



Merced County Employees' Retirement Association

AGENDA
Retirement Board Education Meeting

Monday, November 3, 2025, 1:00 P.M. - 4:30 P.M.

Location: Merced County Employees' Retirement Association
690 W 19th Street, Merced, CA
2nd Floor, Training Room

1. Call to Order- 1:00 P.M.

The Retirement Board may discuss and take action on the following:

2. Roll Call

3. Public Comment

Members of the public may comment on any item under the Board's jurisdiction including items on the Board's agenda. Matters presented under this item will not be discussed or acted upon by the Board at this time. Persons addressing the Board will be limited to a maximum of five (5) minutes in total. Please state your name for the record.

4. Meeting

Board Education

Discussion and possible action on the following presentations:

- a. Educational Session and Actuarial Valuation Results – Graham Schmidt and Tim Hall, Cheiron
- b. Fiduciary and Conflict-of-Interest Education - Ashley K. Dunning, Nossaman, LLP

5. Information Sharing

6. Adjournment

The Agenda and supporting documentation, including any material that was submitted to the Merced County Employees' Retirement Association Board after the distribution of the Agenda, are available online at www.mercedcera.com.

All supporting documentation for Agenda items, including any material that was submitted to the retirement board after the distribution of the Agenda, is also available for public inspection Monday through Friday from 8:00 a.m. to 5:00 p.m. at the administrative office for the Merced County Employees' Retirement Association located at 690 W 19th Street, Merced, California 95340.

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Merced County Employees' Retirement Association

Street, Merced, CA 95340 or telephonically by calling (209) 726-2724. Any such request for accommodation should be made at least 48 hours prior to the scheduled meeting for which assistance is requested.

Spanish and Hmong interpreters are available.

Interpretes de espanol y hmong estan disponibles.

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Merced County Employees' Retirement Association



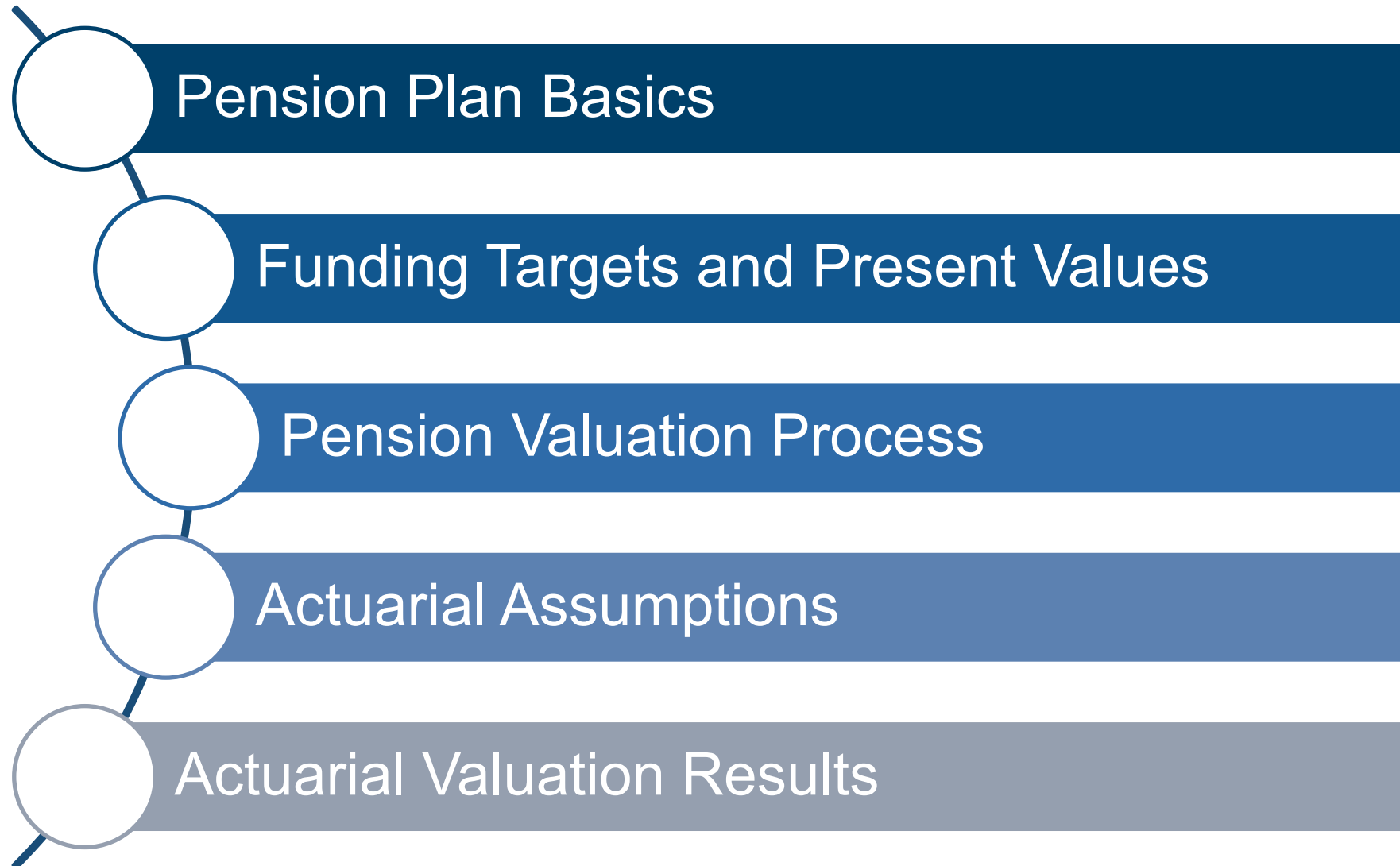
Educational Session & Actuarial Valuation Results

November 3, 2025

Graham Schmidt, FSA, FCA, EA, MAAA
Tim Hall, FSA, EA, MAAA



Today's Discussion





Defined benefit

The pension plan promises to pay a benefit determined by the plan provisions



Funded over career

Contributions are made over the working lifetime of the participant



Lifetime benefit

Participant receives benefit in retirement for lifetime (and possibly spouse's too)

A pension plan is a promise to pay a predetermined benefit to participants that is funded over their career by contributions and investment growth.



$$C + I = B + E$$



Contributions + Investment Earning = Benefits + Expenses

Contributions and interest earned on those contributions over time must equal benefits paid to participants and expenses of running the pension plan



$$C + I = B + E$$

- How do you ensure that **contributions** and **interest** will be adequate to pay promised **benefits** and **expenses**?
 - Routinely monitor
 - Adjust as necessary
 - Consult an actuary

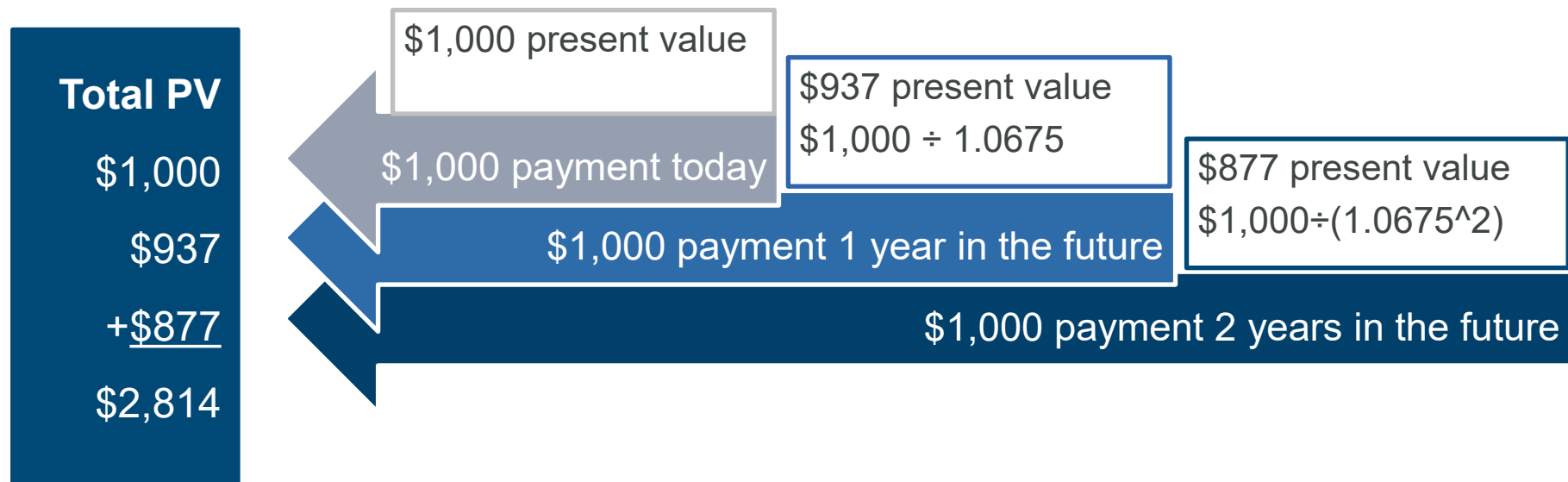


- Project future pension benefits based on:
 - Demographic information of plan members
 - Details on plan benefits/provisions
 - Assumptions regarding member behavior and benefits (Pay increases, COLAs, etc.)
- Discount cash flows to determine the Present Value of Benefits (i.e., value in today's dollars)
- Allocate value of benefits for active members between past and future service

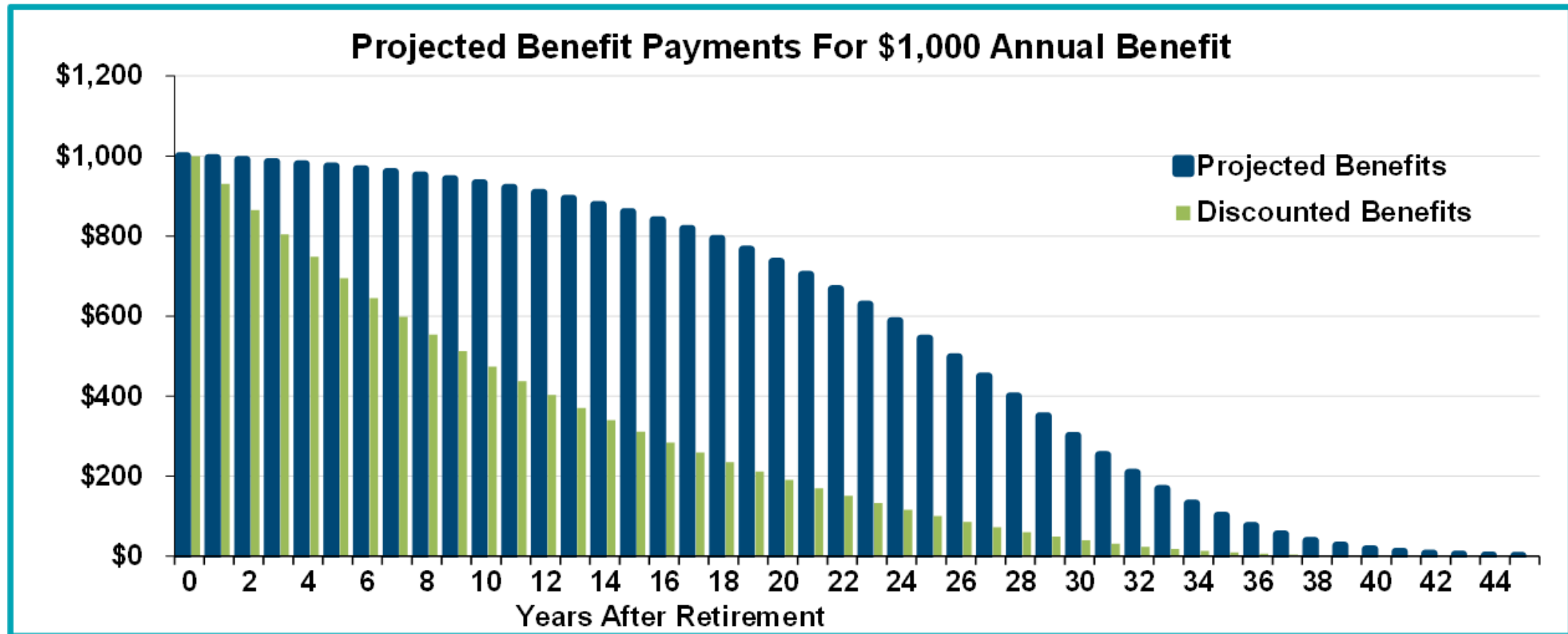
Funding Target



- Present Value (PV) *discounts* future cash flows to today's \$
- Example - the PV of three annual payments of \$1,000, starting today, assuming 6.75% *expected investment return*

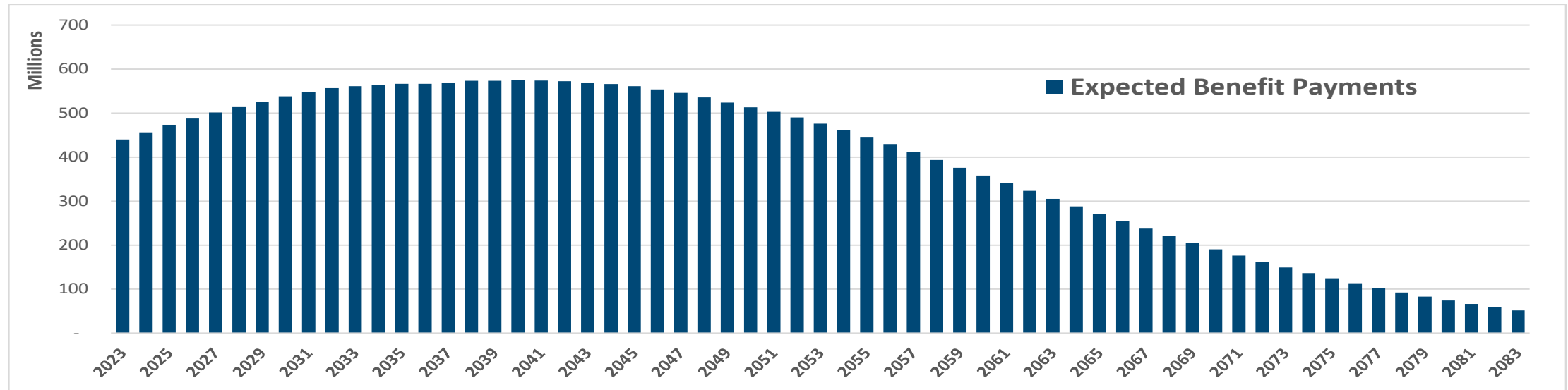


Funding Target



Reflects probability member remains alive and assumes a 6.75% expected investment return.

