INTERIM REPORT NO. 12

REPORT ON SCHEME TO PRICE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM PENSION SERVICE CREDITS BELOW COST IN VIOLATION OF CALIFORNIA LAW

REPORT OF THE

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I.

INTRODUCTION

The San Diego City Attorney is issuing Interim Report No. 12 to provide evidence supporting the assertion that certain employee benefit programs approved by the San Diego City Council and administered by the San Diego City Employees' Retirement System were created and administered illegally. Evidence provided in this report illustrates that the City's Purchase of Service Credit program was created illegally, the cost of the benefit was priced illegally, and that the benefit should be rescinded.

This report is issued as part of the City Attorney's plan for financial recovery, comprised of the following critical steps to restore the financial health of the City: void the illegally created retirement benefits, reset the parameters of the pension system to bring assets and liabilities into balance, and find new revenue sources to pay for legal retirement benefits. The current unfunded liability of the pension system is estimated at more than $1.4 billion. This looming debt is the greatest financial threat facing the City of San Diego.

Evidence presented in Interim Report No. 12 will show that through the creation of the purchase of service program:

1. The City Council illegally authorized the Board of Administrators at the San Diego City Employees' Retirement System to grant pension benefits.

2. The San Diego City Employees' Retirement System violated their fiduciary duties to the pension system by knowingly and willingly pricing the years of service credits below their cost to the City, thereby placing the financial security of the system in jeopardy.

The City Attorney believes that the 5-year Purchase of Service Program (PSC) created as part of Manager's Proposal I ("MP I") in 1996 should be closed and the money paid into the program should be returned to the participating employees, with interest.

II.

THE CREATION OF THE 5-YEAR PURCHASE OF SERVICE CREDIT PROGRAM

Like many retirement benefits administered by the San Diego City Employees' Retirement System, the purchase of service credit benefit program created in 1996 has become an unsustainable burden and threatens the financial integrity of the retirement system.

The five year PSC program was created as part of MP I between the City and the San Diego City Employees' Retirement System (SDCERS) Board. The agreement was a quid pro quo deal whereby the City agreed to increase pension benefits in exchange for the SDCERS Board of Administrators allowing the City to underfund the retirement system.

In the first known correspondence memorializing discussions about employee benefit increases in exchange for granting the City relief in its contributions to the pension system, there was no mention of a modification to the purchase of retirement service program. A memo from then City Manager Jack McGrory on Thursday, 29 February 1996, outlines a discussion which set the stage for the MPI deal.[1] In the memo, McGrory described his conversation with Lawrence Grissom, administrator of the San Diego City Employees' Retirement System (SDCERS), and Keith Enerson, president of the SDCERS Board of Administrators.

The response from Grissom proposed a new benefit that would allow more employees to purchase years of service in the City's pension system in lieu of actual work performed for the City. In short, this meant that if an employee worked for 15 years, the employee would be given the opportunity to buy five additional years of service which would allow an employee to retire with 20 years of service in their retirement package. This new feature would boost the employee's annual pension payments by thousands of dollars. In a memo to Enerson on 1 March 1996, Grissom[2] proposed:

> Change purchase of service. My recommendation follows:
>
> > a. Keep refunds, probationary period, 1981 plan waiting period, and Military & Veteran Code required military service intact.
> >
> > b. Eliminate all other existing categories of purchase.
> >
> > c. Replace with a program allowing any member to purchase up to 5 (3?) years of additional service at any time or at retirement. Purchase cost to be calculated based on individual contribution rate including offset, City contribution rate, and current salary. Purchase at time of retirement can be made using some form of negotiated credits for unused annual leave.[3]

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1 29 February 1996. E-mail from Jack McGrory to "Distribution." Subject: "Retirement" (Exhibit 1)

2 1 March 1996. E-mail from Larry Grissom to Keith Enerson. Subject: Proposed Retirement Package. (Exhibit 2)

3 1 March 1996. E-mail from Larry Grissom to Keith Enerson. Subject: Proposed Retirement Package. (Exhibit 2)

Grissom said this would be a profitable deal for employees, “This is a potentially great benefit.” He, however, immediately identified potential problems with enacting such an expansion in the number of employees allowed to purchase years of service. Specifically, he foresaw potential problems in how the years would be priced by the System and purchased by employees. Grissom expressed his concerns:

> There are, however, some problems. The amount a member is allowed to pay for purchase is governed by Section 415.[4] Paying for purchase with annual leave credits is a possible way around this, but this raises issues with the taxability of the annual leave credits and possible discrimination issues (males tends to have significantly higher leave balances than females). Safety members are likely to scream at the cost calculation basis because their contributions rates are so much higher than general members (150% employee and 300%). There are always solutions. I have talked with Bob Blum and Rick [Roeder] and we are working on a variety of ideas.[5]

The memo was written as the City was entering the meet-and-confer period with municipal labor unions including the Municipal Employees Association, the San Diego Firefighters Association Local 145, the American Federation of State, County and Municipal Employees Local 127, and the Police Officers Association. These negotiations focused on upcoming labor contracts that typically memorialize issues for City employees that include retirement benefits, vacation time, salary increases, etc. It was during these negotiations that the benefit would take form.

The City’s negotiating team met with labor unions for the meet-and-confer on 5 March 1996[6] and 19 March 1996.[7] Both agendas list “Conference with Labor Negotiator” and included representatives of the City and representatives of the City’s municipal labor unions.

At this point, there had been little discussion as to how the PSC program would be priced and how much they would cost the employees. More importantly, there was no mention of how the years would affect the financial health of the system.

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[4] Section 415 of the Internal Revenue Code governs pension plans.

[5] 1 March 1996. E-mail from Larry Grissom to Keith Enerson. Subject: Proposed Retirement Package. (Exhibit 2)

[6] Agenda for the San Diego City Council closed session agenda of 5 March 1996. (Exhibit 3)

[7] Agenda for the San Diego City Council closed session meeting of 19 March 1996. (Exhibit 4)

The City Council went into closed session to discuss the proposed labor contract on 2 April 1996. At the meeting the City Council members were provided a short, numbered list of items that would appear in the proposal which included "Purchase of 5 years Service Credit."

On 2 April 1996, the City hired the Ohio-based law firm, Jones, Day, Reavis & Pouge to "provide legal representation and fiduciary and federal tax implications of the proposed revisions to benefits for the City employees under the San Diego City Employees' Retirement System."

