



# **Analysis of the Governance Practices of the Midland Firemen's Relief and Retirement Fund**

## **Report 2 of 2**

Prepared for:

City of Midland

December 29, 2022

This Report is intended solely for the information and use by the City of Midland and such other persons or entities designated by the City of Midland. It is not intended to be used, and should not be used, by anyone other than the specified parties.



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This report presents the results of our procedures performed in connection with Weaver and Tidwell, L.L.P.'s ("Weaver," "our," or "we") Governance Review ("review") of the Midland Firemen's Relief and Retirement Fund ("the Fund"). The objectives of our review were to perform an independent evaluation of the Fund's governance practices and compliance with the Texas Local Fire Fighters Retirement Act ("TLFFRA" or "TLFFRA Statute"), including review of documented policies and procedures, and communication protocols.

To accomplish the engagement objectives, our procedures included confirming our understanding of current processes and interviewing Fund personnel. Procedures also included reviewing available documentation, and testing compliance with policies, procedures, and applicable regulations. Our review focused primarily on the current state of Fund governance.

The findings included in the accompanying report are based on evaluating our review criteria against TLFFRA requirements and governance practices demonstrated by similar retirement funds.

This report is intended solely for the information and use by the City of Midland, the Board of Trustees of the Fund, and the Texas Pension Review Board, and is not intended to be used, and should not be used, by anyone other than the specified parties.

*Weaver and Tidwell, L.L.P.*

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December 29, 2022

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## I. Background and Scope of Review

Weaver evaluated the adequacy and effectiveness of certain governance practices of the Midland Firemen's Relief and Retirement Fund ("the Fund" or "Plan") and assessed the Fund's compliance with the Texas Local Fire Fighters Retirement Act ("TLFFRA" or "TLFFRA Statute").

The Fund is a single-employer defined benefit pension plan covering substantially all fire department employees of the City of Midland, Texas. The Fund is subject to the provisions of the Texas Local Firefighters' Retirement Act (Article 6243e, Vernon's Texas Civil Statutes 45th Legislature 1937), as amended. All fire department employees are members of the Fund as a condition of their appointment. The Fund had approximately 427 members, including retirees, active members, and beneficiaries<sup>1</sup>

The Fund is governed by a Board of Trustees ("the Board" or "Trustees") which are authorized to evaluate and approve all retirement applications, disability claims, and beneficiary designations. The Board is responsible for the oversight and management of the Fund on behalf of its members and is comprised of three active fire fighters elected by their peers, two local government representatives from the City of Midland, and two volunteer citizen positions that are selected by the Board. The Fund also has one employee, the Administrator of the Fund.

The Fund has approximately \$82M in assets under management, invested in Equity, Fixed Income, Alternative Investments, and Cash.<sup>2</sup>

The scope of our review included the following aspects of board and corporate governance:

- Assessing fundamental governance practices;
- Evaluating the adequacy of administrative oversight procedures of the Fund specific to the Board;
- Evaluating completeness and accuracy of Fund policies and related documents;
- Evaluating existence and adherence of Fund policies benchmarked against common practices of retirement plans and funds;
- Assessing compliance with Fund documents in connection with the TLFFRA Statute; and
- Evaluating whether Board actions in response to the Pension Review Board's ("PRB") Intensive Actuarial Review of the Fund in November 2021 were sufficiently addressed.

<sup>1</sup> From the 2021 Financial Statements Audit Report, issued August 2022

<sup>2</sup> As specified in the MTO Finance Draft Plan Performance Report dated September 30, 2022

## II. Executive Summary

The Board does not currently have a full complement of governing policies and protocols established, which increases the risk that oversight and monitoring of Fund activities will be ineffective. The Board uses the TLFFRA Statute as the primary governing document rather than developing a set of Fund governance policies. Using this approach, however, does not address key areas of governance including responsibility, accountability, and authority. A well-articulated governance structure provides the mechanism for the Board to function effectively over time to address market volatility, changes in membership, and Trustee retirements.