Funding Target



Total expected future benefits

Present Value of Future Benefits

Discount to present

Actuarial Liability

PV of Future Normal Costs

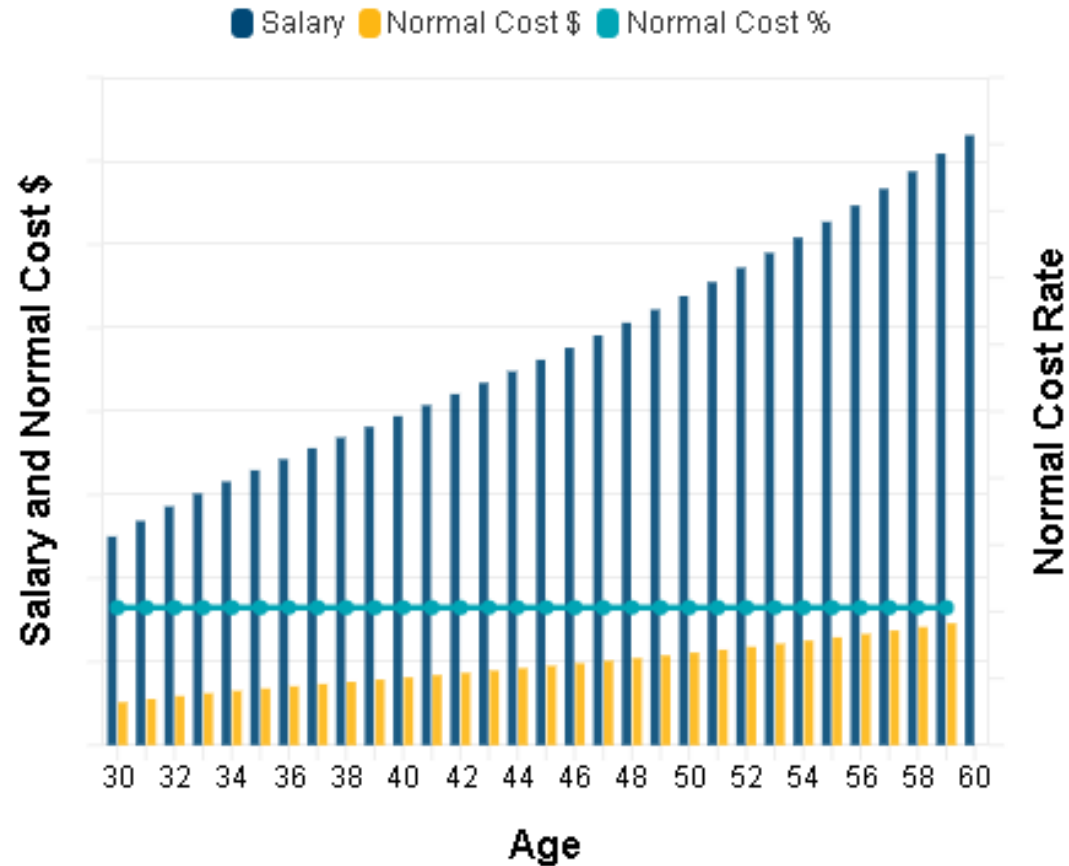
PV Future Benefits are allocated between past and future service

Funding Target



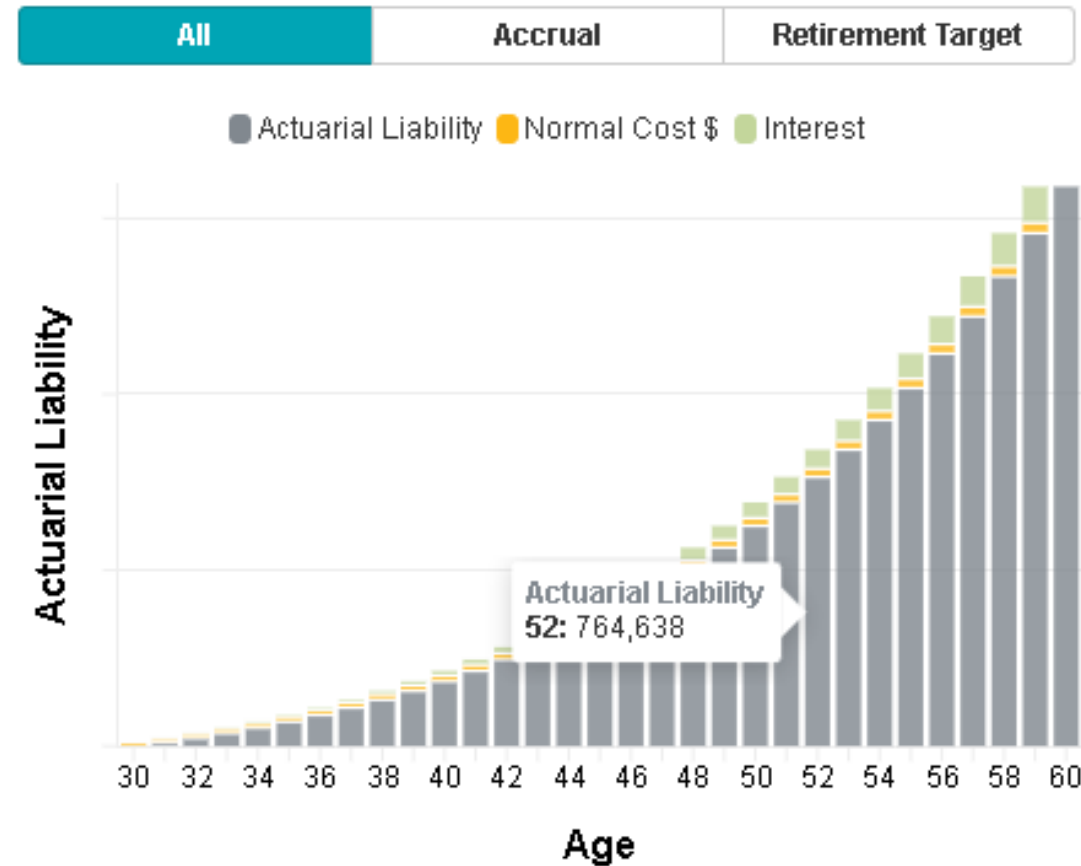
Normal Cost Example

Member Hired at Age 30, Retired at Age 60

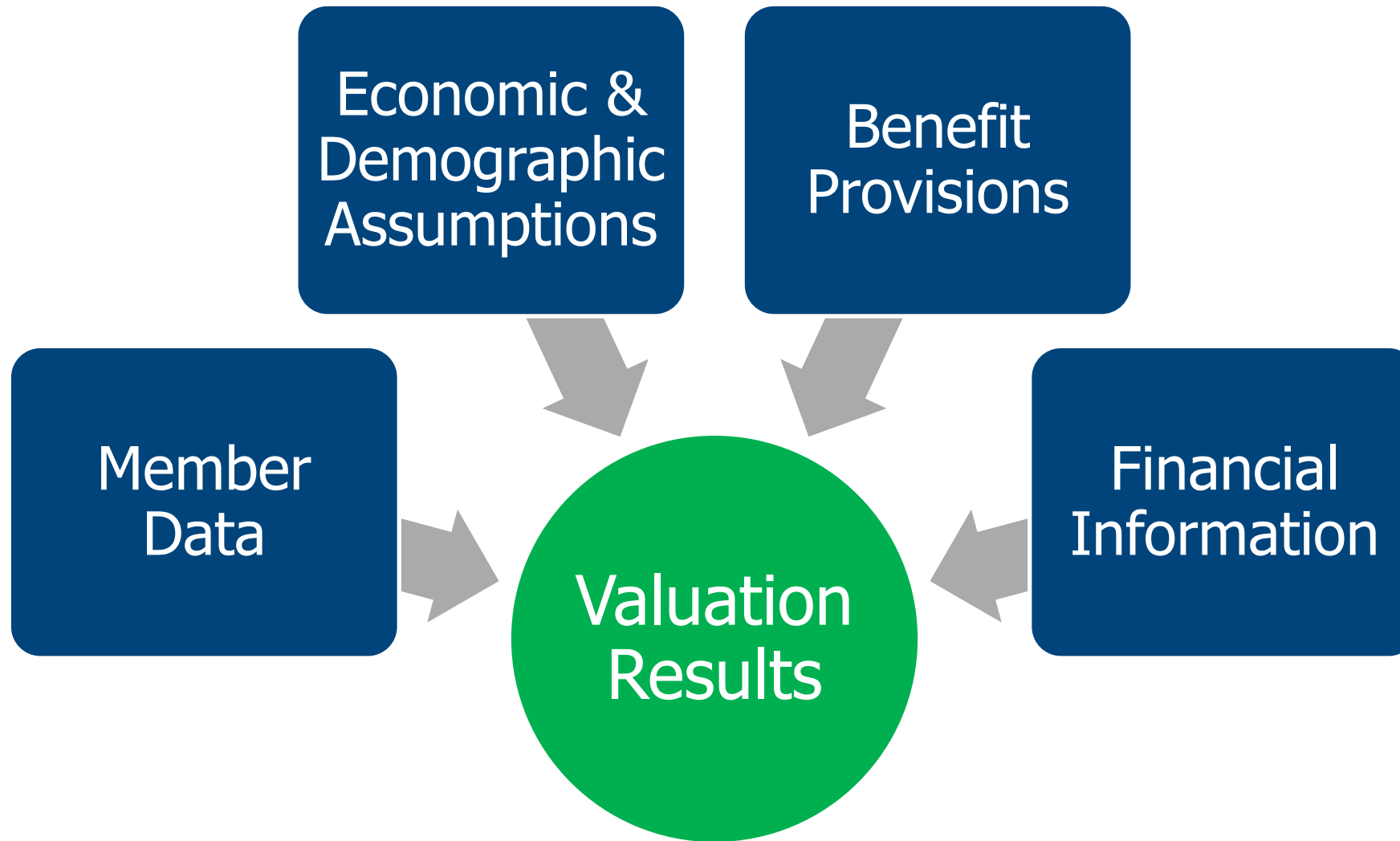


Actuarial Liability Example

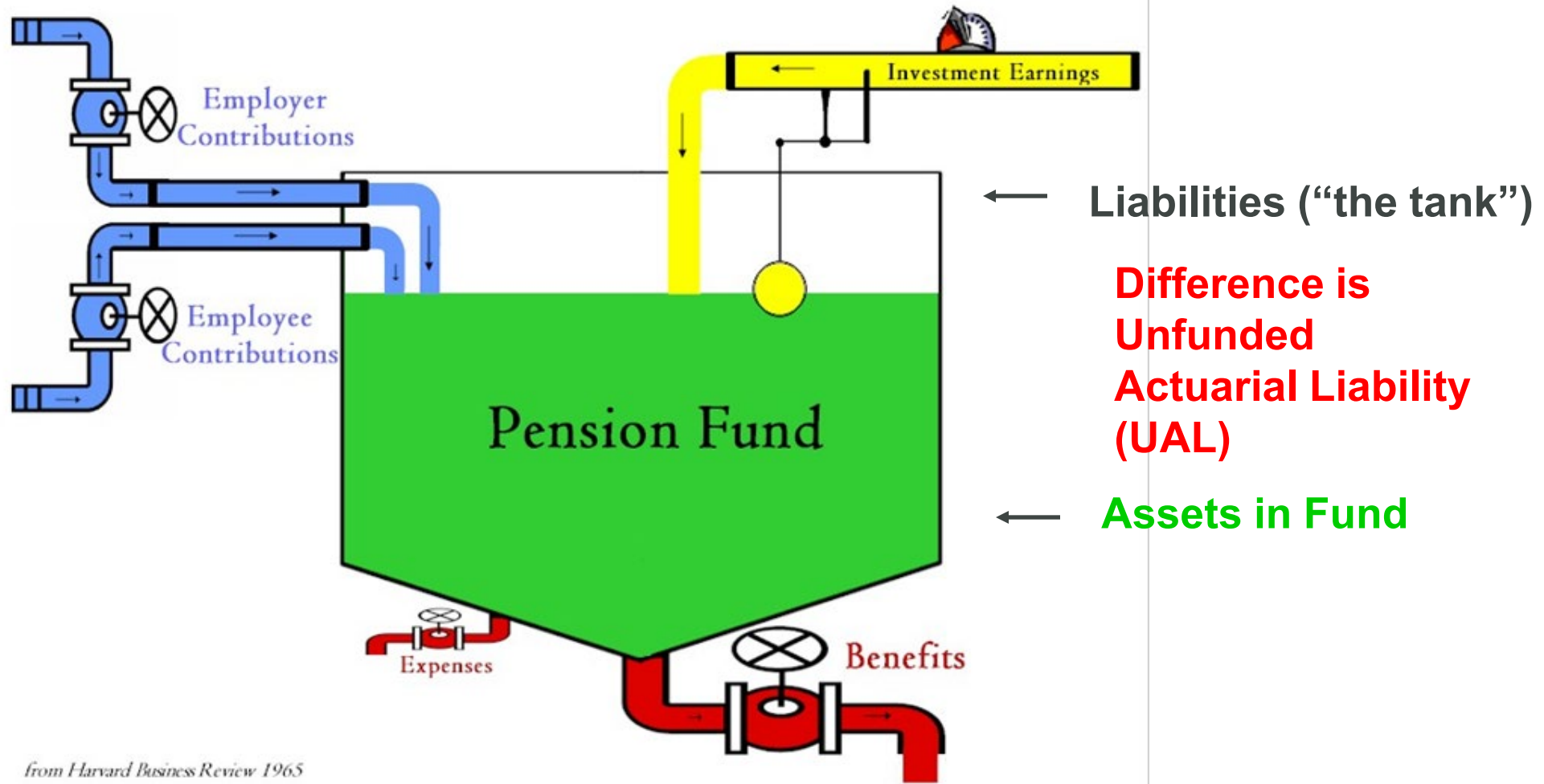
Member Hired at Age 30, Retired at Age 60