The proposal appeared back before the City Council in closed session on 9 April 1996. There is no record, however, of what was said at the meetings. The City Council further discussed the meet and confer labor negotiations in closed session meetings on 16 April 1996 and 23 April 1996. No minutes were taken for either meeting.[8]

At the 18 April 1996 meeting of the SDCERS Board President, Enerson told the panel that a "special meeting" would be set for 2 May 1996 to discuss the proposal from the City Manager's office.[9]

Before the special meeting, the City received a letter from fiduciary counsel, Jones, Day Reavis & Pogue, which outlined the City's fiduciary duty to the trust and to retirees. Jeffery Leavitt, attorney for the firm, outlined the trustees' duties:

> In the context of public pension systems, the California Constitution specifically defines the fiduciary duties of the retirement board or board of administrations:
>
> Notwithstanding any other provisions of law or this Constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system…(a)…The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.[10]

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[8] Minutes of the 16 April 1996 closed session meeting of the San Diego City Council. (Exhibit 5)

[9] Minutes of the 18 April 1996 meeting of the San Diego City Employees Retirement System Board of Administrators. (Exhibit 6)

[10] 29 April 1996. Letter from Jeffery Leavitt, attorney for Jones, Day, Reavis & Puge to Bruce Herring, deputy city manager for the City of San Diego. Carbon Copied: John Kaheny. Re: "Fiduciary Aspects of Plan Revision." (Exhibit 7)

The City was hereby notified that a fiduciary duty to the retirees and the duty to maintain and ensure the financial integrity of the trust fell squarely on the Board of Administrators at SDCERS. The letter was addressed to former Deputy City Manager Bruce Herring and was carbon copied to Assistant City Attorney John Kaheny. This fact is important because the San Diego City Attorney's office served as the general counsel to SDCERS. The City Attorney's office had been put on notice of its fiduciary responsibility to protect the financial integrity of the trust.

The City sent another draft of Manager's Proposal I to the retirement system on 29 April 1996 which spelled out which employees would be eligible to buy credits:

> Purchase of Service Credit: Continue the existing service credit provisions related to refunds, probationary periods, 1981 Plan waiting period and Military & Veteran Code; incorporate all others into new a general provision of a five (5) year purchase of service credit feature for any prior public service, which would also be available to ½ time and ¾ time employees…[11]

The proposal also included language on how the pension credits would be priced, paid for, and how much this benefit would cost the City. Specifically, the report stated that the cost of the benefit for employees would be "discounted." The report stated:

> Provide a one-time purchase of service credit to plan members with fifteen (15) or more years of creditable service as of July 1, 1996. Participants may elect, by December 31, 1996, to purchase up to five (5) years of service (described above) **<u>at a discounted rate</u>** subject to the individual employee's IRS 415 limitations. Options for funding the employee's share (e.g. 401k, SPSP funds, accrued annual leave) are being analyzed by legal counsel. The employer's share will be funded (not amortized) from surplus earnings. **<u>The total cost to the City of this discount will be set at $6 million dollars.</u>** If the calculated cost to the City exceeds $6 million when the total population of those opting for these benefits is known, each employee's request will be reduced proportionally down to the $6 million level.[12] (emphasis added)

The proposal states that City employees would be permitted to purchase years to increase their retirement benefits for less money than it costs the City to pay the benefit. In other words, the City Manager proposed creating an unfunded benefit. Moreover, the money to pay for the discounted benefit was to be drawn from "surplus earnings," which represents gains on retirement system investments.

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[11] 29 April 1996. Memorandum to City Employees Retirement System. "Concept Overview." (Exhibit 8)

[12] 29 April 1996. Memorandum to City Employees Retirement System. "Concept Overview." (Exhibit 8)

Another draft of the proposal was sent out to SDCERS Board members and officials days before the special meeting, scheduled for 2 May 1996. This draft did not include the language that appeared in the 29 April 1996 letter regarding how the years of service would be priced and the cost to the City. The draft stated,

> Purchase of Service Credit: Continue the existing service credit provisions related to refunds, probationary periods, 1981 Plan writing period and Military & Veteran Code; incorporate all others into a new general provision of a five (5) year purchase of service credit feature for any prior public service, which would also be available to ½ time and ¾ time employee. Employees would pay into retirement fund an amount, including interest, equivalent to the employee and employer full cost of such service.[13]

The proposal marked the first time the plan stated that the cost of the credit for the employee would include "the employee and employer full cost of such service."

Jack McGrory, former city manager, appeared at the 2 May 1996 special meeting and delivered a PowerPoint presentation that included proposed information about the purchase of service plan. This meeting marks the first time the proposal by McGrory had been made available to the public. In describing the proposed PSC program, McGrory stated that "Employee Pays for Employer and Employee Costs."[14] Attendees of the meeting included Cathy Lexin, human resources manager for the City and one of the main negotiators in the meet and confer process; Judie Italiano, head of the Municipal Employees Association; and Deputy City Attorney John Kaheny.

The City went back into closed session on 7 May 1996 with the municipal union leadership to discuss and negotiate the proposal.[15] The same PowerPoint presentation was shown at the closed session, also including that "Employee Pays for Employer and Employee Costs."[16]

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[13] 2 May 1996. City Employees Retirement System. "Concept Overview. (Exhibit 9)

[14] Minutes of the 2 May 1996 meeting of the SDCERS Board of Administrators. (Exhibit 10)

[15] Agenda of the 2 May 1996 closed session meeting of the San Diego City Council. (Exhibit 11)

[16] Minutes of the 2 May 1996 closed session meeting of the San Diego City Council. (Exhibit 12)

The City Council met with the municipal unions two more times – on 13 May 1996[17] and 14 May 1996[18] – to discuss the issue before it appeared back before the SDCERS Board at the regularly scheduled meeting on 15 May 1996. In both meetings, the record keeper stopped taking minutes when the meet and confer item came up.[19]

At this point, minimal discussion had taken place to specify how the years of service would be priced for employees.

In a 21 May 1996 e-mail from City Auditor Ed Ryan to Deputy City Attorney Sharon Marshall, Ryan specifically questioned how the purchase of service would be priced. He also raised direct concerns that it could represent an unfunded benefit and result in a cost on the City. Ryan wrote,

> sharon, [sic] the following would be my questions or comments…Have [sic] it been determined that the purchase is beyond the 5 year program?...Just a reminder that this proposal is one that causes a fiscal impact for a benefit presently no funded. Before proceeding far we should get a fiscal impact.[20]

Ryan would repeat his concern about the service credits cost for the City in a later draft of the proposal dated 28 May 1996. The proposal mirrored former proposals and said, "Employees would pay into the retirement fund an amount, including interest, equivalent to the employee and employer full cost of service." Ryan, however, hand-wrote in after this sentence, "This is…implemented at no cost to the City."

The City Council met in closed session on 28 May 1996[21] and again on 4 June 1996[22] for meet-and-confer negotiation sessions. Neither plan included the changes as suggested by Ryan.

