Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 13

MEETING DATE: October 17, 2018

SUBJECT: Final Compensation Review Policy

SUBMITTED FOR:	___ **Consent**	_X_ **Deliberation and Action**	___ **Receive and File**

RECOMMENDATION

Staff recommends the Board adopt the proposed Final Compensation Review Policy in order to affirm the administrative process devised and applied by staff in response to Government Code §31542, which was added by the California Public Employees' Pension Reform Act of 2013 (PEPRA) to the County Employees Retirement Law of 1937.

PURPOSE

This policy supports the 2018-19 Strategic Management Plan to maintain prudent funding practices that support low contribution rate volatility and plan sustainability. The policy reviews and affirms the practices that SCERS has developed to assess the Final Compensation of a retiring member and exclude any elements of compensation that are paid to enhance a member's retirement, as required by PEPRA. The policy contains no significant changes to existing practice and reflects a reformatted version of a February 20, 2013 Board memo, using the Board's policy template.

DISCUSSION

The changes and reforms that PEPRA has applied to governmental plans since 2013 are accompanied by a recognition that retirement boards have the authority and the obligation to monitor a wider range of employer activities. Included among these activities are payroll/compensation reviews for retiring members, which SCERS and other county retirement systems are required to conduct by Government Code §31542.

As explained in the attached policy, Section 31452 requires the Board to (1) establish procedures to assess the elements of compensation considered in individual retirement calculations and (2) disregard any element that is found to enhance the member's retirement benefit before finalizing the individual payment amount. In order to accomplish these objectives, Staff has been and continues to review the base wages and other compensation elements that comprise the Final Compensation of members who enrolled in SCERS or another California public retirement system prior to January 1, 2013 (and are known as legacy members)

Guidelines and communications that Staff prepared when PEPRA was first implemented provide an objective basis for determining when the individual pay elements received by a retiring member require further review. These materials also explain how the Final Compensation review process can affect the initial benefit payments for certain members and what actions must be taken in order for the Board to exclude one or more pay elements from a member's Final Compensation and the corresponding retirement calculation. By taking the information already provided in other memos, publications, and communications, and restating it within this policy, Staff hopes to provide members, employers, and other stakeholders with a single, definitive source of information regarding the compensation review process effected by SCERS for 2013 and future calendar years.

ATTACHMENT

- Final Compensation Review Policy
- "Review of Final Compensation Pay Elements," February 20, 2013 SCERS Board Memo

Prepared by:

/S/

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John W. Gobel, Sr.
Chief Benefits Officer

Reviewed by:

/S/

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Eric Stern
Chief Executive Officer

FINAL COMPENSATION REVIEW POLICY

Revision Date:	October 17, 2018	Policy Number:	024

PURPOSE

This policy reviews the authorities and standards that Staff relies on to assess the final average salary of a retiring member and exclude any elements of compensation that are paid to enhance a member's retirement, as required by the California Public Employees' Pension Reform Act of 2013 (PEPRA).

OBJECTIVE

This policy affirms the administrative process devised and applied by staff in response to Government Code § 31542, which PEPRA added to the County Employees Retirement Law of 1937. Section 31452 requires the Board to (1) establish procedures to assess the elements of compensation considered in individual retirement calculations and (2) disregard any element that is found to enhance the member's retirement benefit before finalizing the individual payment amount:

> The board shall establish a procedure for assessing and determining whether an element of compensation was paid to enhance a member's retirement benefit. If the board determines that compensation was paid to enhance a member's benefit, the member or the employer may present evidence that the compensation was not paid for that purpose. Upon receipt of sufficient evidence to the contrary, a board may reverse its determination that compensation was paid to enhance a member's retirement benefits.
> [Government Code § 31542(a)]

POLICY

Members whose retirement effective dates occur on and after January 1, 2013 have their payroll activity reviewed when Final Compensation is calculated. If a member's Final Compensation increase exceeds the wage growth assumption for SCERS by a standard factor, then the individual pay elements are reviewed for compliance with Section 31452. If Staff determines that any pay elements or elements have been paid to enhance the member's retirement benefit, then Staff recommends exclusion of the element(s) from Final Compensation and submits the matter to the Board of Retirement for final resolution.

APPLICATION

Retirement-Eligible Compensation

For those members who enrolled in a California public retirement system prior to January 1, 2013 (also known as legacy members), compensation can include base salary plus other differentials, allowances, incentives and other pay elements, depending on the member's job classification, grade or status, and possibly, the member's participation in a given bargaining unit.

As a general rule, a compensation element paid in cash in the normal course of regular employment is considered in the calculation of the legacy member's pension benefit. This includes payments received, while working, related to the cash-out of accrued vacation leave by members permitted to sell-back leave.