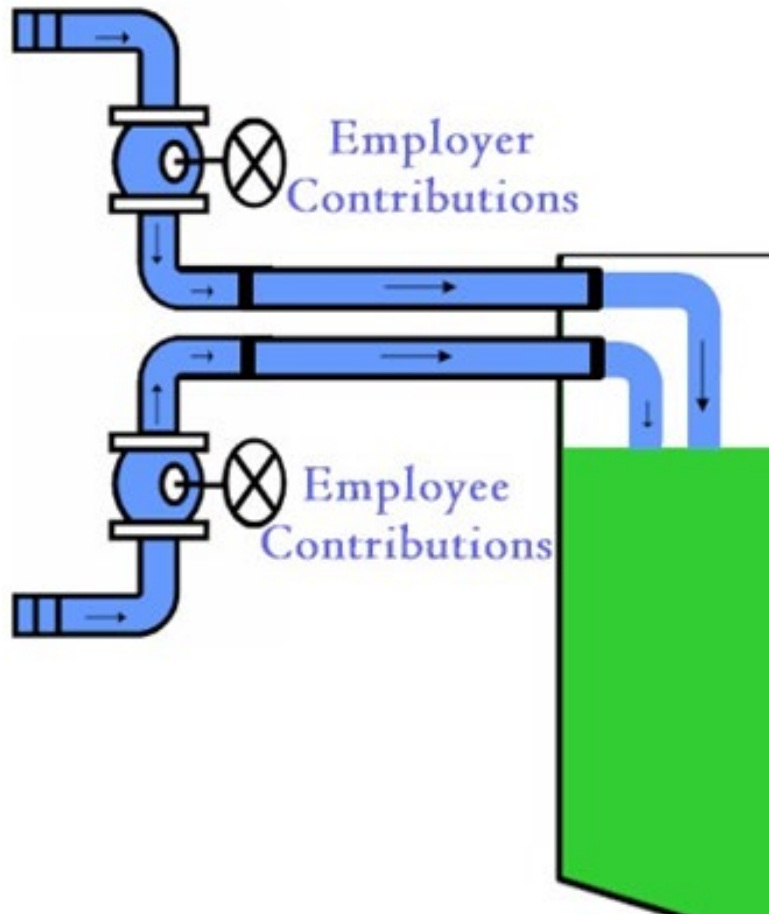


Pension Valuation Process



Pension Valuation Process





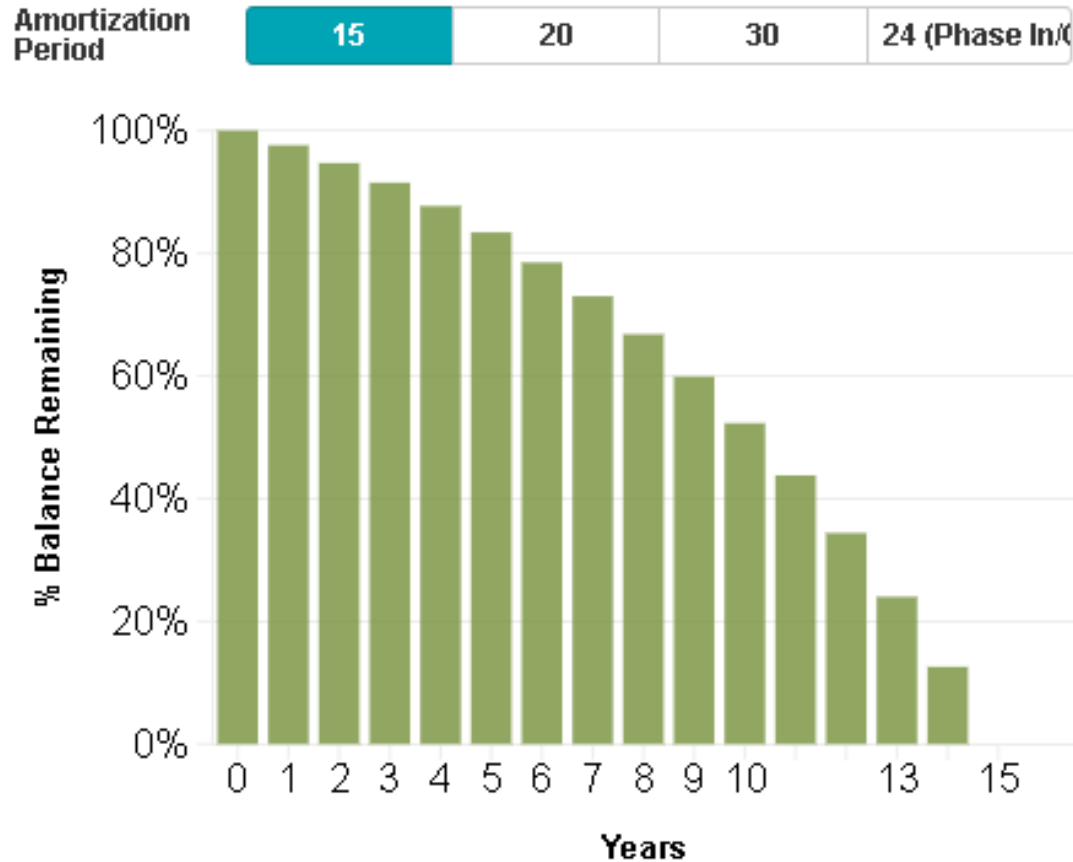
Contribution Components

1. **Normal Cost**
 - **Active benefits earned during the year**
2. **Unfunded Actuarial Liability (UAL) Payment**
 - **Closed or Open Periods**
 - **Level % of Payroll, Level \$**
 - **Length of Period**
 - **Phase In/Out**
3. **Expected Expenses**
4. **Employer Contributions = 1) + 2) + 3);
less Employee Contributions**

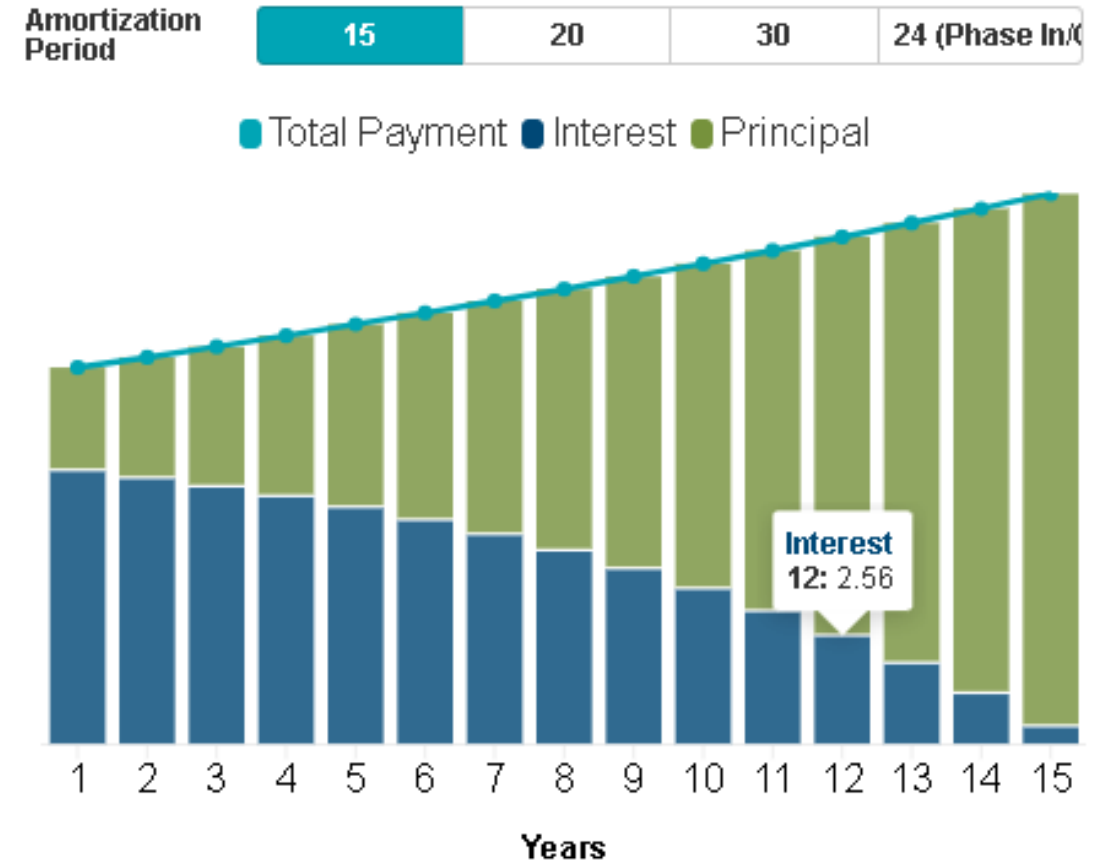
Contributions - Impact of Amortization Periods



Remaining Amortization Balance
2.75% Annual Payment Increase



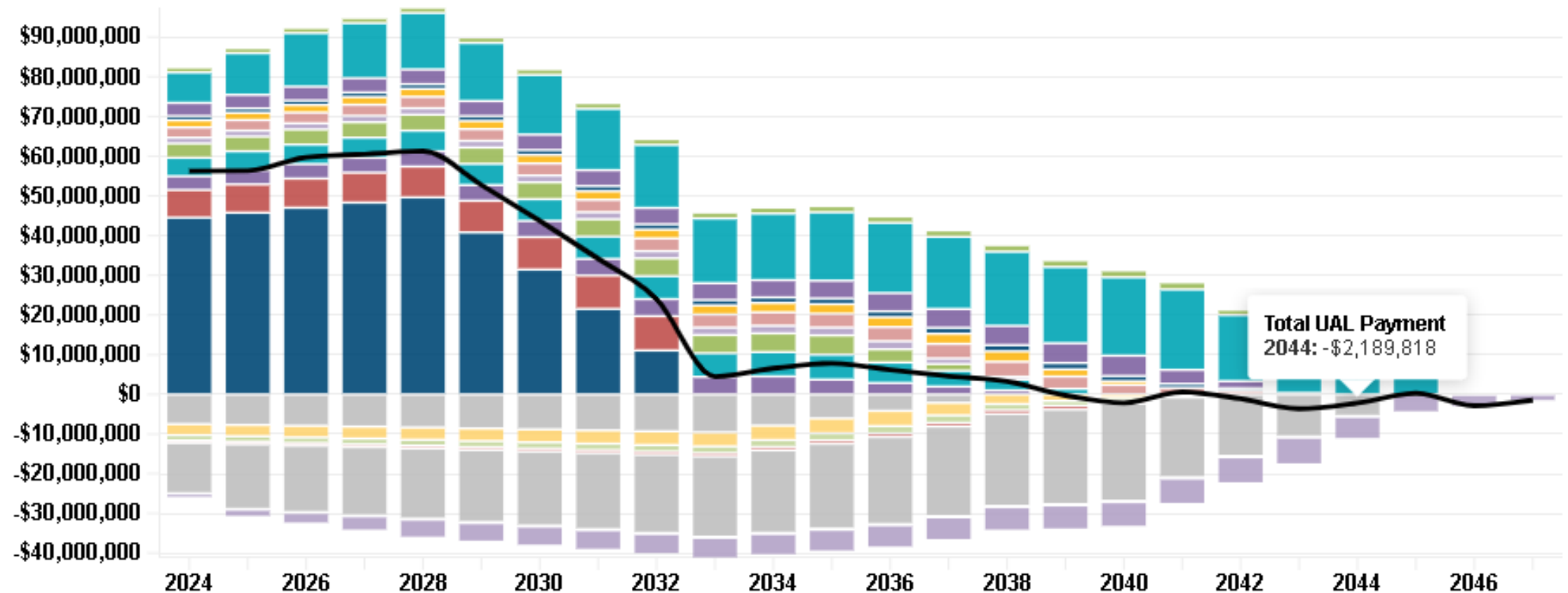
Amortization Payments
2.75% Annual Payment Increase



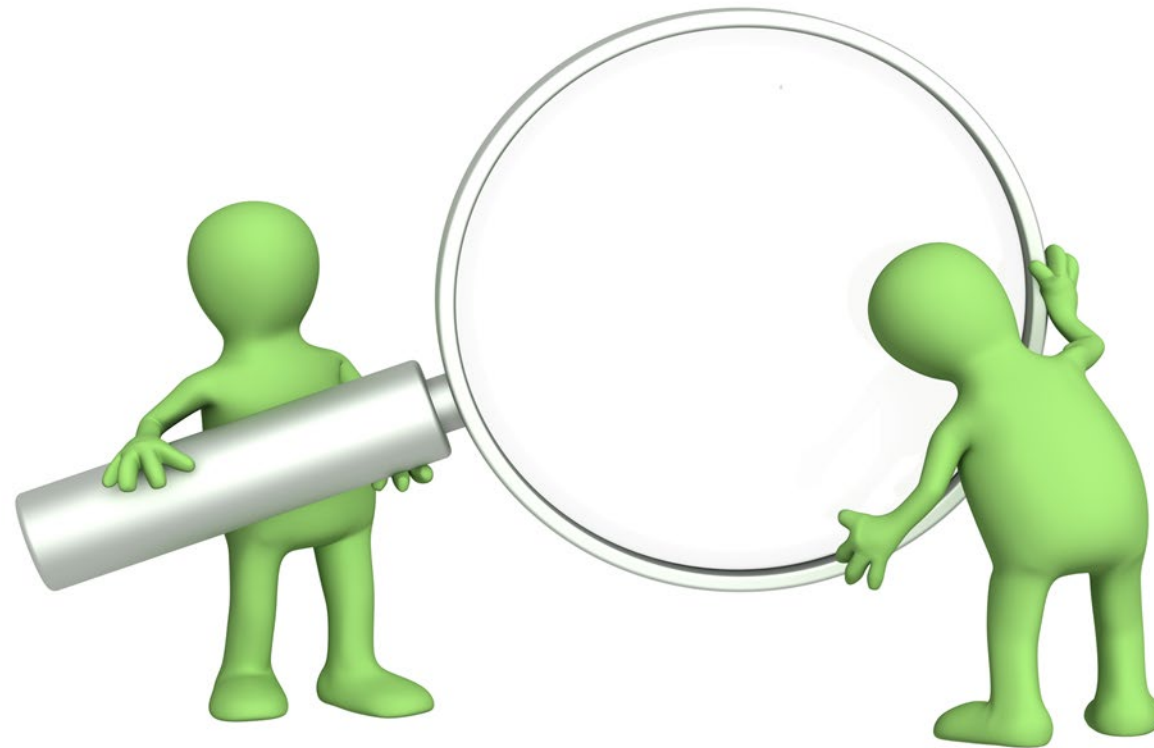
Contributions - Layered Amortization Schedule



Legend: Total UAL Payment, 2013 UAL, 2013 Carve Out, 2014 GL, 2015 GL, 2016 GL, 2016 Assump, 2017 GL, 2017 Assump, 2018 GL, 2019 GL, 2019 Assump, 2020 GL, 2020 Assump, 2021 GL, 2021 Assump, 2022 Loss, 2022 Assump, 2023 Gain, 2024 Gain



Actuarial Assumptions

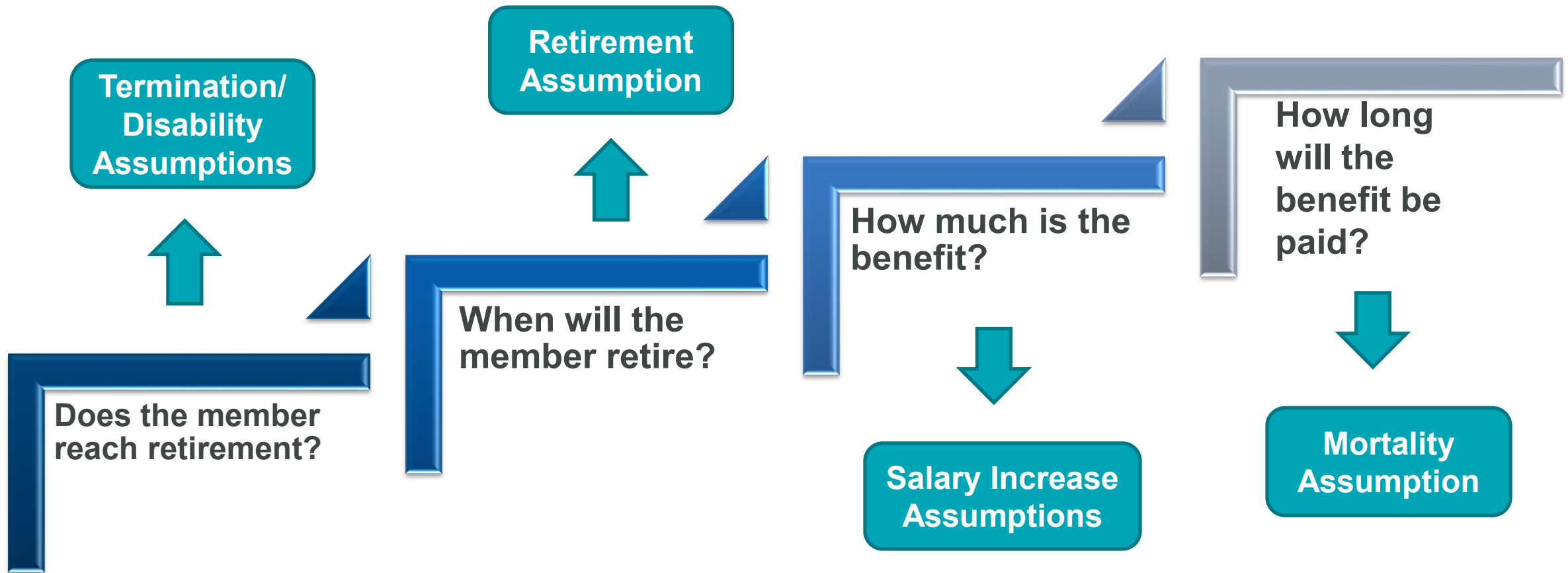


Background on Actuarial Assumptions



- Assumptions needed to form best estimate of each member's projected benefits and actuarial liability
- Actuarial methods and amortization policy determine contribution requirements
- Ultimate cost of benefits depend on actual experience
 - Actual investment returns and participant behavior
 - Actual benefits paid not affected by actuarial assumptions
- Two types of actuarial assumptions
 - Demographic
 - Economic

