Minutes

Marin County Employees' Retirement Association (MCERA)
Retirement Board Strategic Workshop

One McInnis Parkway, First Floor
San Rafael, CA
April 17-18, 2018

Day 1
April 17, 2018

Chair Steven Block

9:00 a.m.
Call to Order
Chair Block called the meeting to order at 9:01 a.m.

Roll Call

PRESENT: Block, Cooper, Given, Gladstern, Jones (alternate retired), Klein, Murphy, Piombo (alternate safety), Shaw (ex officio alternate), Silberstein, Werby

ABSENT: Thomas

Chair Block stated the Ad Hoc Education Committee's intent is that the Retirement Board's Strategic Workshop foster the study of prudent stewardship of MCERA. Mr. Block discussed processes to be followed during the course of the workshop.

Open Time for Public Expression
Open time for public expression, from three to five minutes per speaker, on items not on the Board Agenda. While members of the public are welcome to address the Board during this time on matters within the Board's jurisdiction, except as otherwise permitted by the Ralph M. Brown Act (Government Code Sections 54950 et seq.), no deliberation or action may be taken by the Board concerning a non-agenda item. Members of the Board may (1) briefly respond to statements made or questions posed by persons addressing the Board, (2) ask a question for clarification, or (3) provide a reference to staff for factual information.

No members of the public provided comment.

9:00 a.m. – 9:30 a.m.
Statistics and Probabilities
Jay Kloepfer, Executive Vice President, Callan Associates
Jim Callahan, President, Callan Associates

Chair Block introduced the Statistics and Probabilities presentation to further understanding of common terms used by our advisors during Investment Committee meetings. Jim Callahan, President of Callan Associates, said setting asset allocation policy is by far the biggest driver of return and risk of the portfolio over the long term. In determining asset allocation, the concept is to meet the return objective with the least amount of risk. The primary tool the Board uses to assess the risk is Callan's periodic asset-liability study. In the interim between these studies, Callan updates capital market assumptions annually and presents revised projections to the Board.

Chair Block expressed an interest in considering additional qualitative inputs in terms of goals for return and risk and formalizing processes around asset allocation. Mr. Wickman stated the asset-liability study is formally conducted every five years and he will follow up through the Governance Committee to formalize a policy that outlines the process. Mr. Callahan said that the asset-liability study has a lot of quantitative aspects to it, but ultimately the idea is to find the amount of risk the Board is comfortable with by exploring the qualitative aspect of the study. Chair Block said the Board should make sure we have a well defined process for reviewing and discussing the asset allocation.

Mr. Callan introduced Jay Kloepfer who manages the capital markets research group at Callan Associates. Mr. Kloepfer said capital market theory is the language of investments, borrowing language from statistics and imputing meaning to terms such as Alpha and Beta. The result is a way to define the relationship between return and risk in order to put portfolios together. One key element is return can be expressed on an unrealized basis. Modern portfolio theory makes a big assumption that investment risk and return may be defined in a normal distribution, where the center is the same as the average and tails are the same on either side. Probabilities may be derived from any given point and the variability of outcomes can be inferred. The bigger the variation in returns, the bigger the risk. Risk is measured using standard deviation, which is in the same unit as the return. Using the standard deviation, the probability of occurrence can be described.

Mr. Kloepfer pointed out that getting more return means taking more risk. This is demonstrated by the capital market line that reflects return and risk for asset classes. Presenting a 229-year history of U.S. stock market returns by calendar year, Mr. Kloepfer pointed out what looks like a normal distribution but is skewed to the side of positive returns. Diversification is based on the concept of correlation, that asset classes tend to move differently from one another. By diversifying with more than one investment, the tendency is to get a better risk-return profile. Trustee Given asked how asset correlations have changed over time. Mr. Kloepfer responded that after the 2000 market meltdown, the correlation of stocks and bonds went negative. Currently, the two asset classes are drifting back toward their historical correlation of close to zero.

Return, risk, and correlation expectations are used to identify optimal portfolios. An optimal portfolio is one for which for a given return, risk cannot be reduced, and for a given risk, return cannot be increased. The efficient frontier comprises a range of possible efficient portfolios; then, the question is where you want to be on the efficient frontier, Mr. Kloepfer said.

Mr. Kloepfer reviewed Callan's 2018 10-year capital market projections and discussed how asset classes are put together considering return, standard deviation and correlation. He reviewed a set of potential MCERA asset mixes across the efficient frontier from less to more risk. In summary, Mr. Kloepfer noted the importance of considering risk and return factors over the long term and reviewed key terms such as the Sharpe ratio, excess return and tracking error.

9:30 a.m. – 11:00 a.m.

