



Office of the City Auditor

**Report to the City Council
City of San José**

**RETIREMENT SERVICES:
INTERIM REPORT ON THE
ALIGNMENT OF
CONTROLS BETWEEN THE
CITY AND THE OFFICE OF
RETIREMENT SERVICES**

**Report 23-05
October 2023**

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October 12, 2023

Honorable Mayor and Members
Of the City Council
200 East Santa Clara Street
San José, CA 95113

Retirement Services: Interim Report on the Alignment of Controls Between the City and the Office of Retirement Services

The City of San José (City) has two retirement plans, one for Police and Fire sworn employees and one for non-sworn employees. Two independent boards oversee the plans and have fiduciary responsibility for the investment of moneys and administration of the retirement plans. The Office of Retirement Services (ORS) administers the plans. Despite oversight from the boards, ORS is a City department and is staffed by City employees. The City is the plans' sponsor, and a key stakeholder of the retirement plans. The plans have a significant impact on the City's budget and ability to provide services. In FY 2021-22, the City contributed \$475 million to the plans for retirement and other post-employment benefits (e.g., healthcare). In addition, the City provides various support services to ORS, including finance, human resources, and information technology support.

The objective of this interim report was to review policies and procedures for ORS' administrative responsibilities, including a comparison of other retirement system's oversight of such responsibilities. This audit was conducted in response to direction from the City Council.

Finding I: Alignment of ORS and City Policies Would Strengthen Internal Controls Over ORS Operations. ORS relies on City resources and support services in its operations. This includes information systems such as the City's financial management and payroll systems, and even e-mail. The Finance, Human Resources, and Information Technology Departments provide support by processing biweekly payroll, paying invoices, administering employee benefits, maintaining the City's information systems, providing cybersecurity trainings, and other services. We found:

- There is not clear agreement between the City Administration and ORS on whether all City administrative policies and procedures are relevant for ORS, despite ORS staff being City employees and the boards adopting the City's Code of Ethics.
- ORS does have some internal procedures related to administrative processes, but many date back to the 1990's or early 2000's and staff in some cases were unaware of them. In addition, ORS staff have expressed confusion about what policies they are expected to follow.

- Not having clear direction or up-to-date procedures is an internal control weakness that can lead to practical difficulties in routine operations and could expose the retirement system and the City to unnecessary risks, including inefficient operations, fraud, and susceptibility to cybersecurity incidents.
- Other retirement systems in California are similarly staffed by individuals who are considered employees of their plan sponsor, like San José. In these cases, the systems report that staff generally follow their plan sponsor's administrative policies, or that they have adopted policies that were aligned or in some cases stricter than the plan sponsor's.

RECOMMENDATION:

To strengthen its internal control system, ORS and the Retirement Boards should work with the City to either:

- Adopt City policies and procedures related to information technology, procurement, and other administrative functions, or
- Develop a set of internal policies and procedures that align with the City's in these areas.

This report has 1 recommendation. We plan to present this report at the October 24, 2023, meeting of the City Council. We would like to thank the Office of Retirement Services, the City Manager's Office, the City Attorney's Office, the Information Technology Department, the Finance Department, and the Office of Employee Relations for their time and insight during the audit process. The Office of Retirement Services has reviewed the information in this report, and their response is shown on the yellow pages.

Respectfully submitted,



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Board of Administration of the Federated City Employees' Retirement System
Board of Administration of the Police and Fire Department Retirement Plan

This report is also available online at www.sanjoseca.gov/audits

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Background

The City of San José (City) offers two defined benefit retirement plans to City employees:

- The Police and Fire Retirement Plan for qualifying members of the Police and Fire sworn services, and
- The Federated City Employees' Retirement System for qualifying employees not covered by the Police and Fire plan.

Each plan has multiple tiers (i.e., Tier 1 and Tier 2) which provide different benefits when an employee retires. Which tier an employee belongs to depends on when that employee was hired. Tier 2 was established for new employees in 2012. Some employees, such as part-time unbenefited employees and members of the City Council, are not part of either plan.¹ As of June 30, 2022, there were over 14,800 members of the plans (including active staff, retirees, and beneficiaries).

In addition to pension benefits, the City provides Other Post-Employment Benefits (OPEB) to some employees.² These benefits relate to post-employment healthcare, both medical and dental.

Oversight and Authority

The City Charter, the San José Municipal Code, and the California Constitution all provide direction for how the retirement plans operate and function. They also spell out the responsibilities of the Retirement Boards, who oversee the plans.

San José City Charter

In 2014, San José voters passed Measure G, which added sections 810 and 810.1 to the City Charter. Measure G gave some direction on the separation of responsibility between the City Council and Retirement Boards. This included:

- Requiring that the Retirement Boards administer the retirement plans in accordance with the fiduciary duties and obligations established by law, the City Charter, and as further prescribed by ordinance.
- Requiring the Retirement Boards comply with all open and public meeting requirements established by state law and applicable Council action.

¹ Both the Police and Fire and Federated plans are defined benefit plans, meaning that the City provides stable pension benefits based on retirees' years of service with the City and their final compensation. The City offers a third plan to Executive Management and Professional Employees (Unit 99) staff, which is a defined contribution plan similar to a traditional 401k. That plan—commonly known as Tier 3—is administered by the City's Department of Human Resources. The City also offers a defined contribution retirement plan for part time, temporary, or contract (PTC) employees, including council assistants.

² Benefits depend on an employee's tier. For example, Tier 2 members hired after September 2013 are not provided the same post-employment healthcare benefits as Tier 1 members. Tier 1 members could have opted out of OPEB in 2017.

- Granting the Retirement Boards authority to hire an at-will chief executive officer and a chief investment officer.
- Granting the chief executive officer authority to hire and terminate Retirement Services employees independent of the City Manager's Office.
- Stipulating that the City Council retains the authority to approve the aggregate expense of administration of the retirement plans.
- Stipulating that Retirement Services has the authority to contract with external counsel for legal services.

As noted later, Measure G did not explicitly address all aspects of the City's Office of Retirement Services (ORS) administration and operations.

San José Municipal Code

San José Municipal Code §3.36 Police and Fire Department Retirement Plan and §3.28 Federated Employees Retirement Plan establish the plans and some aspects of plan administration. This includes giving the Retirement boards power to adopt rules and regulations that are necessary to maintain the qualified status of the plan.

California Constitution

Proposition 162, passed in 1992, amended Article 16 §17 of the California Constitution to award boards of public employee retirement systems plenary authority and fiduciary responsibility for investment of moneys and administration.