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17 Agenda of the 13 May 1996 closed session meeting of the San Diego City Council. (Exhibit 13)

18 Agenda of the 14 May 1996 closed session meeting of the San Diego City Council. (Exhibit 14)

19 Minutes of the 14 May 1996 closed session meeting of the San Diego City Council. (Exhibit 15)

20 21 May 1996. E-mail from Ed Ryan, city auditor, to Sharon Marshall, deputy cit attorney. Re: draft. (Exhibit 16)

21 Minutes of the 28 May 1996 closed session meeting of the San Diego City Council. (Exhibit 17)

22 Agenda of the 4 June 1996 closed session meeting of the San Diego City Council. (Exhibit 18)

On 6 June 1996, McGrory issued a memo to Mayor Susan Golding and the San Diego City Council announcing that the labor unions had tentatively agreed on the benefit improvement package.[23] The service credit language approved in the deal stated:

> Purchase of Service Credit: Continue the existing service credit provisions related to refunds, probationary periods, 1981 Plan waiting period and Military & Veteran Code; incorporate all others into a new general provision of five (5) year purchase of service credit feature, which would also be available to ½ time and ¾ time employees. Employees would pay into the retirement fund an amount, including interest, equivalent to the employee and employer full cost of such service.

McGrory appeared back before the retirement board an 11 June 1996 workshop to present the proposal. McGrory specifically stated in his presentation that the cost of purchase of service should be cost neutral to the City. The official minutes from the meeting state, "Mr. McGrory summarized the proposal stating that it offers…a wider purchase of service program at no additional cost to the City…"[24]

At the meeting, Grissom said that the implementation and pricing of the program had not been established. According to the meeting minutes, Grissom said "that the administrative details on how to accomplish this have not been worked out."[25]

The most intricate outline of how the plan would be designed appeared in a memorandum from Grissom to the Retirement Board of Administration on 12 June 1996. The language outlines that the plan will remain in effect as it originally stood: allowing certain employees that meet specific criteria to purchase years of service that they worked part time or missed as a result of military service. Grissom wrote:

> b. In addition to period identified above, employees may purchase five years of service by paying both employee and employer contributions

[23] 6 June 1996. Memorandum from Jack McGrory, city manager, to Honorable Mayor and City Council. Subject: "Labor Negotiations – FY98 Tentative Agreements". (Exhibit 19)

[24] Minutes of the 11 June 1996 San Diego City Employees' Retirement System workshop. (Exhibit 20)

[25] Minutes of the 11 June 1996 San Diego City Employees' Retirement System workshop. (Exhibit 20)

> in an amount and manner determined by CERS Board to make the system whole for such service time.[26]

The proposal, at this point, explicitly states that the purchase of service credits should not create a debt for SDCERS, or as Grissom wrote the cost should be "an amount…to make the system whole for such service time."[27]

On 21 June 1996, Grissom received a letter from Dwight Hamilton, attorney for law firm Frandzel & Share which served as fiduciary counsel to SDCERS. Hamilton opined on the SDCERS Board's fiduciary duty. Hamilton specifically outlined the Board's responsibility in administering the PSC program:

> Once the benefit changes are in effect, the Board of Administration has the plenary authority and fiduciary responsibility to administer the System…and to make such revisions in rates of contribution of members as it deems necessary to provide the benefits that have been granted.[28]

The opinion letter emphasized that the trustees of a municipal pension have a fiduciary obligation to ensure the System is fully funded. Again, the Board was notified of its duty to maintain the financial integrity of the SDCERS trust.

The SDCERS Board met to discuss MP I and approved it at the 21 June 1996 meeting by a vote of 8-to-3, with Trustees Jack Katz, Ann Parode, and Paul Barnett in opposition.[29] Board Trustees that voted in support of the motion included Keith Enerson, Ron Saathoff, Bruce Herring, John Casey, Sharon Wilkinson, Terri Webster, Conny Jamison, Robert Scannell, and John Torres. Specifically, the Board approved a funding relief plan that set the City's annual contributions to SDCERS below the required amount. The Board also approved the using of "surplus earnings" to pay for benefits.

The City Council approved the package on 2 July 1996 by a vote of 9-to-0, with supporting votes from Council members Mathis, Wear, Kehoe, Stevens, Warden, Stallings, McCarty, Vargas and Mayor Golding. The Council approved a series of

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[26] 12 June 1996. Memorandum from Lawrence Grissom, SDCERS Administrator, to Retirement Board of Administration. Subject: "Actions Relating to the City Manager's Proposals." (Exhibit 21)

[27] 12 June 1996. Memorandum from Lawrence Grissom, SDCERS Administrator, to Retirement Board of Administration. Subject: "Actions Relating to the City Manager's Proposals." (Exhibit 21)

[28] 20 June 1996. Draft letter from Hamilton & Faatz to Lawrence Grissom, Retirement Administrator for SDCERS. (Exhibit 22)

[29] Minutes of the 21 June 1996 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 23)

retirement benefit increases that included the expansion of the purchase of service programs. The language stated:

> Purchase of Service Credits: Continue the existing service credit provisions related to refunds, probationary periods, 1981 Plan waiting period and Military & Veteran Code; incorporate all others into a new general provision of five (5) year purchase of service credit feature, which would also be available to ½ time and ¾ time employees. Employees would pay the retirement fund an amount, including interest, equivalent to the employee and employer full cost of such service.[30]

The new program which now enabled a City employee to purchase five years of retirement service – without actually working them – was now established in the City of San Diego Municipal Code.

The City Council was now tasked with passing the Ordinance to enact the purchase of service credit benefit. Once complete, the SDCERS Board would price the years and then the program would become available to employees.

A draft of the ordinance was presented to the City Council in a closed session meeting on 10 December 1996. The proposed ordinance outlined the "General Provision for Five Year Purchase of Service Credit." The proposal stated, "Any person employed by the City of San Diego on the date of December 31, 1996 may purchase up to a maximum of five years of service credit." The proposal also addressed how the years of service would be priced by the SDCERS Board. The ordinance stated:

> The cost of service credit purchased pursuant to this section shall be calculated on the basis of employer and employee contribution rates and interest rates in effect at the time the purchase is made in accordance with rules prescribed by the board.[31]

Notably, the draft ordinance stated that each year of service credit would be priced based on the employee's salary plus "interest rates" as identified by the SDCERS board. The draft included no information on exactly what "interest rate" the employee would be charged.

Another draft of the ordinance was provided to the City Council on 25 February 1997. The draft stated:

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[30] 23 June 1996. Memorandum from Lawrence Grissom, Retirement Administrator, to Cathy Lexin, Labor Relations Manager. Subject: City Manager's Retirement Proposal. (Exhibit 24)

[31] Draft "Strikeout Ordinance" for Discussion at the 10 December 1996 meeting of the San Diego City Council. (Exhibit 25)

> The cost of service credit purchased pursuant to this section shall be the amount determined by the Board to be the equivalent to the employee and the employer cost of that service credit.[32]

The language that included an "interest rate" was notably dropped from the ordinance. Importantly, the ordinance included new language that required that the years of service be priced at an "amount determined by the Board to be the equivalent to the employee and the employer cost" of the benefit.