Capital Markets Update and Asset Allocation Review

Jay Kloepfer, Executive Vice President, Callan Associates

Jim Callahan, President, Callan Associates

Mr. Kloepfer explained the capital markets update is presented every year to look at the big picture and consider what would cause a change in assumptions. In recent years Callan has reduced the equity return assumption. Assumptions have to make sense for the asset class and the portfolio, he said. Discussing macroeconomic conditions, Mr. Kloepfer said among impacts of tax reform legislation he expects greater demand for elongated debt and relatively better returns from domestic equities. In the capital markets, stock and bond valuations look high, and market volatility has returned to normal from very low levels. Along with MCERA, most public funds have lowered their discount rates. He also noted that that some plans are also inching out on the efficient frontier to get more return. Current one-year forward price-earnings ratios for selected equity benchmarks across the globe compared with ten-year ranges were presented. The emerging markets index looks the cheapest, Mr. Kloepfer said. In the fixed income sector, yields remain low and remarkably stable, and there is still a yield advantage for high yield and bank loans.

Diversification remains the key risk control, Mr. Kloepfer said, as demonstrated by the Callan Associates' Periodic Table of Investment Returns from 1998-2017 showing that asset class returns vary over time. Callan's 10-year return projections for the period ending December 31, 2017, were close, except for non-U.S. stock markets, Mr. Kloepfer observed.

The economic backdrop is U.S. Gross Domestic Product (GDP) looking better at around 3% this year and 2.4% for non-U.S. economies, Mr. Kloepfer said. This is a long growth cycle and the Federal Reserve Open Market Committee (FOMC) has begun rate increases; the futures market predicts fewer hikes at a slower pace than FOMC median expectations. Rising energy prices brought inflation back to 2%. The biggest concern for the economy is a potential trade war and how well the European economy recovers.

Given the relatively weak economy since the global financial crisis, the long-term assumption for GDP is 2% to 2.5% for the U.S., 1.5% to 2% for non-U.S. developed markets, and 4% to 5% for emerging markets. For broad U.S. equities Callan's return expectation remains at 6.85%. Broad U.S. fixed income assets are projected to return 3.00%. For long term strategic planning Callan is projecting a 4.5% real return for equities, which is conservative relative to the long-term average. The set of assumptions for inflation, fixed income and other asset classes were presented, along with the 10-year projected compound return and standard deviation. These projections were applied to MCERA's asset classes and alternative efficient mixes were presented, assuming a maximum allocation of 15% for real assets. Mr. Kloepfer said none of the mixes reaches the nominal 7% assumed rate of return. Still, the Plan has a reasonable chance of achieving the return target over 10 years. He noted that the expected real return is close to the target and no added return for actively managed portfolios is included in the assumptions. Returns from private equity portfolios are likely to be better than projected, he said.

Trustee Klein asked whether private equity is worth having given the level of volatility evidenced by the projected standard deviation as compared with the projected return. In response, Mr. Kloepfer stated the standard deviation is a very stylized number since there is no daily value markup for private equity. Callan expects private equity to return several basis points over public equity over time. Mr. Kloepfer concluded that MCERA's asset allocations are reasonable and pointed out that the whole portfolio has a favorable Sharpe ratio of over one. Trustee Werby observed that moving the asset allocations out on the risk curve would lower the fixed income allocation and distribute the balance in private and public equity. Mr. Callahan explained that the fixed income allocation provides liquidity and a low correlation to equity. Asset allocations since 2000 show the Fund has become more diversified, the biggest change being the equity allocation has become more global and private equity was introduced. In response to Trustee Silberstein's inquiry, Mr. Callahan explained the evolution of MCERA's real asset allocation from strictly private real estate in Northern California to two diversified core real estate funds and other public real asset strategies: TIPS, commodities through managed futures, natural resource equities, and REITs.

In summary, Chair Block requested that there be a formal policy to solidify the processes and timing for conducting asset/liability studies, for example. He indicated an interest in addressing our ability to pay liabilities, how those are integrated with returns, and how other inputs get integrated into decision making, such as black swan events and tail risk. Several trustees pointed out that MCERA has detailed processes with multiple inputs. There was consensus for the Governance Committee to develop a policy on processes as an educational tool for new trustees and a guidepost for the Board.

In response to Trustee Klein's inquiry, Mr. Callahan said the asset/liability study would need to be reevaluated if something changes the long-term plan; for example, a dramatic change in the capital markets, the introduction of a new asset class, a meaningful change to liabilities or the discount rate, or a change in benefits policy.

Chair Block recessed the meeting for a break at 11:03 a.m., reconvening at 11:13 a.m.

11:00 a.m. – 12:00 p.m.
Proxy Voting Advisory Services
Joshua Russell, Senior Account Executive and Vice President
Nathan Worthington, Executive Director, Regional Director of Client Service & Consultants
Institutional Shareholder Services

Chair Block introduced the presentation on proxy voting for the purpose of gaining insight into proxy voting mechanics and proxy voting services available to MCERA. Joshua Russell, Institutional Shareholder Services (ISS) account executive, stated that in the United States proxy season is primarily between April and June when 80% of annual shareholder meetings are held. Mr. Russell introduced Nathan Worthington who provides client services support. Mr. Worthington defined corporate governance as a public company's structure for how to interact with its stakeholders considering how that might affect its future value. Corporations must hold an Annual General Meeting when, in addition to voting, shareholders have the opportunity to discuss their views and values with corporate directors.

