



MEMORANDUM

To: Amy Pechacek, Interim Director, ERS
Date: March 8, 2017
Client: Employees' Retirement System of the County of Milwaukee
Subject: Overview of ERS and Roles and Responsibilities

This memorandum provides an overview of the Employees' Retirement System of the County of Milwaukee ("ERS") and the Omnibus Budget Reconciliation Act 1990 Retirement System of the County of Milwaukee ("OBRA"), the two tax-qualified retirement systems Milwaukee County (the "County") maintains for its employees.¹ The memorandum also addresses the duties and obligations of various parties associated with ERS and OBRA. It further explores certain operational errors, why those errors occurred (to the extent known to counsel) and changes that have been made to address those errors.

BACKGROUND OF ERS & OBRA

The County maintains two tax-qualified defined benefit retirement systems for the benefit of its employees: ERS and OBRA. The written terms of ERS are found in section 201.24 of the Milwaukee County Code of General Ordinances (the "Ordinances"). The written terms of

¹ Unless otherwise noted, references to ERS include OBRA.

OBRA are located in Chapter 203 of the Ordinances. ERS and OBRA are also governed by the Rules promulgated by the Pension Board of the Employees' Retirement System of the County of Milwaukee (the "Pension Board") for each respective system.

1. Membership. ERS is the primary retirement system for County employees. In general, every employee of the County automatically becomes a member of ERS, unless the employee is an excluded employee. Ordinance section 201.24(2.5); Rules 203 and 204. Some employees become members of the OBRA system, which was established in 1990 to provide retirement benefits for temporary, seasonal, and other "non-traditional" employees not enrolled in ERS. Previously, certain employees were permitted to choose between membership in ERS and OBRA, and were thus designated "optional employees." Rule 202. The Pension Board repealed the rule that allowed for optional employment on May 20, 2015. As a result of that repeal, members whose positions previously would have been classified as optional may only participate in OBRA.

2. Retirement Benefits. ERS and OBRA are designed to provide retirement benefits to members. Normal pension benefits under ERS and OBRA are generally determined based on a member's compensation and years of service. Ordinance sections 201.24(5.1); 203(4.1).

3. Forms of Distribution. The normal form of distribution under ERS is an annuity for the member's life (often referred to as the "Maximum" form of benefit). Ordinance section 201.24(7.1). Before benefits commence, a member may elect to receive his or her pension benefit in an optional form designated under ERS (*e.g.*, 50% survivor benefit or 100% survivor benefit). *Id.*

In addition, members whose membership began prior to March 15, 2002 (other dates apply for employees covered by a collective bargaining unit) are eligible for a normal

pension may elect to receive pension benefits through a “retroactive deferred retirement option program,” which is commonly referred to as a “back DROP” benefit. Ordinance section 201.24(5.16); Rule 711. As explained below, the back DROP option permits eligible members who remain employed beyond their earliest possible retirement date to choose to receive a lump sum benefit representing the monthly pension benefits they could have been collecting had they chosen to retire earlier.

The back DROP benefit is a two-part pension benefit. Under the first part of the back DROP benefit, a member receives a “lump sum DROP benefit” at retirement. Ordinance section 201.24(5.16); Rule 711. The lump sum DROP benefit is the sum of all monthly DROP benefits (as explained below) between the “back DROP date” ““selected by the member and the date that the member actually retires from the County. Ordinance section 201.24(5.16); Rule 711. The lump sum DROP benefit also includes interest, which is compounded monthly and accrues at a rate equal to ERS’s actuarial assumed rate of return. Ordinance section 201.24(5.16); Rules 711, 713.