*[T]he retirement board of a public pension or retirement system shall have **plenary authority and fiduciary responsibility for investment of moneys and administration of the system**, subject to all of the following:*

(a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

(b) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries,

*minimizing employer contributions thereto, and **defraying reasonable expenses of administering the system.** A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty. [emphasis added]*

The Retirement Boards

The retirement plans are overseen by two independent boards who have fiduciary responsibility for investment of moneys and administration of the retirement plans. The Retirement Boards are also responsible for appointing and overseeing the work of ORS' Chief Executive Officer and the Chief Investment Officer.

- The Federated Board consists of seven appointed members: four public members appointed by the City Council, two employee representatives, and one retiree representative.
- The Police and Fire Board consists of nine appointed members: five public members appointed by the City Council, one Police employee representative, one Fire employee representative, one Police retiree representative, and one Fire retiree representative.

Public members appointed by the City Council must have at least twelve years of experience relevant to the administration of a pension plan.

The Retirement Boards and ORS invest contributions to try and meet an expected rate of return that will enable them to make current and future benefits payments. The Retirement Boards annually adopt an administrative budget, approved by the City Council, for ORS. ORS is almost entirely funded through the Federated and Police and Fire Retirement Funds.³

The City Council

Per the Municipal Code, the City Council establishes the Boards to administer retirement plans. The City Council approves the ORS budget annually and appoints Retirement Board members.⁴ Each Board also includes one nonvoting City Councilmember who acts as a Council liaison to the Boards.

The Office of Retirement Services

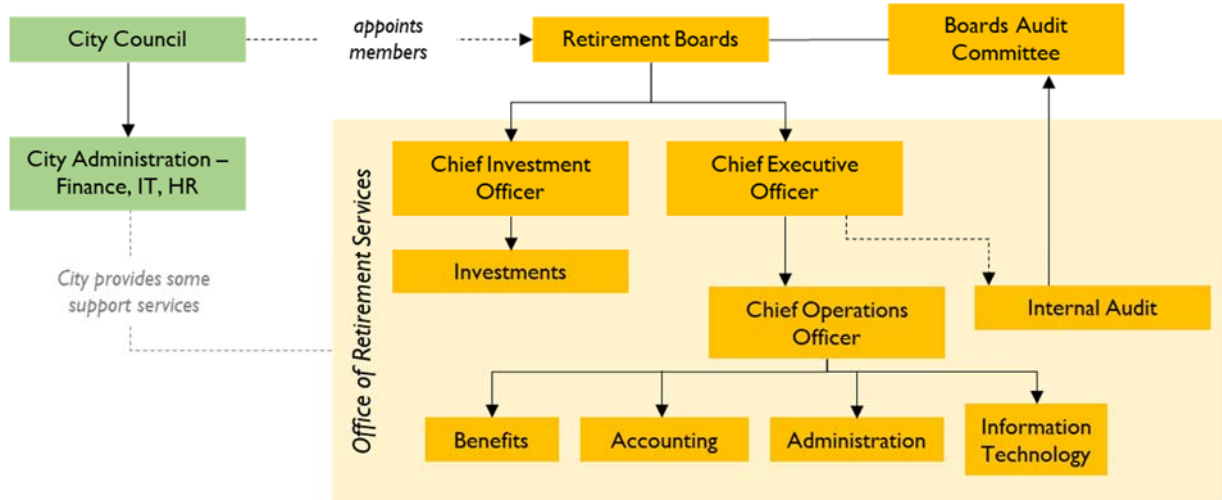
ORS administers the retirement benefits provided by the City. Its mission is to “provide quality services in the delivery of pension and related benefits and maintain financially sound pension plans.”

³ In FY 2023-24, 1 percent of the ORS budget came from the General Fund.

⁴ Retiree and active Board members are elected by their respective plan members and then appointed by the City Council.

ORS' Chief Executive Officer oversees the entire office, including authority to hire and fire ORS staff. In FY 2023-24, ORS has 43 full-time equivalent positions with a personnel budget of \$8.7 million.

Exhibit I: Simplified Chart of Office of Retirement Services and City of San José Oversight



Source: Auditor analysis of City Charter, San José Municipal Code, Office of Retirement Services organizational chart, and interviews with City and ORS staff regarding support services

The office is split into several divisions which handle different aspects of ORS operations.

- The **Investment** division, overseen by the chief investment officer, manages retirement plan assets. The team aims to produce long-term net returns that exceed the actuarial assumed rate of return while maintaining a reasonable level of investment risk.
- The **Benefits** division provides retirement planning and counseling services to plan members and administers health care and other benefits for retirees and beneficiaries.
- The **Accounting** division prepares annual comprehensive financial reports for the retirement plans, runs monthly benefit distributions for retirees and beneficiaries, manages the budget, and handles all other financial transactions for the department.
- The **Information Technology** division manages the Pension Administration System and provides other information technology services, planning, system development, and maintenance for the department.⁵
- The **Administration** division supports the operations of the Police and Fire Department Retirement Board, the Federated City Employees'

⁵ The Pension Administration System houses all retirement data and runs most of the retirement business transactions.

Retirement Board, and Board Committees. They also provide administrative support to Board Trustees and the Chief Executive Officer.

- The **Internal Auditor** provides an independent, objective assurance and consulting activity designed to add value and improve ORS' operations. The internal auditor is accountable to the joint audit committee of the Retirement Boards.

ORS Staff Are City Employees

ORS staff are City employees, hired by the Chief Executive Officer. Most ORS staff are members of the Federated City Employees Retirement System, except for staff in the Investment division (who are members of CalPERS, the California Public Employees' Retirement System).

ORS staff have the same benefits as other City employees and are subject to the same employment terms. Most ORS staff are members of an employee bargaining unit (either the Municipal Employees' Federation or City Association of Management Personnel); the remainder are unclassified, primarily as Unit 99.⁶

Role of the City

The City is the *plan sponsor* of the two retirement plans. The City acts as the financial backstop for the plans and is required to make employer contributions into the pension funds. These may take the form of one annual payment into the funds or contributions throughout the year.

The plans are established in the City's Municipal Code and the City Charter, and the City employs the members of the retirement plans. Unlike in some other jurisdictions, no other agencies are sponsors of the City's retirement plans.