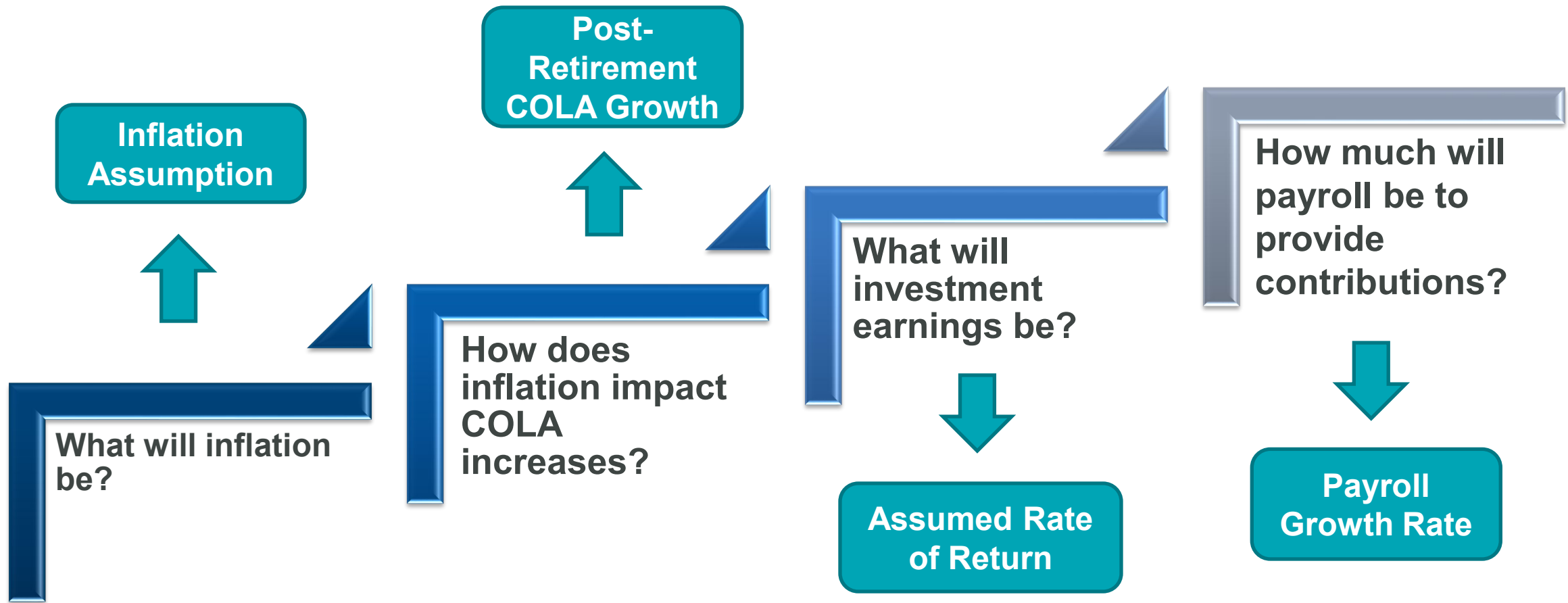
Actuarial Assumptions - Demographic





- Other Assumptions
 - How many members take a refund of their employee contribution balance when they leave?
 - How many members who leave go to a reciprocal employer?
 - What is the likelihood of member granted a disability benefit due to a duty related incident?
 - What is the percentage of retirees who are married?
 - What are the ages of spouses/domestic partners?
 - How much sick leave/vacation cash-outs do members have at retirement?

Actuarial Assumptions - Economic



Actuarial Assumptions



- Assumptions impact the *timing* of costs

$$C + I = B + E$$

- Actuarial process is self-correcting
 - Gains and losses are amortized with every actuarial valuation
 - Periodic experience studies
- Good assumptions produce level costs**





Which assumption is the most powerful?

- a) Retirement Rates based on age and service
- b) Salary Increases
- c) Investment Returns
- d) Inflation

Expected Rate of Investment Return



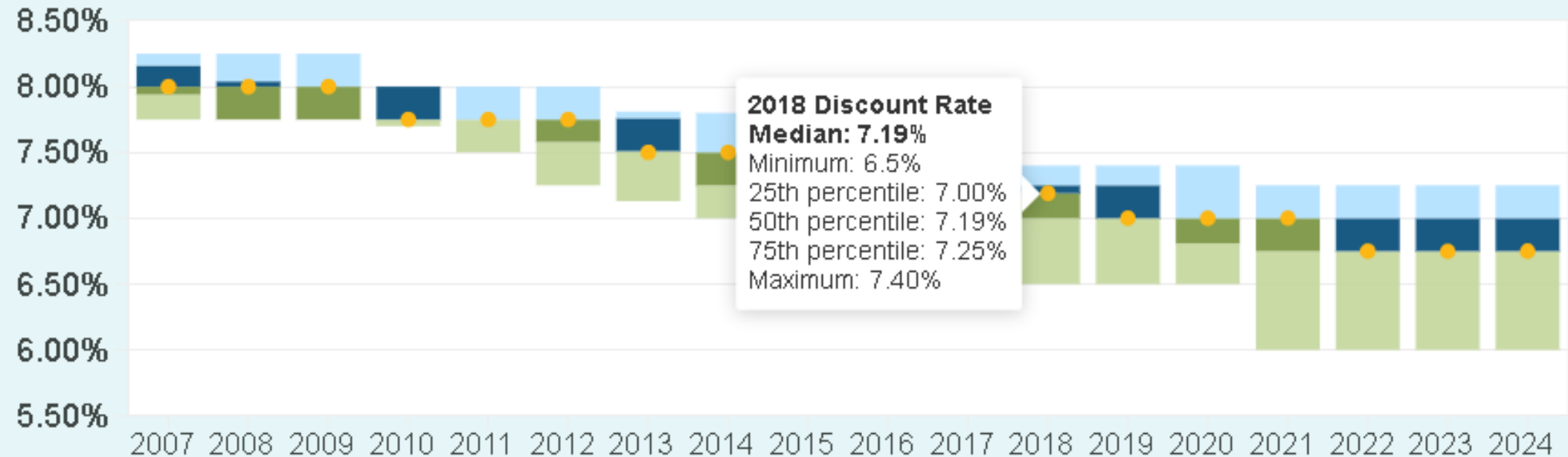
- Most powerful single assumption
 - Higher expected return → Lower expected contributions
 - An aggressive assumption increases the likelihood that future contributions will be higher than expected
 - A conservative assumption increases the likelihood that future contributions will be lower than expected
- Over time, actual contributions will depend on actual, **not expected**, investment returns
- Current assumption = 6.75%



California Public Retirement Systems - Distribution of Discount Rates

Gold dot = **Median**

Percentiles of Distribution ■ Min to 25th ■ 25th to 50th ■ 50th to 75th ■ 75th to Max



Hover over a bar to see the statistics for that year. Click on a bar to see a bee swarm of the plans for the year. Close the tab in the browser to return to the menu.

Purpose of Actuarial Experience Study



- Patterns of retirement, termination and member behavior may change over time
- Investment markets and economic environments are dynamic and complex
- For each assumption, the following questions are addressed
 - What was the plan's actual experience?
 - What are future expectations, industry trends?
 - How does this compare with current assumptions?
 - Is a change warranted?



Should answer three questions:

- 1) Where are you now?
- 2) Where have you been?
- 3) Where are you going?

2024 Actuarial Valuation Results



Assets

- Investment returns for FY 2023-2024 were favorable
- 11.9% return on market value of assets, for a gain of \$58M

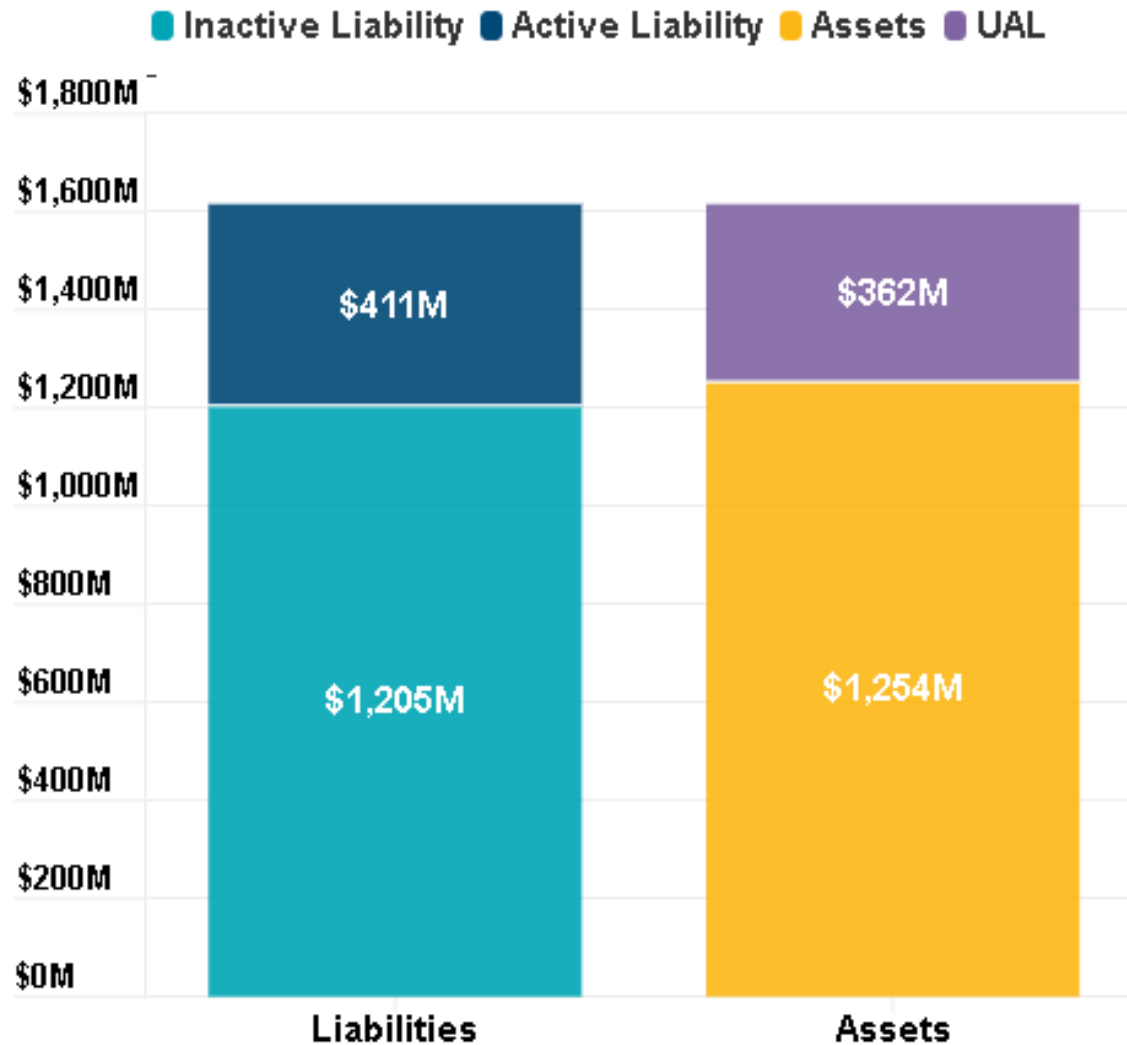
Liabilities

- Actuarial liability was close to expected (less than a \$6M loss, < 0.4% of total liability)

Other

- Payroll grew slightly faster than expected (4% vs 2.75% assumption)
- No changes to assumptions

2024 Actuarial Valuation Results

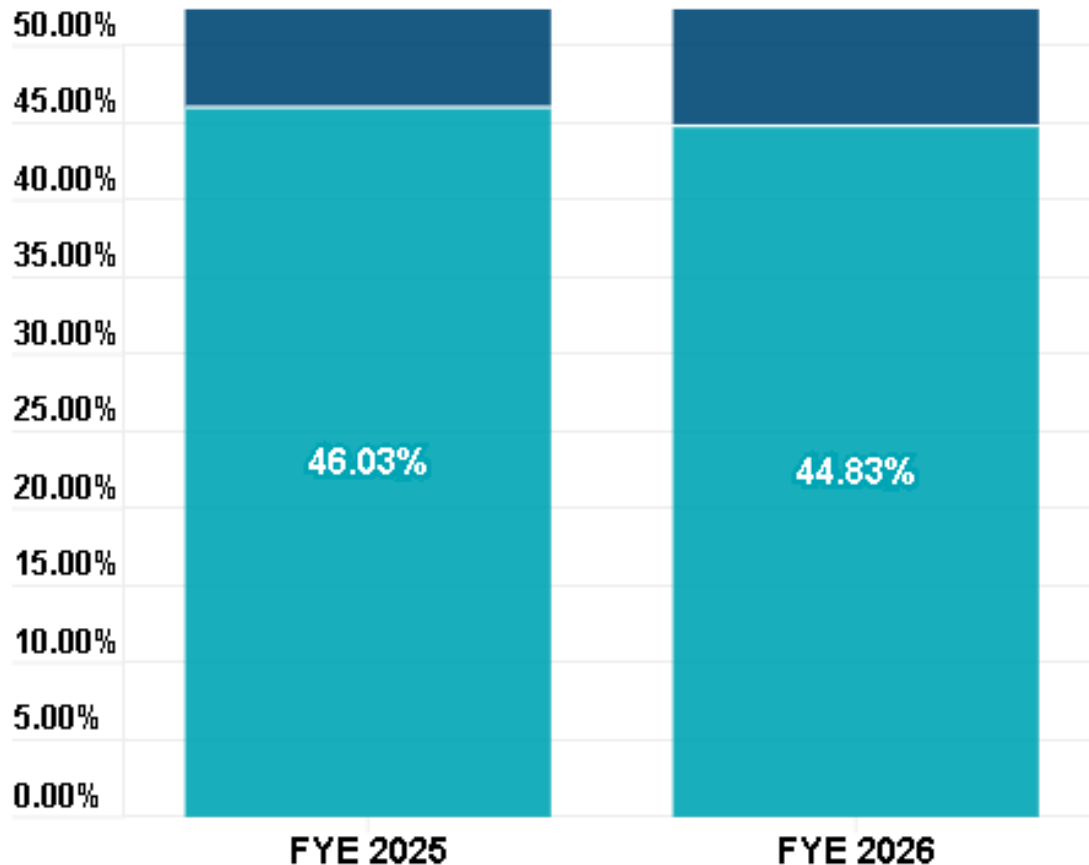


- Funded Ratio (Assets / Liabilities) = 77.6%, increased from 72.1% in prior valuation
- Unfunded Actuarial Liabilities (UAL) dropped from \$440M to about \$360 million
- Members in pay status account for **75%** of the Actuarial Liability