Under the second part of the back DROP benefit, a member receives a “monthly DROP benefit” at retirement. Ordinance section 201.24 (5.16); Rule 711. The monthly DROP benefit is the normal or early monthly pension benefit, which is calculated based on the member’s years of service and final average salary as of the “back DROP date.” Ordinance section 201.24(5.16); Rule 711. The “back DROP date” is any past date selected by the member that is more than one year prior to the date the member actually leaves County service. Ordinance section 201.24(5.16); Rule 711. In addition, the back DROP date cannot be earlier than the date on which the member first became eligible to commence early or normal pension benefits. Ordinance section 201.24(5.16); Rule 711. Because the back DROP date is earlier than

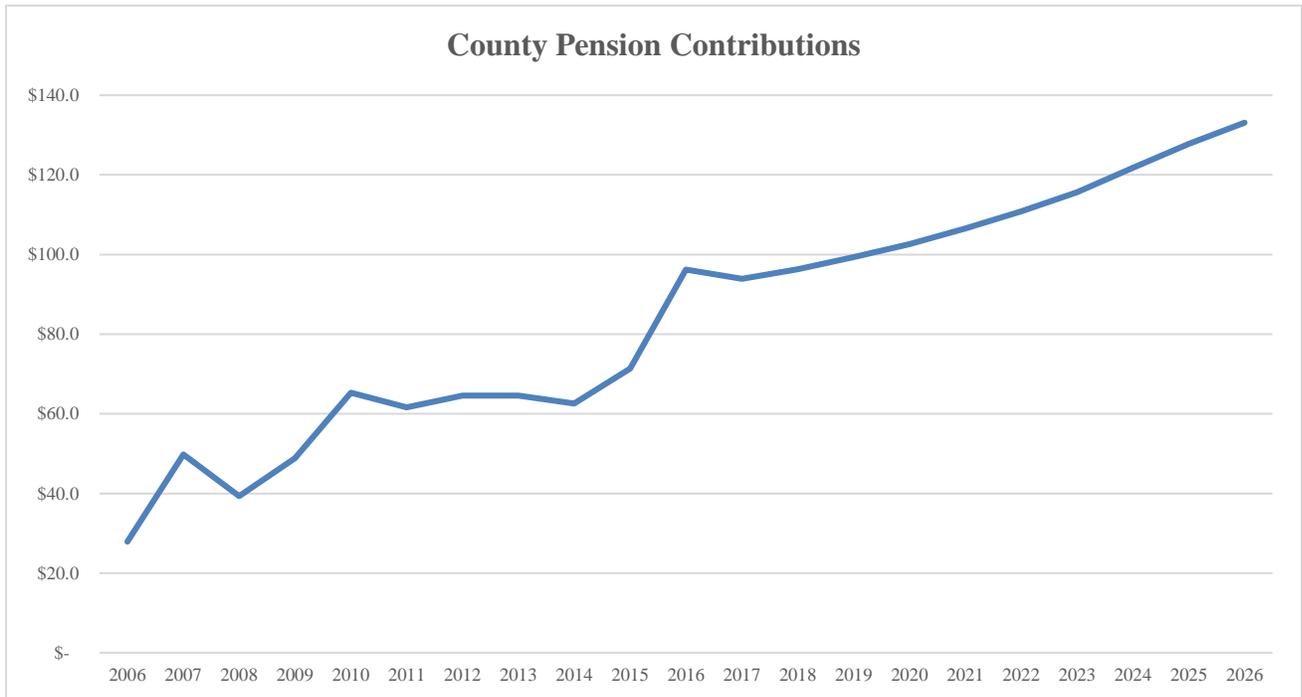
the member's actual retirement date and thus reflects fewer service credits than the member had accumulated at the time of actual retirement, a member who selects the back DROP receives a lower monthly pension benefit than he or she would otherwise have been entitled to.

Under OBRA, a member's retirement benefit is typically paid in the form of a life annuity beginning after the member's normal retirement date (age 65). Ordinance sections 203(2.9), (4.1). An OBRA member's pension benefit will be paid in a lump sum, instead of a monthly annuity, if the actuarial equivalent lump sum value of his or her pension benefit is \$5,000 or less. Ordinance section 203(4.4).

4. Funding. ERS and OBRA are funded through contributions and investment returns. Ordinance sections 201.24(3.1); 203(3.1), (3.2). County contributions to ERS and OBRA are based on actuarial calculations that take into account, among other factors, the retirement benefits to be provided and expected investment returns on the assets in the pension funds. Currently, the assumed rate of return is 8%. However, the Pension Board voted in 2016 to reduce the rate to 7.75% on January 1, 2018 and to further reduce the rate to 7.5% on January 1, 2020.