There are exceptions to this general rule, however, and some payments are not considered when calculating a pension, for example: (1) Payments for overtime; and (2) Payments made at and associated with the termination of employment ('terminal pay'). In addition, payments related to the cash-out of accrued leave in any year are limited to the amount of leave the member can accrue in one year.

For those members who enrolled in a California public retirement system on or after January 1, 2013 (also known as PEPRA or CalPEPRA members), compensation is generally limited to base salary.

A summary of the compensation or pay elements that are included in Final Compensation is provided as appendices to this policy.

Final Compensation Standard of Review

The review process mandated by PEPRA and addressed by this policy focuses on why a pay element is provided – that is, whether it is provided for the purpose of enhancing the member's retirement benefit. If an otherwise eligible pay element meets that criterion, then it is still to be paid to the member, but no considered for pension purposes.

A situation where a pay element may be excluded under the PEPRA standard would be where the compensation was previously provided in-kind or paid to a third party on behalf of the member, but converted to a cash payment to the member in the final average salary period – for example, if a member previously had a car provided by the employer but shifted to a cash car allowance, or if the employer previously paid a health insurance company for health care coverage for the member but the member subsequently opted to receive a cash-back payment instead.

Other examples where the PEPRA standard may result in a pay element being excluded would be: (1) A one-time or ad hoc payment not given to similarly situated members in the same job classification or grade; or (2) Severance or separation pay received by the member prior to the termination of employment.

Final Compensation Review Process

The Final Compensation review starts once SCERS receives a retirement application and occurs at the same time as many other tasks that are required to process the application.

All pay elements in the final average salary period undergo the required review. However, the scope of review corresponds to the degree to which compensation in the final average salary period exceeds the compensation prior to that period and/or the nature of the pay element(s) in question. A small increase in compensation in the final average salary period and/or common, widespread pay elements require less review. A larger increase in compensation or an unusual or isolated pay element requires more review.

In some cases, SCERS requires additional information to complete the assessment of a pay element. Depending on the item of concern, SCERS may request information from the employer, the member or both to reach a determination.

If SCERS determines there is evidence that a pay element may have been provided for the purpose of enhancing the applicant's retirement benefit, then the applicant and the employer are notified and given an opportunity to submit additional information to rebut that assessment.

If it is still believed that the pay element is provided to enhance the applicant's retirement benefit, and the applicant chooses not to contest that decision, SCERS will finalize the retirement benefit calculation. If the applicant chooses to contest the recommendation, then the matter will be presented to the SCERS Board for final determination on whether the pay element should be excluded from the calculation of the retirement benefit.

The SCERS Board will consider the matter in open session at the next scheduled SCERS Board Meeting. The retirement applicant and/or the employer will have an opportunity to submit additional written information, and the SCERS Board will make its determination on the written record.

If the SCERS Board determines that a pay element must be excluded from the Final Compensation used to calculate the retirement benefit, then the employer and the retirement applicant will be so notified, and will have an opportunity to seek review of the decision by a court of law.

Distribution of Initial Benefit Payment

The final compensation review process need not delay the first benefit payment. However, the amount of the first payment (and, if necessary, subsequent benefit payments) can be limited if the Final Compensation review process is not concluded (without issue) before the first payment is processed by SCERS.

The key factor in whether the amount of the first payment may be impacted by the Final Compensation review is the length of time between when the retirement application is submitted and the date of retirement. The earlier the retirement application is submitted relative to the retirement date, the more time there is to conduct the required Final Compensation review, and the greater the likelihood that the review will be completed by the time all the other necessary steps have been taken to issue the first benefit payment.

If there is insufficient time to complete the Final Compensation review prior to issuance of the first benefit payment, then a ‘hold-back’ amount based on the pay element(s) under review will be applied to the first benefit check, and if necessary, to subsequent benefit payments until a determination has been made regarding Final Compensation.

While the amount of a potential hold-back will vary, members should consider the possibility that initial (and possibly subsequent) benefit payments could be less than the benefit estimates they have received, and members should assess how the possibility of a reduced benefit could impact their decision to retire and/or the timing of submission of the retirement application relative to the date of retirement. SCERS will not review compensation elements and/or advise members whether particular pay elements might be excluded prior to the submission of a retirement application.

When necessary, benefit payments are adjusted after the review is completed. If all potential pay elements are included in Final Compensation, then subsequent benefit payments will reflect the higher benefit and include any retroactive amounts associated with the initial hold- back. If SCERS determines that a pay element must be excluded from Final Compensation, then the reduced benefit payment and the corresponding ‘hold-back’ will become permanent and final. If the retirement applicant or the employer elect to contest that decision in court, the benefit payments will continue to include the hold-back unless/until there is a final court ruling that the pay element be included in the retirement calculation.

BACKGROUND

With the enactment of PEPRA, the Legislature effected significant changes and reforms for governmental defined benefit plans in California. Included among these changes was a recognition that retirement boards have both the authority and the obligation to monitor a wider range of employer activities than they have in the past.