Contributions Into the Plans

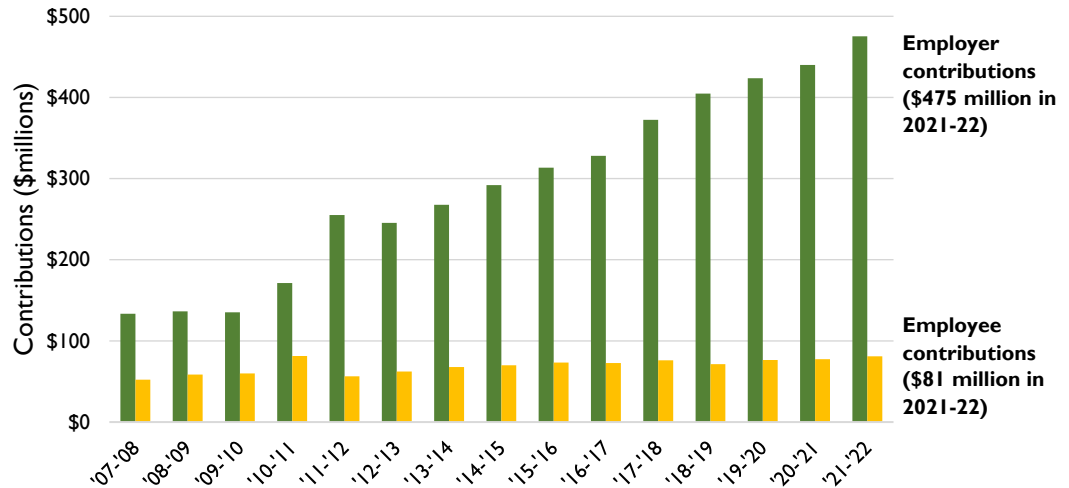
The City and current employees who are plan members contribute to the plans at a defined rate, and the City transfers the funds to ORS to manage and pay for benefits.

These retirement contributions constitute a sizeable portion of the City's budget. In FY 2021-22, the City's total contributions to the two plans included \$420 million for pension benefits and roughly \$55 million for OPEB, a total of \$475 million. For context, this is about a quarter of the City's overall spending on department budgets (which totaled \$1.8 billion that year). As such, the overall health of the Retirement plans impacts the City's budget, and thus its ability to provide services to residents.

⁶ ORS also employs temporary retiree-rehires, who are unclassified but not in Unit 99. Unit 99 includes executive management and professional staff across the City who are not members of one of the other City bargaining units.

Additionally, City employees contributed \$81 million into the plans in FY 2021-22.

Exhibit 2: Total Annual Contributions for Pension and Retiree Health and Dental Benefits



Source: Police and Fire Department Retirement Plan and Federated City Employees’ Retirement System Annual Comprehensive Financial Reports.

As of June 30, 2022, though the plan assets totaled \$7.7 billion, there was a net liability of \$4.1 billion (meaning the plans overall pension and OPEB liabilities were greater than its total assets). The difference between plan assets and liabilities is called the unfunded liability. Both the City and City employees are responsible for paying off the unfunded liability. For the City, this will continue to result in large annual contributions in coming years.

Operational Support for ORS

The City also provides some support services to ORS. This includes payroll, invoice processing, human resources (such as new employee orientation and providing benefits), information technology (such as email and network services), and employee relations (including negotiating with bargaining units on terms of employment).

The City also maintains the City Policy Manual (CPM). The CPM covers a range of topics, including ethics, workplace rules, compensation and benefits, finance, and technology. Per the City’s website:

The policies contained within the CPM reflect not only the City’s values as an employer, but also convey the standards that the City has for its employees.

Per the City’s Code of Ethics, City employees are obligated to abide by all City policies.

Audit Direction

In May 2023, the ORS internal auditor released a report regarding ORS procurement and contracting oversight.⁷ Further details on the findings in that audit are discussed in Finding I of this report.

In response to that audit, the Mayor and two Councilmembers issued a memo noting that the internal audit report found confusion among ORS staff about proper procedures and whether they are required to follow City policies. The Mayor and Councilmembers directed the City Auditor to conduct an audit of ORS to address the following areas:

1. *Identifying internal process controls for financial activities such as accounting, purchasing and contracting;*
2. *Identifying policies and procedures around information systems and security;*
3. *Compliance with City policies for financial activities, information systems and security, and other relevant administrative functions;*
4. *A comparison of the governance structures of other pension plans, including board oversight of management's administrative functions and responsibilities.*

The audit was approved by the City Council's Rules and Open Government Committee in August 2023 for inclusion in the City Auditor's Fiscal Year (FY) 2023-24 work plan. This is an interim audit addressing portions of the audit direction. More detailed testing for compliance with City policies was not included in this interim report.

⁷ The ORS internal auditor is not part of the Office of the City Auditor.

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Finding I **Alignment of ORS and City Policies Would Strengthen Internal Controls Over ORS Operations**

Summary

The Office of Retirement Services relies on City resources and support services in its operations. This includes information systems such as the City's financial management and payroll systems, and even e-mail. Staff in the Finance, Human Resources, and Information Technology Departments also provide support by processing biweekly payroll, paying invoices, administering benefits, maintaining the City's information systems, providing cybersecurity trainings, and other services. However, there is not clear agreement between the City Administration and ORS on whether all City policies and procedures in these areas are relevant for ORS, despite ORS staff being City employees. ORS has some internal procedures, but many date back to the 1990s or early 2000s and staff in some cases were unaware of them. Not having clear direction or up-to-date procedures is an internal control weakness that can lead to practical difficulties in routine operations and expose the retirement systems and the City to unnecessary risks.

Other retirement systems in California are similarly staffed by individuals who are considered employees of their plan sponsor, like San José. In these cases, the systems report that staff follow their plan sponsor's policies, or that they have adopted policies that were aligned or stricter than the plan sponsor's. We recommend that ORS and the Retirement Boards, in coordination with the City Administration, adopt City procedures around information security, procurement, and other administrative functions, or develop a set of policies that are in alignment with the City's in these areas.

ORS Operations Rely on City Resources and Support Services, But Procedures in Some Areas Should Be Clarified

ORS relies significantly on City resources and support services in its operations. However, the City Administration and ORS do not appear to agree on whether ORS staff should follow all City policies and procedures, including those areas where ORS relies on City resources or support staff.⁸

- The **City Administration** has expressed concern that ORS staff are not following City policies, such as for procurement and information security, and have outlined the risks of noncompliance.

⁸ The Retirement Boards have an investment policy, specific to the retirement plans, as the Boards have full authority over the investment of retirement funds and payments to beneficiaries.