The Trustees appear to understand their role as fiduciaries to manage the assets the Fund, oversee benefits to members, and perform certain monthly and quarterly monitoring activities. However, without well-structured and defined governance, including oversight and monitoring protocols, there is increased risk of ineffective execution and lack of consistent operations in the following areas:

- Inter-generational, long-term sustainability of the Fund through consistent Board practices
- Trustee onboarding, training, and succession planning
- Ethics policies and conflicts of interest
- Risk management and risk assessments
- Investment due diligence, monitoring and investment performance reporting
- Meeting actuarial funding obligations
- Compliance with laws and regulations
- Due diligence over engaging and monitoring of third-party investment manager performance
- Fund administration and monitoring fees
- Transparency in communications and reporting

Based on our procedures, the following summarizes our findings. Each finding, along with respective recommendations, are more fully described below in the *Findings and Recommendations* section to this report. Addressing these issues will assist the Board to build a stronger and more structured governance program for consistent, long-term Fund oversight and sustainability.

### High Risk Findings<sup>3</sup>

1. The Board has not established a comprehensive Governance Policy that outlines the roles and responsibilities of Trustees and defines requirements essential to establish a long-term framework for effective governance. The Board has chosen to use the TLFFRA Statute rather than develop governing policies. Though this approach may address regulatory requirements, it does not define the responsibility, authority, or accountability expected of a Fund Board or provide guidance on Board interpretations of the Statute.
2. **The Board's approach** in responding to issues identified in the 2021 PRB report and the 2022 Foster & Foster report did not address and provide remediation plans for many of the issues raised. This includes developing a risk assessment and action plans to mitigate key risks.
3. The current Investment Policy Statement (“IPS”) does not address certain key requirements necessary for effective oversight of the Fund’s **investments**. The IPS does not include, or is unclear, on certain key elements that would be expected for a pension fund of equivalent size with a similarly complex investment portfolio.
4. The Fund is not following the Asset Class definitions in the IPS, and alternative investments are misclassified as equity investments in current Board reports. As a result, the Fund is slightly outside established allocation thresholds for U.S. equities, alternative investments and cash positions without planned Board action to accept, monitor, or remediate the breaches. Additionally, related portfolio performance reports are not aligned with allocation targets and thresholds to provide transparency of investment activity to Trustees and members. While these reports are being refined, they are currently included in Board meeting materials.
5. There are administrative issues related to information security, efficiency, and record keeping. Specifically, there are concerns regarding the use of personal email for Fund business and selection of investment and other consultants has occurred without proper due diligence and Board resolution.
6. The Code of Ethics Policy does not address certain conflicts of interest that are relevant to the Fund and the Board.

<sup>3</sup> The risk rating definitions are provided in the Appendix.

7. The Board has not established a stable Funding Policy that defines key elements required for effective long-term administration and stability. The Board has chosen to utilize the TLFRA Statute rather than adopt a specific Policy, and as a result, **has not clearly articulated the Board's responsibility, accountability and authority over this process.**

#### Moderate Risk Findings

8. The Midland FRRF Plan Document does not reflect, or needs to clarify, how certain requirements of the Texas Local Fire Fighters Retirement Act are being met.

#### Action Plans and Remediation

Based on the results of our review, we consider the findings presented to be collectively critical and time sensitive. We recommend action plans be developed and implemented as soon as possible, in addition to fully addressing the findings presented by the PRB in their report issued in November 2021. Developing and implementing action plans to remediate the findings will greatly strengthen governance of the Fund.

At a minimum, action plans should document the root cause of the finding, risk levels, planned actions, responsible parties, necessary resources, required data or information, and a reasonable timeframe for remediation. Progress of the remediation plan should be monitored by the Board, with third-party assistance if deemed necessary. In creating action plans, using industry guidance and best practices by peer funds will provide a roadmap for execution that is sustainable over time. Action plans should also assess the requisite skills and resources necessary for remediation.

The Board should add a standing agenda item to meetings to monitor the approach, progress, resourcing and proper disposition of the issues described in this report.