Chair Block noted corporate directors have fiduciary duties and shareholders have influence through derivative lawsuits and shareholder voting. Trustee Silberstein noted that shareholders elect directors and the question is how they represent us.

Mr. Worthington continued by listing typical agenda items at shareholder meetings: corporate director elections, auditors, say on pay, shareholder proposals, dividends or stock option plans, and compensation plans. Of the 700 different codes ISS has for various agenda items, 80% are director elections. By evaluating and providing rationales for vote recommendations, ISS gives clients the ability to have direction on voting proxies, Mr. Worthington said. He explained that shareholder proposals are likely to have a deadline to participate that includes showing the period of time securities have been held.

Proxy voting matters, Mr. Worthington said, because Boards of Directors are responsible for considering shareholder views. As shareholders participate, they promote better governance which creates more value for the corporation. Many ISS clients' proxy voting policies show how they are adding value and effectively communicating the most appropriate governance practices in the market.

Chair Block asked about the process for changing Boards of Directors. Mr. Worthington replied this is a proxy contest where a dissident group makes an argument to gain control with certain candidates, and vice versa. Depending on whether the dissident group has made a case for change, ISS will evaluate the candidates and make a determination on who to support and why.

Chair Block asked what the pros and cons would be of voting our own proxies. In response, Mr. Worthington said there are three main reasons a public fund would want to vote proxies:

1. To act as an informed fiduciary and have a strong rationale with full transparency
2. To meet compliance requirements
3. To have a way to promote a Plan's viewpoint

Chair Block noted in deciding to vote its own proxies, MCERA would take on the related cost and the commitment to keep policies up to date and provide auditing and oversight, including reviewing proxy votes. He observed there is a cost with voting proxies either internally or through a service provider like ISS. Mr. Worthington noted this is a policy framework that can be defined in proxy voting.

Mr. Russell said ISS is the largest proxy voting service provider in the world. The firm uses smart technology to manage processes such as research, governance rating tools, and securities transactions. Reporting is automated with full service provided to smaller clients, including environmental-social-governance (ESG) screening. He noted the firm processed 9.6 million ballots for clients last year and covered about 42,000 out of a total of 42,500 corporate meetings in a very labor-intensive process. ISS votes a majority of institutional ballots annually, Mr. Worthington said, and its baseline policy is to vote 92% of the time to support director elections. On Say on Pay, ISS policy is to vote with managers in the Russell 3000 Index about 75% of the time.

The ISS online proxy voting platform features a control panel showing upcoming annual meetings, agenda items to which specific policies can be applied, and related vote recommendations and rationales. The panel allows the user to override any given ISS vote recommendation.

Trustee Werby asked if ISS proxy votes are available to the public. Mr. Worthington replied ISS provides proxy voting information and policies on its public website; clients choose whether proxy voting is made public or kept private. Trustee Gladstern noted that MCERA frequently hears from groups who raise various issues about the Plan's investments. She noted that MCERA's policy is focused on engagement and one avenue for engaging could be joining shareholder proposals.

Noting MCERA's proxy voting policy contemplates a 'should' concept, Chair Block asked if any trustees have concerns about voting our own proxies. Trustee Werby indicated considerations would be the amount of work involved and achieving consensus on how to vote.

Mr. Worthington said that ISS has specialty, thematic policies that might be geared to our preference. He suggested starting with one of those and then working from there to define more specific guidelines to follow.

Responding to Chair Block's inquiry, Mr. Russell said the main driver of fees is the amount of voting ISS will manage, including how many companies per year. Chair Block asked how ISS proxy voting policies line up with those of CII. In response, Mr. Worthington said generally, ISS would be in line with CII proxy voting policy. Typically, ISS presents a proxy voting report once per year to clients. In conclusion, Mr. Worthington said ISS would operate as an extension of MCERA's team in an operationally smooth process. Trustee Silberstein said one reason for MCERA to vote proxies in-house would be to have votes align with our governance policy.

Chair Block recessed the meeting for lunch at 12:21 p.m., reconvening the meeting at 1:31 p.m.

Trustee Given was excused from the meeting at 12:30 p.m.

Trustee Jones joined the meeting at 1 p.m.

12:00 p.m. – 1:30 p.m.
Lunch (on site)

1:30 p.m. – 2:30 p.m.
Investments – Pros and Cons of Different Legal Structures
Yuliya Oryol, Nossaman LLP

Yuliya Oryol, Partner with Nossaman, said her presentation focuses on the legal structures for investment vehicles typically used by public pension plans. These include investment management agreements (IMAs), partnerships, limited liability entities, and trusts. The investment management agreement is an agency agreement delegating investment authority to a third party. The third party is likely to be an investment manager who acts as the Plan's agent to make investment decisions and have discretion over Plan assets. The IMA can be customized as to guidelines to be used and tailored to the relationship. Responding to Chair Block's inquiry, Mr. Wickman said MCERA employs IMAs with custody assets managed by fixed income managers Wellington Management and Western Asset Management and domestic small cap equity manager Columbus Circle Investors.