- **ORS management** stated that in their view, ORS staff should be following most City policies, with some exceptions. Management acknowledged that which policies constitute those exceptions needs to be clarified.
- The **Retirement Boards' outside legal counsel** has stated publicly that some ORS staff follow City procedures out of habit, but not out of requirement and law.
- **Retirement Board members** reported ambiguity around which policies applied to ORS and stated that clarification in this area was needed. In September 2023, the Boards' Joint Audit Committee voted to engage a consultant to conduct a review of ORS's policies on procurement and contracting issues.

Agreement between the City and ORS management regarding adherence to most of the City's policies provides some clarity. However, ambiguity impacts the strength of ORS's internal controls. Not having clear direction for staff can create confusion around administrative processes, such as invoice processing, accounting, procurement, and information security. This in turn can be a risk for error, potential fraud, or a cybersecurity incident.

ORS Has Historically Followed City Policies and Procedures Related to Procurements and Payment Processing

The City's Finance Department (Finance) supports ORS procurement and payment processing in multiple ways. For procurements that require formal bidding, ORS uses Biddingo, the City's e-procurement system. Finance also processes purchase orders and authorizes payments on invoices through the City's financial management system.⁹

Because the Retirement Boards have the ultimate authority on how retirement funds are spent, ORS accounting and administrative staff follow their broad direction for financial activities. However, in the past, ORS has expected staff to comply with City policies for procurement. For example:

- In 2021, ORS violated Finance policies by contacting a vendor to procure goods or services without a purchase order or other agreement in place. In response to a reprimand letter from Finance, ORS' CEO stated: "We are now aware of these policies and will abide them."
- ORS staff also have City-issued procurement cards (p-cards).¹⁰ ORS Accounting staff report that they have historically complied with the City's p-card policy (City Policy 5.1.2). In addition, the ORS internal auditor's workplan includes an audit reviewing ORS compliance with the

⁹ Finance processed 12 purchase orders in FY 2021-22.

¹⁰ In 2022, 8 ORS staff had p-cards.

City's p-card policy. This workplan was approved by the Boards' audit committee.

- In 2008, the Retirement Boards adopted the City's travel policy for all Board members and staff. They passed an additional resolution in 2016 which reiterated the adoption of the City's updated travel policy.¹¹ ORS Accounting staff report filing after-the-fact memos, per Finance orders, if they have not complied with the policy.

Internally, ORS has policies regarding contract payments that date back to 1994. Staff report that generally, these internal policies are not used.

Per the California Constitution, the Retirement Boards have a fiduciary duty in the administration of the plans and have a duty to oversee management's performance of the administration of the plans. Per the City Attorney's Office, such duties would include having procurement processes in place as a means to defray reasonable expenses for the administration of the plans.

Internal Audit Findings Show Noncompliance With City Policies

ORS Accounting staff report that they have historically followed the City's procurement rules, and largely continue to do so. Two ORS internal audit reports in recent years had findings related to procurements and invoice processing.

1. In February 2020, the ORS internal auditor at that time issued an audit on cash disbursements. The audit found that invoices were paid late, and wire transfers were sent through fax, which is less secure than normal practices. The audit, which was heard by the Boards' audit committee, recommended strengthening monitoring of the invoice payment process and training staff on City policies.
2. In May 2023, the current ORS internal auditor issued a procurement and contract oversight audit. Among the findings were that ORS violated City policies and ORS practices by making wire transfers to pay invoices without authorized contracts and paid an insurance broker without a competitive selection process or a contract. These invoices related to work in the Investment Division but were not to investment managers. As such, they would typically have been paid through the Finance Accounts Payable process like other ORS transactions.

The audit noted that operationally, there is confusion among ORS staff and management about the need to follow City policy, creating procurement and cybersecurity concerns. The audit stated:

¹¹ The Boards adopted the City's 2015 update to the travel policy, but do not appear to have adopted the more recent 2019 revision.

ORS staff disagreed among themselves on whether the ORS is required to follow San José's procurement rules, as stated in the San José Municipal Code and the Finance Department's procurement policies and procedures.

The response to the audit highlighted management's differing opinion on whether City policies and procedures apply to ORS operations. At the May 2023 audit committee meeting, management indicated that overriding City policies to continue smooth operations of the plans would be repeated if necessary.

Unclear or Conflicting Direction Creates Operational Challenges for ORS Accounting and City Finance Department Staff

ORS uses the City's financial management system and processes transactions through Finance Accounting staff. In FY 2021-22, ORS had seven financial management system users and Finance's Accounts Payable Division processed over 1,000 invoices for ORS totaling \$13 million. Finance's Payroll team also processes ORS staff paychecks biweekly, like other City employees.

ORS standard processes and City procedures maintain clear segregation of duties to protect financial assets. ORS Accounting staff indicate that when transactions are processed by Finance, these controls are in place. However, the May 2023 ORS internal audit report reports that wire transfers directly from the retirement plans' custodian bank do not comply with these processes and violate basic segregation of duties.

Unclear direction on policies and procedures can present practical problems for ORS and the City. For example, Finance staff require certain documentation to be submitted with a request to pay an invoice. ORS staff are expected to provide that documentation, and it could present problems if they do not follow this requirement.

- If ORS sets policies that do not include the requirement to submit that documentation, Finance staff may simply refuse to process the payment. This leaves ORS Accounting staff in a difficult position or may prompt ORS staff to make the payment using non-standard procedures.
- Alternatively, if Finance staff do process the payment, they would be in violation of their own procedures.

In either situation, not having consistent, standard procedures in place increases the risk of error, or even fraud. In a memo to the City Auditor in response to the May 2023 internal audit on procurement and contract oversight, the City's Finance Director stated:

To ensure strong fiduciary management, uniform accounting and reporting procedures are required of public entities that conform

to Generally Accepted Accounting Principles (GAAP) as prescribed by the Government Accounting Standards Board (GASB).

ORS Uses City Networks and Applications Without Clear Adherence to City Policies

The City's Information Technology Department (ITD) supports ORS in a similar way to other departments. ORS uses the City's networks and software applications, such as the City's financial management system and the City's human resources management system. The City's ITD provides email and productivity applications. At the time of the audit, ITD hosted one server for ORS and provided network communications, identity and access management, base cybersecurity protections, and some technical support for ORS employees. Cybersecurity trainings provided by ITD are required of all City staff, including ORS staff. Due to increasing risks and the severe impacts of cybersecurity attack, the City Administration reports that all City departments are required to actively engage in cybersecurity responsibilities defined in City policy and guidelines. This includes policy compliance, security assessments, incident response, and business resilience planning and exercises. Additionally, ORS is covered by the City's cybersecurity insurance.