In addition, we understand the Budget Office of the Department of Administrative Services ("Budget Office") has estimated that the cost of retiree pensions is increasing at a greater rate than previously observed. Correspondingly, as we further understand, according to Budget Office estimates, the County's pension contributions have also been rising at an increasing rate, as shown below:²

² The Budget Office provided all of the estimated projections reported herein, which were not independently verified by Reinhart. This information is being provided for context only.



Specifically, in 2006, the County contributed \$27.9 million to the pension; in 2016, the County contributed \$96 million; and the projected contribution as estimated by the Budget Office for 2026 is nearly \$135 million.³ When added to the costs of retiree health care, we understand that Budget Office estimates project that the combined costs of retiree benefits will quickly begin to account for well over half of the county’s annual property tax revenues, and may actually eclipse tax revenues by 2035.⁴

In 2010 and 2011, ERS implemented mandatory employee contributions for the majority of ERS members. Ordinance section 201.24(3.11). The County has not mandated employee contributions for OBRA.⁵ Other legislative changes were made in the early 2000s to

³ As noted above, the Budget Office has provided all of the estimated projections, which were not independently verified by Reinhart. This information is being provided for context only.

⁴ See n.3, *supra*.

⁵ Additionally, optional members who elected into ERS (prior to the repeal of Rule 202 in May 2015) have 6% of their wages contributed to ERS. Ordinance sections 201.24(2.20), (3.3).

discontinue the buy-in, buy-back option, the back DROP option, and to eliminate free health care for retirees. *See, e.g.*, County Ordinance No. 15-4; Pension Board meeting minutes (July 20, 2005). While these changes have improved the pension's funding status, the County may continue to be challenged by the substantial vested (i.e., guaranteed) benefits many long-tenured county employees and current retirees enjoy.

ROLES & RESPONSIBILITIES

1. County. The County is the sponsor of ERS and OBRA. As such, it is the “settlor” of the ERS and OBRA trusts. *See* Ordinance section 201.24; *see also* Wis. Stat. § 701.0106 (23); *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 443 (1999) (noting that plan sponsors perform settlor, rather than fiduciary, functions when they adopt, modify or terminate benefit plans under ERISA); *cf.* Wis. Stat. § 59.02 (providing that the county board has the power to enact ordinances). A settlor is an entity or individual that establishes a trust and determines how property or assets shall be paid from that trust. Black's Law Dictionary, 7th ed. (1999), at 1378. The County's settlor functions are effectuated through the County Executive and County Board. As settlor, the County may set and amend benefits for the pension's members, as well as vesting rules, multipliers, etc. through County Ordinances and/or collective bargaining agreements. The County also specifies who is to administer the fund and may designate other specific operations of or limits to that administrative function. The settlor does not administer the plan, decide on investments, nor does the settlor get enmeshed with day-to-day management (and this applies to the Executive and Board as well).

2. County Executive. The County Executive is responsible for ensuring that all Ordinances adopted by the County Board are properly carried out and followed. Ordinance section 1.25(2). The County Executive is required to report to the County Board a failure by an

official directed to perform a duty or make a report. Ordinance section 1.25(2). The County Executive also receives annual pension funding requests from the Pension Board. Ordinance section 201.24(3.1).

The Ordinances do not specify any explicit, enumerated duties or oversight responsibilities of the County Executive with respect to ERS beyond what is noted above. However, the administration of ERS is facilitated by the Director of RPS and RPS personnel, who are employed within the Human Relations Department and overseen by the HR Director, who in turn answers to and is appointed by the County Executive. Ordinance 58.01.

The County Executive appoints three members to the Pension Board, subject to confirmation of the County Board. Ordinance section 201.24(8.2).

The County Executive is generally not a fiduciary⁶ of the fund because he or she does not exercise any discretionary authority over ERS's investments or administration. 29 U.S.C. § 1002(21)(A); 29 C.F.R. § 2509.75-8(Q&A. D-2).⁷

3. County Board. It is the obligation of the County Board to provide a retirement plan for County employees and to authorize the County contributions required to properly fund ERS. Ordinance section 201.24(3.1); Ordinance section 203(3.1). The County Board is authorized by statute to pass Ordinances that establish, maintain and govern the operation of

⁶ The Office of Corporation Counsel has issued a memorandum to the Pension Board contemporaneously herewith, which specifies the fiduciary obligations of pension board trustees (but also provides useful guidance for other fiduciaries to ERS). But broadly, individuals identified as fiduciaries in this memorandum must comply with the exclusive benefit rule, which requires fiduciaries to perform all activities and transactions on behalf of a plan for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of plan administration. 29 U.S.C. § 1104(a)(1); 29 U.S.C. § 1103(c)(1); Internal Revenue Code § 401(a).