We recognize that Trustee efforts have been ongoing, and while there is evidence of progress before and since the PRB Report, additional remediation is necessary to achieve sound governance of the Fund. The Trustees, Administrator, and Fund's consultants cooperated with us during the review and were accessible for interviews and follow-up questions.

### III. Findings and Recommendations

Our detailed findings and recommendations are presented below. The risk rating definitions are provided in the Appendix to the report.

#### High Risk Findings

##### 1. Establishing an overall Board Governance Policy:

The Board does not have a policy outlining the roles and responsibilities of Trustees that includes requirements essential to establishing a long-term and sustainable framework for effective governance. The Board has chosen to use the TLFRA Statute rather than develop a governing set of policies. While this does address regulatory requirements, it does not define the key governance elements of responsibility, authority, or accountability expected of a Fund Board, or provide guidance on Board interpretations of the Statute. Key elements of the Board's policy should, at a minimum, include:

- a. *Board Size, Composition, and Self-evaluation Criteria:* The Board currently meets the TLRFFA standards for size and composition, though this requirement is not defined in existing documents. Additionally, there is no policy or procedure of the Board for conducting self-evaluations on the areas they are responsible for overseeing.
- b. *Term Limits, Elections, and Succession Planning:* Term limits are not defined and a number of Trustees have historically been long-standing members for over 20 years. While continuity of service is not a concern, the policy should define whether there are term limits and provide guidance on how to ensure a smooth succession plan for Trustee transitions.

Also, a policy is not in place that defines the qualifications recommended for selection of new Trustees, the timing of elections, the process by which those elections occur, and who is responsible for calling for an election.

##### c. *Transparency in Reporting:*

- A policy has not been established that defines how the roles, responsibilities and expectations of the Board, their decisions, and the Fund's status are reported to Fund members.

- Board policies, actions taken, actuarial reports, investment performance, and Fund holdings are not consistently made available to members via the website, and a number of links on the site are not functioning properly.
- d. *Board Committees:*
- The roles of the Investment Committee are not clearly defined in policies or a charter. The Investment Committee appears to be the only consistent committee of the Fund and is responsible for making investment recommendations to the Board.
  - There are currently no clear definitions of what materials are to be presented at Board meetings, when the materials are to be made available to Trustees, and what is required to be provided to members to meet the transparency expectations of the Fund.
- e. *Oversight of Fees, Expenses, Transactions, Third Parties, and Operations:* The Board has oversight of these activities, though there are no policies or procedures that define: (a) Board responsibilities, (b) what reports are required for monitoring, (c) transaction limits and (d) what duties individual Trustees and Administrators are responsible for to ensure objectives are achieved.
- f. *Trustee Training:* The Board does not have a policy on Trustee training and what is required for each Trustee to understand their role as a fiduciary of the Fund. There are also no requirements documented for new Trustees as part of the onboarding process or for existing Trustees regarding administration, Fund oversight and regulatory requirements. New Board members are provided a copy of the TLFRA Statute and current Plan Document to review as part of their onboarding process.
- g. *Statutory Reporting:* The Board has not established policies or procedures for completing statutory reporting to the PRB, including Investment Expense Reporting, Investment Practices and Performance Evaluations, and Investment Reports. The PRB expressed concern due to delays and inaccurate statements provided. These items have yet to be addressed by the Board in policy or procedures to prevent future reporting issues.
- h. *Governance Manual:* The Board has not aggregated key policies and procedures into a Governance Manual that is reviewed annually to provide guidance to Trustees and disclosure to members. Policies and procedures should be provided on the Fund's website as best practice and may include, but not be limited to, ethics, elections, funding, travel, gifts, public participation in meetings and investment and strategy documents.