The City Attorney believes that this draft raised two important issues: First, the City Council ordinance stated that the benefit would be paid entirely by employees. Second, the cost of the benefit would be processed by the Board, whereby the SDCERS Board was given the authority to grant a benefit – a power legally vested to elected officials by the City Charter. These issues will be discussed in greater detail below.

The San Diego City Council unanimously adopted the ordinance on 25 February 1997 by a 7-to-0 vote, with Council members Christine Kehoe and Barbara Warden absent.[33]

The San Diego City Attorney believes that the City Council's decision to give decision making authority to political appointees that was previously exercised by, and legally reserved to, elected officials is a clear violation of the City Charter.

As set forth in San Diego City Charter Article IX, the San Diego City Council is vested with the authority to set retirement benefits administered by the San Diego City Employees' Retirement System.

Under the language set forth in San Diego City Council ordinance O-18383, employees and retirees are eligible to purchase a retirement benefit priced by the SDCERS Board. The Board, in short, is in the position to set the price excessively low, transferring the cost to the City, and granting the employee or retiree a retirement benefit that was not paid for or earned. The City Attorney will show in this report that the SDCERS Board knowingly and intentionally priced the service credits below the actual cost thereby transferring a liability to the City.

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[32] San Diego City Council Ordinance O-18383. Section 24.1312. Adopted 25 February 2006. P. 36. (Exhibit 26)

[33] Minutes of the San Diego City Council meeting of 25 February 1997. Council members supporting the adoption of O-18838 included Council member Harry Mathis, Byron Wear, George Stevens, Valerie Stallings, Judy McCarty, Juan Vargas, and Mayor Susan Golding. (Exhibit 27)

III.

ORIGINAL PRICING OF SERVICE CREDITS BY SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM BOARD

Following the City Council approval of the purchase of service credit program, the SDCERS board began the task of pricing the credits.

On 3 March 1997, Rick Roeder, the SDCERS actuary, wrote a letter to Grissom suggesting the pricing to purchase service credits. In the letter, Roeder points out that in an earlier meeting the SDCERS Board suggested "an approach that would charge General members a cost of 15 percent of current pay per year purchased. The corresponding cost for Safety employees would be 26 percent of current pay."[34]

Under this pricing scheme, a general member earning $100,000 per year could buy a year of pension credits for $15,000.

Roeder warned that "[t]hese rates are slightly less than the sum of the average employees rate" and suggested that General members pay 17.12% of current pay per year purchased and Safety members pay 29.55% of current pay per year purchased.[35] He specifically notified the Board that anything less than his suggested rate would lead the City paying a "significant subsidy" to pay for the benefit. Roeder, however, opined in the letter that a 15 percent rate for general members and 26 percent of salary for safety members would be sufficient. He wrote:

> If the proposed purchase rates are used, we believe that the overall cost will be close enough to true actuarial costs so that there will not be a significant subsidy of the proposed percentages that are used.[36]

The SDCERS board decided on the pricing of the service credits on the 21 March 1997 meeting. The board noted that the recommendation of the actuary was for the

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[34] 3 March 1997. Letter from Rick Roeder, SDCERS outside actuary, to Lawrence Grissom, retirement administrator. (Exhibit 28)

[35] 3 March 1997. Letter from Rick Roeder to Lawrence Grissom. (Exhibit 28)

[36] 3 March 1997. Letter from Rick Roeder to Lawrence Grissom. (Exhibit 28)

employee to pay "the combined employee and employer contribution rates."[37] The SDCERS Board approved the rate by a unanimous vote.[38]

The SDCERS Board was now responsible to ensure that the program was cost neutral for two reasons:

a. San Diego Municipal Code Ordinance O-18383, as approved by the City Council on 25 February 1997, stated that the cost was to be set at an "amount determined by the Board to be the equivalent to the employee and the employer cost of that service credit."[39] In short, the service credits should be cost neutral to the City and SDCERS.

b. As fiduciaries, the SDCERS Board's main responsibility is to protect the financial integrity of the trust thereby ensuring that the benefit was not an unnecessary drain on SDCERS and creating an unfunded liability.

The City Attorney will provide evidence in this report to support a conclusion that the SDCERS Board failed to fulfill both of these responsibilities.

IV.

THE DEBT CONTINUES TO GROW

The PSC program became a big sales item for the San Diego City Employee's Retirement System. City employees were given the opportunity to increase retirement benefits for life by buying years of service without having to work them – all at a discount price.

It was not long until the cost of this subsidy began to catch up with the SDCERS Board. In the June 30, 2001 valuation for the retirement system, the system's actuary issued a warning that the program was not cost neutral and that the SDCERS was incurring debt by setting service credits at a discounted rate. The valuation, issued to the Board on 12 February 2002, stated:

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[37] Transcript of the 21 March 1997 meeting of the San Diego City Employees' Retirement Board meeting. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Lawrence Grissom, then administrator for the San Diego City Employees' Retirement System. (Exhibit 29)

[38] Minutes of the 21 March 1997 meeting of the San Diego City Employees' Retirement System Board of the Administrators. (Exhibit 30)

[39] San Diego City Council Ordinance O-18383. Section 24.1312. Adopted 25 February 2006. P. 36. (Exhibit 31)

> We are recommending that we receive service credit data for service purchases. Currently, valued liabilities for active members are understated to the extent that they have purchased service.[40]

The valuation also pointed that the funded ratio for SDCERS had grown to 89 percent[41], a significant decline from the 97 percent funded ration as presented in the City's Blue Ribbon Committee Report on Finances.[42] In other words, SDCERS had funds to pay 89 cents for every dollar owed to retirees and current employees.

The valuation raised concerns within SDCERS and provoked Paul Barnett, assistant retirement administrator, to write a letter to the Board echoing Roeder's concerns that the program is not cost neutral. Barnett suggested that the pricing method be adjusted in a 5 May 2002 letter.

> Staff is recommending that the Purchase of Service (PSC) rules be amended to standardize both the types of service credit available for purchase and the calculation method used to 'price' this product. The reason for this recommendation include re-pricing the cost of PSCs to more accurately reflect the actuarial impacts of service purchase….The other important point to note about current PSC rules is the negative actuarial impact…Staff strongly urges the Retirement Board to update its PSC calculation methodology to reflect the true cost of purchasing service credit [43]

Barnett pointed to one of the specific problems with the pricing:

> [C]ontributions…would be priced using the member's current salary at the time of application times a factor determined each year by the Actuary that reflects current benefit level. Rick Roeder has reviewed the concept of PSC simplification, and agrees that the current pricing method contains actuarial inequities.

