current benefits should not be borne disproportionately by future generations of plan members and taxpayers.

Appendix C

As a result of the stakeholder outreach efforts that took place subsequent to the release of Cortex's draft report, numerous comments and suggestions were provided by stakeholders. In addition to providing general comments, some stakeholders suggested alternative governance models or structures. We have listed these proposals below along with Cortex's comments:

Alternative Structure 1 –- Majority of Each Board to be Selected by Active or Retired Plan Members.

During the public outreach sessions, a number of speakers suggested that a majority of each City retirement board should consist of individuals elected by the active or retired members of the Systems rather than by City Council.

Cortex's Response

Cortex does not support the above proposal for reasons discussed in our report and presentations. Specifically, there is already a significant imbalance in the current governance structure with respect to the safeguards in place to protect the interests of the membership and City taxpayers.

Active and retired plan members currently have a number of strong protections that substantially safeguard their interests in the retirement systems including:

- The pension benefits are required by law to be funded in accordance with standards and practices established by the actuarial profession;
- The assets of the Systems are required to held separately in trust for the sole purpose of paying benefits to members;
- The retirement systems are administered by retirement boards, which are separate entities largely (but admittedly not fully) independent of the City;
- The retirement board members and certain of their staff and advisors are fiduciaries under law and therefore are required to administer the benefits of the systems in accordance with strict standards prescribed in law.
- Short of the City entering into bankruptcy, the City and ultimately the taxpayers effectively guarantee the benefits promised to plan members and must fund any shortfalls in the Systems.

Current and future taxpayers of San Jose, on the other hand, have no significant safeguards to protect their interests in the retirement systems, despite the fact that they ultimately bear the financial risk associated with the systems.

To allow active and retired members to select a majority of the members of each retirement board would provide an additional safeguard in favour of the membership at the expense of taxpayers. In our view, this would be inappropriate and would further exacerbate the organizational issues identified in our report.

Alternative Structure 2 –- Joint/Equal Trusteeship

Another of the alternative governance structures suggested by stakeholders would require that the City and plan members each select three members of each retirement board, and the six board members so selected would in turn jointly select the seventh member of each board.

Cortex's Response:

While uncommon among public funds, the above structure is often found at multi-employer union plans. Given that the members and sponsors of multi-employer union plans usually share both the funding risks and investment rewards equally, a structure in which the members and the sponsor(s) select an equal number of board members is reasonable. Having the six board members so selected determine the seventh board member resolves the issue of voting gridlock.

The above structure, however, is not ideal for the City of San Jose, given that the funding risks and rewards associated with the City retirement systems are not shared equally by plan members and the City, but rather are skewed negatively against the taxpayers. Accordingly, we have suggested that to compensate for this, taxpayers should, through City Council, select a majority of the members of each retirement board.

The above notwithstanding, Alternative Structure 2 would result in boards that are better positioned (i.e. more qualified and independent) than the current boards to effectively oversee the two City retirement systems. Accordingly, while perhaps not ideal, Alternative Structure 2 may be a workable model that could serve all stakeholders.

Alternative Structure 3 --- Separate Investment Board or Investment Committee

A third suggested governance structure involves creating a separate investment board or investment sub-committee that would be responsible for making investment decisions and would be comprised of individuals with investment expertise. The composition of the retirement boards would presumably remain unchanged, but their mandates would be limited to benefit administration. This proposal appears to be intended to allow greater investment expertise to be brought to bear on the investment process while maintaining direct representation on the retirement boards by active and retired plan members.

Cortex's Response

Though not widespread, the above structure has been implemented at some U.S. public retirement systems.

During the public outreach sessions a number of plan members indicated that they did not want independent investment experts to be responsible for investing their retirement assets. Accordingly, it is likely that this alternative structure would not be viewed as being preferable to the model proposed by Cortex, as it still introduces independent board members. Furthermore, the above proposal does not address the fundamental issue of how the members of the separate investment boards or committees would be selected. It is likely that plan members would expect to select a majority of the investment board or investment committee. For the reasons discussed in our response to Alternative Structure 1, Cortex would suggest that if an investment board or investment committee were to be established, the City should still appoint a majority of its members.

It is also important to note that the proposed structure appears to be based on a perception that Cortex has suggested that the only type of expertise that is needed on the retirement boards is investment expertise. That is not the case. We believe that the retirement boards must have the capacity to address a wide range of challenging issues beyond investments, including but not limited to benefits, human resources, law, accounting, actuarial science, custody, information technology, organizational design, risk management, and business strategy. Accordingly, while creating an investment board or investment sub-committee comprised of individuals with investment expertise may help the investment programs of a retirement system, it would not necessarily benefit the retirement system as a whole. In fact, by separating the oversight of the investments from the oversight of the benefit administration function, the oversight of the retirement system as a whole may in fact be weakened.