ITD also maintains the City's information security policies, which are included in the City's Policy Manual. ORS IT staff report that they were instructed to use an internal ORS information security policy, but that it is not adequate; ORS' current policy dates back to the year 2000. During this audit, ITD noted that they were aware of some ORS information systems that may not comply with City security standards and an assessment is required. ORS staff have also stated concerns about the current cybersecurity practices in ORS.

The ORS internal audit from May 2023 found that the delayed procurement of laptops in 2020 caused security vulnerabilities and raised operational risks because staff were accessing sensitive information on personal devices. During this audit, we were alerted that personal devices were still being used to conduct some ORS business. In the memo to the City Auditor in response to the May 2023 internal audit on procurement and contract oversight, the City's Finance Director noted that using personal computers to conduct City business is a violation of the City's Information Systems and Security guidelines.

ORS Maintains Internal Operational Procedures and Board Policies

ORS and the Retirement Boards have their own policies and procedures, separate from the City Policy Manual. These procedures cover topics such as beneficiary enrollment, benefit payments, accounting and invoice processing, investment practices, and information security.

Most of these internal policies and procedures were written in the 1990s and early 2000s. For example, the Procedures for Contract Payments was last

updated in July 1994. ORS staff report that they are not using those procedures for their current operations, and in some cases, they did not know that they existed until recently. ORS management acknowledges that the policies and procedures are out of date and are undertaking efforts to update them.

The Retirement Boards also have a set of governing policies. These include policies specific to the Boards, such as the Board Communication Policy, and policies regarding investments. They do not include policies specific to the daily operations of ORS functions.

As Part of the City Organization, ORS Can Expose the City to Certain Risks

As a department that relies on City support services, ORS can expose the City to certain risks that can have adverse impacts. Because of this, it is in the City's interests that ORS operates efficiently under a cohesive, clear set of internal controls.

- **Information Security** ORS uses City-issued laptops and connects to the City's networks. As such, cybersecurity incidents by ORS staff or through ORS devices could impact the City's networks.¹² Additionally, ORS's pension administration system contains personally identifiable information (PII) about current and former City employees.

Because ORS is covered under the City's cybersecurity insurance, City ITD reports that any ORS cybersecurity incidents would most likely increase the insurance renewal cost for the City and may result in hindering the City's ability to obtain insurance due to high risk.

As noted earlier, ORS staff have used, and reportedly continue to use, personal devices to conduct ORS business. The City Administration expressed concerns around the risks associated with this practice and the timeliness of City device procurement by ORS.

- **City Budget** From a budgetary perspective, the City is responsible for a portion of the retirement plans' unfunded liability. Any actions that would increase this liability would affect the City's required contributions into the retirement funds. As noted in the Background, contributions into the retirement funds have been a substantial cost to the City in recent years, totaling \$475 million in FY 2021-22.
- **Reputational Risk** As part of the City organization, actions on the part of ORS and ORS staff can have repercussions to the City's reputation. This could include violations of the Code of Ethics on the part of ORS staff. Additionally, if there are concerns about inappropriate procurement practices, this could damage the City's reputation with

¹² ITD conducts cybersecurity trainings that are required for all City staff. ITD tracks whether ORS staff have completed the required trainings, and reports that information to ORS management.

vendors and risk alienating key vendors in the community. In a memo responding to the May 2023 ORS internal audit on procurement and contract oversight, the City's Finance Director stated that by not following standard invoice payment processes, "ORS violated City policy and introduced significant financial and reputational risk to the City."

- **Financial Statements** The retirement funds are included in the City's overall financial statements (the Annual Comprehensive Financial Report or ACFR). Net pension and OPEB liabilities are included in the City's Statement of Net Position. In FY 2021-22, net pension and OPEB liability was the largest liability included in the City's financial statements. As a result, the financial health of the retirement funds can impact how investors view the City as a whole.

Internal Controls Are Essential to Achieve an Organization's Objectives and Reduce Risk

To meet an organization's needs, management should establish a clear and effective system of internal controls. Internal controls include policies and procedures, monitoring, and evaluating risks.

The Government Accountability Office has published *Standards for Internal Control in the Federal Government*. These standards provide guidance for management as to how to establish an effective system of internal controls. They state:

A key factor in improving accountability in achieving an entity's mission is to implement an effective internal control system. An effective internal control system helps an entity adapt to shifting environments, evolving demands, changing risks, and new priorities.

The GAO lays out a variety of principles for effective internal controls in its *Standards for Internal Control*. These include:

- **Tone at the top** (principle 1). The oversight body and management set the tone of the organization's values, philosophy, and operating style. These are fundamental for an effective control system. Tone at the top can be either a driver or barrier to effective internal controls.
- **Establish structure, responsibility, and authority** (principle 3). Per the *Standards for Internal Control*: "Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives." Delegating authority for internal control tasks through segregation of duties "prevents fraud, waste, and abuse."
- **Identify, analyze, and respond to risks, including fraud** (principles 7 and 8). Management should identify and analyze risks and determine appropriate responses. This should include an assessment of the potential for fraud.

- **Design and implement control activities** (principles 10 and 12). Management should design control activities, such as policies, procedures, techniques, and mechanisms, to achieve the entity's objectives. These should follow management's directives and address related risks, including areas such as transactions. Controls should be established at multiple levels, including at the entity level. Entity-level controls include preventions against management override and monitoring. Per the *Standards for Internal Control*: "Management should implement control activities through policies."
- **Design activities for the information system** (principle 11). Along with other control activities, management should design controls around information systems. This includes the guidance that: "*Management designs control activities over the acquisition, development, and maintenance of information technology.*"

Policies and Procedures Need Alignment to Clarify Responsibilities for City Employees

Because ORS uses City support services, alignment of procedures between ORS and City staff is important to ensure operations can run efficiently and to reduce risks. The current legal and operational guidance does not clarify how ORS and the City's processes should align and what ORS staff responsibilities are as City employees.

As noted in the Background, San José voters passed Measure G in 2014 to change and clarify the role of the Retirement Boards and their governance. The resulting changes to the City Charter are included in Appendix B.

Measure G established clear lines of authority in some areas, such as the appointment of the Chief Executive Officer and of the Retirement Board members. It did not specifically cover the question of what administrative and operational processes and policies ORS staff, as City employees, should follow. This is not specifically addressed in the Municipal Code either, where the retirement plans are codified.