2024 Actuarial Valuation Results



■ Total Rate ■ UAL Rate ■ Employer Normal Cost Rate
■ Admin Expense



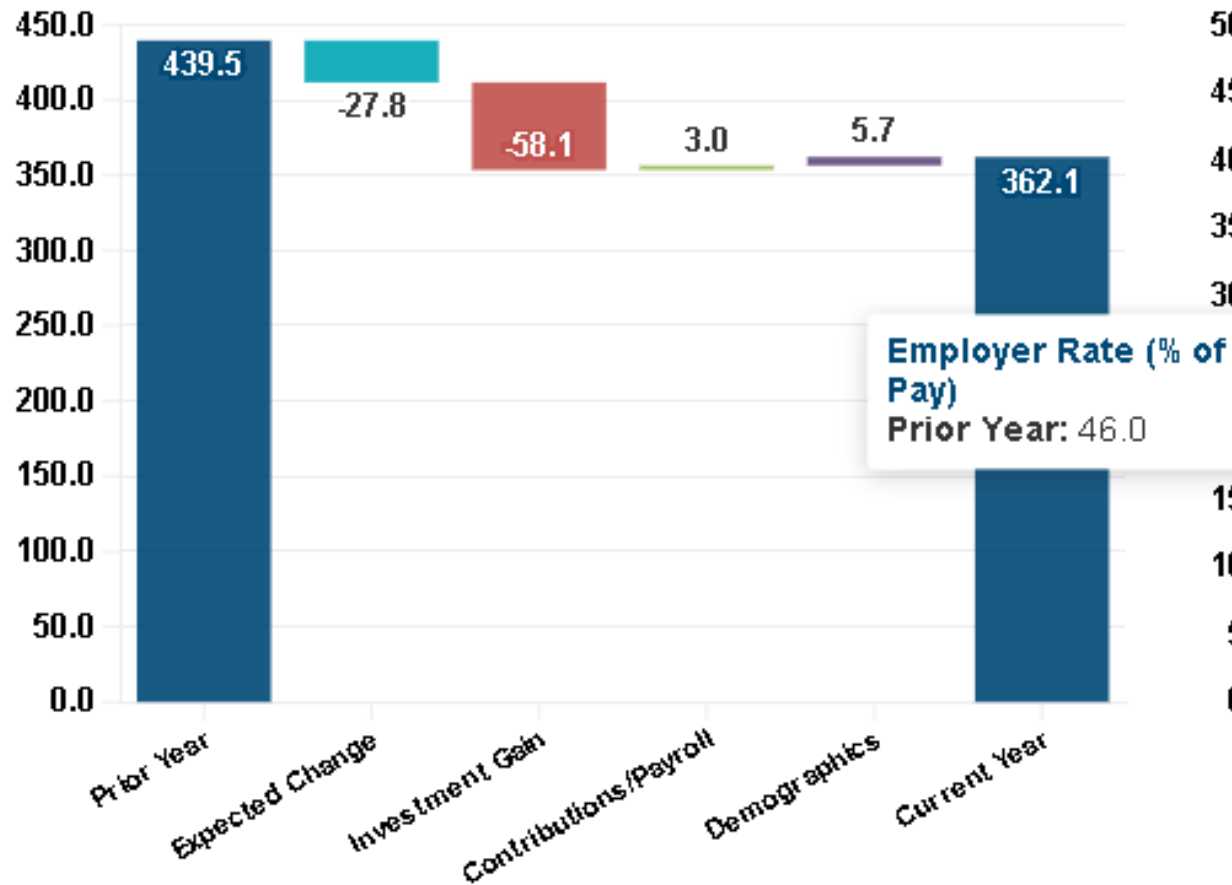
- Contribution rate about 1.2% of pay less than prior year
- UAL payment makes up more than 75% of the total rate

Changes in UAL / Cost Since Last Valuation

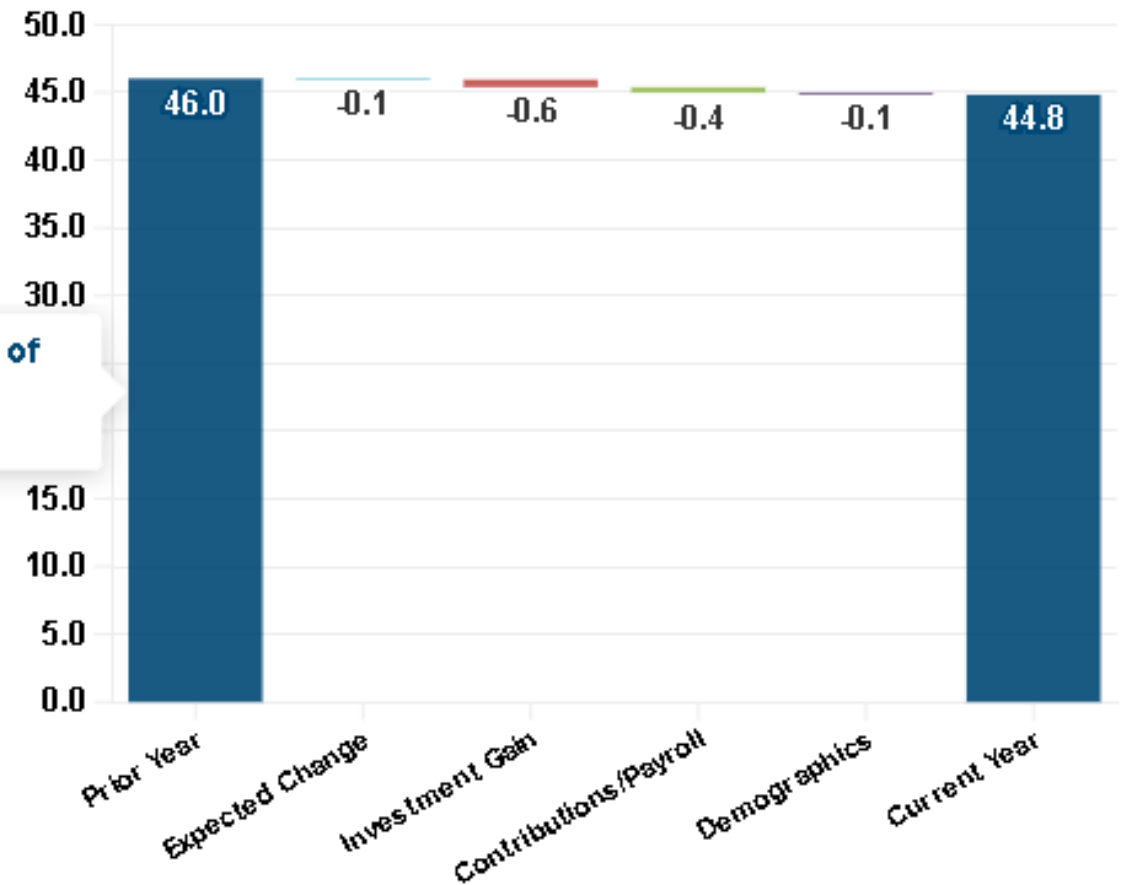


UAL and Employer Rate Change by Source

UAL (\$ in Millions)

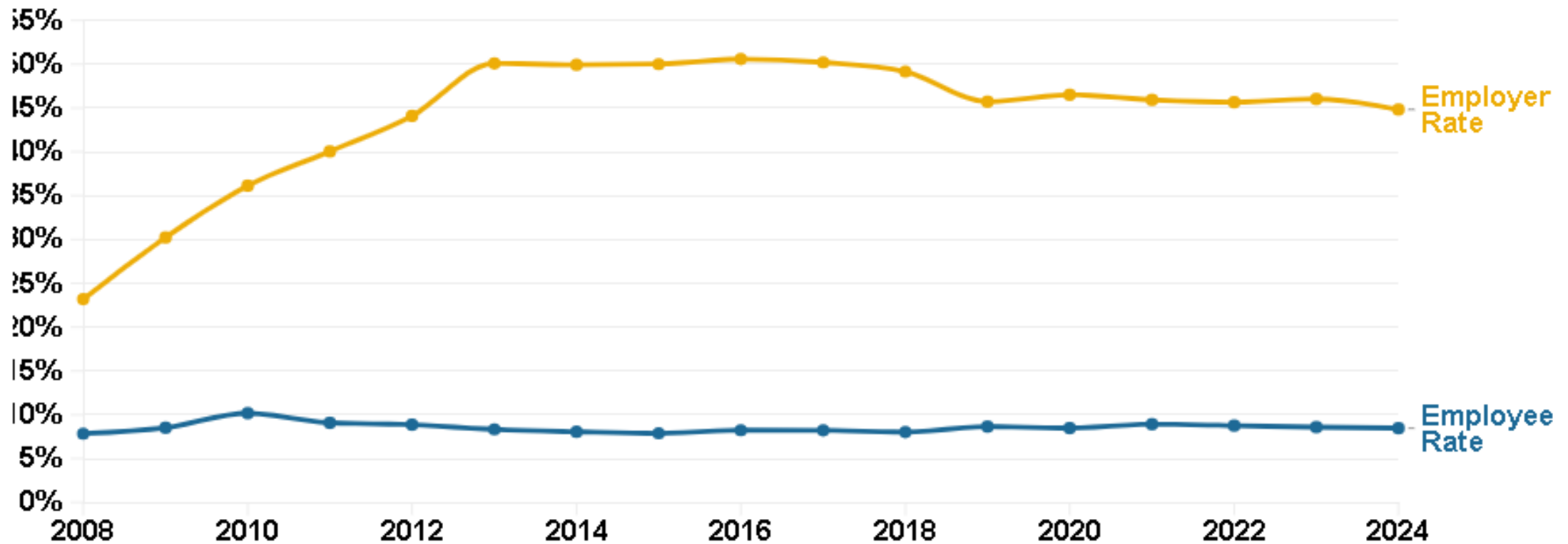


Employer Rate (% of Pay)





Historical Trends

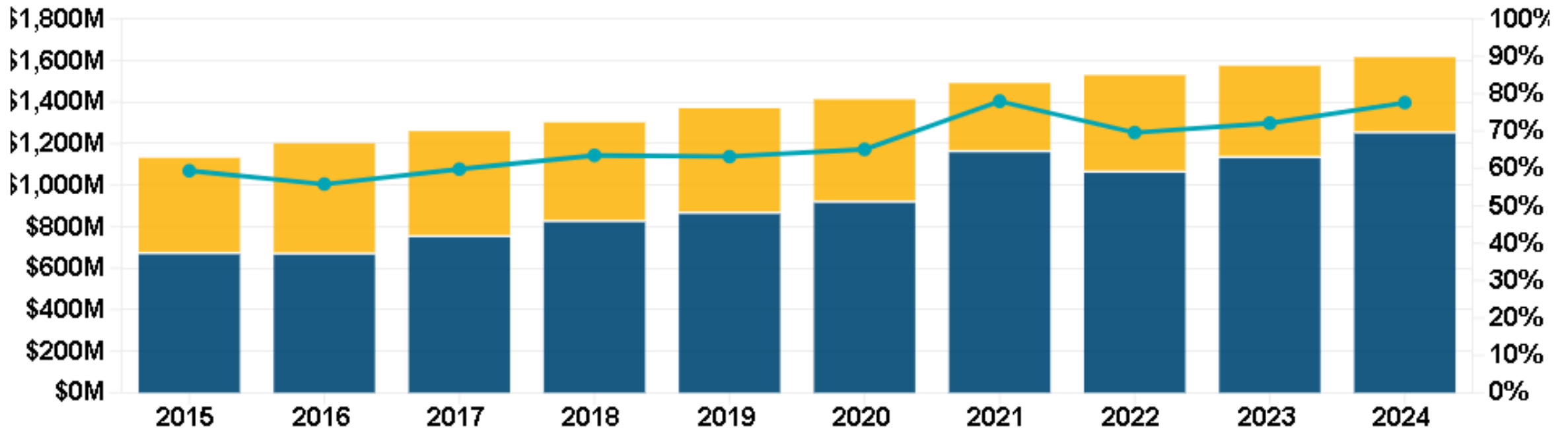


- Employer contribution rates increased from 2008-2013, primarily as a result of the GFC, and have remained relatively stable since then
- Individual member rates have increased due to more conservative assumptions, but average rates have remained stable as a result of PEPRA members replacing Legacy members

Historical Trends



Funded Ratio Market Value of Assets Unfunded Actuarial Liability



- **Assumption Changes: \$120 million**
- **Liability Losses: \$8 million**
- **Investment Gains: -\$37 million**
- **Contributions: -\$167 million**