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[40] San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001. P. 17. (Exhibit 32)

[41] San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001. P. 13. (Exhibit 32)

[42] Mayor's Blue Ribbon Committee Report on Finances. (Exhibit 33)

[43] 5 May 2002. Letter from Paul Barnett, assistant retirement administrator, to Business and Procedures Committee. (Exhibit 34)

The problem, as identified by Roeder, is that younger employees who purchased credits were paying the same as older employees and the payment of the elder employees PSC benefit enhancement costs were heavily subsidized by SDCERS.

According to Roeder, the program was originally cost neutral when a general member employee pays the 15 percent or a safety member pays 26 percent of current salary and that money is invested for a sufficient time to collect interest to cover the payments when the employee retires. Roeder pointed out that an older employee that purchased the service credits closer to retirement does not allow the money ample time to gain interest, leaving an unfunded deficit that SDCERS or the City must pay. In other words, SDCERS and the City subsidies the PSC benefit for older PSC buyers.

> In other words, purchasing service credit when an individual is closer to retirement and the System has less time to earn interest in the funds received requires a higher PSC cost to that member than to an individual who has several years remaining before retirement benefits are paid.[44]

Barnett pointed out that Roeder suggested a solution: creating a tiered pricing program where employees that purchase service credits closure to retirement pay more. Barnett wrote:

> [Roeder] has proposed new PSC calculation factors for General and Safety members based on the member's age at the time of application, less than 40 years old, 40 to 50 years old and over 50 years old…The PSC calculation factors increases the time between a member's purchase of service and the expected retirement age when benefits will be paid decreases.

The letter included recommended rates to create a cost neutral purchase of service program.[45]

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[44] 5 May 2002. Letter from Paul Barnett, assistant retirement administrator, to Business and Procedures Committee. (Exhibit 34)

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Attained Age Band	% of Current Pay Per Service Year
20 – 24	11.3%
25 – 29	13.1%
30 – 34	14.7%
35 – 39	17.1%
40 – 44	19.1%
45 – 49	22.2%
50 – 54	25.9%
55 – 59	30.2%
60 – 64	30.7%
65+	29.3%

Attained Age Band	% of Current Pay Per Service Year
20 – 24	17.6%
25 – 29	20.5%
30 – 34	22.9%
35 – 39	26.7%
40 – 44	31.1%
45 – 49	36.2%
50 – 54	40.6%
55 – 59	40.1%
60 – 64	37.5%
65+	34.3%

It is important to emphasize that at this point, in May 2002, the price for general members year of service was 15 percent and for safety members a year of service cost 26 percent. The percentages in Roeder's proposed graphs provide a good illustration the deep discount in the pricing.

For example, under Roeder's recommendation a 55 year-old city employee that makes $100,000 annually would pay $30,200 for one year of service. This is critically important because, as Roeder points out in his letter, the older employees are the individuals that the System subsidizes heavily. In contrast, under the old PSC pricing methodology, this individual pays $15,000 for one year of PSC – a $15,200 difference that becomes a liability to SDCERS.

The SDCERS Board scheduled a discussion of Barnett's suggestion at the 24 May 2002 meeting.[46]

At the meeting, Grissom told SDCERS trustees out that the pricing of the retirement benefits is not cost neutral. Grissom said:

> From an actuarial or funding point of view the other main point is that…purchase of services are being made at yester-, you know today's benefits but yesteryear's prices.[47]

Grissom pointed out that the City and its labor unions were in the meet-and-confer process, where salary adjustments and potential retirement benefit enhancements are discussed for a new labor contracts for City workers. The meet-and-confer process in 2002 would later result in the deal between the City, labor unions, and retirement board known as Manager's Proposal II. The deal resulted in a significant benefit increase for retirees. At the meeting, Grissom alluded to these discussions and the possibility that further retirement benefit enhancements would result SDCERS and the subsiding more PSC purchases. Grissom said:

> So there's a gap and given the most recent meet and confer….now we are, we are talking about the benefit going up slightly again. So the gap only widens. So you've got a cost of product that doesn't reflect the benefit being received. And in between those two issues, the administrative complexities and the cost differential, we really feel this issue needs to be addressed if we're to, to both provide good service and, and fund, and keep the fund [inaudible] what it should be.[48]

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[46] Agenda of the 24 May 2002 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 35)

[47] Transcript of the 24 May 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Lawrence Grissom, then administrator for the San Diego City Employees' Retirement System. (Exhibit 36)

[48] Transcript of the 24 May 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Lawrence Grissom, then administrator for the San Diego City Employees' Retirement System. (Exhibit 36)

Terri Aja Webster,[49] a Board member and former assistant city auditor, said at the meeting, the Board has a fiduciary obligation to make changes to the service credit pricing now that a concern has been raised. Webster said:

> Oh, as, fiduciaries, you know once we have the information that the current method is not, is not covering the costs, I, I feel we have no choice but to change it. It's, it's the, the cost to live up to employees but we have, we have, I don't think we have any other option as fiduciaries but to make a change. So, the, the question is just how, you know how do we, how do we implement the change and, and, and go forward with it.[50]

Grissom echoed Webster's comment that correcting the program to a cost neutral pricing methodology is the fiduciary obligation of the Board. He also said that the cost of the benefit is not a vested benefit for employees and can be changed at the Board's will:

> It's my understanding, as we have looked at this, that the cost of benefit is not a vested right and that it is the [inaudible] responsibility of the Board as fiduciaries to establish that cost. And, as we know, costs change over time for a var-, for a variety of reasons. So that, that the actual cost of the benefit is not a vested right and therefore not negotiable, meet-able and conferrable.[51]

Despite the concerns and the "strong" recommendation from staff, the Board did not vote on the item and kept the discounted pricing in place. According to the Board minutes, "Mr. Saathoff stated this is a complex issue and will come back for action in June 2002."[52]

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[49] Terri Aja Webster was indicted by the U.S. Grand Jury on 6 January 2006 for conspiracy to commit wire and mail fraud; wire fraud; mail fraud; and aiding and abetting. (Exhibit 37)

[50] Transcript of the 24 May 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Terri Aja Webster, former assistant auditor for the City of San Diego and former SDCERS trustee. P. 14. (Exhibit 36)

[51] Transcript of the 24 May 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Lawrence Grissom, then administrator for the San Diego City Employees' Retirement System. P. 32. (Exhibit 36)

[52] Minutes of the 24 May 2002 meeting of the San Diego City Employees' Retirement System Board of Administrators. P. 23. (Exhibit 38)

Barnett wrote another letter to the SDCERS Board on 11 June 2002[53] outlining the proposed modification to the PSC pricing methodology and stressed that the current program is not cost neutral. Barnett wrote:

> At the May Board meeting, the attached recommendation for PSC Simplification and a new costing method was introduced….staff continues to recommend that the Retirement Board approve updating PSC calculation methodology to reflect the true cost of purchasing service credit.[54]

Attached to the letter was the same cost breakdown that Roeder devised for the May letter to the Board.[55]

The Board discussed Roeder and Barnett's new proposal at the 19 July 2002 meeting at SDCERS. The concern was raised for the third time that the pricing of the credit was not cost neutral and resulted in a liability to the retirement system. Grissom said:

> And focusing on the five year, obviously the City adopted that benefit and put it in the Muni Code with the understanding that it would not increase the liability regarding the five year air time [inaudible.] How the 15 percent was derived at I don't remember obviously. We're finding out there must not have been some solid theory behind it.[56]

Grissom said that because the discounted PSC cost to the System had been brought to the Board's attention that it had a fiduciary obligation to increase the price of the credits.