Recommendations:

The Board of Trustees should establish a Governance Policy for the Fund that addresses each of the areas listed above to better define the roles, responsibilities and practices of the Board within their capacity as fiduciaries. Areas to address include:

- a. Board size, composition, and self-evaluations
- b. Term limits, elections and succession planning
- c. Transparency to members
- d. Roles and responsibilities of the committees of the Board
- e. Oversight of fees, expenses, transactions, third parties and operations
- f. Trustee training requirements including both new and existing Trustees
- g. Statutory reporting
- h. The creation of a Fund Governance Manual that aggregates the policies, the Fund's plan document, procedures and key Fund administrative documents. These documents should be reviewed annually by the Board and Administrator to identify necessary updates regarding current practices, regulatory expectations and other industry guidance.

Each of the above areas should be reviewed in conjunction with governance guidance available from the Government Finance Officers Association ("GFOA"), the Chartered Financial Analyst ("CFA") Institute and other sources so that specificity of current practices are reflected in Fund policies.

Additionally, the Fund Administrator should review the current Midland FRRF website and update the links and documentation to increase transparency to members on investments, financial condition, and policies. Where technology support is required, the Board should be informed so they can address any resource needs.

## 2. Board Responses to Key Issues Raised by the PRB:

The November 2021 Intensive Actuarial Review by the PRB raised a number of significant issues, including the long-term sustainability of the Fund. To date, the Board has not developed an action plan to fully address the PRB findings and a number of issues remain outstanding. Given the extent of time since the PRB report was issued, the Board should assess progress through an issues tracking document to monitor concerns raised, along with progress of the remediation plans that ensure appropriate timeframes for resolution. Where management identified evidence contradicting issues reported by the PRB, documentation should be reviewed by the Board and provided to the PRB for disposition.

Based on the results of the governance review, the following critical matters remain outstanding:

- a. *Establishing a Funding Soundness Plan:* The Board has not established a Funding Soundness Plan. Management has indicated they are awaiting the results of the Forensic and Governance reviews and require more accurate portfolio reporting to effectively respond. The May 2022 Actuarial Report by Foster & Foster also indicated a number of Fund changes that remain outstanding and have not been addressed by the Board. While progress has been made, it would be expected that action plans that respond to findings, along with target implementation dates, be monitored by the Board to ensure issues are remediated timely.
- b. *Providing accurate total portfolio returns prior to 2022:* The lack of accurate portfolio reporting was a known issue of the Board and additional details **are included in Weaver's** Midland FRRF Forensic Audit Report. Despite knowledge and discussion of this critical issue since 2014, the Board failed to implement a workable solution until MTO Financial Services ("MTO") was retained in November 2021. While the MTO reports remain in draft, they were issued as part of in the most recent Board presentations to review Fund performance.
- c. *Selection of an Investment Consultant and defining their role:* The Board has not formally approved and documented its selection of an investment consultant for the Fund; however, the Investment Committee indicated in its May 2022 meeting that Parenteau Analytics would analyze the portfolio and make recommendations to the Committee due to **the firm's** long-standing relationship with the Fund. This positioned Parenteau Analytics as the Investment Consultant without Board resolution, and with no documented due diligence performed on the qualifications or recommendations on how current issues will be addressed. Additionally, there was no contract or agreement with Parenteau Analytics as to the scope of services provided and there was no consideration of other potential qualified consultants by the Board or Investment Committee. Parenteau Analytics resigned as a consultant to the Fund, effective January 12, 2023

The IPS reflects that the Investment Consultant is considered non-discretionary and is not authorized to modify allocation targets or recommended investment portfolio weighting. Parenteau Analytics was scheduled to perform quarterly updates to the Investment Committee, and no regular presentations were made to the full Board on potential allocation changes based on market volatility or opportunities.

- d. *Allocation of Investments:* The PRB indicated that the Fund allocation is complex and has a high allocation to real estate and alternative assets. This may not be appropriate given the size, resources and liquidity needs of the Fund. Based on our review, there have been no changes evident to the allocation ranges or targets, and there remains a high asset allocation to real estate.
  
- e. *Providing appropriate Transparency to Members:* As noted above in issue 1c, the Board has failed to address the concerns raised by the PRB regarding the availability of expected information and reports to members of the Fund. The Fund Chairman and Administrator indicated this issue is being resolved, though a number of reports continue to have missing information.
  