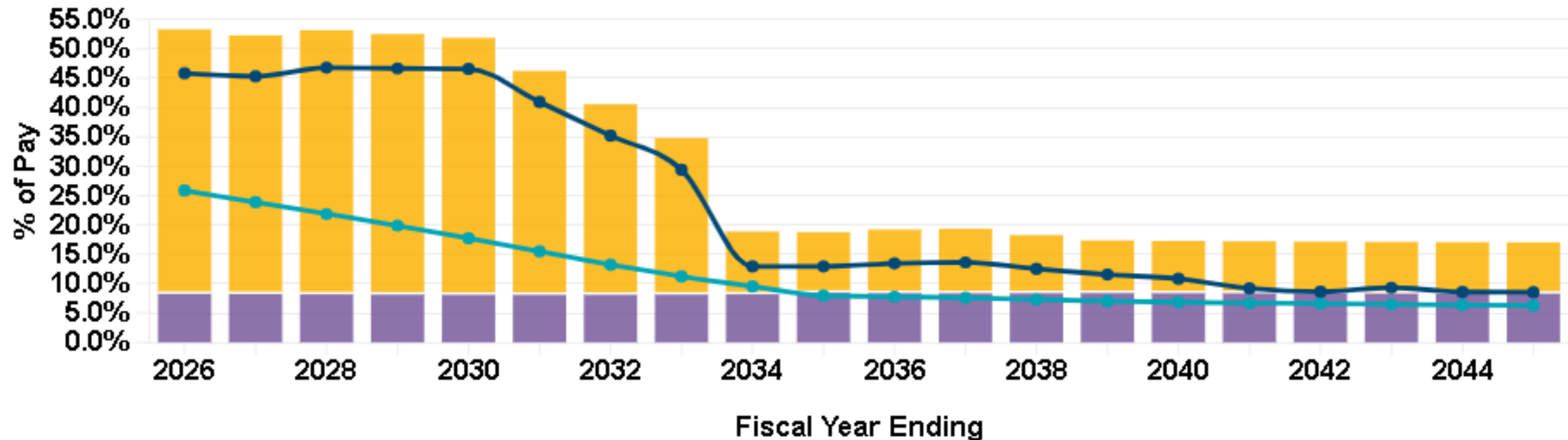
Projections



2024 Projections – Total Contribution Rate

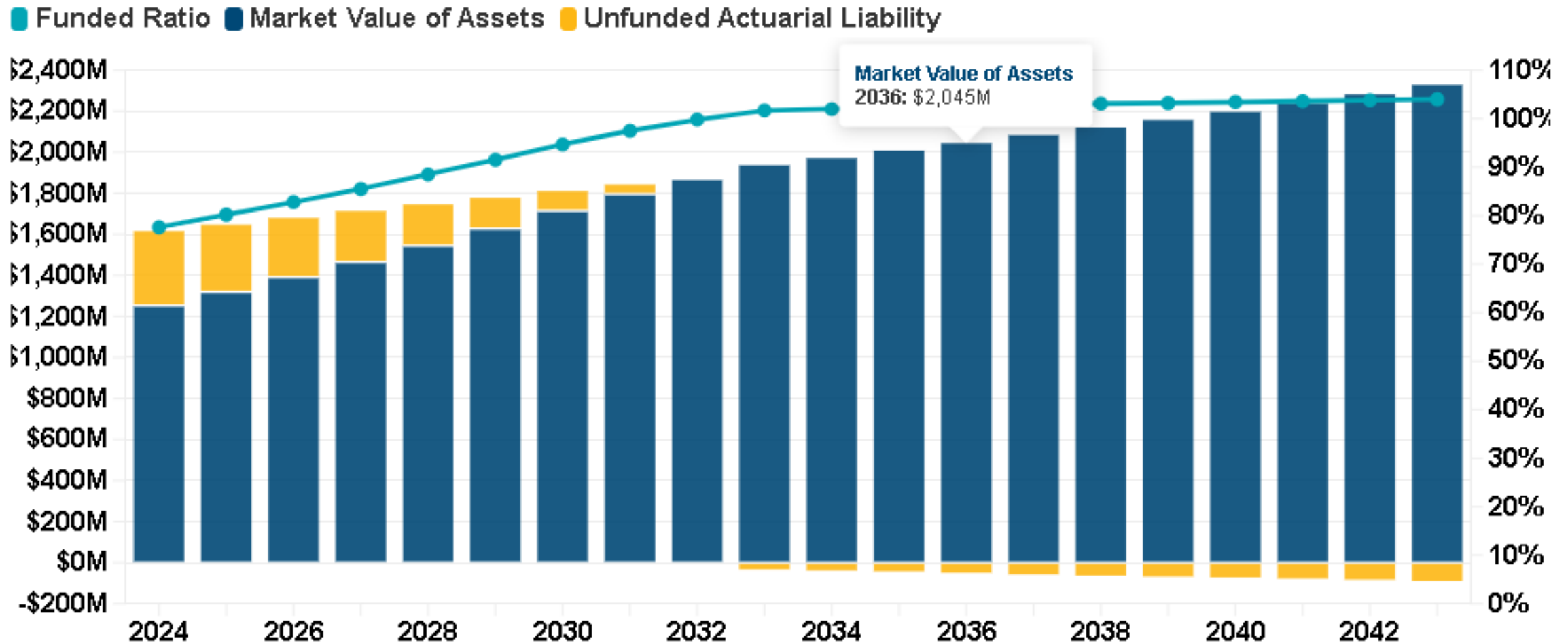


■ Tread Water ■ Prior Year ■ Member Contribution ■ Employer Contribution



- The Total Contribution (ADC) is projected to fluctuate moderately over the next few years
- Pattern of future contributions driven by pattern of UAL payments; large decline from FYE 2030 - 2034
- Total Normal Cost rate declines very gradually over the projection period as new hires continue to enter the PEPRA Tier

2024 Projections – Funded Ratio





1. Actuarial Assumptions

Assumptions as to the occurrence of future events affecting pension costs such as mortality, withdrawal, disability, retirement, changes in compensation, and rates of investment return.

2. Actuarial Cost Method

A procedure for determining the actuarial present value of pension plan benefits and expenses and for developing an allocation of such value to each year of service, usually in the form of a normal cost and an Actuarial Liability.

3. Actuarial Gain (Loss)

The difference between actual experience and that expected based upon a set of actuarial assumptions during the period between two actuarial valuation dates, as determined in accordance with a particular actuarial cost method.

4. Actuarial Liability

The portion of the actuarial present value of projected benefits that will not be paid by future normal costs. It represents the value of the past normal costs with interest to the valuation date.

5. Actuarial Present Value (Present Value)

The value as of a given date of a future amount or series of payments. The actuarial present value discounts the payments to the given date at the assumed investment return and includes the probability of the payment being made.



6. Actuarial Valuation

The determination, as of a specified date, of the normal cost, Actuarial Liability, Asset Value, and related actuarial present values for a pension plan.

7. Amortization Payment

The portion of the pension plan contribution, which is designed to pay interest and principal on the Unfunded Actuarial Liability in order to pay for that liability in a given number of years.

8. Funded Ratio

The ratio of the Assets to the Actuarial Liability.

9. Normal Cost

That portion of the actuarial present value of pension plan benefits and expenses that is allocated to a valuation year by the actuarial cost method.

10. Projected Benefits

Those pension plan benefit amounts which are expected to be paid in the future under a particular set of actuarial assumptions, taking into account such items as increases in future compensation and service credits.

11. Unfunded Actuarial Liability

The excess of the Actuarial Liability over the Assets.



Fiduciary and Conflict-of-Interest Education for MercedCERA Board of Retirement

Ashley Dunning | MercedCERA Fiduciary Counsel

Nossaman Partner, Co-Chair, Pensions, Benefits & Investments Group

Meeting of the Board of Retirement | Merced County Employees' Retirement Association

November 3, 2025



Your Presenter



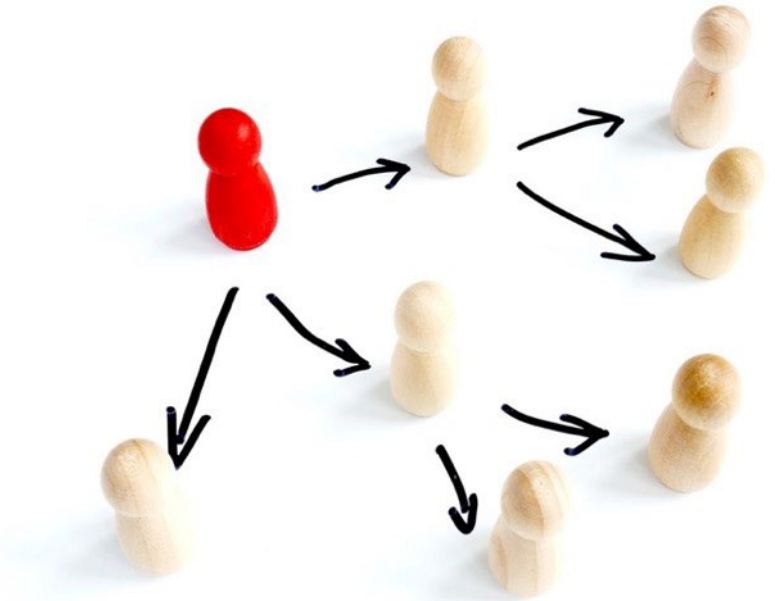
Ashley K. Dunning
MercedCERA Fiduciary Counsel

Nossaman LLP

Partner and Co-Chair, Pensions, Benefits &
Investments Group

Overview

- Fiduciary Framework:
 - What and who is a fiduciary?
 - Duties of a California public plan fiduciary
 - Discussion of hypotheticals for each duty
- Conflicts of Interest:
 - A primer on rules applicable to public officials, such as retirement system trustees and executives, at MercedCERA



What is a Fiduciary?

- A fiduciary is any person or organization that has discretionary authority or control over management or disposition of retirement plan assets or plan administration for the benefit of members and beneficiaries of MercedCERA or that has a duty to put the interests of those members/beneficiaries ahead of all other interests.



Who is a Fiduciary?

- **By definition, therefore:**
 - All MercedCERA Board members and executive officers:
 - are **fiduciaries**
 - who thus owe **duties of care and loyalty**
 - to MercedCERA **members and their qualified beneficiaries**
 - with respect to the **benefits due to them**
 - by **the retirement system.**

Who is (not) a Fiduciary?

- Not everyone who interacts with MercedCERA is a fiduciary, either to MercedCERA or its members.
 - For example: plan sponsors, employee associations, state agencies, investment professionals (unless by contract with MercedCERA), trustees of *other* public retirement systems, and members themselves (unless they are also MercedCERA Board or executive staff members) are not MercedCERA fiduciaries.



Six Duties of a Public Retirement Board Fiduciary in California

1. Duty of loyalty
2. Duty of care
3. Duty to diversify investments
4. Duty to assure competency of retirement system assets to pay promised benefits
5. Duty to defray administrative expenses
6. Duty to administer plan in accordance with plan terms and other applicable law



Duty of Loyalty: Exclusive Benefit and Primary Duty Rules

- Under the California Constitution (Article XVI, Section 17) and other applicable law, a fiduciary must discharge its duties:
 - Solely in the interest of, and for the exclusive purposes of providing benefits to, participants (i.e., members) and their beneficiaries
- The Board's duty to MercedCERA members and beneficiaries “**shall take precedence over any other duty.**” In trust law, this is referred to as the “primary duty” rule.
- Constitutional obligation of “minimizing employer contributions” and “defraying reasonable expenses” of administering the system are secondary to the primary duty.
- Note that the Board's constitutional duty to “minimize employer contributions” is not a “fiduciary” duty (because fiduciary duties are owed by Board members to system members, not to plan sponsors).



Fiduciary Duty of Loyalty

- Putting a plan sponsor's, union's, other party's, or your own, interests ahead of the overall best interests of members and beneficiaries in the security of their vested MercedCERA retirement benefits is not consistent with the exercise of a trustee's fiduciary duties.
- Basically a conflict-of-interest rule—fiduciaries cannot have conflicting loyalties. A fiduciary has a duty not to use or deal with trust assets for the benefit of a third person, including that of the plan sponsor, or for any other purpose unconnected with the trust.

Fiduciary Duty of Loyalty: Not an “Agent” for Another

- Trustees are not permitted to administer the retirement system as an “agent” for the party that appointed, or subgroup of members that elected, that individual to the Board.
- On the contrary, the California Constitution, Art. XVI, Sec. 17 (Prop. 162) seeks to prevent such political “meddling” or “interference” by others and mandates loyalty to the overall best interest of members and beneficiaries.
 - See *Los Angeles County Employees Retirement Association v. County of Los Angeles* (2024) 102 Cal.App.5th 1167 (S. Ct. review pending)



Fiduciary Duty of Loyalty: Conflicting Interests Among Various Members and Beneficiaries

- Can be complex and crosscutting.
- Determinations of priorities among members and beneficiaries must serve their overall best interest with respect to the trust purpose.
- Appropriate balance may not be obvious when the interests within the member and beneficiary groups are not the same.



Hypothetical No. 1:

Fiduciary Duty of Loyalty

- Phil is a member of the Board of Retirement (“Board”). Phil also has been active for many years with the union representing active members of the retirement system (“Union”).
- Penny also is a member of the Board, and Penny has been active for many years with the retirees’ association of Merced County.
- Prudy is a member of the Board, who also is on the Merced County Board of Supervisors.
- The retirement system’s actuary has completed an experience study and is recommending no changes in actuarial assumptions.
- What are, and are not, fiduciarily appropriate considerations for Board members with respect to this topic?



Fiduciary Duty of Care

- Under Article XVI, Section 17, a fiduciary must discharge its duties:
 - “With the care, skill, prudence, and diligence then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims”
 - Carefully consider the particular expertise needed to address a topic within the Board’s jurisdiction.
 - Medical? Legal? Plan administration? Investment? etc.
 - The question is whether the fiduciary, at the time it made the decision, employed the appropriate methods.
 - Reasonable consultation with experts is important, but not a substitute for independent exercise of trustee’s responsibilities

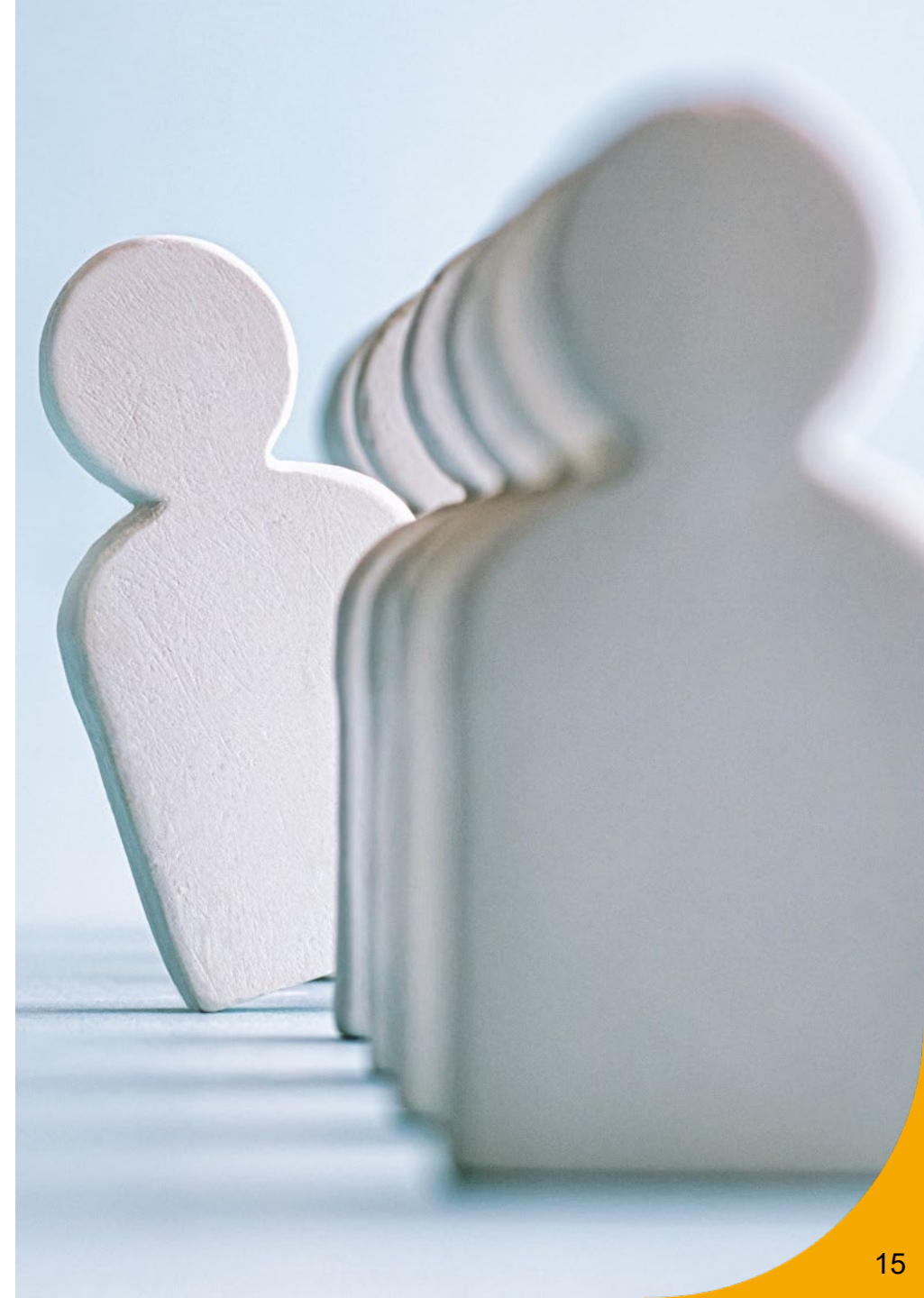


Fiduciary Duty of Care: The “Prudent Fiduciary with Experience Dealing with a Similar Enterprise”

- Good faith is not enough.
 - **Example No. 1:** Board member, convinced that a particular investment action is morally right, even though MercedCERA’s CIO and Investment Consultant have concluded that it is not appropriate for MercedCERA from a risk-adjusted return perspective, advocates to other Board members about “doing the right thing” on the topic.
 - **Example No. 2:** MercedCERA’s actuary has identified that experience losses are occurring on service credit purchases because MercedCERA has not applied interest to the purchase of such service credit, which is required by CERL. Board is concerned that service credit purchases will be too expensive if interest is applied to purchase prices, and thus the Board directs staff to continue not to apply interest to such purchases.
- What fiduciary issues are implicated by these examples?