Advantages of an IMA include control over fees and most favored nation status; the objective is to control the terms as much as possible. Typically, the investment guidelines are incorporated into the IMA. As compared with a commingled fund, the IMA improves transparency and planning for assets that are already held by the custodian. MCERA should have the right to terminate the relationship for cause or convenience, and the IMA makes this process easier. Considerations of an IMA are that some plans find them to be operationally challenging and prefer commingled funds where fees are shared. According to Mr. Callahan, it depends on the asset class and strategy whether the advantages of an IMA outweigh the considerations.

The asset level threshold for using an IMA is typically at least $100 million, Ms. Oryol said. Some managers prefer more discretion than IMA provisions allow. Through the IMA, the investment manager is an agent and a fiduciary, therefore allowing for the highest standard of care to be imposed on the manager. Ultimately, she said, the Plan is responsible for how investments are made, and the IMA provides for some control up front. The Plan's investment restrictions should become the manager's investment restrictions. Operationally, the Plan would also have a sub custodian account, a legal operational structure for futures, swaps and derivatives, and a prime broker, for example. The IMA agreement should be one single document that incorporates other documents, such as guidelines and the fee schedule, by reference. Provisions may include performance incentives, clawback rights, and negotiated targets.

Chair Block noted it is important, when there are multiple accounts with one bank, to make sure under default circumstances that the Plan's assets are ringfenced so that the bank cannot tap into the assets of other accounts. Counsel Dunning stated any indemnification provisions are limited to the amount of the retirement system's investment in the Fund.

Ms. Oryol discussed other legal structures. With alternative investments such as private funds for private equity investments, the first document would be the private placement memorandum disclosing the risks undertaken. Other documents may include limited partnership agreements or limited liability company operating agreements, subscription agreements, investment advisory agreements, guaranties, investor acknowledgement letters, opinions, and side letters. Side letters offer additional protections for investors in private funds. A limited partnership has a general partner and multiple limited partners who are investors sharing in profits and losses. The general partner controls day-to-day operations and has unlimited personal liability for debts and obligations of the fund. Limited partners do not have personal liability for partnership obligations.

Trustee Given rejoined the meeting at 1:56 p.m.

In limited partnership agreements, terms are controlled by the general partner and limited partners join through the subscription agreement. The typical private fund fee structure is a 2% management fee and 20% profit to the general partner. Considerations for limited partners are no direct control over management or investments, and participation is limited to an advisory committee, if that is available. In closed-end funds, there is a lack of liquidity. Private funds lack transparency due to competition and not wanting to share information. As a result of recent legislation, MCERA requires its private equity managers to provide detailed fee information annually that can be posted to MCERA's website and/or reported on at least an annual basis at its Board meeting open to the public. The fee disclosure information is partially based on the Institutional Limited Partners Association (ILPA) fee reporting template.

Trustee Silberstein noted that in limited partnerships the general partner can be dismissed by the limited partners. Ms. Oryol said there should be withdrawal rights, pointing out that for-cause termination is very difficult to obtain since it often requires a super-majority vote of the limited partners after a court determination of cause, requiring gross negligence and/or fraud to be proven, for example. In addition, a considerable amount of time and money would be required in the process of going to court and proving the allegation. She indicated for this reason, limited partners would want to be able to remove the general partner without cause, if possible. Many limited partnerships do not allow this and would require the limited partners to vote to terminate the partnerships instead.

Limited liability companies were created to offer the flexibility of a partnership while providing corporation-like protection against personal liability. Provisions are set forth in operating agreements that outline the rights and responsibilities of members and the manager/managing member, who usually controls the terms.

A Fund of One is an alternative to the IMA using either a limited partnership or limited liability company structure. Advantages for investors include control over fund-related decisions, favorable legal terms, customized business terms (including fees), use of the Plan's customized investment guidelines and priorities, termination rights, and privacy with some public disclosures. The Fund of One is similar to a separate account for larger investors. Limitations on use include higher costs, tax considerations, and the minimum commitment size.

A trust is a common investment vehicle for public market transactions. A collective investment trust is similar to a U.S. mutual fund but available to qualified retirement plans. A trust company or bank organizes the entity to invest assets that are exempt from federal income tax. Trust documents include a prospectus, declaration of trust, bylaws, subscription agreement, investment advisory agreement, and servicing agreement. Side letters are less common but recommended.

In conclusion, Ms. Oryol stated complex investments require more investor knowledge, time and staff resources. Market dynamics, liquidity needs, manager selection and manager due diligence are important considerations. Additional factors for investments are the level of manager discretion, alignment of interests, suitable performance benchmark and fee structure, resolution of conflicts of interests, and ending the relationship.