The Final Compensation process reviewed in this policy arose from an implementation memo from the former Chief Executive Officer (which the Board of Retirement discussed during their December 19, 2012 meeting) and was effected with the delivery of a subsequent memo regarding “Review of Final Compensation Pay Elements” (which the Board of Retirement discussed and approved during their February 20, 2013 meeting). Since that that time, the guidance available to members and participating employers of SCERS has expanded to include a publication regarding “CalPEPRA and Final Compensation Review at SCERS” (which was last updated during the 2015 calendar year) and a Member Handbook for legacy members (which was released during the 2017 calendar year). This policy affirms and provides a consolidated document of the longstanding practice reflected in those materials.

APPENDICES

1- Legacy Members (Entry Dates Before January 1, 2013)
2- PEPRA Members (Entry Dates After December 31, 2012)

RESPONSIBILITIES

Executive Owner: Chief Benefits Officer

POLICY HISTORY

Date	Description
12-19-2012	Board Materials for Agenda Item 14: Memo re "Implementation of AB 340 and AB 197"
02-20-2013	Board Materials for Agenda Item 16: Memo re "Review of Final Compensation Pay Elements"
08-19-2015	Board Materials for Agenda Item 17: Memo re "Proposed Amendment to the Final Compensation Review Process Mandated by CalPEPRA"
2015 Calendar Year	Updated Memo re "CalPEPRA and Final Compensation Review at SCERS"
2017 Calendar Year	*Member Handbook for Members Hired Before January 1, 2013*, p. 41: Final Compensation Review
2017 Calendar Year	*Member Handbook for Members Hired Before January 1, 2013*, Appendix A: Summary of Pension–Eligible Pay Elements

APPENDIX 1 -
Legacy Members (Entry Dates Before January 1, 2013)

Earnings Type	Description	Included*	Excluded
Regular Earnings	Paid for hours worked	X	
One Time Bonus Payment	Payments normally made once a year as a result of bargaining	X	
Overtime - includes CTO Expired	Paid for hours worked in excess of normal work schedule		X
7/12 Work Shift	Paid for regular work schedule of 12 hours per day; 84 hours per bi-weekly pay period	X	
Extra-help wages	Paid to employees who are not regular (permanent) county employees		X
Holiday-in-lieu paid after 104.0 hours	Paid for hours over the maximum of 104.0	X	
Workers' Compensation Temporary Disability	Paid Workers' Compensation benefits integrated with existing leave balances for employees who have an accepted industrial injury and are temporarily disabled	X	
State Disability Integration	Paid State Disability benefits integrated with existing leave balances for employees who are temporarily disabled	X	
Shift Differential	Paid to employees working other than the day shift	X	
Standby Pay	Paid to employees assigned to remain on call if the need arises for emergency work	X	
Food Allowance	Paid to employees hired or transferred into food service prior to July 1971 represented by Health Services Unit	X	
Terminal Pay – vacation, holiday in lieu, CTO, and leave payout	Accumulated leave balances paid to an employee upon separation from employment.		X
Special Pay Allowances	Additional pay for performing work considered to be out of or in addition to the class	X	
Incentive Pay Allowances	Additional pay for possession of educational degrees or required certificates	X	
Miscellaneous Allowances	Assignment differentials paid as a percentage of base pay	X	
Management Differential	Additional pay to managers in lieu of other benefits, i.e., tuition reimbursement	X	
Transcription Fees for court reporters	Paid to court reporters to transcribe their cases		X
Retirement Offset	Additional pay for certain employees in-lieu of the county paying ½ retirement contributions	X	
Leave Balance Usage (vacation, compensating time off (CTO), holiday in-lieu, sick leave, etc.)	Paid leave for authorized absence from work	X	
Vacation Cash-In	Additional pay for cashing in accrued vacation that does not exceed what may be earned in each 12-month period during the final compensation period	X	

APPENDIX 1 -
Legacy Members (Entry Dates Before January 1, 2013)

Earnings Type	Description	Included*	Excluded
Payoff Beyond Maximum Accrual	Additional pay for vacation or holiday-in-lieu hours over the maximum accrual	X	
Mental Health Retention	Paid to employees who work at the mental health facility	X	
Disability Pay	Additional pay that, when combined with Workers' Compensation Disability Pay, equals 50% of an employee's bi-weekly pay	X	
4850 Time Pay	Paid for up to one year, tax free, in lieu of temporary disability for Safety personnel in accordance with Labor Code Section 4850	X	
Clothing Allowance	Paid to employees for the cost of maintaining a uniform	X	
Equipment Allowance	Paid to reimburse employees who are required to provide their own equipment; i.e., court reporters	X	
Animal Allowance	Paid to employees assigned as a canine handler for scheduled work of ten (10) hours per month for ordinary care and informal training	X	
Insurance Subsidy	Cash payment of the amount of the county contribution towards health insurance over the premium, less the cost of social security	X	
Fair Labor Standards Act Adjustment	Differential paid when the value of overtime per FLSA guidelines is greater than that negotiated		X**
Insurance Subsidy Offset	An amount paid in January of each year to refund the social security reduction of the health insurance subsidy to employees who were at social security maximum	X	
Auto Allowance	Payment for use of personal vehicle for county business	X	