⁷ The Employee Retirement Income Security Act of 1974 ("ERISA") does not directly apply to government plans such as ERS, but ERISA and its related rules and case law provide important guidance for government plan sponsors. Courts will often look to ERISA case law in evaluating claims involving a government plan. *See, e.g., State ex rel. Cannon v. Moran*, 321 N.W.2d 550 (Wis. Ct. App. 1982) *rev'd*, 331 N.W.2d 369 (Wis. 1983).

ERS. 1965 Wis. Sess. Laws 656⁸; Ordinance section 200.1. The County Board utilizes a Pension Study Commission to review proposed changes to ERS. Ordinance section 200.03. Through the annual County budget process, the County Board also determines annual employee contribution percentages based on actuarial recommendations. Ordinance section 201.24(3.11).

The County Board Chairperson appoints two members to the Pension Board, subject to confirmation by the County Board and County Executive. Ordinance section 201.24(8.2).

The County Board's responsibility to pass Ordinances necessary to operate ERS is a "settlor function." *See Hughes Aircraft Co.*, 525 U.S. at 443; *Lockheed Corp. v. Spink*, 517 U.S. 882, 890 (1996). Settlor functions include amending, terminating or redesigning a plan. When performing settlor functions, the County Board is not a fiduciary. *Hughes Aircraft Co.*, 525 U.S. at 443; *Lockheed Corp.*, 517 U.S. at 890.

4. Pension Board. The Pension Board is a fiduciary of ERS and OBRA. *See* Ordinance section 201.24(8.1); Ordinance section 203(5.1). As specified in Ordinance sections 201.24(8.1) and 203(5.1), the Pension Board oversees and has authority regarding investment decisions and the administration of ERS. Additionally, the Pension Board maintains the tax-qualified status of ERS (along with the County as Sponsor) and is charged with ensuring that RPS administers the plan based on the Ordinances and Rules. Ordinance sections 201.24(2.2), (8.1) and (8.17); Ordinance sections 203(5.1) and (6.1).

⁸ In 1965, the Wisconsin State Legislature passed a statute providing that "[e]ach county which is required to establish and maintain a retirement system pursuant to this act is hereby empowered, by county ordinance, to make any changes in such retirement system which hereafter may be deemed necessary or desirable for the continued operation of such retirement system, but no such changes shall operate to diminish or impair the annuities, benefits or other rights of any person who is a member of such retirement system prior to the effective date of such change." 1965 Wis. Sess. Laws 656.

The Pension Board also serves as the trustee of ERS funds. Ordinance section 201.24(9.1); Ordinance section 203(6.1). “In acquiring, investing, reinvesting, exchanging, retaining, selling and managing” ERS funds, the Pension Board is charged with exercising the “judgment and care and other circumstances then prevailing which persons of prudence, discretion and intelligence exercise in the management of their own affairs.” Ordinance section 201.24(9.1)(a).

The Pension Board is required to provide the County Executive with an estimated annual budget contribution and otherwise reconcile contributions and the proposed budget. Ordinance section 201.24(3.1); Ordinance section 203(3.1). The Pension Board must also make a written referral to the County Board and County Executive for review of any proposed benefit changes. Ordinance section 201.24(8.17). The Pension Board must review and provide comment on the fiscal impact of proposed benefit changes referred from the County Board within 30 days. *Id.*

The Ordinances specifically allow the Pension Board to designate an actuary and a medical review board. Ordinance sections 201.24(8.12) and (8.13); Ordinance section 203(5.6). Additionally, to comply with its fiduciary duties, to serve as trustee of ERS funds and oversee the administration of ERS, the Pension Board also hires other professionals, such as custodian banks, investment managers and investment consultants. As a fiduciary board, the Pension Board must diligently oversee, monitor, and evaluate all those who provide services to and for the plan and the Board. Put simply, the Board’s function is monitoring, oversight, and occasionally, review of particular benefit decisions. But the Board does not and should not get enmeshed in day-to-day plan operations, administration, or investment decisions.