ORS Staff are City Employees

ORS management, legal counsel, and the City Administration agree that ORS staff are City employees. There is not agreement on what responsibilities that entails with regards to fully following City policies and procedures.

The Retirement Boards adopted the City's Code of Ethics in February 2018. The City's Code of Ethics states:

City officials and employees are obligated to uphold the Constitution of the United States and the Constitution of the State

of California and to comply with Federal, State, and local laws and City policies. [emphasis added]

Additionally, ORS staff participate in the City's standard performance appraisal process. This includes signing that staff will adhere to the City Policy Manual (Appendix C). As noted in the Background, the City Policy Manual includes policies such as code of ethics, information security, and procurement. Even as recently as August 2023, ORS staff were signing this standard acknowledgement that they would adhere to the City Policy Manual.

ORS management stated that in their view, all ORS staff should be following the policies listed on that acknowledgement form. Despite this, ORS staff report confusion regarding whether City policies and procedures apply to them and have difficulty understanding what other set of policies would apply instead.

Benchmark Jurisdictions Generally Align Retirement System and Plan Sponsor Policies and Procedures for Administrative Functions

Like San José, other public retirement systems are operationally linked to their plan sponsor.¹³ Retirement systems we surveyed had varying approaches to administrative oversight, but generally reported that staff aligned internal policies to the city or county policies when their operations used those systems. Understanding how other jurisdictions structure the relationship between the plan sponsor and the retirement system can give insight into options that San José has for clarifying how ORS can improve their internal control system.

- **City/County Employees:** All benchmarked retirement systems reported that either all or the majority of their staff were considered city/county employees.¹⁴
- **Reliance on City/County Functions:** Benchmarked retirement systems varied in their reliance on city/county administrative functions. At a minimum, nearly all benchmarked systems reported reliance on their respective city/county for payroll for retirement system employees. Some relied on city/county support for human resources, information security, and finance functions. One system relied on their city staff for all these processes, similar to San José.
- **Alignment of Policies:** In areas where the retirement system used city/county support functions, all benchmarked retirement systems reported that staff either followed the city/county policies in those areas

¹³ Benchmarked retirement systems were Los Angeles City Employees' Retirement System (LACERS), San Diego City Employees' Retirement System (SDCERS), City of Fresno Retirement System (CFRS), San Francisco Employees' Retirement System (SFERS), Orange County Employees Retirement System (OCERS), and Alameda County Employees' Retirement Association (ACERA).

¹⁴ Orange County reported that some staff, supervisors and management, are employed directly by the retirement system. Other staff are employees of Orange County.

or aligned their internal policies with the city/county policies. In some cases, the internal policies were stricter than what the city/county required.

- **Governance Structure:** All benchmarked retirement systems shared key aspects of their governance structures with San José. All have independent retirement boards who appoint the chief executive. All but one have an internal audit function, and nearly all have audit committees. There is variation around how the internal auditor is appointed, with some appointed by the audit committee or board and others by the CEO. Some plans retain both in-house legal counsel and hired external counsel, two reported receiving general legal counsel from their City Attorney's Office; San José, like one other retirement system, only uses external legal counsel.

For complete results of the benchmarking analysis, including these and other topics, see Appendix D.

To Reduce Risk and Improve Internal Controls, ORS Policies Should Align with City Policies and Procedures

Because ORS is part of the City organization and uses City processes, alignment of policies between ORS and City staff is important to reduce risk and ensure efficient operations. Other benchmarked retirement systems have addressed this by either aligning internal policies with their plan sponsor's or by following the plan sponsor policies when applicable. ORS and the Boards should work together with the City Administration to ensure that ORS staff are following City policies, either by adopting the City policies and procedures for administrative functions, or developing a set of policies and procedures that align with the City's in key areas.

Recommendation:

- I: **To ensure that the Office of Retirement Services has efficient operations and strong internal controls around administrative functions, the Office of Retirement Services and the Retirement Boards, in coordination with the City Administration and the City Attorney's Office, should either:**
 - a) **Adopt the City's policies and procedures related to information systems and technology, and support services such as procurement, invoice processing, and other relevant administrative functions, or**
 - b) **Develop a set of internal policies and procedures that are in alignment with the City's policies and procedures.**

Conclusion

Though ORS staff are City employees, ORS management and the City Administration have provided differing direction on whether they should be following all City policies. The result is that it is not clear what internal controls apply to ORS operations, either for ORS staff or the Retirement Boards. ORS has some internal procedures, but many date back to the 1990s or early 2000s and staff in some cases were unaware of them. Not having clear direction or up-to-date procedures is an internal control weakness that can lead to practical difficulties in routine operations and expose the retirement systems and the City to unnecessary risks. To ensure that ORS has strong internal controls, ORS and the Retirement Boards should work with the City Administration and City Attorney's Office adopt City policies and procedures for ORS staff or develop internal policies and procedures that align to the City's.

RECOMMENDATION

Finding I: Alignment of ORS and City Policies Would Strengthen Internal Controls Over ORS Operations

Recommendation #1: To ensure that the Office of Retirement Services has efficient operations and strong internal controls around administrative functions, the Office of Retirement Services and the Retirement Boards, in coordination with the City Administration and the City Attorney's Office, should either:

- a) Adopt the City's policies and procedures related to information systems and technology, and support services such as procurement, invoice processing, and other relevant administrative functions, or
- b) Develop a set of internal policies and procedures that are in alignment with the City's policies and procedures.

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APPENDIX A

Audit Objective, Scope, and Methodology

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability, and our audits provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, effectiveness, and equity of City operations and services. In accordance with the City Auditor's Fiscal Year (FY) 2023-24 Audit Work Plan, we have completed an audit of the governance structure of retirement services. The audit was conducted in response to a City Council request.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objective of this interim audit report was to review policies and procedures for Office of Retirement Service's administrative responsibilities, including a comparison of other retirement system's oversight of such responsibilities. We sought to understand the relevant management controls over Retirement Services administration, and have performed the following to achieve the audit objective:

- Reviewed the Municipal Code, City Charter, and California Constitution to understand governance regulations.
- Reviewed the ORS internal audits published between October 2019 and May 2023.
- Reviewed ORS internal policies and procedures and the City Policy Manual to understand guidance provided to staff.
- Interviewed ORS staff to understand the procedures and policies.
- Interviewed City staff to understand how they support ORS operations and the impact of ORS operations on the City organization.
- Reviewed the City's FY 2023-24 Cost Allocation Plan to determine how ORS used City support services.
- Benchmarked other jurisdictions to understand how the City's retirement system governance and administrative structures compared to peers, including the cities of San Diego, Los Angeles, and Fresno; the city and county of San Francisco; and the counties of Alameda and Orange. This included sending questionnaires, interviewing staff, reviewing policies and procedures, and researching municipal codes.