* Compensation can be excluded if: (a) Board of Retirement determines compensation had been paid to enhance retirement benefits, (b) compensation had previously been provided in kind and converted to cash payment in the final compensation period; (c) any one-time or ad-hoc payment made to a member, but not to similarly situated members in the member's grade or class, and (d) any payment for unused leave balances that exceed what may be earned in each 12-month period during the final compensation period.

** Per prior, written agreement, one exception has been established to the standard exclusion of the pay element reserved for FLSA adjustments. That exception is the additional “half rate” payable for 12 hours of contractual overtime to members who work 24-hour schedules.

APPENDIX 2 -
PEPRA Members (Entry Dates After December 31, 2012)

Earnings Type	Description	Included*	Excluded
Regular Earnings	Paid for hours worked	X	
7/12 Work Shift	Paid for regular work schedule of 12 hours per day; 84 hours per bi-weekly pay period	X	
Workers' Compensation Temporary Disability	Paid Workers' Compensation benefits integrated with existing leave balances for employees who have an accepted industrial injury and are temporarily disabled	X	
State Disability Integration	Paid State Disability benefits integrated with existing leave balances for employees who are temporarily disabled	X	
Leave Balance Usage (vacation, compensating time off (CTO), holiday in-lieu, sick leave, etc.)	Paid leave for authorized absence from work	X	
Disability Pay	Additional pay that, when combined with Workers' Compensation Disability Pay, equals 50% of an employee's bi-weekly pay	X	
4850 Time Pay	Paid for up to one year, tax free, in lieu of temporary disability for Safety personnel in accordance with Labor Code Section 4850	X	
Animal Allowance	Paid to employees assigned as a canine handler for scheduled work of ten (10) hours per month for ordinary care and informal training	X	
One Time Bonus Payment	Payments normally made once a year as a result of bargaining		X
Overtime - includes CTO Expired	Paid for hours worked in excess of normal work schedule		X
Extra-help wages	Paid to employees who are not regular (permanent) county employees		X
Holiday-in-lieu paid after 104.0 hours	Paid for hours over the maximum of 104.0		X
Shift Differential	Paid to employees working other than the day shift		X
Standby Pay	Paid to employees assigned to remain on call if the need arises for emergency work		X
Food Allowance	Paid to employees hired or transferred into food service prior to July 1971 represented by Health Services Unit		X
Terminal Pay – vacation, holiday in lieu, CTO, and leave payout	Accumulated leave balances paid to an employee upon separation from employment.		X
Special Pay Allowances	Additional pay for performing work considered to be out of or in addition to the class		X
Incentive Pay Allowances	Additional pay for possession of educational degrees or required certificates		X
Miscellaneous Allowances	Assignment differentials paid as a percentage of base pay		X
Management Differential	Additional pay to managers in lieu of other benefits, i.e., tuition reimbursement		X

APPENDIX 2 -
PEPRA Members (Entry Dates After December 31, 2012)

Earnings Type	Description	Included*	Excluded
Transcription Fees for court reporters	Paid to court reporters to transcribe their cases		X
Retirement Offset	Additional pay for certain employees in-lieu of the county paying ½ retirement contributions		X
Vacation Cash-In	Additional pay for cashing in accrued vacation that does not exceed what may be earned in each 12-month period during the final compensation period		X
Payoff Beyond Maximum Accrual	Additional pay for vacation or holiday-in-lieu hours over the maximum accrual		X
Mental Health Retention	Paid to employees who work at the mental health facility		X
Clothing Allowance	Paid to employees for the cost of maintaining a uniform		X
Equipment Allowance	Paid to reimburse employees who are required to provide their own equipment; i.e., court reporters		X
Insurance Subsidy	Cash payment of the amount of the county contribution towards health insurance over the premium, less the cost of social security		X
Fair Labor Standards Act Adjustment	Differential paid when the value of overtime per FLSA guidelines is greater than that negotiated		X**
Insurance Subsidy Offset	An amount paid in January of each year to refund the social security reduction of the health insurance subsidy to employees who were at social security maximum		X
Auto Allowance	Payment for use of personal vehicle for county business		X

* Compensation can be excluded if: (a) Board of Retirement determines compensation had been paid to enhance retirement benefits, (b) compensation had previously been provided in kind and converted to cash payment in the final compensation period; (c) any one-time or ad-hoc payment made to a member, but not to similarly situated members in the member's grade or class, and (d) any payment for unused leave balances that exceed what may be earned in each 12-month period during the final compensation period.