5. Retirement Plan Services. As provided under Rule 1040, the Pension Board has delegated to the Director⁹ of RPS the general administrative and operational responsibility of ERS, including the authority to calculate benefits for specific individuals that comply with the Ordinances, Rules, and applicable collective bargaining agreements. The Director of RPS, together with RPS staff, manage the day-to-day operations of ERS. Based on ERISA and case law, the RPS Director is a fiduciary, as is any RPS staff member to the extent they exercise discretion over administration. *See, e.g.,* 29 U.S.C. § 1002(21)(A); *Edmonson v. Lincoln Nat'l Life Ins. Co.*, 725 F.3d 406, 421-22 (3d Cir. 2013); *Brooks v. Pactiv Corp.*, 729 F.3d 758 (7th Cir. 2013); *Schmidt v. Sheet Metal Workers' Nat'l Pension Fund*, 128 F.3d 541, 547 (7th Cir. 1997); *Reich v. Lancaster*, 55 F.3d 1034, 1047-50 (5th Cir. 1995); *Dana Ltd. v. Aon Consulting, Inc.*, 984 F. Supp. 2d 755, 761-65 (N.D. Ohio 2013); 29 C.F.R. § 2509.75-8(Q&A. D-2).

The County has fiduciary liability insurance coverage related to ERS. ERS is the named insured on the existing policy and the policy expressly covers members of the Pension Board. Total coverage through three policies totals \$30 million.¹⁰

Typically, the head of a pension fund will be hired, fired, and supervised by a board of trustees. Under this usual governance structure then, a fiduciary board is holding accountable a fiduciary director. Milwaukee County's ERS, however, has a more unusual arrangement wherein the RPS Director, as noted above, reports to the HR Director, who is answerable to the County Executive. Thus, in ERS, you have a non-fiduciary (the executive)

⁹ Rule 1040 refers to the "Manager" of ERS. While the title changed from Manager to Director of RPS, the position remains the same.

¹⁰ In the past, we recommended that RPS staff that exercise administrative discretion, including the Director, be expressly added to the policy as additional insureds. This has been attempted previously to no avail. When the fiduciary policy is set to expire, we recommend retaining an insurance broker to determine if more comprehensive and updated coverage can be obtained.

overseeing a fiduciary. Contemporaneously, the Director reports and must be responsive to the Pension Board, even though the board has no direct or indirect employment authority over the Director. Last, the Director can be compelled to appear before the County Board and to provide certain reporting and other information. Wis. Stat. § 59.794(3)(b).

6. Third Parties. Some, but not all, of the other vendors and professionals that assist the fund are fiduciaries. Typically, such standard of care is specified in the relevant contract. However, over the past decade, following the County's lawsuit against Mercer, with varying degrees of success, most benefit professionals now resist being named a co-fiduciary in a contract and instead argue for some standard of care less than the demanding rubric of fiduciary duties, which is the law's highest standard of care. Regardless, the plan's investment consultant and all investment managers are indisputably fiduciaries because they make determinations regarding how the plan's assets are invested.

HISTORY OF ERRORS

As described above, RPS is in charge of the day-to-day administration of ERS. The position responsible for overseeing RPS staff has seen fairly significant turnover since 2000. Specifically, Director Marian Ninneman worked in that capacity from July 2011 to February 2017. Before that:

- Gerald Schroeder (2008 to 2011);
- Jack Hohrein (May 2005 to 2008);
- Matthew Janes (2003 to May 2005); and
- Jac Amerell (1990s to 2003).

Based on the information available to counsel, it appears that errors have historically stemmed from the following: (1) a lack of proper application of the Ordinances, Rules, and/or

bargaining agreements to members and/or lack of clear Rules or policies/procedures; (2) issues with the computer systems designed to assist RPS in administering benefits; (3) internal RPS controls; and (4) actuarial errors. Each is discussed further below.