Duty of Care: “Prudent Fiduciary with Experience Dealing with a Similar Enterprise”

- A fiduciary need not be the expert but may need to consult an expert. When using experts, the fiduciary may take into consideration the advice of relevant experts, but the fiduciary is still ultimately responsible.
- Expertise resides both with *in-house* MercedCERA staff, as well as in MercedCERA’s outside retained experts.
- Trustees also *develop* their own capability to provide *prudent oversight* through
 - careful review of Board materials;
 - communication with staff on questions about those materials;
 - thoughtful participation in board meetings; and
 - MercedCERA-provided and other appropriate and cost-effective educational opportunities on topics focused within the Board’s jurisdiction and consistent with MercedCERA’s policies.



Fiduciary Duty of Care: Process and Soundness of Analysis Matter

- Duty of care does not require a fiduciary to guarantee specific outcomes but does require use of a prudent process.
- Highlights the importance of documenting fiduciary considerations and decision-making.
- However . . . (see next slide)

Fiduciary Duty of Care: Process and Soundness of Analysis Matter

- Substantively, a prudent decision may be neither “arbitrary” nor “capricious,” and deliberations by fiduciaries should illustrate the relationship between the information presented and the action taken, if any.
 - Courts may review a fiduciary’s decisions substantively, rather than simply deferring to a determination that a fiduciary may make after a prudent process.
 - Not dissimilar from U.S. Supreme Court’s discussion in *Loper* of courts’ duty to “exercise their independent judgment in deciding whether an agency has acted within its statutory authority,” while “[c]areful attention to the judgment of the Executive Branch may help inform that inquiry”.
 - Under California law, courts afford fiduciaries the authority to exercise judgment as to prudent administration of the plan, so long as the administration of the plan comports with the plan design set forth in plan documents. See generally, *Alameda Health System v. Alameda County Employees’ Retirement Association* (2024) 100 Cal.App.5th 1159; see also *City of San Diego v. San Diego City Employees’ Retirement System* (2010) 186 Cal.App.4th 69.

Fiduciary Duty of Care: Process and Soundness of Analysis Matter (cont.)

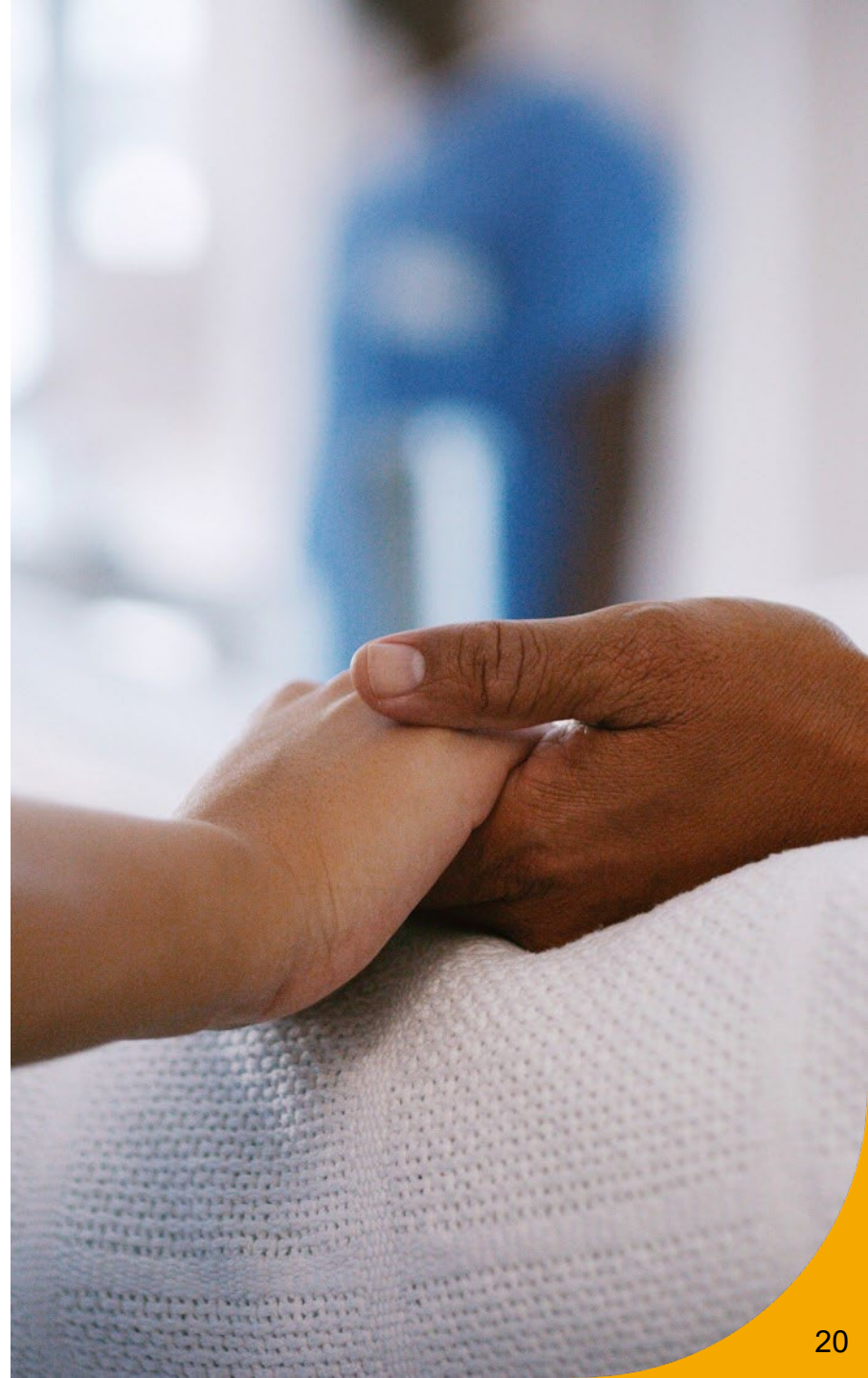
- What does prudence look like?
 - Acting consistently with laws and plan governance documents, which include Board policies and procedures (and making sure the plan governance documents match each other).
 - Where aspects of fiduciary duty are delegated, periodic and systematic monitoring.
 - Facts, analysis, questions, answers.
 - Documented decision-making.
 - Agendas, staff/consultant supporting materials, minutes, resolutions detailing facts, findings and conclusions are all ways to document procedural prudence.
 - Periodic review and reevaluation of processes and approaches—*continuous process improvements*.

Fiduciary Duty of Care: Consult with Experts

- “To the extent necessary or appropriate to the making of informed investment judgments by the particular trustee, care also involves securing and considering the advice of others [such as legal, actuarial and investment counsel] on a reasonable basis.” Rest. 3d Trusts, *supra*, § 227, p. 15, comment d.
- The implicit corollary to the duty to consult with experts is that if a fiduciary fails to follow the advice of its professional consultants, it must demonstrate an informed, reasonable, and prudent rationale for failing to do so.
- Another implicit corollary is that expert advice from a reasonable source should provide the basis for a Board’s decision to take an alternative course of action on a topic within that area of expertise (e.g., investment, actuarial, legal).

Hypothetical No. 2: Duty of Care

- Board member, May, is personal friends with an ailing active member of the retirement system who has applied for disability retirement. May has spoken with the member about the application.
- The competent medical evidence establishes that the member is not permanently incapacitated under the applicable legal standards, and retirement system staff recommends that the Board deny the application.
- The applicant attends the Board meeting at which the application is considered and speaks to the Board about the application, urging the Board to grant it.
- What are, and are not, fiduciarily appropriate considerations for all Board members, and in particular May, with respect to this topic?



Fiduciary Duty to Diversify Investments to Maximize Risk-Adjusted Returns

- Under Article XVI, Section 17, of the California Constitution a fiduciary must “diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.”
- Diversification is generally considered based on the plan’s entire portfolio.



Hypothetical No 3: Fiduciary Duty to Diversify Investments

- Board member Xavier is a retired private equity manager. Xavier is passionate about private equity investment opportunities, and is a self-professed contrarian as to any other investment-types in the public or private markets.
- Board member Xanadu is active with a group that is urging public retirement systems nationally to divest from fossil fuels, citing climate change risks.
- Retirement system's Chief Investment Officer and Investment Consultant are presenting the retirement system's annual asset-liability study, and they are proposing various alternative tilts in the allocations of the retirement system, all of which result in a well-diversified portfolio, but with varying levels of anticipated risk-adjusted return.



Hypothetical No 3: Fiduciary Duty to Diversify Investments

- A retired member of the system presents in public comment to the Board and urges the Board not to adopt any of the recommended asset allocations, and instead to adopt policies that will remove all fossil fuels from the portfolio, citing to the work performed by Board member Xanadu in other contexts.
- A private equity manager who used to work with Board member Xavier urges the Board to increase the allocation to private equity beyond that which is proposed in all of the recommended alternatives.
- From a fiduciary perspective, what considerations should Board members take, and not take, into account with respect to this topic?



Divestment mandates?

- Statutorily-provided divestment
 - “The Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and *provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section.*”
 - Cal. Const., art. XVI, § 17(g) (emphasis added).



Fiduciary Duty to Control Actuarial Services and Assure “Competency” of Assets

- Under Article XVI, Section 17 of the California Constitution, the Board:
 - “consistent with the exclusive fiduciary responsibilities vested in it, shall have the *sole and exclusive power* to provide for actuarial services in order to *assure the competency of the assets* of the public pension or retirement system.” (Emphasis added.)

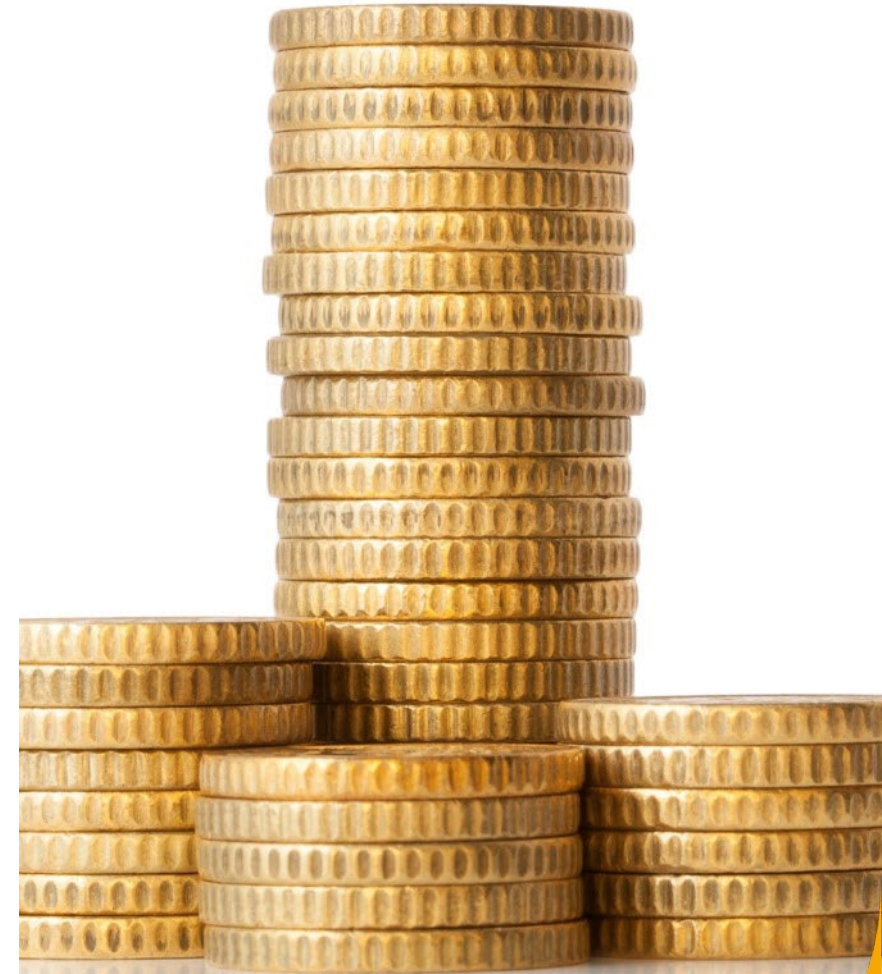
Fiduciary Duty to Control Actuarial Services and Assure “Competency” of Assets

- In *O’Neal v. StanCERA*, petitioners challenged various board of retirement decisions relating to the actuarial methodologies and transfers of funds among reserves authorized by the board of retirement.
- *O’Neal* concluded that the retirement board had not violated its fiduciary duty of care by making certain actuarial decisions that resulted in lowering the employer contribution rate (such as permitting negative amortization), though it deferred a final decision on that topic with respect to the alleged breach of the duty of loyalty (resolved in board’s favor after trial).