We should note that many Auditor's Office staff, including this audit team, are members of the Federated City Employees' Retirement System.

We would like to thank the Office of Retirement Services, the City Attorney's Office, the City Manager's Office, and staff from Office of Employment Relations for their time and insight during the audit process.

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APPENDIX B

San José City Charter Sections 810 and 810.1

SECTION 810. Retirement Board or Boards.

- (a) The City Council by ordinance shall establish one or more retirement boards to administer the retirement plans established pursuant to Article XV of this Charter.
- (b) The term of membership, qualifications of the members and the size of each retirement board shall be prescribed by ordinance. The members of any retirement board shall be appointed and removed in a manner prescribed by ordinance with a majority of the members appointed by the City Council. The City Council shall appoint and remove the members of any retirement board in a manner prescribed by ordinance. The members of each retirement board shall be paid a monthly stipend determined pursuant to the provisions of Section 1001.1 of this Charter.
- (c) Each retirement board shall administer the retirement plan or plans that the retirement board has been designated to administer in accordance with the fiduciary duties and obligations established by law, the City Charter, and as further prescribed by ordinance.
- (d) Each retirement board shall annually adopt a budget approved by the City Council covering the entire aggregate expense of administration of the retirement plan or plans that the retirement board has been designated to administer for the ensuing fiscal year, using the same fiscal year as the City pursuant to Section 1200 of this Charter.
- (e) Each retirement board may retain or employ, by contract, attorneys to assist the retirement board on matters reasonably necessary to carry out their fiduciary duties in the administration of the retirement plan or plans that the retirement board has been designated to administer.
- (f) Each retirement board shall comply with all open and public meeting requirements established by state law and applicable Council action.

SECTION 810.1. Retirement Board; Power of Appointment.

- (a) The retirement board or boards may appoint and prescribe the duties of the chief executive officer and the chief investment officer or such equivalent positions of the Office of Retirement Services to assist in the administration of the plan or plans. Such appointed officers shall serve in unclassified positions at the pleasure of the appointing retirement board; if more than one board then the boards shall jointly appoint the chief executive officer and the chief investment officer.
- (b) The chief executive officer or the officer holding an equivalent position of the Office of Retirement Services may appoint and prescribe the duties of the professional and technical employees and clerical employees employed in the Office of Retirement Services.
- (c) In addition, when the chief executive officer or the officer holding an equivalent position deems it necessary for the good of the service he or she may suspend without pay, demote, discharge, remove or discipline any such employee in the Office of Retirement Services subject to any applicable Civil Service provisions of the Charter and any Civil Service Rules adopted thereto.
- (d) Neither the Council nor any of its members nor the Mayor shall in any manner dictate the appointment or removal of any such officer or employee whom the retirement board or boards is empowered to appoint or the chief executive officer is empowered to appoint, but the Council

may express its views and fully and freely discuss with the retirement board or boards anything pertaining to the appointment and removal of such officers and employees.

(e) Compensation set for chief executive officer, chief investment officer, or their equivalent and the investment professional staff shall be set in accordance with Charter Section 902 and the board or boards shall consider compensation of equivalent positions in comparable United States Public Pension Plans in recommending the total compensation for the positions of chief executive officer, chief investment officer or their equivalent and the investment professional staff.

APPENDIX C

Acknowledgement of Receipt and Understanding of Key Policies

I, _____, acknowledge that I have received and will review
Print Name

the following Key Policies, which are located in the City Policy Manual, as well as any other policies, including Departmental policies, listed below:

- Discrimination and Harassment (1.1.1)
- Nepotism Policy (1.1.3)
- Non-Retaliation (1.1.4)
- Code of Ethics (1.2.1)
- Gift Policy (1.2.2)
- Outside Employment (1.2.3)
- Customer Service Guidelines (1.2.9)
- Workplace Violence (1.3.1)
- Disaster Service Workers (1.3.4)
- Drug-Free Workplace (1.4.1)
- Substance Abuse (1.4.2)
- Personal Use of City Equipment (1.6.2)
- Use of Email, Internet Services, and Other Electronic Media (1.7.1)
- Mobile Communications and Devices (1.7.4)
- Information and Systems Security Policy (1.7.6)
- Use of City and Personal Vehicles (1.8.1)
- Discipline (2.1.3)
- _____

I understand that the City Policy Manual, which is located on the City's intranet, contains important information on the general rules, policies and practices of the City of San Jose. I understand that it is my responsibility to familiarize myself with the rules, policies, and practices contained in the City Policy Manual, including, but not limited to, the foregoing Key Policies.

I understand that it is my responsibility to adhere to and abide by the terms and conditions set forth in the City Policy Manual, including, but not limited to, the foregoing Policies, including Departmental policies, and that violation of City policies may result in disciplinary action.

Employee Signature

Date

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APPENDIX D

Results of Benchmarking to Other Retirement Systems

	CITY OF SAN JOSE (SJ ORS)	SAN FRANCISCO (SFERS)	CITY OF LOS ANGELES (LACERS)	CITY OF SAN DIEGO (SDCERS)	CITY OF FRESNO (CFRS)	ORANGE COUNTY (OCERS)	ALAMEDA COUNTY (ACERA)
Size of Plan (Total Members)	14,839 (as of 6/30/22)	77,003 (as of 6/30/22)	44,346 (as of 6/30/22)	21,533 (as of 6/30/22)	4,804 (as of 6/30/22)	50,633 (as of 12/31/22)	25,493 (as of 12/31/22)
Retirement staff are city/county employees	YES	YES	YES	YES	YES	SPLIT Managers and executive staff are OCERS employees. Other OCERS staff are county employees.	YES
Retirement relies on city/county support functions	YES - Finance - Payroll - HR - IT	YES - Finance - Payroll - HR	YES - Finance - Payroll - HR	YES - Payroll - HR	YES - HR - Information Services - Finance - Payroll	YES - Payroll - HR	YES - HR
Retirement staff follow city/county policies or their internal policies are aligned	City and Boards disagree on applicability of City Policy Manual for retirement staff, and internal ORS policies are outdated.	YES	YES	YES	YES	YES	YES
Retirement staff follow city/county administrative procedures	City and Boards disagree on applicability of City policies and standard administrative	This is not a code requirement, but there is an expectation for SFERS staff as city employees to	LACERS is generally subject to the same policies and procedures as other non-	SDCERS report staff are generally subject to policies, rules and practices set by the city and	This is not a code requirement, but an expectation for CFRS employees as city staff.	OCERS staff considered county employees are expected to follow the County Code of Conduct,	County gives board deference for posting, hiring, and RFPs. ACERA generally follows