1. Lack of Rules and/or Improper Application of Existing Rules. Numerous errors uncovered over the last ten years stem from a failure to properly apply the Ordinances and Rules to member benefit payments. RPS generally applies the basics of the Ordinances and Rules accurately. However, it appears that at times, RPS either applied different rules to similarly-situated members or applied the same rules to similarly-situated members but reached different results. Furthermore, some Rules appeared to be vague or unclear as to their application, further complicating administration. Last, benefits changed repeatedly and significantly over time, further frustrating consistent and correct benefit administration.

a. 2007 VCP and Supplement. The majority of the errors reported in the 2007 VCP arose from the above-referenced failures to properly apply the Ordinances, Rules, and bargaining agreements. Key causes are discussed in turn below.

i. Buy Backs and Buy Ins. The 2007 VCP was initially prepared to report the numerous operational errors that occurred with respect to “buy backs” and “buy ins.” Under a “buy back,” if an ERS member terminated employment with the County, withdrew his or her membership account, and subsequently returned to active service with the County, the member could repurchase the prior service credit. Ordinance section 201.24(11.1)(1) (repealed in February 2015). However, the Ordinances imposed limits on buy backs. An extensive audit revealed a number of operational errors related to the buy backs, including a failure to enforce the two-year rule and the internal contribution limits a vast majority of the time until the errors were discovered in 2007. The two-year rule provided that members who terminated County

employment and returned to active service after withdrawing their membership accounts could buy back their prior service credit if they subsequently earned two years of service, and within the two-year period, they redeposited the amount of contributions previously withdrawn from their membership accounts, plus interest. The internal contribution limit provided that annual additions to members' membership accounts were limited to the lesser of (1) the greater of \$30,000 or 25% of the limit set forth in the Internal Revenue Code or (2) 25% of the compensation paid to the member for the year.

Prior to January 1, 2007, ERS members could complete "buy ins," meaning they could purchase ERS service credit for periods of employment during which enrollment in ERS was optional and the employee had either chosen not to enroll in ERS or was unaware of his or her eligibility to enroll.

Emblematic of many of the practices and policies that took hold over many years and decades at ERS that were untethered from any specific authorizing Ordinance, Rules, or other written policy, buy ins were nowhere expressly authorized in Ordinances or Rules. Notwithstanding a lack of any affirmative legal authority to provide this option to substantially increase a member's benefits, RPS continued to administer and permit these buy ins until 2007.

Exactly when, where and why this practice originated is unknown. However, in November 1991, RPS sent active employees a letter (attached) that was intended to disclose the time frame to purchase prior service credit (buy back) at the 5% interest rate in connection with a court decision. However, the letter also informed employees that they can purchase service credit for prior optional service (a buy in). This letter appeared to serve as the basis for new wave of members asking to elect to "buy in." Before this letter, the Pension Board

apparently permitted only a handful of buy in purchases of service credit based on specific fact patterns. Why this letter included a discussion (and effectively a marketing) of the buy-in option, when it was unrelated to the court decision, is unknown.

Buy ins appear to be broadly permitted after 1991. Once this benefit was ensconced, it is clear that it became part of the administrative “norms” because, like other practices that were not tied to an particular Ordinance, Rule, bargaining agreement, or any written internal RPS policy, particularly when faced with vague rules or otherwise incompletely-defined benefits, staff and RPS leadership accepted (or were arguably forced to accept) “we’ve always done it this way,” or, “that’s never been done,” as a sufficient rationale for certain benefit administration practices.

Buy ins continued until 1997, when the Pension Board recognized that the buy in benefit had no corresponding authorization in the Ordinances and Rules. The Board amended the plan document (Rule 207) to allow buy ins, but to also place limits on buy in purchases of service credit. Buy ins were sunset by the Pension Board in 2007, and ultimately, since buy ins were no longer permitted, the Pension Board repealed Rule 207 in 2015.

ii. Lack of Training and Clear Rules / Procedures.

Many of the errors addressed in the 2007-2008 VCP stemmed from other, similar administrative practices that occurred because of poor training of RPS staff and/or a lack of sufficiently explicit rules and procedures. It has also become clear that throughout much of the early 2000s, some RPS employees did not understand their function and role at its most basic: when administering ERS and calculating benefits, they must adhere strictly to the Ordinances and Rules (and applicable regulations) and that if there are any questions, it is not

permissible to “guess,” they must seek guidance from the director, legal counsel, the Pension Board, or through further legislation.