** Per prior, written agreement, one exception has been established to the standard exclusion of the pay element reserved for FLSA adjustments. That exception is the additional “half rate” payable for 12 hours of contractual overtime to members who work 24-hour schedules.

SCERS
SACRAMENTO COUNTY
EMPLOYEES' RETIREMENT SYSTEM

Executive Staff
Richard Stensrud
Chief Executive Officer
Scott Chan
Chief Investment Officer
Kathryn T. Regalia
Chief Operations Officer
John W. Gobel, Sr.
Chief Benefits Officer

For Agenda of:
February 20, 2013

February 17, 2013

TO: President and Members
Board of Retirement

FROM: Richard Stensrud
Chief Executive Officer

SUBJECT: Review of Final Compensation Pay Elements

Recommendation:

That your Board approve the recommended process and parameters for reviewing and determining whether a pay element in the final compensation period will be included for purposes of calculating a member's retirement benefit.

Introduction:

Over the last few months, your Board has approved various parameters associated with the implementation of CalPEPRA. This Memorandum will outline the proposed process and parameters for addressing the duty placed on retirement systems by CalPEPRA to determine whether an otherwise eligible element of compensation in the final average salary period will be excluded from the retirement benefit calculation because it was paid for the purpose of enhancing the member's retirement benefit (i.e., because it was intended to produce 'pension spiking'). It is important that your Board address this topic since retirement applications filed on or after January 1, 2013 (the effective date for CalPEPRA) are currently being processed and guidelines need to be established for conducting the required review.

Background:

SCERS has always reviewed compensation paid during a member's work career to assure that it was comprised of permissible pay elements, with a particular focus on the pay elements in the final average salary period that are used to determine the 'final compensation' utilized to calculate the member's retirement benefit. Prior to CalPEPRA, the rules for determining whether a compensation element was eligible for pension benefit purposes were largely grounded in court decisions from the 1990s (the 'Ventura' cases).

As a general matter, the Ventura rules stated that a compensation element paid in cash in the course of employment would be considered when calculating the pension benefit. Accordingly, as such pay elements were received over the member's working career, employer and employee contributions were made on them to provide funding for the ultimate pension benefit.

The Ventura decisions also established exceptions to this general rule, whereby compensation paid in cash would not be considered when calculating the pension benefit. Examples included: (1) Payments for overtime; and (2) Payments made at and associated with the termination of employment (e.g., payments to cash-out accrued leave balances).

It must be noted, however, that the payment in the last example above was excluded because of when it was made, not because of what it was for. In fact, up to an annual limit, the Ventura rules permitted consideration of payments for leave cash-outs if they were made in the course of employment. The annual limit for such a cash-out was the amount of leave the member could accrue in one year.

Effective with retirement applications filed on or after January 1, 2013, CalPEPRA mandates an expanded level of review of the pay elements in the final average salary period. Specifically, SCERS must now review the pay elements to assess whether an otherwise permissible pay element was paid for the purpose of enhancing the member's retirement benefit, and if SCERS determines that it was, the pay element is to be excluded from the final compensation used to calculate the retirement benefit.

The impetus for the new CalPEPRA mandate largely stemmed from the disclosure of instances where, with the cooperation of the employer, an employee received large pay elements in the final average salary period that caused the final compensation to be substantially higher than the normal level of compensation for a person in the job position. Accordingly, the pension benefit for that individual was much higher than it would have been, and higher than what would have been expected relative to the previous salary history. As a further result, the higher benefit resulted in a measure of unfunded liability since the total benefit obligation would be higher than had been assumed for benefit funding purposes.

These cases were not the result of illegal behavior, but rather, represented exploitation of the limitations of the Ventura rules. And while such cases were very much the exception, and not reflective of the outcome for the vast majority of employees, they cast public employee benefits in a bad light, and prompted the legislature to include measures in CalPEPRA for addressing and preventing such results going forward for both pre-CalPEPRA and post-CalPEPRA employees.

CalPEPRA takes two different approaches to accomplish this, depending on whether a person becomes a member of the retirement system on or after January 1, 2013, or was a member of the retirement system before that date. CalPEPRA does this to avoid potential problems associated with the 'vested rights' doctrine, which places limitations on changes that can be imposed on current employees. For new employees, the doctrine does not apply and hence there is greater freedom in establishing the rules that will be applied.

Accordingly, for members joining SCERS on or after January 1, 2013, CalPEPRA places broad restrictions on what qualifies as pension-eligible compensation (i.e., 'pensionable compensation'), with express exclusion of certain pay elements that would have been permitted by the Ventura cases.