	procedures for retirement staff.	follow the City Administrative Code.	proprietary city departments. There is not an explicit code requirement, but an expectation for city staff based on municipal code	the SD Ethics Commission.		recruitment rules, and salary setting.	county guidelines for this.
Retirement system has their own policies for areas such as payment processing	ORS has internal policies and procedures, dating back to the year 2000. Staff reported that, in some cases, they were not aware of policies.	SFERS staff, as city employees, generally follow city policies for any procurement or payment processing.	LACERS can develop additional or supplementary policies that should not be in conflict citywide policies.	SDCERS sets internal operational policies, rules, and requirements for staff.	CFRS does not have their own internal policies for payment processing and follow the city's policies for this.	OCERS reporting having their own procurement policy.	ACERA reports having their own policy for vendor procurement, but generally follow the county's rules for payment processing.
Board appoints the CEO	YES	YES	YES	YES	YES	YES	YES
Internal auditor(s)	YES Hired by CEO	NO	YES Audit Department Manager appointed by the General Manger in consultation with the Audit Committee	YES Board appointed	YES Board appoints/hires Independent Auditor	YES Audit Committee appoints the Director of Internal Audits	YES Chief of Internal Audits appointed by the CEO
Audit committee	YES	NO	YES	YES	NO	YES	YES

Legal support for retirement system	ORS contracts for external legal counsel. Does not have internal legal counsel nor receives support from City Attorney's Office.	SFERS is assigned legal counsel by the City Attorney's Office. The City Attorney's Office is responsible for contracting for external legal counsel for the System, as needed.	LACERS is assigned legal counsel by the City Attorney's Office. They also retain external legal counsel.	SDCERS maintains internal legal support as well as retaining external legal counsel.	CFRS only maintains external legal counsel to support retirement system operations.	OCERS maintains internal legal support as well as retaining external legal counsel.	ACERA maintains internal legal support as well as retaining external legal counsel.
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Source: Auditor analysis of questionnaire responses and interviews with benchmarked retirement systems

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TO: Joe Rois
City Auditor

FROM: Roberto Peña
Director

SUBJECT: See Below

DATE: October 10, 2023

Approved

Date

SUBJECT: Response to the audit of Retirement Services: Report on the Alignment of Controls Between the City and the Office of Retirement Services

BACKGROUND

The Office of Retirement Services (“ORS”) has reviewed the Audit of Retirement Services: Report on the Alignment of Controls Between the City and the Office of Retirement Services (“Report”), and we partially agree with the recommendation identified in the Report. The ORS response to the finding of the City Auditor’s recommendation is provided below.

Although ORS is a department of the City of San Jose (“City”), it is unique from any other City department. This is because, under San Jose Municipal Code (“SJMC”) § 2.04.3120, ORS serves and operates at the pleasure and direction of the Boards of Administration (“Boards”) for the Federated City Employees’ Retirement System (“Federated”) and Police and Fire Department Retirement Plan (“Police and Fire Plan”), who are independent fiduciaries separate from the City—the plan sponsor.

The California Constitution grants the Boards plenary and exclusive authority over the administration of the public retirement systems they are charged to oversee. Because the Boards are fiduciaries who owe a duty to the members and beneficiaries of the retirement plans, the City’s governing law provides the Boards with independence in administration so that the Boards have flexibility in how best to discharge those fiduciary duties. Indeed, the San Jose City Charter and Municipal Code acknowledge and recognize the Boards’ independence in matters relating to the administration of these public retirement systems. Charter § 810; SJMC §§ 3.28.310 (Federated), 3.36.510 (Police and Fire); *see also id.* § 3.28.100 (Federated), & 3.36.300 (Police and Fire).

ORS exists to serve the operational needs of the independent Boards in administering the retirement systems. The Boards delegate authority to ORS staff to assist the Boards in carrying out the day-to-day business operations of the plan. Although ORS carries out its functions at the direction of the Boards, it remains a City Department, subject to the City’s authority on compensation and budgeting issues.

Given this unique hybrid arrangement between the City and ORS, the Boards are engaging their governance consultant and legal counsel to clarify the rules, procedures and protocols that will apply to ORS in administering the retirement systems and will work with the City to establish ground rules where roles and responsibilities overlap.

The City in many instances has useful, existing resources that benefit ORS' operations. The City has policies on areas of ethics, conflict-of-interests, gifts prohibitions, revolving door employment that all City employees are bound to follow and the Boards may adopt. There are several areas where the City provides services for the two retirement plans (e.g., human resources, IT infrastructure, risk management, premises, etc.), and the Boards may exercise its judgment to utilize City processes.

RECOMMENDATIONS AND ADMINISTRATION'S RESPONSE

Finding 1: Alignment of ORS and City Policies Would Strengthen Internal Controls Over ORS Operations.

RECOMMENDATION

To strengthen its internal control system, ORS and the Retirement Boards should work with the City to either:

- Adopt City policies and procedures related to information technology, procurement, and other administrative functions, or
- Develop a set of internal policies and procedures that align with the City's in these areas.

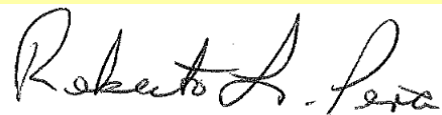
Administration's Response: The ORS partially agrees with this recommendation.

ORS recognizes that updates and improvements in policies and procedures need to be prioritized. The Boards are embarking on the process of engaging with an external governance consultant to work with our legal counsel on developing a set of policies and procedures to ensure that the Office of Retirement Services has efficient operations and strong internal controls around administrative functions. ORS will also work with the City on areas of overlap in operations, where prudent to do so and at the direction of the Boards.

Target Date for Completion: June 2024

CONCLUSION

The Office of Retirement Services would like to extend its gratitude to the City Auditor's Office which dedicated their time to the completion of this audit.



Roberto L. Peña
Chief Executive Officer
Office of Retirement Services