> But now we are aware of this problem it seems like it is our fiduciary duty to fix it 'cause every time that somebody signs a purchase of service contract, or almost every time it seems like, we're increasing the liability to the plan sponsor, which isn't right. And the Board doesn't have the

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[53] 11 June 2002. Letter from Paul Barnett to Retirement Board, via Lawrence Grissom, Retirement Administrator. Subject: Purchase of Service Credit Simplification – Revised Pricing (Exhibit 39)

[54] 11 June 2002. Letter from Paul Barnett to Retirement Board, via Lawrence Grissom, Retirement Administrator. Subject: Purchase of Service Credit Simplification – Revised Pricing (Exhibit 39)

[55] 5 May 2002. Letter from Paul Barnett, assistant retirement administrator, to Business and Procedures Committee (Exhibit 34)

[56] Transcript of the 19 July 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. P. 9-10. (Exhibit 40)

> authority to allow subsidizing for the member's purchase…So anyway I do think we should, and this is the third month it's been on the agenda so I, I definitely think we need to take care of it one way or the other…But I, again I do think we need to fix the bleeding.[57]

An interesting point is also brought up by a member of the Board at the meeting, Following the Board's 5 June 1996 meeting where discussions were first aired about the possibility of increasing the price on the PSCs, the System received a flood of requests to purchase. Certain members of the Board pushed for the establishment of a grandfathering period so more people can get in at the discounted price.

> 'Cause I think it's true and I, I know at least a lot of our members have been, you know there was this June 5th deadline rumor that got out there. And it has more to do with grandfathering [inaudible] purchase of service for the general member system…But it reverberated through the safety ranks too. And they've been inundated with people coming in wanting to make requests 'cause they wanted to lock in a date…We have to have some sort of grandfather period.[58]

At this point, Board members had been told three times that the pricing for the credits was not priced accurately and was increasing the liabilities of SDCERS.

Despite the warnings, the Board voted to continue the item to the August meeting. The City Attorney believes that this delay was another attempt to allow employees to apply for the purchase at the low rate. According to the minutes of the meeting, "Mr. Saathoff stated that the Purchase of Service Simplification and Costing Method was trailed to August with Staff to further research costing through the actuary."[59]

Barnett issued another proposal to the Board on 6 August 2002 that marked a significant change in the proposed costing method. Prior to this memo, Barnett and Roeder had advocated for a pricing method based on age. The logic was that older member's purchases resulted in a liability to SDCER because the money, when invested, would not have sufficient time to cover the cost of the benefit. Barnett stated:

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[57] Transcript of the 19 July 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. P. 9-10. (Exhibit 40)

[58] Transcript of the 19 July 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Ron Saathoff. P. 11. (Exhibit 40)

[59] Minutes of the 19 July 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. (Exhibit 41)

> Originally, the Fund's actuary proposed charging for purchased service based on the member's age at the time of application. This was based on the fact that Purchase of Service contacts are generally less expensive for younger members because there is a linger period of time before the purchased service credit is applied to a retirement benefit. However, this methodology inadvertently penalizes older members who would end up paying significantly more for purchasing a year of service credit than they would pay if they simply were to work.[60]

Barnett's new proposal was strikingly different:

> This simplification would include calculating all service purchases using the Member's current salary at the time of application. Upon further review and discussions with the Actuary, staff recommends continuing the cost factor for any purchase of 15% for General Members and 26% for Safety Members (the current cost for 5-year PSCs).[61]

In other words, despite the numerous warning from SDCERS staff and Board members of the fiduciary obligation to increase the price, no increase was recommended in the new proposal.

Barnett provided a brief explanation for backtracking on restructuring the pricing to achieve a cost neutral program for the System.

> The perceived inequity of these higher purchase factors has caused some discussion with employees groups regarding possible diminishment of benefits. This would likely result in the Board being requested to establish an extensive window period prior to implementation. This would in turn cause the majority of impacted members to complete purchases before the expiration of the window, negating any impact of the proposed changes.[62]

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[60] 6 August 2002. Letter from Paul Barnett, assistant retirement administrator, to Retirement Board, via Lawrence Grissom, retirement administrator. Subject: Purchase of Service Credit Simplification. (Exhibit 42)

[61] 6 August 2002. Letter from Paul Barnett, assistant retirement administrator, to Retirement Board, via Lawrence Grissom, retirement administrator. Subject: Purchase of Service Credit Simplification. (Exhibit 42)

[62] 6 August 2002. Letter from Paul Barnett, assistant retirement administrator, to Retirement Board, via Lawrence Grissom, retirement administrator. Subject: Purchase of Service Credit Simplification. (Exhibit 42)

The pricing modification appeared before the SDCER Board at the meeting of 16 August 2002.[63] At the meeting, the Board approved keeping the pricing for PSC at 15 percent of salary for general member and 26 percent of salary for safety members.[64] The only difference, the price would be computed using the employees highest-rate of pay instead of the 12-month average. At the meeting, Grissom noted that the new proposal would not bring the purchase of service to a cost neutral program.

> The statement was made, has been made, and has been made in discussions in the past, the purpose of costing purchase of service is to make sure that the system is whole. And I submit to you that that's impossible to do…So, what we need to recognize is that this costing in terms of, of, of coming up with absolute neutrality I don't think there's a number that staff can give you, that the actuary can give you that will actually guarantee that.[65]

As part of the vote at the 16 August 2002 meeting the Board requested that the System's actuary complete an analysis to determine whether the new adjustment "will not detrimentally impact the fund over the current methodology."[66]

Perhaps more disturbing, the SDCERS Board approved allowing employees calculate their purchase under the new cost and the old cost and then keep the cheaper method. The motion approved by the Board stated, "additionally, all applications currently on file at SDCERS or those that have been prepared less than 90-days prior to today will be calculated under both the old and new methodology, with the lesser of the two being executed."[67] In other words, the SDCERS staff calculates the cost under the new and old methodology and allows the employee to pay the cheaper – all at the expense to the SDCERS.