For members of SCERS prior to January 1, 2013, CalPEPRA codified the Ventura rules regarding pension-eligible compensation (for such members, this is referred to as 'compensation earnable'), but then applies the additional level of review noted above.

The basis for the additional CalPEPRA final compensation review for pre-January 1, 2013 members can be summarized as follows: The Ventura decisions define what qualifies as a permissible pay element for pension benefit calculation purposes, but the Ventura decisions do not sanction or approve pension spiking. In fact, it can be argued that implicit in the Ventura rules is the recognition of the potential for detrimental impact from spiking, and therefore the rules place limits on what would otherwise be permissible pay elements (e.g., the exclusion of terminal pay, the limit on annual leave cash-outs). The legislature can therefore expressly declare that pension spiking is not permitted and provide a definition of what constitutes spiking. If an otherwise eligible pay element meets that definition, it can still be paid to the employee, but it will not be counted for benefit calculation purposes.

To that end, CalPEPRA declares in Section 31461 of the 1937 Act that for pre-January 1, 2013 members, compensation earnable does not include any compensation that the SCERS Board determines was paid for the purpose of enhancing the member's retirement benefit. CalPEPRA provides guidance regarding pay elements that could meet that definition through the following examples: (1) Compensation previously paid in-kind or to a third party on behalf of the member but converted to cash payment to the member in the final compensation period; (2) A one-time or ad hoc payment not given to similarly situated members in the same grade or class; and (3) Severance or separation pay received by the member while employed. Beyond that, however, CalPEPRA does not provide a specific definition of what would cause a pay element to be considered as paid for the purpose of enhancing the member's retirement benefit.

Nevertheless, CalPEPRA requires that SCERS establish a procedure for assessing and determining whether an element of compensation was paid to enhance the member's retirement benefit (see Section 31542 of the 1937 Act). CalPEPRA provides SCERS with tools for this task by declaring that SCERS can audit the employer to determine whether compensation has been reported correctly, including the authority to require the employer to provide information or make records available for inspection (see Section 31543 of the

1937 Act). CalPEPRA also places a duty on the employer to correctly report compensation to SCERS, and if SCERS determines that the employer has knowingly failed to comply with this duty – i.e., the employer knew or should have known that the compensation reported was not compensation earnable – then SCERS may assess the employer a reasonable amount to cover the cost of the audit or any necessary adjustment or correction (see Section 31542.5 of the 1937 Act).

Finally, CalPEPRA provides that the employer and/or the member shall have an opportunity to present evidence that the pay element was not paid for the purpose of enhancing the member's retirement benefit. If, despite such evidence SCERS were to conclude that the pay element must be excluded from the benefit calculation, the employer and/or the member can seek judicial review of that determination (see Section 31542 of the 1937 Act).

Discussion:

The discussion that follows outlines the proposed process and parameters that will be utilized by SCERS in carrying out the review mandated by CalPEPRA. Fundamental principles, standards and key elements of the process will be discussed, as well as the basic steps in the process. The discussion is not intended, however, to provide step-by-step details regarding the process as certain components may need to evolve based on actual experience in conducting the new level of review. Also, in some instances it is advisable that the discussion focus on a higher rather than detailed level in order to protect against possible subversion of the review process.

At the outset, it should be noted that, as previously communicated to your Board, because SCERS has already been reviewing compensation in a manner consistent with the Ventura rules, for pre-January 1, 2013 members it is expected there will be little change with respect to the pay elements that will be eligible for benefit calculation purposes. Accordingly, it is anticipated that regular, recurring pay elements provided to all qualified members in a given job classification will not be excluded from compensation earnable under the CalPEPRA standard, particularly if they were also received by the member prior to the final average salary period. A similar outcome is anticipated with respect to the cash-out of leave by those members who are authorized to do so, since permitted annual leave cash-outs are below the Ventura limit. Please note that the determination of the categories of members entitled to cash-out leave and the amount that can be cashed-out is made by the employer.

That being said, a process must still be established for assessing and determining whether an element of compensation was paid for the purpose of enhancing the member's retirement benefit, and all compensation elements will need to be reviewed under that standard.

A. Fundamental Principles:

The process proposed for your consideration is grounded in the following premises:

- The process needs to be efficient. It should take into account available resources and not unduly delay the issuance of the first retirement check.

- At the same time, the process must produce sufficient evidence and documentation to support the recommended determination regarding the pay elements.

- The level of review should correspond to the degree to which the compensation exceeds a baseline benchmark and/or the nature of the pay element in question. That is, a small increase in compensation in the final average salary period will be of less concern than a larger increase, and a common, wide-spread pay element will trigger less suspicion than an unusual or isolated pay element.

- Responsibility for obtaining/providing necessary information should be sensibly allocated between SCERS Staff and the employer and/or member. SCERS should first draw upon information within its knowledge and control before requesting additional information from the employer/member. It is expected that in most cases necessary information will be more accessible to the employer than the member and hence will be obtained from the employer.