Chair Block asked Ms. Oryol and Mr. Callahan to discuss the regulatory framework and the due diligence process. Ms. Oryol said the regulatory framework depends on the investment class. For example, private equity funds have to register with the Securities and Exchange Commission (SEC). Noting that the SEC regularly examines registered investment advisors, Chair Block asked if we demand that investment advisors be registered with the SEC. Ms. Oryol replied that both of MCERA's private equity managers are registered, but the underlying funds might not be registered. The private equity managers are generally required to confirm they are fiduciaries under the Investment Advisors Act.

Mr. Callahan said investment managers have to consider how to structure their product and that may impact where it is distributed. For example, a commingled fund would be limited to institutional investors, and a mutual fund would access retail investors. In response to Trustee Gladstern's observation that in manager searches different vehicles are presented, Mr. Callahan said these are likely to be different variations of a pooled vehicle.

2:30 p.m. – 4:00 p.m.
Domestic Equity Structure and Manager Review
Jim Callahan, President, Callan Associates
Anne Heaphy, Vice President, Callan Associates

Mr. Callahan said there has been an ongoing discussion about the Fund's domestic equity portfolio, including the percentage of large cap versus small cap and how each should be implemented. The large cap portfolio is in a non-lending S&P 500 Index fund. For domestic small cap equities, the decision was to combine growth and value strategies into the Dimensional Fund Advisors (DFA) small cap core separate account.

Using guiding principles and best practices for determining asset allocations, Callan begins with the Russell 3000 index as the standard for domestic equity exposure. The two biggest drivers of return over time are the size of the stock and the style, value versus growth. Trustee Werby asked whether there is a movement to invest more in the technology sector. In response, Mr. Callahan said it is rare to overweight technology since it is already a large part of the market (as much as 40%). Callan's view is that small cap is worth overweighting because of its long-term premium and the ability of active managers to add value there.

Mr. Callahan reviewed and compared characteristics of major stock market indices, such as the Russell 3000 and the S&P 500 Index that represent the broad domestic equity market. MCERA's large cap domestic equity allocation is 70%; in 2012 the small cap percentage was increased from 20% to 30% of the domestic equity portfolio. Over the past seven years, large cap has outperformed small cap, and Mr. Callahan discussed possible reasons for this. There are fewer publicly traded stocks now than in the past and private equity is taking bigger companies private. Trustee Klein added that companies are going public later when they are no longer small cap. Mr. Callahan believes the overweight to small cap is justified; the question is how pronounced the overweight should be. Trustee Piombo asked if private equity is where to look for the small cap premium. In response, Mr. Callahan said a diversification argument can be made to be able to access a larger opportunity set of companies in private equity.

Mr. Callahan presented metrics comparing large and small cap domestic equities, including rolling 10-year returns, historical return premiums, and standard deviation showing the greater volatility of small caps. Details on the DFA small cap core strategy were reviewed, such as the median market cap and regional and economic allocations as compared with the benchmark Russell 2000 Index.

Given the current domestic equity portfolio structure, Mr. Callahan discussed potential alternative structures. First, the small cap overweight could be reduced to 20% of domestic equities. To illustrate how varying the domestic small cap allocation would have affected the Fund, Mr. Callahan presented back-tested returns and other metrics for 10%, 20% and 30% allocations to the DFA small cap core strategy and the balance to the S&P 500 Index. Chair Block asked about adjusting the rebalancing range for small caps to let them run. Mr. Callahan replied the rebalancing ranges are designed to capture favorable volatility, adding that rebalancing is a risk-control tool. Mr. Wickman noted when rebalancing ranges are pierced, other factors such as cash needs are considered. Mr. Callahan said the data shows the returns are worth the risk for the 30% small cap allocation in response to Chair Block's inquiry.

Turning his attention to the domestic large cap equity portfolio, Mr. Callahan stated it is currently invested in the State Street Global Advisors S&P 500 Non-Lending Index Fund. Based on the direction of the Investment Committee, Mr. Callahan presented and reviewed fee information on selected passive large cap investment vehicles and managers. The options included the S&P 500 and Russell 1000 indices, commingled or separate accounts, and lending or non-lending vehicles. Mr. Callahan pointed out that the lending vehicles have lower management fees since the manager receives securities lending fees. Of those presented, Mr. Callahan said the least expensive is the BlackRock S&P 500 vehicle.

Chair Block asked about the relative differences among the passive large cap managers presented. Mr. Callahan indicated in response that he does not expect to find qualitative differences when Callan completes its due diligence process. Trustee Silberstein said there is a big difference in how these managers vote proxies. Based on discussions, the consensus was to wait until Callan completes its research before changing the large cap portfolio.

Trustee Jones was excused from the meeting at 3:56 p.m.

4:00 p.m. – 4:30 p.m.
Closing and Follow-up Items from Today's Agenda

Chair Block asked Board members to share their thoughts on the domestic large cap equity portfolio discussion. The majority of the Board expressed a desire to keep the current 70/30 split between large and small cap for the domestic equity allocation. As for the type of investment vehicle, the general preference was to utilize a separate account that includes securities lending. Further discussion will be needed with the Investment Committee to determine if the current S&P 500 Index will be maintained or a different index like the Russell 1000 would be used. If the Investment Committee adopts changes to the current domestic equity structure, the Board expressed an interest in including an analysis of proxy voting during the manager selection process.