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63 Agenda for the 16 August 2002 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 43)

64 Minutes of the 16 August 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The vote was 8-to-2, with Trustees Terri Webster and John Casey in opposition. (Exhibit 44)

65 Transcript of the 16 August 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. The transcription was taken from tapes of the meeting. The individual believed to have spoken in the quote is Lawrence Grissom, former administrator of SDCERS. P. 11. (Exhibit 45)

66 Minutes of the 16 August 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. (Exhibit 44)

67 Minutes of the 16 August 2002 meeting of the San Diego City Employee's Retirement System Board of Administrators. (Exhibit 44)

Roeder sent a letter to Barnett on 20 August 2002 confirming the directive of the Board on the 16 August meeting. In the letter, Roeder repeated concerns that recent raises given to employees and increased retirement benefits granted by the City render the PSC a liability to the System. Roeder also states that the new method will have little effect on the liability being incurred by SDCERS.

> We have been asked to render an opinion whether the proposed method would increase or decrease the level of subsidy compared to the more complicated current method. Recognizing that there is limited available data, we believe it likely that the proposed method would either not change or somewhat reduce the level of subsidy that assuredly exists in the current method.[68]

Roeder stated in the letter that a full report of the impact of the new pricing method on the System would be prepared in the next 12 to 28 months.[69]

The San Diego City Council on 18 November 2002 approved a series of retroactive retirement benefit enhancements to employees and retirees of the City.[70] A major enhancement in retirement benefits was the increase of the "benefit multiplier" from 2.25 percent at 50-years-old to 2.5 percent at 50-years-old.

The "benefit multiplier" is a piece of the mathematical formula SDCERS uses to calculate a retiree's annual payment. The increase approved by the Council provided a notable boost to retiree's annual pension payments.

V.

THE DEBT CONTINUES TO GROW
2003—2004

At the turn of the new year, the SDCERS Board immediately received another warning that the pricing of the service credits was too low and that SDCERS was

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[68] 20 August 2002. Letter from Rick Roeder, SDCERS outside actuary, to Paul Barnett, assistant retirement administrator. Re: Actuarial Costs Related To Service Purchase Program. (Exhibit 46)

[69] 20 August 2002. Letter from Rick Roeder, SDCERS outside actuary, to Paul Barnett, assistant retirement administrator. Re: Actuarial Costs Related To Service Purchase Program. (Exhibit 46)

[70] Minutes of the 18 November 2002 meeting of the San Diego City Council. (Exhibit 47)

subsidizing the benefit. The SDCERS Board received the 30 June 2002 annual actuarial valuation at its 17 January 2003 Board meeting.[71]

The financial analysis presented in the report confirmed all suspicions that the pricing of the service credit was adding debt to SDCERS. The report stated that these purchases have cost SDCERS a total of $77.7 million. Roeder wrote in the valuation, "The added liabilities associated with the service purchase was $77.7 million."[72]

Roeder also included a more detailed analysis of how the number of years purchased.

> To date, 994 General member purchased 4,601 years of 'permissive' service... 192 Safety members purchased 618 years of service.[73]

The actuarial valuation appeared before the SDCERS Board of the 21 February 2003 meeting[74] and the PSC issue was addressed. SDCERS Board Trustee Diann Shipione pointed out that $21.3 million dollars worth of years of service had been purchased by employees of the City of San Diego in 2001 alone.

The SDCERS board approved the June 30, 2002 actuarial valuation by a unanimous vote. There was, however, no discussion at the meeting about adjusting the cost of the PSC and its effect on liabilities for the System.

It was not until 16 July 2003 that discussions resumed over the pricing of PSCs. In a 16 July 2003 e-mail exchange between Terri Webster and Lawrence Grissom, both openly discuss the new pricing methodology established at the 16 August 2002 was not cost neutral.

> Ok [sic] Larry…since this will be published I want to double check if this statement is accurate….
>
> 'As of June 30, 2002 the system has incurred an approximate $56 million loss due to the under funding of Purchase of Service Credit program. Said another way: since the system is charging 15% for General and 26% for Safety and the true cost is estimated to be over 25% for General and 30%

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71 Minutes of the 17 January 2003 meeting of the San Diego City Employee's Retirement System Board of Administrators. (Exhibit 48)

72 San Diego City Employees' Retirement System Annual Actuarial Valuation. June 30, 2002. p. 17. (Exhibit 49)

73 San Diego City Employees' Retirement System Annual Actuarial Valuation. June 30, 2002. p. 17. (Exhibit 49)

74 Minutes of the 21 February 2003 meeting of the San Diego City Employees' Retirement System. (Exhibit 50)

> for Safety, the system has incurred over $56 million in losses thru June 30, 2002.'[75]

Grissom replied in an e-mail dated 16 July 2006:

> Make the Safety amount 'over 35%' and I'm fairly comfortable. Too much going on to nail it down further right now. Larry[76]

The exchange provides further evidence that trustees of SDCERS were aware that the pricing of the PSC program was grossly discounted for employees. An e-mail exchange between Roeder and Webster later in the year would show that Webster's $56.6 million estimate was too low.

A letter was sent to Grissom and Barnett by Roeder on 6 August 2003 that included the analysis of the PSC pricing methodology that was promised on year earlier.[77] Roeder's analysis reiterated his earlier reports:

> These numbers show that the plan sponsors are currently subsidizing a significant amount of the added liabilities associated with service purchase.[78]

Barnett wrote another letter to the Board on 6 August 2003 echoing Roeder's request and reiterating his prior requests that the Board increase the pricing of the PSC for both general and safety members. Barnett explained that Roeder finished the study to determine a cost neutral price for general members, safety members, and members of the elected officers' retirement plan. At that point, elected officials paid the same rate as general members. Barnett made two suggestions:

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[75] 15 July 2003. E-mail from Terri Webster, former SDCERS Trustee and former assistant city auditor, to Lawrence Grissom, former SDCERS administrator. Subject: "Re: PSC". (Exhibit 51)

[76] 16 July 2003. E-mail from Lawrence Grissom, former SDCERS administrator, to Terri Webster, former SDCERS Trustee and former assistant city auditor. Subject: "Re: PSC". (Exhibit 51)

[77] 6 August 2003. Letter from Rick Roeder, SDCERS outside actuary, to Larry Grissom, retirement administrator, and Paul Barnett, assistant retirement administrator. (Exhibit 52)

[78] 6 August 2003. Letter from Rick Roeder, SDCERS outside actuary, to Larry Grissom, retirement administrator, and Paul Barnett, assistant retirement administrator. (Exhibit 53)

> 1. Adjust the cost for all City PSC applications received after Board approval to 27% for General Members, 37% for Safety Members and 50% for Legislative Members. These percentages would be applied to the Members current annual salary to determine the purchase price for a year of service credit…
>
> 2. Adjust the cost as detailed above 90-days after Board approval and notify the membership of the pending cost increase so that applications received during this 90-day window period would be processed using the 15%/26% cost methodology.[79]

The second recommendation is particularly disconcerting because after numerous warnings that the PSC price was too low over a two year period, SDCERS staff continued to recommend allowing members to purchase the benefit at deep discount. This, as illustrated by evidence presented in this report, results in a direct liability to SDCERS.

