

From: Harvey L. Leiderman
 Direct Phone: +1 415 659 5914
 Email: hleiderman@reedsmith.com

Reed Smith LLP
 101 Second Street
 Suite 1800
 San Francisco, CA 94105-3659
 +1 415 543 8700
 Fax +1 415 391 8269
 reedsmith.com

By Electronic Mail

To: Boards of Administration
 Police and Fire Department Retirement Plan
 Federated City Employees' Retirement System

Date: March 26, 2018

Subject: **Boards' Authority Over Investment Expenses**

ISSUE

In October, 2017, the San José City Auditor's Office issued its "Audit of Retirement Services," Report No. 17-06. Among the Report's findings was "Finding I - Retirement Services Budget Process is Not Well Defined" (*see* Report, pp. 13-23.) Finding I includes observations about the retirement boards' obligation to "annually adopt a budget approved by the City Council covering the entire aggregate expense of administration of the retirement plan or plans..."¹ The Report recommends that the boards include in their annual administrative budgets all investment-related fees and expenses, rather than reporting some investment expenses as deductions from gross investment income.

On January 9, 2018, the City Council directed the City Attorney to clarify whether, under Measure G and other relevant authority, the City should consider investment expenses as being within the mandate that the Council approve the Boards' administrative budgets.

In its January 30, 2018 response, the City Attorney observes: "In the case of investments, the compensation paid to investment consultants and managers for investment consulting services relate to the administration of the retirement plans and per Measure G should be identified in Retirement Services' annual budget." The City Attorney goes on to suggest: "While Measure G does not provide the details on what the 'entire aggregate expense of administering the retirement plan or plans' includes, an ordinance could be drafted to clarify the types of information for inclusion in the proposed budgets submitted by the boards to the City Council for approval." A copy of the City Attorney's memorandum is attached for convenient reference.

You asked for our view as to whether Measure G requires City Council approval of the Boards' annual investment expenses, or whether the Council could adopt a new ordinance requiring Council approval of the Boards' annual investment expenses.

¹ The quoted language is excerpted from Measure G, adopted by San José voters in 2014, which amended the City Charter.

As we explain below, we believe any attempt to subject the Boards' investment authority to City's budgetary control likely would be found to be unconstitutional. We believe the Boards could challenge successfully any such attempt to subject the Boards' investment authority to the plan sponsor's approval.

For purposes of this analysis, we include in "investment expenses" all payments to third parties, including fees and costs, incurred in connection with the investment program, including consultant fees, investment management fees, carried interest and other external costs of the program. We note that the Boards do not use the Office of Retirement Services to internally manage any assets. Further, we do not consider costs associated with the *internal* operation of the Office of Retirement Services (personnel compensation and benefits, furniture, fixtures and supplies, Bloomberg terminals, software systems, allocations of general and overhead expenses, etc.) to be "investment expenses" for purposes of this analysis.

ANALYSIS

The Boards' "Plenary Authority and Fiduciary Responsibility"

California Constitution, article XVI, section 17 provides that "the retirement board of a public ... retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system." We note the separate and distinct references to "investment of moneys" and "administration of the system." Further, the board is authorized to use the assets of the system only to pay benefits and "reasonable expenses of administering the system." *Id.* at subd. (a), (b). The members of a retirement board must "discharge their duties with respect to the system 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 a like character and with like aims" (*id.* at subd. (c)) and "diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so" (*id.* at subd. (d)).

The Municipal Code provides similar authority to the Boards. The Boards have "exclusive control of the administration and investment of the retirement fund[s]" (referred to again as two distinct activities). Muni Code §§ 3.28.310, 3.36.510. The Boards have exclusive authority to authorize payments from the respective retirement funds. *See* Muni Code §§ 3.28.320, 3.36.520. The Municipal Code also establishes the same essential standards for the Boards' plenary administrative and investment authority as article XVI, section 17 of the California Constitution. *See* Muni Code §§ 3.28.350, 3.36.540.

The City's Approval of the Boards' Budgets

Section 810(d) of the San José City Charter provides: "Each retirement board shall administer the retirement plan or plans that the retirement board has been designated to administer in accordance with the fiduciary duties and obligations established by law, the City Charter, and as further prescribed by ordinance." New language added to subdivision (d) by Measure G in 2014 provides: "Each retirement

board shall annually adopt a budget approved by the City Council covering the *entire aggregate expense of administration of the retirement plan* or plans that the retirement board has been designated to administer for the ensuing fiscal year, using the same fiscal year as the City pursuant to Section 1200 of this Charter (emphasis added).” Historically, the retirement plans’ budgets have not included—and the City Council has never demanded that the budgets include—investment expenses.