Chair Block recessed the meeting for the evening at 4:30 p.m.

Day 2
April 18, 2018

9:00 a.m.
Call to Order

Chair Block called the meeting to order at 9:00 a.m.

Roll Call

PRESENT: Block, Cooper, Given, Gladstern, Jones (alternate retired), Klein, Murphy, Piombo (alternate safety), Shaw (ex officio alternate), Silberstein, Thomas, Werby

ABSENT: None

Open Time for Public Expression

No members of the public provided comment.

9:00 a.m. – 10:30 a.m.
Disability Process Review and Discussion
Jeff Wickman, Retirement Administrator
Ashley Dunning, Nossaman LLP

Chair Block introduced the disability process review to consider how those processes might be improved. Mr. Wickman noted there has been a lot of discussion on how the disability process works. The focus of this discussion was to review changes the Board had previously implemented and discuss proposed changes for further improving the Board's process for reviewing and deliberating disability retirement applications. In addition, the Administrator is working with the Chair to document the process for closed session presentations and the detail included in the staff summary.

Board Counsel Ashley Dunning, Partner with Nossaman LLP, presented the disability process review to further understanding of the Board's role in adjudicating rights when assessing eligibility for disability retirement. Four major questions under the County Employees

Retirement Law of 1937 (CERL) to be addressed when considering an application for disability retirement are:

1. Is the applicant eligible for disability retirement?
2. Has the applicant proven that it is more likely than not he or she is incapacitated?
3. Is the incapacity "permanent"?
4. Did employment substantially cause the incapacity?

Is the applicant eligible for disability retirement?

Eligibility for disability retirement includes the following requirements:

- A nonservice-connected disability requires 5 years of service.
- Service-Connected disability retirements have no minimum service requirements.
- The application must be timely filed within 4 months of leaving work.
- The applicant must currently be an active, deferred, or service retired member and cannot have withdrawn contributions, having been properly advised.

Has the applicant proven that it is more likely than not he or she is incapacitated?

Once eligibility for disability retirement is established, the first question for the Board to consider is whether there is incapacity, meaning the substantial inability of the applicant to perform usual duties. Ms. Dunning discussed examples of qualifying incapacities, including situations where pain may be part of the inability to work. Mr. Wickman said pain in itself may not necessarily establish an incapacity. Ms. Dunning advised the applicant has the burden of establishing the member's incapacity. If the Board determines that no incapacity exits, the application is denied, and the applicant is given the opportunity to appeal the denial at an administrative hearing.

Trustee Jones joined the meeting at 9:17 a.m.

Trustee Cooper said he would like to have more information, such as would be presented during an administrative hearing. Ms. Dunning responded that staff will be presenting proposals to improve the process along those lines. She continued by discussing how usual duties are defined and the ability of the employer to provide reasonable accommodation. Mr. Wickman observed that short-term accommodations are noted in the response MCERA receives from the employer but longer-term accommodations are not commonly observed in the responses. Trustee Piombo shared his experience working with accommodations. Ms. Dunning stressed the importance for Board members to understand their role and fiduciary obligation to be rigorous on standards on both sides of the matter.

Is the incapacity "permanent"?

If the Board determines that an incapacity exists, the next step is to determine if it is permanent. In public employee retirement law, Ms. Dunning stated, the key reference for permanent incapacity is that there must be competent supporting medical evidence. Therefore, an applicant's subjective complaint is not enough to grant disability retirement. Responding to Trustee Piombo's inquiry on surgical intervention, Ms. Dunning said there is some case law requiring applicants to submit to reasonable treatment; it depends on the medical evidence and the risks and benefits. She suggested this may be an area where the Board could request more information.

Did employment substantially cause the incapacity?

If a permanent incapacity is established, the final determination for the Board is whether the job made a real and measurable contribution to the injury. In some cases, there are presumptive service connections. Ms. Dunning explained the heart presumption in response to Trustee Werby's inquiry. If a presumptive condition exists, MCERA has the ability to attempt to rebut the presumption based on the medical evidence. Ms. Dunning distinguished requirements and rules for disability retirement from those for Workers' Compensation cases. As further background for discussions, the Disability Retirement Handbook, Frequently Asked Questions, and Guidelines for Discussion of Disability Retirement and Survivor Benefit Applications at Board Meetings were presented as handouts.

In response to Trustee Silberstein's inquiry, Mr. Wickman said MCERA receives approximately 13 new disability retirement applications per year. The Board hears about 20 cases per year, most being service-connected. Trustee Jones asked about the basis for administrative law judges (ALJ) granting disability retirements. Mr. Wickman replied staff attends the hearings and witnesses the testimony presented to the ALJ. The hearings are similar to court proceeding and the ALJ ultimate decision is based on their view of the evidence and which testimony the ALJ found to be the most credible. Although in recent history the ALJ decisions have been contrary to the Board's initial determinations, that is not always the case. Determining any patterns in the final ALJ decisions is challenging, he noted. Ms. Dunning noted the due process and impartiality involved in OAH hearings.