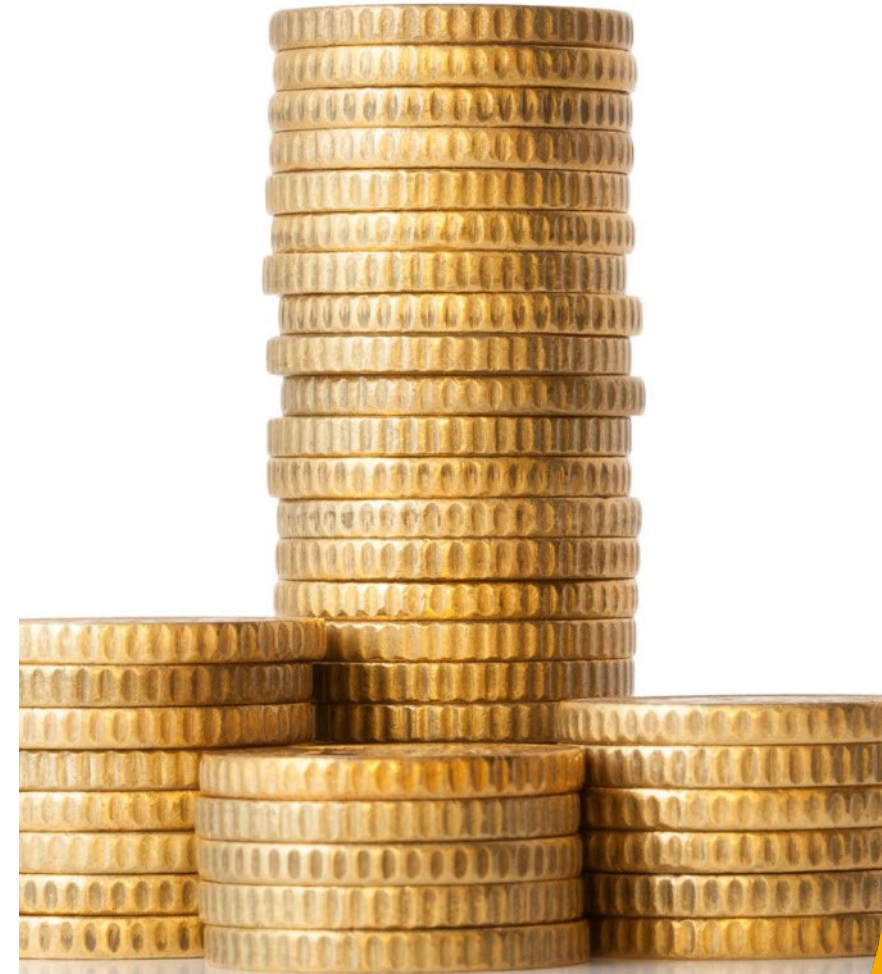
Hypothetical No 4: Fiduciary Duty re Actuarial Matters

- Board's actuarial funding policy includes layered amortization that results in some tail volatility when layers reflecting larger unfunded liabilities are paid off.
- Board's consulting actuary presents three different approaches with respect to managing this tail volatility, all of which have differing impacts on employer contribution rates, in the short-term and/or long-term. The actuary states that it recommends two of the approaches, but notes that the third alternative, which results in the lowest immediate employer cost, is a reasonable "option" but is not "recommended".
- An active member of the system presents in public comment to the Board and urges the Board to select the alternative that results in lowest employer cost in the short-term, because her employer's already constrained budget is preventing it from providing raises to its employees.



Hypothetical No 4: Fiduciary Duty re Actuarial Matters (cont.)

- A retired member of the system presents in public comment to the Board and urges the Board to adopt the alternative that results in the highest employer cost in the short-term, expressing concern about the security of her retirement benefits if funding of those benefits is delayed.
- A department head from one of the retirement system's participating employers presents in public comment and argues that the Board should reject both of actuary's recommendations and other "option," and instead use a different funding method that it argues is "fairer" to it given its own employment practices.
- What are fiduciarily appropriate, and inappropriate, considerations for Board members to take into account with respect to this topic?

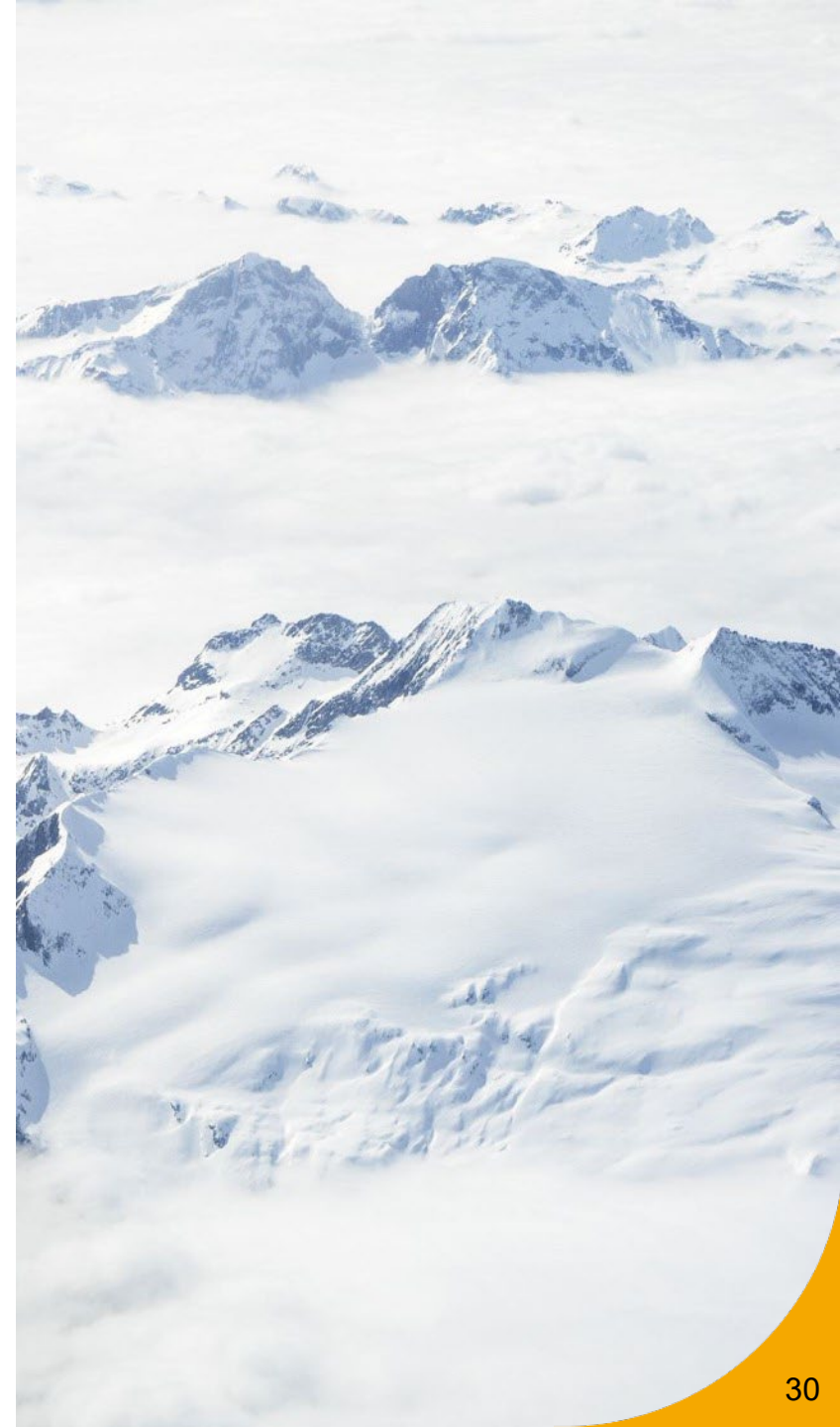


Fiduciary Duty to Defray Administrative Expenses

- “The assets of the public pension or retirement system are trust funds and shall be held for the exclusive purpose of providing benefits to participants in the pension or retirement system and their beneficiaries and **defraying reasonable expenses of administering the system.**” (Cal. Const., art. XVI, §17(a).)
 - “Cost-conscious management is fundamental to prudence” and requires that expenses be monitored and periodically reviewed. See *Tibble v. Edison Int’l*, 843 F.3d 1187, 1197-1198 (9th Cir. 2016) [decided under ERISA]; see also Rest. 3d Trusts, §90(c)(3) (A trustee is to “incur only costs that are reasonable in amount and appropriate to the responsibilities of the trusteeship.”).
- **Note:** This duty does not mandate a specific course of action, but rather that the Board is to have a prudent process to determine the expenses needed to perform MercedCERA business.
 - Board exercises this responsibility through adoption of, and MercedCERA compliance with, policies, such as its Travel and Expense Reimbursement Policy,

Hypothetical No. 5: Duty to Defray Reasonable Expenses of Administering Retirement System

- Board has an Education Policy that permits periodic travel for pre-authorized trainings for public retirement system trustees, but limits costs per trustee.
- Board member Penelope requests an exemption from policy to attend a conference occurring in Switzerland, and requests reimbursement for (i) business class travel, and (ii) an additional weekend stay, which results in lower airfare but higher hotel costs.
- Board member Pam requests authorization for the same business travel, citing his desire to have an additional opportunity to socialize with fellow board member Penelope.
- What fiduciary issues are implicated by this hypothetical?



Fiduciary Duty to Act in Accordance with Plan Documents and Other Applicable Law

- Fiduciaries have a duty to administer plans in accordance with plan terms and applicable law.
- California courts, including the California Supreme Court in 2020, have articulated this principal consistently.



Fiduciary Compliance

- The Board must use *informed judgment* and act in the *overall best interest of system members/beneficiaries* in a manner that is *consistent with applicable laws* when exercising its *plenary authority over the administration* of MercedCERA and investment of its assets.
- The Board's actions in that regard may not be "arbitrary" or "capricious," must be *consistent with its fiduciary responsibilities*, and must be *rationally related to the information presented to the Board by MercedCERA's in-house and outside consulting experts*.

WHAT'S

YOUR

NEXT

STEP?

Ethical Rules: Avoiding Conflicts of Interest

- Combination of statutes and common law
- Public officials must avoid even the appearance of acting in their self interest
- Laws are minimum standards
 - The public expects and deserves the highest standard of conduct

Personal Financial Gain: General Rule

- Public officials must make decisions in the public interest, not in their own financial interest
- Even the appearance of a financial conflict is to be disclosed or avoided



Political Reform Act: multi-step analysis

1. Are you a public official?

- MercedCERA board members & executives answer: “yes”

2. Are you “involved” in the decision?

- Broadly defined



Political Reform Act: multi-step analysis

3. Do you have a “financial interest”

- Focus on interests identified in your Form 700, including those of your spouse or registered domestic partner
- Note however, certain assets need not be disclosed on your Form 700, but also may be a “financial interest” for this analysis

4. Is it reasonably foreseeable that MercedCERA’s decision will have financial effect on your “financial interest”?

- If your financial interest is the subject of the MercedCERA decision, then, “yes”
- If the financial interest is not explicitly involved in the decision but the financial effect is a realistic possibility (for than hypothetical), then also, “yes”

Political Reform Act: multi-step analysis

5. Is the effect on your financial interest “material”?”

- If the decision will have a “measurable financial benefit or loss” on the official or family member (i.e., \$500 or more in any 12-month period – FPPC Reg. 18702.5)
- Excludes certain items such as legally authorized official travel expenses, meeting stipends and employment or retirement benefit decisions that apply equally to all employees in the same bargaining unit or other representative group
- Excludes “small shareholders” (as defined) **unless** certain monetary thresholds are met (e.g., decision may result in increase or decrease in entity’s annual gross revenue of \$1 million or more) or involves substantial effect on a financial interest’s real property.
- Includes the “parent or subsidiary of the business entity or an otherwise related business entity” (as defined by FPPC Reg. 18700.2(c), **unless** the official’s interest is that of a passive shareholder with less than 5 percent of the shares in the corporation **and** the parent corporation is required to file annual Form 10-K or 20-F Reports with the Securities and Exchange Commission and has **not** identified the subsidiary on those forms or its annual report. (Regulation 18700.2(d).)

Political Reform Act: multi-step analysis

- **Cautionary Note: FPPC Advice Letter No. I-17-093**

- Retirement board trustee reports stock ownership in companies in which retirement system invests on Form 700. This constitutes a “business interest” in those companies because of stock ownership in excess of \$2,000 each.
- FPPC says: “Disposing of interests in those entities or creating a blind trust for investments can eliminate the potential for conflicts of interest under the Act.” The Act “would prohibit the Board member from taking part in a decision relating to [four named companies] if the decision would have a reasonably foreseeable material financial effect on one or more the Board Member’s financial interests in those business entities.”
- Although the FPPC did not address the topics expressly, **neither the Small Shareholder Exception, nor the Parent, Subsidiary, Otherwise Related Business Entity exceptions applied.**

Political Reform Act: multi-step analysis

6. Is the effect on the financial interest too insignificant?

- Notwithstanding the foregoing specific materiality standards there is a generally applicable exception in FPPC regulation 18702(b) that may potentially override them, stating:
 - “... the financial effect of a governmental decision is not material if it is nominal, inconsequential, or insignificant.”
- This is an objective, not a subjective test, and recent FPPC advice letters and enforcement decisions appear not to rely on it in a disqualification analysis

7. Does the economic effect apply to the public generally?

8. If no statutory exception is applicable, is participation legally required?

Effect of Economic Conflict

- Board Member: Disqualified
 - Publicly declare the specific interest
 - Refrain from participating as board member and leave the room unless as a public participant on matters relating solely to the official's personal interests
 - Board may make decision without participation of disqualified officials
- Employees:
 - Follow same rules of non-participation as to non-ministerial matters
- Criminal conviction of misdemeanor precludes public office for four years
- Fines up to \$5,000 per occurrence
- Decision may be voided

Hypothetical

- The retirement board is considering allocating \$100 million to an investment strategy through Hypothetical Investment Manager (“HIM”), and a trustee on the board reported owning between \$10,000-\$100,000 in stock in HIM on her Form 700 for the prior year.
- Must the trustee recuse herself under the Political Reform Act?
 - Yes, trustees cannot be impartial with respect to any company in which they own stock.
 - No, the board’s decision will only have a nominal financial effect on trustee.
 - No, the decision will have the same effect on all similarly situated holders of stock and is not discretionary as to a particular board member.
 - Maybe, depending upon whether the Small Shareholder Exception and/or Parent, Subsidiary, Otherwise Related Business Exception applies (note: even if the trustee owns under \$25,000 in stock, the exception might not apply given the size of the allocation). Discuss with system counsel.

Questions?



Conflicts of Interest in Contracting: General Rules

- Public officers and employees shall not be financially interested in any contract made by them or by any body/board of which they are members (Gov. Code Sec. 1090)
- Board members presumed to be involved in all contracts under Board's jurisdiction
 - Even disqualification or recusal of the interested member will not allow the board or board to make the contract unless an exception applies
- Interested employees may not participate
- Statute also prohibits any individual from aiding or abetting a violation of Section 1090 by any public official or employee

Contracting Factual Analysis

- Public officer or employee?
- Is there a contract? Broadly defined
- Involved in making a contract?
 - Developing, negotiating, modifying and soliciting bids
- Financial Interest?
 - Direct or indirect, positive or negative
- Does an Exception Apply?
 - Non-Interest
 - Remote Interest
- Rule of Necessity? Only for essential services
- Violation to aid or abet another's violation



Violation of Contracting Law

- Ordinarily a Board member cannot escape liability for a contracting law violation by recusal
- Financially interested Board member must resign from the Board (and/or irrevocably renounce interest) unless an exception applies to permit the Board to act
- Staff members with financial interest must be screened from Board action (and/or irrevocably renounce interest); only “involvement” must clearly state action is in individual, not official, capacity (see FPPC Advice Letter No. A-17-087)
- Violation of contract law is felony that can result in imprisonment of the public official, permanent disqualification from public office, and fines
- Disgorgement of all benefits received under illegal contract may be required



Thank You for Your Time



Ashley K. Dunning **MercedCERA Fiduciary Counsel**

Nossaman LLP

Partner and Co-Chair, Pensions, Benefits &
Investments Group

San Francisco, CA
415.398.3600 | adunning@nossaman.com