- The affected parties should receive sufficient information to understand the nature and potential impact of the compensation review process. The employer should have a clear understanding of its responsibilities to provide information. The member should be made aware that a compensation review process will take place and receive information regarding how it might impact the member's retirement benefit. Both the employer and the member should be advised of the status of the compensation review.

- Consistency is critical. The steps taken in reviewing a pay element should be undertaken in a consistent manner and reflected in the record of the review.

- The review and evaluation of pay elements should reflect that due process has been provided in the determination. The employer and employee should have a reasonable opportunity to provide information to support their belief that a pay element should be included in the calculation of the retirement benefit.

B. Burden of Proof:

An important component of any benefit determination process is the burden of proof. The burden of proof has two components: The burden of going forward and the burden of persuasion. Typically, when a member is seeking a benefit under the 1937 Act, the member has the burden of proof (see, e.g., the disability retirement determination process). With respect to the review of compensation elements, however, CalPEPRA places the burden of proof on SCERS. With respect to the burden of going forward, SCERS must establish a process for assessing and determining whether an element of compensation was paid to enhance the member's retirement benefit. With respect to the burden of persuasion, SCERS must be able to show that the pay element meets the standard for exclusion based on the preponderance of the evidence.

Under the proposed process, the responsibility will be on SCERS Staff to undertake the necessary review and make a preliminary determination of whether there is sufficient evidence to recommend to your Board that a pay element be excluded. Your Board will then make the final decision whether the evidentiary standard for excluding the pay element has been met.

C. Scope of Review:

As previously noted, the intent of CalPEPRA is to prevent pension spiking by members in the system prior to January 1, 2013 as well as by members who join the system on or after January 1, 2013. Consistent with that intent, under the proposed process all pay elements in the final average salary period will be reviewed under the CalPEPRA standard, including pay elements received by the member prior to January 1, 2013.

As a general rule, a statute is not applied retroactively unless it expressly declares that it will be. Based on that rationale, it is possible that an employer and/or member could claim that even though a pay element might be deemed spiking under CalPEPRA, spiking was permissible when it was paid and therefore the pay element should not be excluded.

The key in this case, however, is the law in effect at the point in time when the retirement allowance is calculated, not the law in effect when the compensation was paid. Section 31705 of the 1937 Act states: "The retirement allowance shall be calculated according to the provisions of this chapter as they exist at the time of commencement of the retirement allowance." Relying on this code section, the court in Maffei v. Sacramento County Employees' Retirement System (2002) held that a recent statutory amendment giving reciprocity to a member on deferred status was not a retroactive application of a new law, but rather application of the new law at the time of the calculation of the retirement allowance.

Accordingly, consistent with the statutory language, case law and legislative intent, it is recommended that the review of compensation review required by CalPEPRA be applied to all pay elements in the calculation of retirement allowances after January 1, 2013, regardless of when the items of compensation were earned.

D. Steps in the Process:

The basic steps in the proposed compensation review process will be as follows:

- Upon receipt of a retirement application, SCERS' Benefit Staff will determine whether the pay elements in the final average salary period qualify as compensation earnable under the Ventura/CalPEPRA rules. Benefits Staff will then compare the gross compensation in the final average salary period to the gross compensation reported for the year immediately prior to the start of the final average salary period. If the compensation in the final average salary period exceeds the compensation in the year prior by a threshold amount, the individual pay elements in the year prior will be identified and compared to the individual pay elements in the final average salary period. The information will then be provided to SCERS' Accounting Staff for further analysis.

- The Accounting Staff will review the compensation comparison in light of broad payroll events during the final average salary period, e.g.: Were COLAs paid, and if so, in what amount? Were there equity adjustments for the member's job classification? If the broad payroll events fully explain the increase in compensation, the review ends. If the broad payroll events do not fully explain the increase in compensation, additional information will be requested of the employer. The employer will be required to provide the information by a fixed date so as to limit potential delay in the processing of the retirement application.

- If necessary, the Accounting Staff will undertake additional audit procedures in order to obtain information regarding a pay element under investigation.

- The information assembled by the Accounting Staff will be reviewed by the Chief Executive Officer, Chief Benefits Officer and SCERS' legal counsel. If the conclusion is that there is sufficient evidence to establish that the pay element was provided for the purpose of enhancing the member's retirement benefit, the employer and member will be notified of the determination and invited to submit additional information to rebut that determination.

- If, after reviewing any additional information submitted by the employer and/or member, Staff continues to believe that the pay element was provided for the purpose of enhancing the member's retirement benefit, Staff will present a recommendation to your Board that the pay element be excluded from the calculation of the retirement benefit. The employer and member will be notified of the recommendation and given a final opportunity to provide information to rebut that recommendation by Staff.