Mr. Wickman discussed how the independent medical examiner (IME) is selected in response to Trustee Piombo's inquiry. Chair Block indicated he wanted to consider how the IME is selected; he proposed giving applicants a single veto over the IME selection. Mr. Wickman indicated he disagreed with this approach and it would be administratively unfeasible. Mr. Wickman said in selecting IME's staff tries to make sure we do not rely on the same ones. Staff aggressively manages IME's to avoid biases and make sure they are experts in the specific fields being reviewed. Counsel Dunning suggested the Board find a way to fairly address the IME selection process.

Before disability applications are presented to the Board, staff reviews all the materials submitted and makes sure they are complete. The application material is presented to the Medical Advisor who reviews the information and advises the disability coordinator whether an Independent Medical Examination (IME) is warranted. The majority of cases require an IME review. The IME reviews material provided by MCERA and the applicant, meets the applicant to conduct an examination, and writes a report based on the review of medical records and results of the examination. The Medical Advisor reviews the report produced by the IME along with all the other medical evidence from the applicant and treating physicians and prepares their report for staff and Board. Only after that do cases go to the Board. After the Board's initial decision, an applicant whose application is denied may request an administrative hearing. The decision by the ALJ comes back before the Board for its final decision. Ms. Dunning advised there is limited ability to deny disability retirement if the ALJ recommends granting a disability retirement to the applicant unless the Board conducts its own evidentiary hearing as provided by CERL. If the ALJ supports the Board's denial of an application, the applicant can file a case for review in Superior Court.

MCERA has done a considerable amount to inform members, Ms. Dunning said in response to Chair Block's reference to making sure members are advised of their rights. Ms. Dunning discussed options for further proposed improvements to the disability retirement process:

1. If staff recommends denying the application, should an additional process be afforded before the Board's initial consideration of the application? For example:
    - Require briefs from applicant's and MCERA's counsel
    - Use a standing committee of the Board to provide initial review of the application and provide the applicant the opportunity for submission of additional evidence and/or argument
    - Board consultation with its own disability retirement counsel
2. Or, if the Board's initial decision is to deny, should the applicant be afforded an opportunity for a further Board consideration of the matter, with briefing by counsel (if any), before proceeding to an administrative hearing before an ALJ. Some other '37 Act systems allow members to bring additional information forward to the Board to consider.

Upon discussion of the process that would lead to the best decision, there was consensus on adopting the second numbered option listed above.

It was M/S Given/Gladstern to direct staff to initiate the amendment of disability processes and policies to include the second numbered option listed above whereby the applicant is afforded an opportunity for a further Board consideration of the matter.

In response to Trustee Given's preference to see what the contention is at the initial consideration, Mr. Wickman advised modifying the process so that applicants have the opportunity to brief up front. Trustees Given and Gladstern amended the motion to align with this modification.

AYES:	Block, Cooper, Given, Gladstern, Klein, Murphy, Silberstein, Thomas, Werby
NOES:	None
ABSTAIN:	None
ABSENT:	None

Responding to Trustee Piombo's and Chair Block's respective inquiries on the selection of the IME and whether applicants should be able to object to an IME, Mr. Wickman indicated he believes in the majority of the cases the IME is not an issue. The IME reviews all the medical evidence to answer two questions: 1) is there a permanent incapacity, and 2) did the job contribute to the injury. Ms. Dunning advised staff is acting as a fiduciary when selecting an IME.

Chair Block invited discussion on any further ideas. There was general agreement that staff should continue providing case summaries with staff recommendations and the Disability Consent Agenda. Trustee Cooper sought clarification of the Board's understanding of whether the job contributed to the injury due to a preexisting condition. He indicated the ALJ does not seem to need as much information to determine service connection. Chair Block said we are tied by the law on service connection, and Ms. Dunning added that the ALJ decision should be based on the competent medical evidence.

Chair Block recessed the meeting at 10:59 a.m. for a break, reconvening at 11:09 a.m.

10:30 a.m. – 11:30 a.m.
Open Public Meeting Requirements
Ashley Dunning, Nossaman LLP

Mr. Wickman stated Open Public Meeting Requirements is an important topic because the public needs to be able to witness Board deliberations, unless they are properly agendized for a closed session. Ms. Dunning stated open public meeting laws derive from the Ralph M. Brown Act and the State of California Constitution. Balanced with the right to privacy is the public's right of access to the public's business. Laws are to be broadly construed for improving public access and will therefore err on the side of transparency. Privacy provisions do not change in the face of public meeting requirements. Policy declarations in the Brown Act reflect the obligation of public agencies to conduct business in public. Among these obligations are that agendas must be posted within 72 hours of meetings and all people may address topics within the Board's jurisdiction.