- f. *Fund Reporting:* The Board has not defined the key data and ratios that demonstrate a clear link between asset management and the Fund's liability ratios; specifically, the following key reporting elements have not been developed: (a) unfunded actuarial accrued liability (UAAL), (b) Funded Ratio, (c) UAAL as a % of payroll, (d) assumed rate of return vs actual, payroll growth rate, and (e) actual vs assumed contribution rates. Parenteau Analytics has indicated they are working to provide certain data by second quarter 2023, though this timeframe could be extended due to the Fund missing key information and data points.

Recommendations:

To strengthen governance and oversight, the Board should use the findings and recommendations in the PRB Report to help structure and implement a long-term action plan. The action plan should include description of the root cause of the findings, risk levels, planned actions, responsible parties, necessary resources, required information and reasonable timeframes for implementation. The action plan should be reviewed and approved by the Board and set as a standing agenda item to monitor progress of specific actions.

A structured plan and approach to remediate findings would help identify areas where outside resources are necessary to help achieve objectives and where additional focus is required by the Board. It is evident that actions are taken in certain areas, including Portfolio Reporting, though there has not been significant progress toward full resolution of issues. Due to the current approach, there is increased risk that critical exposure items will not be addressed timely.

Other actions necessary to address PRB findings include:

- a. Develop a long-term Funding Soundness Plan (“Soundness Plan”) using information from the Fund’s most current actuarial reports by Rudd and Wisdom, and the recommendations from the May 19, 2022 Actuarial Report by Foster & Foster. Developing a soundness plan should be done in collaboration with the City of Midland and the Investment Consultant. The Soundness Plan and progress should be continuously monitored and made a standing agenda item by the Board in future meetings.
- b. Continue progress on providing portfolio return reports across each asset class and for the Fund in total. Once final, the reports should be included in Board materials going forward.
- c. Establish clear hiring criteria for the Investment Consultant, including specific experience with pension plans and funds, certification requirements, and other technical expertise. Once criteria has been established, the Board should utilize those requirements when issuing requests for proposal (“RFP”) to evaluate and secure consultants.

Additionally, the Board should evaluate whether the current non-discretionary advisor and quarterly reporting by the Investment Consultant to the Investment Committee is sufficient based on current market volatility, complexity of alternative investments, extent of illiquid assets, and existing funding concerns.

- d. Reassess target allocations across asset classes, with a specific focus on alternative, illiquid assets to determine the most prudent investment approach. Changes to the allocation should be documented in the Investment Policy Statement and any rebalancing should be reported to and approved by the Board.
- e. The Board and Administrator should evaluate obstacles that prevent consistent disclosure of key information to members and establish a process for consistent reporting. The process should be clearly documented and repeatable so that temporary staff can perform if resource constraints exist. The Board should also assess whether new technology or staff resources are needed and seek to identify and retain those resources.
- f. The PRB Report should be used to develop reporting protocols that help accomplish governance and oversight objectives. The reporting requirements should be provided to the Investment Consultant and included as part of the negotiated contact discussed in

Finding and Recommendation 2c above. Where data challenges exist, those should be clearly documented and monitored by the Board until resolved.

### 3. Structure and Compliance with the Investments Policy Statement

The Board updated the Investment Policy Statement (“IPS”) in November of 2021. However, the Policy does not address, or is unclear, on how Trustees manage the following key elements of the Fund:

- a. *Investment Committee*: The IPS does not address the role of the Investment Committee and its Trustee Members. The Investment Committee has historically completed all investment research, manager evaluations, and provided recommendations to the Board on investments or divestitures. The Investment Committee continues to perform these functions without clearly defined guidelines.
- b. *Allocation Plan Development*: The IPS does not address how the allocation plan is defined, taking into account actuarial returns, risk expectations, growth vs. income, liquidity, volatility, investment time horizons, monitoring and compliance. These factors are critical to establishing Fund guidelines and meeting expected rates of return and cash needs.
- c. *Asset Allocation*: The Fund allocation ranges and target weights in the IPS are not clearly defined, as there are two different allocation ranges listed that have the following variances:
  - Alternatives: the Min / Max allocation ranges are either 15-30% or 20-35% and the target weight is 35%, which is outside or at the maximum of the allowable range.
  - Equities: There are two different target weights listed, 35% and 40%.
  - The definition of alternatives is broad. It currently does not provide allocation targets for real estate, private equity, and specialty strategies for hedged positions or high derivative use.
- d. *Rebalancing and Allocation Breaches*: The IPS does not require the Board to receive monthly reporting on allocation targets. Additionally, there is no reporting on how breaches or near breaches in allocation are escalated to the Board, monitored and assessed due to market conditions, liquidity, income and risk. The IPS specifies that allocation ranges are not intended to require portfolio activity reporting and exceeding

- targets are treated as discussion topics in quarterly meetings. However, the fund is currently in excess of the IPS threshold for cash holdings, and there has been no reporting evident in Board or Investment Committee minutes.
- e. *Liquidity*: The IPS does not address reporting on liquidity, despite a high allocation to illiquid assets, including private equity and real estate. There is also an ongoing concern related to the underfunded status of the Fund.
  - f. *Valuation*: The IPS does not reference required valuation practices for investment positions. This is specifically relevant due to the high allocation in alternative investments where valuation requirements should be clearly defined.
  - g. *Total Benchmarks*: The IPS does not specify a total portfolio rate of return benchmark and certain benchmarks referenced in the IPS are not included in current monthly performance reports.
  - h. *Investment Manager Selection*: The IPS discusses the role of Investment Managers, but does not address how managers are selected, what materials must be provided, such as fund performance, Global Investment Performance Standards (“GIPS”) requirements, Service Organizational Control (SOC) reporting, financial statements, SEC filings, manager changes, compliance or cybersecurity issues. Additionally, there is no documented process for how manager selection evaluations are scored, how evaluations are presented to the Board for resolution, and what documentation is retained by the Administrator.
  - i. *Investment Manager Evaluations*: The Policy indicates that certain events trigger when an Asset Manager is placed on “watch notice” or when a more thorough review is warranted; however, the Board has not defined when and how this will occur.

Also, ongoing manager due diligence evaluations do not have defined requirements or show evidence regarding the review of reporting threshold reviews, peer comparisons, required quarterly or annual reporting, style or strategy assessments, fee monitoring, or compliance event reporting, as would be expected by a retirement fund outsourcing its investment management activities. The evaluation practices prescribed by the IPS are also insufficient and do not specify what steps and documentation should be provided by the Investment Manager.

- j. *Alternative Asset Due Diligence:* The IPS does not address the requirements for performing due diligence on alternative investments, which include private equity, hedge funds, and real estate, all of which have a higher allocation than would be expected for a Fund of this size. Also, the IPS currently does not require review by legal counsel or provide guidance on the structure of the due diligence to be performed. For complex investments, there is no Policy or guidance on the assessment of the initial and ongoing investment process, including review of available forms, including private placement memoranda, limited partnership agreements, SEC Form ADV, fees structures, cash flow waterfall calculations, comparison against peers, catch-up and claw-back provisions, general partner commitments, financial statements, and other fund details to effectively oversee the investment strategy.

Additionally, in prior years certain Investment Committee members performed due diligence of Fund real estate acquisitions, which, from a standard industry practice, is outside of the role and expectations of Investment Trustees of similar size portfolios. The in-person assessments were discussed at the Investment Committee meetings, though no supporting documentation was retained of the due diligence performed. As mentioned above, there are no procedures or training as to what should be evaluated, no clear structure to performing due diligence, no retention of financial analysis performed, and no specific qualifications required by Trustees to perform these evaluations.