- A staff recommendation to exclude a pay element, and any information provided by the employer and member to rebut that recommendation will be considered by your Board in open session at the next scheduled Board Meeting. Your Board's consideration of the matter will be 'on the written record' and will not include oral testimony unless so desired by your Board.

- If your Board approves the Staff recommendation, the employer and member will be so advised and will have the opportunity to have the decision reviewed by a court.

E. Use of Hearing Officer in Decision to Exclude a Pay Element:

The proposed compensation review process does not include involvement of a hearing officer comparable to the approach utilized in the disability determination process. This is because there is no body of case law or prior administrative decisions interpreting and applying the CalPEPRA standard for excluding a pay element for a hearing officer to draw upon in developing a recommended decision. As a result, involvement of a hearing officer at this juncture could lead to inconsistent and incompatible recommendations and complicate the development of a clear, consistent standard.

Involvement of a hearing officer can be re-considered when your Board or a court has had an opportunity to establish some precedent in this area and/or if the need for such determinations becomes numerous or time consuming.

F. Communication with the Member:

Efforts will be made to advise all prospective retirees that pursuant to the requirements of CalPEPRA, pay elements in the final average salary period will be reviewed and that such review could result in a pay element not being considered in the calculation of the member's retirement benefit. Information regarding this matter will be placed in the Member Handbook, retirement application packet, and on the retirement application. Information will also be placed on the SCERS website retirement benefit calculator. The goal is to try to assure that members understand that any benefit estimates they receive may not match the benefit that is ultimately paid.

G. Issuance of the First Retirement Allowance:

As previously noted, a goal of the proposed process is to not unduly delay issuance of the first benefit check. A challenge in this regard is that the time between when SCERS receives a retirement application and the effective date of retirement can be very short. Accordingly, in some cases the time necessary to complete the compensation review could extend past the date when the first benefit check would normally be issued.

To address that possibility, under the proposed final compensation review process the first check will be issued when all other necessary retirement processing elements have been completed, but the first check (and if necessary, subsequent checks) will be reduced by a 'hold-back' amount commensurate with the size of the pay element under review. When the review is completed and final compensation earnable has been determined, future benefit payments will be adjusted appropriately, including payment of any retroactive amounts due. If the decision by SCERS to exclude a pay element is appealed in court, the benefit payments will continue to reflect the hold-back until such time as the court orders that the pay element be included in the benefit calculation.

H. Refund of Contributions:

If it is determined that a pay element should be excluded because it was paid for the purpose of enhancing the member's benefit, the question arises whether the employer and member contributions made on the pay element when it was paid must or should be refunded. Unfortunately, CalPEPRA is silent on the topic. A further complicating factor is that it is very problematic under federal tax law for a tax qualified plan like SCERS to refund monies paid into the pension trust except in certain limited circumstances. The complications increase when the party who will receive the refund is a retiree and no longer an active member in the system.

One could argue that it is not necessary to refund the contributions to the member because the contributions add to the total contributions available to the member's beneficiary in the case of a refund of contributions due to the member's death early in retirement. In other words, no refund is required because the member will receive value for the contributions. However, this particular outcome is somewhat rare, and in most cases the contributions will not increase the pension benefit because the pay element on which they were based has been excluded from the benefit calculation. It would seem, therefore, that refunding the member's contributions would be both appropriate and fair.

On that assumption, and given the complications associated with SCERS providing such a refund, the proposed compensation review process contemplates that if and when a refund of member contributions is required, it will be done by the employer.

The rationale for doing so is twofold: (1) Placing the responsibility for providing the refund on the employer is consistent with federal tax law requirements in comparable 'correction' situations; and (2) It is supported by the provisions of CalPEPRA that authorize SCERS to assess the employer a reasonable amount to cover the cost for any necessary adjustment or correction if SCERS determines that the employer knew or should have known that the compensation reported was not compensation earnable (see Section 31542.5 of the 1937 Act). Since the pay element was knowingly paid by the employer and was excluded because it was provided for the impermissible purpose of enhancing the member's benefit, the employer can be viewed as having knowingly reported compensation earnable incorrectly and therefore must be responsible for dealing with the contributions.

I. Subsequent Legislation:

As with other elements of CalPEPRA, subsequent legislation may be necessary to provide additional direction and guidance with respect to the final compensation review process.

For example, the complications associated with refunding contributions are not limited to SCERS. Similarly, it is understandable that employers may not be pleased with being deemed responsible for resolving the problem of contributions on excluded pay elements. Accordingly, this is an area where additional legislative action may be forthcoming to clarify responsibilities and/or provide a more effective means for addressing the situation.

If and when subsequent legislation requires a change in the final compensation review process, it will be modified accordingly.

I hope this information is helpful. I will be happy to answer any questions you might have.

Respectfully,

Richard Stensrud
Chief Executive Officer