In one example, a member (initials C.M.) sent a letter to RPS in 2001 asking to purchase service credit. In the letter, C.M. notes that she is going to be laid off. RPS responded two business days later informing her that she could purchase service credit even though the Ordinances and Rules did not allow non-active employees to purchase service credit. As part of the 2007 VCP, C.M.’s purchase was discovered, and she was not allowed to retire with her purchased service credit.

A similar situation occurred with another member (initials S.B.), who was allowed to complete a buy in even though she had not documented her alleged optional employment and therefore was not eligible for such a purchase.

In yet another example, staff permitted members to use 457 Plan funds to purchase service credit, even though the Ordinances and Rules did not allow for such a transfer.

In a final example of misapplied and/or unclear rules, in 2012, RPS discovered that in 2003, RPS incorrectly paid out a survivor benefit to multiple beneficiaries and allowed the beneficiaries to elect a back DROP. The Ordinances and Rules do not authorize annuities to be paid to multiple beneficiaries, and only current, living members can elect a back DROP.¹¹ Ordinance section 201.24(5.16).

¹¹ The member (initials Y.W.) considered retiring and completed a retirement application, but did not retire. Y.W. then died in active service. Because she died without a spouse, no survivor benefit is payable unless she elected a Protective Survivorship Option (which requires the completion of a specific form). RPS staff decided that her retirement application (which was void when she continued to work for the County) should be considered an application for a Protective Survivorship Option. The multiple errors resulting from Y.W.’s benefit have been reported to the IRS as part of the 2014 VCP Supplement. Unsurprisingly, Y.W.’s beneficiaries have filed suit against the County and Pension Board, which is ongoing.

Over the past week, RPS has identified rules and procedures that require clarification and review and agreed to provide a comprehensive list of these issues before the current Agreed Upon Procedures (“AUP”) review is completed by the plan’s auditors, Baker Tilly. However, by far, the overarching challenge for both RPS staff (and the software system) is the sheer number and complexity of potentially applicable pension benefit calculations. This level of complexity makes programming software nearly impossible and when individual calculations are required for many benefits, particularly when interpretation rules are not comprehensive and/or procedures are lacking to address questions, errors will occur.

iii. Mortality Table Errors. In the early 2000s, errors involving the mortality table used to calculate certain benefits also occurred. Upon advice of the actuary, the Pension Board amended Rule 1014 to change the mortality table in 2001. RPS failed to update the computer software to account for the change in the table, which resulted in the mortality table errors. These errors were also reported as part of the 2007 VCP.

b. OBRA Audit. Beginning in 2007, an internal review of OBRA operations was conducted by RPS. In late 2007 and early 2008, we drafted a VCP submission to report to the IRS violations discovered during this OBRA review. In 2008, prior to completion and submission of the VCP, the IRS initiated an employee plans examination of OBRA for the 2005 and 2006 plan years. The errors identified by the internal review and confirmed by the IRS through the audit included the failure to make mandatory payments to members after their absence from County employment for five years or attainment of normal retirement age, the failure to pay a benefit in the form of an annuity (for amounts over \$5,000), and the failure to properly calculate some members’ average annual salaries. It appeared from the errors that RPS was unaware of how to properly apply some OBRA Ordinances and Rules. The OBRA audit

was concluded upon the execution of a Closing Agreement in March 2012 and the corrections of the errors identified in the Closing Agreement.

2. RPS's Computer System. Prior to 1992, ERS maintained paper records to calculate pension benefits. *See* March 2012 Audit Report ("2012 Audit") (copy attached). In 1992, RPS installed the Genesys Def-Ben computer system. *Id.* This system did not work well and was poorly maintained. *Id.* In 2006, RPS began transitioning to the Vitech V-3 system ("V-3"). *Id.* The transition was completed in 2009. *Id.* V-3 was intended to prepare more accurate estimates and assist with benefit processing. *Id.*

Unfortunately, despite this substantial effort to automate benefit calculations, because of programming challenges and/or insufficient data, the V-3 system could *not* "be relied upon to generate accurate pension calculations and disbursements without extensive manual review and intervention." *Id.* The V-3 system required a significant amount of manual review and intervention to prevent or rectify errors. For example, the V-3 system failed to include interest on members' back DROPs between 2009 and 2012. This was discovered by RPS in 2012 and reported as part of the 2014 Supplemental VCP.