- k. *Investment Consultants:* While the IPS addresses using Investment Consultants to assist the Board in managing the investment process, the requirements of the Consultant are very limited to provide only non-discretionary recommendations, assist with investment management searches, or to perform due diligence when directed. Additionally, the Board has not established requirements for the selection of the Consultant, including required experience, expertise with pension funds, alternative investments, certifications required, requirements for financial stability and other key attributes of an investment consultant. The IPS further **does not indicate how the Board will oversee the consultant's performance in fulfilling their duties.** The Board, and specifically those in the Investment Committee, have historically acted as the Investment Consultants for the Fund and are continuing to do so.
- l. *Fees and Costs:* The IPS contains a section on measuring the costs associated with management of the Fund; however, fees and costs of the Fund are not evaluated using

existing portfolio reports. Also, there is no contract in place with a firm or individual to provide this data to the Board.

- m. Board Reporting: The IPS does not address the reports required for the Board to govern the Fund. While progress is ongoing to develop the necessary Performance Reports, the Board has not defined what additional information is required and when the reviews will periodically be performed.

Recommendations:

The Board should review the current IPS and investment allocations to address the areas identified above. At a minimum, the IPS should be updated annually, with Trustees able to raise any concerns on a more immediate basis. Specifically, the Board should update the IPS and/or policies where necessary to:

- a. Describe in the IPS the roles, responsibilities of the Investment Committee. Assess whether this Committee should meet during a stand-alone session or be part of existing Board meetings, as is the practice in similarly sized funds.
- b. Provide guidance in the IPS on how the Fund allocation plan is determined and what data should be assessed by the Board to determine allocation ranges and targets. The Board should document the actions taken and report when an allocation is in breach of a specified range for a given asset class.
- c. Clearly state in the IPS specific allocation target ranges and weights and provide further clarity on alternative investments for monitoring by the Board.
- d. Include in the IPS the monthly Board reporting requirements related to allocation of the Fund and how it aligns with IPS target weights and ranges. When asset class allocations are near or outside of IPS ranges, the IPS should specify:
  - Disclosure requirements as to whether the breach was active or passive
  - Requirements of an action plan, including potentially rebalancing the Fund
  - How the action plan will be monitored
- e. Address Fund liquidity in the IPS and include acceptable thresholds for illiquid or semi-

illiquid investments. Additionally, enhance current reports to include a chart or graph indicating the overall liquidity of the Fund for periodic monitoring.

- f. The IPS should address asset valuation, with specific focus on the valuation methodology of alternative assets and the requirements of third-party managers to conduct independent valuations of illiquid assets.
- g. Include a total return benchmark of the Fund that can be added to the MTO (independent report preparer) reports so that performance can be monitored on a monthly basis.
- h. The Board and Administrator should establish specific procedures, guidelines or checklists on the information required for new investments. Procedures should include a scoring methodology used by the Board to ensure consistency of the evaluation and consideration of risks prior to selection. The evaluation can be done in collaboration with an Investment Consultant. The evaluations and documentation for all managers should be retained by the Board.
- i. The IPS should require ongoing due diligence of Investment Managers by the Board that clearly define how managers are monitored. This documentation would help ensure the due diligence can be performed by Investment Consultant(s) or designated Board members. The documentation should include reporting requirements by managers to the Fund, including: (a) financial reports, (b) underlying investment holdings, (c) compliance issues, (d) manager changes, (e) strategy changes, (f) fees, and (g) other issues that impact key risks. These reporting areas are considered standard industry practice and are regularly requested of asset managers of similarly sized funds.
- j. Update the IPS to include the specific due diligence necessary for alternative assets when considering a new investment or reviewing a current investment in this strategy. The Fund should assess the guidance provided by the GFOA when designing the update to the IPS and work with the Investment Consultant to provide a structured approach as to what must be evaluated when considering this strategy. The Fund should also consider engaging experienced outside counsel to review complex contracts in connection with the investment strategy, when necessary.
- k. Ensure the IPS considers requirements, experience and qualifications of the Investment

Consultant based on: (a) the current issues facing the Fund, (b) the need for long-term stability in the management of the underlying assets, and (c) current market volatility. The Board should consider whether using an Investment Committee is best versus using a modified approach with experienced, professional asset managers for the Fund.