The City Attorney notes that the phrase “entire aggregate expense of administration of the retirement plan or plans” is not defined in the Charter. The City Attorney then looks to the definition of the word, “administration” in the Merriam-Webster Dictionary for guidance. We believe, however, that the California Constitution, analogous statutes and published case law provide stronger and more relevant pension fund authority than the dictionary’s generic definition of “administration.”

The City’s Budgetary Authority Does Not Extend To Investment Expenses of the Retirement Plans

For several reasons, we believe that the City’s budgetary approval authority does not extend to the investment expenses incurred by the Boards in connection with their investment programs.

First, article XVI, section 17 of the California Constitution *separately* identifies the concepts of “investment of moneys” and “administration of the system.” This demonstrates that the two functions are considered to be separate obligations of the Boards. Thus, “investment of moneys” is not subsumed within “administration of the system.”

Second, published case law holds that article XVI, section 17, as enhanced by Proposition 162 in 1992, was intended to “insulate the administration of retirement systems from oversight and control by legislative and executive authorities.” *Singh v. Board of Retirement* (1996) 41 Cal.App.4th 1180, 1192. Another court explained that Proposition 162 prevented the plan sponsors’ ability to “meddle in [a retirement board’s] investment decisions.” *Bd. of Ret. v. Santa Barbara County Grand Jury* (1997) 58 Cal.App.4th 1185, 1193. In *Westly v. California Public Employees’ Retirement System Board of Administration* (2003) 105 Cal.App.4th 1095, the appellate court found limitations on a retirement board’s plenary authority over the “administration of the system,” but in doing so confirmed a retirement board’s distinct and broad authority over the “investment of moneys.” That court explained that the “express ‘purpose and intent’ of the Pension Protection Act [Proposition 162] was to ‘give the sole and exclusive power over the management and investment of public pension funds to the retirement board’s selected or appointed for that purpose, to strictly limit the Legislature’s power over such funds, and to prohibit the Governor or any executive or legislative body of any political subdivision of this state from tampering with public pension funds.’” *Id.* at 1110. The court also noted that the ballot materials stated that “art. XVI, § 17 would give ‘the board of each public pension system complete authority for administration of the system’s assets and for the actuarial function.’” *Id.* at 1112. The court concluded that the CalPERS board had to follow state civil service rules with respect to the compensation of its board members and personnel, but confirmed that “the voter intent, evidenced by the published ballot materials, is that Art. XVI, § 17 would give the Board the authority to administer the investments, payments, and other services of CalPERS[.]” *Id.*

Third, although not binding on the Boards, the County Employees' Retirement Law of 1937, Government Code sections 31450 *et seq.* ("CERL") provides strong, closely analogous guidance. The CERL governs twenty county retirement boards in California that are subject to the same provisions of the California Constitution as these Boards. Section 31580.2 provides a cap on "the entire expense of administration of the retirement system" (excluding costs of technology upgrades). Section 31596.1, however, *excludes* the "expenses of investing its moneys" from the definition of "cost of administration of the retirement system" for the purposes of the administrative budget cap. That provision explicitly declares that such expenses "shall be considered as a reduction in earnings from those investments or a charge against the assets of the retirement system, as determined by the board," including,

"[a]ny fees stipulated in an agreement entered into with investment counsel for consulting or management services in connection with the administration of the board's investment program, including the system's participation in any form of investment pools managed by a third party or parties." CERL § 31596.1(d).

CERL's carve-out of investment expenses from CERL's administrative budget cap was passed as urgency legislation, effective September 30, 1984, less than four months after the People of California passed Proposition 21, which amended the California Constitution to lift prior restrictions on retirement boards' investment authority.² It is clear that the Legislature understood that a retirement board fully diversified across global investment markets as a reasonably prudent investor should not be handicapped by external constraints on its authority to incur investment expenses. While this history is not dispositive as to the Boards, it does generally support the conclusion that the California Constitution's delegation of "plenary authority and fiduciary responsibility for investment of moneys" protects a retirement board from direct oversight by a plan sponsor with respect to plan investment expenses.