In response to Barnett's letter, the SDCERS Board docketed the "Recommendations Regarding the Costs Associated with SDCERS' Purchase of Service Program" for the 15 August 2003 meeting.[80]

In the days preceding the meeting, SDCERS trustees acknowledged their potential legal liability for their failure to adjust PSC pricing in 2002.

Webster sent an e-mail to SDCERS Board Trustee Ray Garnica on 11 August 2003 outlining the importance of increasing the pricing. Webster also told Garnica that the Board may have violated the City's Municipal Code by not increasing the pricing of the PSC in 2002. Webster wrote:

> Want to make sure you understand it and the importance of 'fixing the problem'.
>
> In summary…The City created a benefit of buying 5 years of 'air time' in 1997. <u>The Board was to administer it in a cost neutral manner.</u> Instead the program has been administered by the Board at a loss…to the Fund…which means to the City…which increases UAAL and employer rates and lowers the funding ratio.
>
> From 1997 thru 6-30-02 Rick, our actuary, estimates the 'loss' to be **$56 million**…

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[79] 6 August 2003. Letter from Paul Barnett, assistant retirement administrator, via Lawrence Grissom, retirement administrator. To: Retirement Board, via Business Procedures Committee. Subject: Purchase of Service Credit Cost Analysis. (Exhibit 53)

[80] Agenda for the 15 August 2003 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 54)

> So the mis-administration of the PSC program by the Board is more than the 'underfunding' issue!...
>
> Rick Roeder, at least a year ago, advised the Board it was being administered at a loss.
>
> Terri[81]

Webster's e-mail provides evidence that SDCERS trustees were aware of the problems with the PSC pricing method. Trustees and were also cognizant of their non-compliance with their duty to administer the fund as specified in the City of San Diego Municipal Code.

Webster sent an e-mail to Roeder on 13 August 2006 to rehearse questions for the 15 August meeting and establish the numerical value of the SDCERS liability resulting from discounted PSC pricing was. Webster wrote:

> Rick…I wanted you to confirm what the $56.4 number represents….I was told it was the 'underfunding' of the permissive 5 year buy back.[82]

In a reply, Roeder wrote the actual liability created by the PSC program is $77.7 million.

> The $77 million represents our calculations since inception of the 5-year service purchase program (clearly prior to 6/30/01) for all purchasers who are STILL active members as of 6/30/02…The $77 million is LESS than the related gross total liability for the 5-year service purchase program.[83]

The SDCERS Board discussed the PSC pricing issue at the meeting of 15 August 2003. The motion, made by trustee Ronald Saathoff[84] and trustee Cathy Lexin,[85] was to

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[81] 11 August 2003. E-mail from Terri Webster, former SDCERS trustee and former assistant city auditor, to Ray Garnica, former SDCERS trustee. Subject: PSC. (Exhibit 55)

[82] 13 August 2003. E-mail from Terri Webster, former SDCERS trustee and former assistant city auditor. Subject: "Re: Service Purchase". (Exhibit 56)

[83] 14 August 2003. E-mail from Rick Roeder, former SDCERS actuary, to Terri Webster, former SDCERS trustee and former assistant city auditor. Subject: "Re: Service Purchase". (Exhibit 56)

[84] Ronald Saathoff, former SDCERS trustee and president of the San Diego Firefighters Association Local 145, was indicted by the U.S. Grand Jury on 6 January 2006 for conspiracy to commit wire and mail fraud; wire fraud; mail fraud; and aiding and abetting. (Exhibit 37)

approve Barnett's second recommendation to increase pricing to "27% for General Members, 37% for Safety Members and 50% for Legislative Members" and allow a 60-days after Board approval and notify the membership of the pending cost increase so that applications received during this 60-day window period would be processed using the old PSC pricing methodology.

Under this new pricing, a general member earning $100,000 annually could purchase one of PSC for $27,000 – a total of $12,000 more than the old pricing.

The motion was met with immediate argument by trustee Richard Vortmann, who according to the meeting minutes, "asked about the pricing. He said it appears to be analogous to an annuity and doesn't look to be cost neutral program, nor will it ever be. Thus, he doesn't understand why employees are being given a 60 day notice."

According to the minutes, trustee Steven Meyer said "the idea of a 60-day notice would give members time to get their contracts submitted. However, he asked if the cost to purchase would be borne by the member."

Saathoff said the cost would be born by the members.[86]

Flying in the face of Saathoff's response to the question, Roeder immediately followed and repeated his warning the PSC pricing method in place would not cover the cost of SDCERS' payment of the benefit. According to the minutes:

> Mr. Roeder said that 15% rate for general members and legislative members and the 26% rate for safety members is not sufficient to finance this program on an actuarially meaningful basis. The purchase of these benefits puts upward pressure on both the unfunded accrued liability and on the amortization of the liability.

Despite this repeated warning by Roeder, the SDCERS Board approved the increased PSC pricing but allowed for the 60-window for employees to buy credits under the old pricing methodology.[87]

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[85] Cathy Lexin, former human resources director for the City of San Diego, was indicted by the U.S. Grand Jury on 6 January 2006 for conspiracy to commit wire and mail fraud; wire fraud; mail fraud; and aiding and abetting. (Exhibit 37)

[86] Minutes of the 15 August 2003 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 57)

[87] Minutes of the 15 August 2003 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 57)

Shortly after the meeting, the staff at SDCERS sent a notification to all city employees alerting them that PSC purchase application received by SDCERS prior to 1 November 2003 will be priced under the old methodology – 15 percent for general and legislative members and 26 percent for safety members.[88]

The City Attorney believes that postponing the implementing for nearly two years after the Board was originally notified that SDCERS was subsidizing employee purchase of PSC is a violation of the trustees' fiduciary duty and the San Diego Municipal Code.

Meanwhile, the liability to SDCERS that was created by the discounted PSC pricing continued to grow. According to the SDCERS June 30, 2003 annual actuarial valuation, more general members purchased 6,157 years of service and safety members purchased an additional 948 years of service.[89] The valuation also stated that SDCERS liability as a result of the discounted PSC was $12.7 million[90] Roeder also predicted "that there will be one more year of significant, actuarial losses until the new, hire purchase rates largely mitigates losses in the future."

VI.
CONCLUSION

Based upon the evidence presented in this report, it the City Attorney's considered judgment that legal action need to be taken to correct the misappropriation of public funds used to subsidize the illegal pricing scheme for the Pension of Service Credit program.

By ______________________________

Michael J. Aguirre
City Attorney

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[88] Notification from SDCERS to all City employees. (Exhibit 58)

[89] San Diego City Employees' Retirement System Annual Actuarial Valuation. June 30, 2003. P. iv. (Exhibit 59)

[90] San Diego City Employees' Retirement System Annual Actuarial Valuation. June 30, 2003. P. 10. (Exhibit 59)