Last week, RPS agreed to work with the plan's auditors, Baker Tilly, during the course of their ongoing AUP review to identify both data and programming shortfalls.

3. Insufficient Internal Controls. According to the 2012 Audit, RPS also lacks proper internal controls, including sufficient written procedures and a documents/records policy.

For example, the 2012 Audit noted inadequate controls to cease benefit payments under the 10-Year Certain Annuity option (this option pays a benefit to a member for his or her life and guarantees 120 payments will be made to the member or the member's beneficiary if the member dies prior to receiving 120 payments). The failure to cease benefit payments at the

correct time resulted in overpayments to beneficiaries. These errors were reported as part of the 2014 Supplemental VCP. At the time the error was uncovered, RPS staff noted that there were no written procedures for processing the 10-Year Certain option.

The 2012 Audit also noted that, in 2008, while reviewing paper records to prepare for implementing V-3, RPS destroyed important documents necessary to verify some pension calculations. It appears that RPS implemented a purging process to discard unnecessary documents, but the 2012 Audit noted that this purging process was poorly organized. Additionally, according to the 2012 Audit, RPS hired five temporary employees in 2008 and seven in 2009 to help with the streamlining of records. It is likely that the inexperience of these employees and the poorly organized process led to the destruction of significant documents. The 2012 Audit noted that in 2009, RPS created an updated records retention policy. This policy was slated for review after the 2012 Audit.

Concerned about the number of errors being discovered, the Pension Board Audit Committee requested in February 2016 that RPS disclose errors to the Pension Board Audit Committee each month. This has been a formal or informal agenda item at each Pension Board Audit Committee meeting since February 2016. While RPS would note that errors had been found, the Pension Board Audit Committee would generally be assured that corrections were being made for any error that was reported. Given the recent discovery of an overpayment error that had been known to the former Director for nearly 3 years, it appears the Pension Board Audit Committee was not provided accurate information at those meetings, despite its efforts to stay informed.

4. Actuarial Errors. While the majority of the errors concerning ERS arise from RPS, other significant and costly errors have previously been the result of actuarial errors.

a. Calculation Error. It was recently determined that liabilities were understated for the 2013 and 2014 valuations. Corporation Counsel's office is reviewing this error.

b. Back DROP Error. In 2000, Gary Dobbert, then Director of Human Resources, suggested that the County consider adding a deferred retirement option program ("DROP") to ERS. As part of the County's consideration, the County consulted with its actuary, Mercer Human Resource Consulting, Inc. ("Mercer"), to determine the fiscal impact a DROP program would have on ERS. To a large extent, with some limited qualifications, Mercer opined that the implementation of a back DROP benefit would have no material fiscal consequences to the County. After some consideration, the County implemented the back DROP option. *See* Ordinance section 201.24(5.16). Notwithstanding Mercer's analysis, the back DROP subsequently cost ERS a significant amount of money. In 2006, the County filed a lawsuit against Mercer for actuarial malpractice, in which the County contended that Mercer failed to adequately inform the County of the potential costs of a back DROP. The County stated that Mercer had mischaracterized the financial impact of the back DROP option as minimal, and that had the County been aware of the potential for such high additional costs, it would not have implemented the back DROP option. In May 2009, Mercer and the County settled the case out of court for a significant sum.

CURRENT STATUS

Given the errors that have come to light since January 1, 2017, the pension fund engaged Baker Tilly, as well as the County's Audit Department, to conduct an AUP review to determine the extent and relative prevalence of errors, which is in addition to and distinct from the required annual Baker Tilly audit of RPS financials. The Audit Department, RPS, and the Office

Corporation Counsel instructed Baker Tilly to use personnel separate and distinct from personnel involved in the annual financial statement audit, to ensure independence. Also, as noted above, RPS staff is compiling lists of data/programming that is required to better operate V-3, as well as a list of procedures/rules which remain unclear.

Attachments.