Fourth, like most (if not all) public retirement systems in California, the Boards account for their investment management expenses within their assumed rate of return on investments (or "discount rate"), rather than as an administrative expense. Investment management expenses directly reduce realized investment income, and both San José funds report their *net returns* in their financial statements and investment performance reports. Indeed, this is how investment expenses *must* be reported annually in both systems' Comprehensive Annual Financial Reports ("CAFR"), under the applicable rules and regulations. *See, e.g.*, Government Accounting Standards Board, Rules 67 and 68; *see also* Police and Fire 2017 CAFR at p. 32 and Federated 2017 CAFR at p. 33 (both showing investment expense as an offset to "additions" rather than as a "deduction"). Indeed, the City uses the same model to report its own investment expenses. *See* City of San José 2017 CAFR at p. 40.³ Furthermore, both Boards report

² Prior to the enactment of Proposition 21, public retirement funds in California could invest up to (but no more than) 25% of their portfolio in stocks, and those stocks had to be so-called "blue chip" stocks.

³ The City Attorney states that the Los Angeles and San Francisco city pension funds report investment expenses to their respective city councils, but there is no indication in the City Attorney's memorandum, the documents it cites or the City Charters of Los Angeles and San Francisco that those city councils have the power to limit investment expenses and, if so, from what legal authority such power emanates.

fund performance net of investment manager fees (*see* Police and Fire 2017 CAFR at p. 120 and Federated 2017 CAFR at p. 118) and specifically break out reporting on their investment consulting expenses (*see* Police and Fire 2017 CAFR at pp. 85, 127 and Federated 2017 CAFR at pp. 80, 125). Copies of these excerpts from the Boards' and City's CAFRs are attached. Accordingly, there is already full, public disclosure of all investment expenses incurred by the Boards, and full disclosure to the City, whose own CAFR specifically incorporates the financial statements of both Boards. *See* City of San José 2017 CAFR at pp. 246-249.

Fifth, the four points of law above were all true at the time the People of the City passed Measure G. The primary thrust of Measure G was to provide *more*, not less, independence to the Boards. Thus, we believe that any ambiguity in the phrase "entire aggregate expense of administration of the retirement plan or plans" would be interpreted in favor of voter intent to maintain the Boards' independence with respect to investment authority, rather than to subject an important aspect of that authority (determining reasonable investment expenses) to the discretion of the City Council.

CONCLUSION

We believe that, if the City attempted to require Council approval of the Board's investment expenses as part of the administrative budget approval process, either under Measure G or through new legislation, the Boards could challenge successfully such a requirement in court, as an unconstitutional encroachment on the Boards' legal authority.

Of course, the Board's discretionary judgment is not completely unfettered, or unreviewable if challenged. The Boards have constitutional obligations to prudently manage the assets of the systems, and to incur only reasonable expenses in doing so. The Board's determinations are always reviewable for abuse of discretion in the courts. *See, e.g., Singh*, 41 Cal.App.4th 1180 (retirement boards' "plenary" authority does not insulate them from judicial review). Thus, if the Boards' decisions with regard to investment expenses were found to be arbitrary or capricious, a court would have authority to order appropriate remedies.

Frankly, we do not believe it is in any party's interest to go to litigation over the Boards' investment expenses. *See County of Alameda v. Alameda County Employees Ret. Ass'n* (1988) 46 Cal.3d 902, 917-18 (Justice Mosk writing separately to express his "disenchantment" over the courts being called upon to "resolve a local turf controversy" between a governmental plan sponsor and the plan). Thus, while it is proper for the Boards to assert and protect their constitutional authority over investment expenses, it is also proper for the Board to take reasonable steps to assure the City Council and the public that the Boards are prudently managing investment expenses. This would include providing transparency with respect to investment expenses and giving due consideration to input received from the City Council and other stakeholders (as recommended by the City Auditor in her recent report).⁴ The Boards are actively

⁴ Government Code section 7514.7, effective January 1, 2017, requires public retirement boards to make annual disclosures of investment management fees and charges paid to managers of alternative investment vehicles in which they invest. The Boards have made their fee reports public. *See, e.g.,* Minutes of Police and Fire Board Meeting on September 7, 2017 item 2(d); Minutes of Federated Board Meeting on September 21, 2017, item 5(e).

pursuing such opportunities to improve their communications with stakeholders. We are encouraged that any disagreement between the City and the Boards over investment expenses can be resolved timely and effectively.

We are prepared to work with the Boards as necessary to resolve any issues raised by these matters.