A meeting is broadly defined as a majority of the Board or a standing committee communicating on matters within the Board's jurisdiction. Serial meetings, where two trustees talk and then one of them speaks with other trustees about the same topic, are prohibited. Conferences that are open to the public are not subject to the public meeting restrictions for the trustees.

The meeting agenda needs to have sufficient information for the public to determine whether they should attend. Agenda topics should not exceed twenty words, and standard topics do not need elaboration. Adding items to the agenda is restricted to emergencies if a matter comes up after the agenda had been posted. On MCERA's agendas, there is language on how the Board may respond to public comments. Responding to Chair Block's inquiry, Ms. Dunning explained the public may comment on items not on the agenda or on agenda items when the item is called. Discussion followed on the correct sequence for public comment on agenda topics. Ms. Dunning added it is the prerogative of the Chair and she advised beginning and then closing the item with public comment. Trustee Piombo indicated an interactive discussion with the Board should be discouraged. The Administrator agreed and said the Chair is ultimately responsible for managing public comment.

Prohibited practices include elaborate, non-agendized reports and requiring the public to sign in. Ms. Dunning addressed parameters for the contents of agenda packets. Minutes of meetings should accurately record deliberations but are not a verbatim account of debates. Topics may be addressed in closed session only if specifically permitted by statute, which must be cited on the agenda. It is illegal to discuss closed session proceedings outside of closed session, unless a majority of the Board votes to open the topic. Ms. Dunning explained the reason is because it is the Board's privilege to be in closed session. Typical closed session matters are existing or anticipated litigation that can be identified; for example, when considering filing a lawsuit or an *amicus curiae* brief. Certain personnel matters may be in closed session; however, the Board may not discuss compensation in closed session.

Trustee Cooper was excused from the meeting at 11:50 a.m.

Real property negotiations may also be held in closed session on the purchase, sale, or lease of property to grant authority in terms of price and terms of payment. Negotiators and the address of the property under consideration are to be disclosed on the agenda. Reportable action from closed sessions must be reported by roll call vote; otherwise, it should be reported that there was "no reportable action" taken.

11:30 a.m. – 12:30 p.m.
Securities Lending Overview
Yuliya Oryol, Nossaman LLP

Yuliya Oryol of Nossaman LLP stated securities lending is the temporary lending of securities on a collateralized basis. Ownership of the securities is legally transferred to the borrower and the lender agrees to buy the securities back. The lender receives collateral in exchange for the securities. The lender shares revenue with the lending agent depending on the size of the program and the type of securities on loan. For the lender, securities lending can be viewed as a lower-risk venture for idle securities to generate income. Borrowers of securities are looking to cover short positions and cover settlements. Typically, the lending agent is the custodian.

Borrowers may be selected from an approved list. This is done since the borrower exercises authority and discretion and acts as a fiduciary for the securities. The lending agent has the same standard of care and must determine if the borrower is credit worthy. Ms. Oryol recommended using a separate securities lending agreement from the custody agreement for securities lending programs. When securities are loaned, collateral from the borrower is placed in a separate account with conditions and investment guideline parameters. The collateral value should be no less than 100% of the value of the borrowed security. The agent can terminate the loan at any time and must provide regular reporting and abide by applicable law.

Risks associated with securities lending include counterparty risks of failure to respond to call for collateral, insolvency, failure to return securities, operational risk, and legal risk. Collateral must be invested in liquid securities. Before the financial crisis custodians took more risk in investing the cash collateral, resulting in considerable litigation on related losses due to the liquidity squeeze during the financial crisis. Ms. Oryol cited related settlements from major financial institutions. Mr. Callahan explained all the issues in securities lending during the financial crisis were due to cash collateral investments. Custodial banks set up cash collateral pools invested in structured asset-backed securities. When liquidity dried up, custodians were forced to sell investments at deep discounts to par and durations got extended. As the lender, MCERA is indemnified by the agent to get all the securities on loan back.

In response to Chair Block's inquiry, Mr. Callahan reviewed the collateral investment process. Collateral is invested into a pool. The borrower negotiates a rebate to the lending agent, State Street, on what that should be a combination of earnings and intrinsic value which is based on the demand for the security. MCERA receives a portion of the spread which includes yield and intrinsic value, less any split with the agent. Since the financial crisis, guidelines have been restricted to MCERA receiving mostly the intrinsic value of the security on loan. Mr. Callahan said lendable securities are limited to a few of the separately managed portfolios. Securities lending is carefully managed with appropriate guidelines for the cash collateral pool and regular reporting. It is an important function in the capital markets, Mr. Callahan said. Since its inception in 2008, MCERA's securities lending program has generated $3.8 million through June 30, 2017.

Trustee Shaw was excused from the meeting at 12:52 p.m.

Closing and Follow-up Items from Today's Agenda
12:30 p.m. – 1:30 p.m.

Mr. Wickman stated there will be further discussion on yesterday's topics at the June Investment Committee meeting.

There being no further business, Chair Block adjourned the meeting at 12:56 p.m.

Steve Block, Chair

Attest: Jeff Wickman
Retirement Administrator