The Board should clearly define in policy what experience, certifications and specific expertise is required by an Investment Consultant, and the timing and approach to performing formal due diligence of the Investment Consultant. The Board should also require that a contract be executed prior to engagement, and use legal counsel to review the sufficiency of the fees and contract provisions.

- I. The Board and Administrator should work with a consultant to evaluate current investment fees and costs to the Fund, and amend any current existing contracts if necessary.
- m. Update the IPS to include reports and schedules required from the Administrator, Investment Consultants, and other third parties so the Board can properly govern the Fund. The Board should also assess the reports recommended by the PRB and should contractually obligate the engaged third party to provide this data on a regular basis.

#### 4. Investment Classification of Assets and Allocation:

The Fund does not appear to be following the IPS definitions for its asset classes. Although still in draft, the Fund's performance reports are used as the Board's primary tool for monitoring asset class allocations. Based on our review, there are a number of areas to be addressed by the Board, including:

- a. Investment Classifications: The classification of assets shown on the MTO reports has been customized at the direction of the Board Chairman into categories that do not align with the underlying holdings or the definition of an Equity investment by the IPS. The IPS limits Equity investments to common stocks, American Depository Receipts, ordinary shares of non-US companies, mutual funds, and ETFs.
  - Alkeon Growth Offshore Fund ("Alkeon") is classified as U.S. equity; however, it is an illiquid private equity fund using a long / short strategy in global equities and should be reclassified as an alternative investment using IPS definitions and industry standards. The \$2.49M Alkeon investment represented 14% of the reported U.S. equity holdings in August 2022.

- NBW Capital is classified as U.S. equity, and not identified as being primarily invested in Master Limited Partnerships (“MLPs”). The correct asset classification for publicly traded MLPs is not defined within the existing IPS and could be classified as either Equity or Alternatives. , The \$7.5M invested as of August 2022 represented 42% of the U.S. equity holdings.

The misclassifications of private equity and MLP holdings as U.S. equity creates a misleading representation of the types of investments held, liquidity of the portfolio and the associated risks to both the Board and to members of the Fund.

- b. Current and Revised Classifications: After considering the reclassification of Alkeon and NBW Capital in accordance with the IPS definitions, the Fund appears to be outside of the allocation ranges for U.S. equity, alternatives, and cash holdings. The current and revised allocations for August 2022 is represented in the table below, with asset classes outside the established targets highlighted in blue. Using the revised classification of assets, we observed these breaches were consistent throughout 2022.

Asset Class	Range	Current Allocation	Revised Allocation
U.S. Equity	18% - 50%	20.63%	17.71%
International Equity	15% - 25%	16.50%	16.50%
Alternatives	20% - 35%	32.74%	35.66%
Fixed Income	10% - 30%	13.62%	13.62%
Cash	1% - 10%	16.51%	16.51%

While breaches may occur occasionally due to market volatility and timing of acquiring and disposing of assets, allocations should be closely monitored so that deviations outside of established ranges can be reviewed and addressed promptly.

- c. Performance Reporting: There is a general lack of clarity to performance reporting whereby underlying holdings by managers do not reflect how allocations to certain asset classes are determined. As part of the agreements with the managers, this information would be typically provided to the Fund and included in performance reports, or in detailed appendices to the reports.
- d. Asset Allocation Ranges: The allocation ranges for each asset class are not included on the draft reports, including specific commentary on when an asset class is near, or in

breach of, the defined acceptable range. Additionally, allocation targets defined in the IPS are not reflected in the performance reports for:

- Large Cap, Mid Cap, Small Cap Equities
- Blend, Growth, and Value allocations across all U.S. Equity classes
- Developed or Emerging Markets for International Equity
- Short Term, Intermediate and High Yield Bond positions for Fixed Income

Recommendations:

The Board should document how assumptions are incorporated into performance reports for classification of assets. These should also align with IPS requirements and industry definitions so that appropriate transparency and risks are evident to the Board and Fund members. Additionally, the Board should:

- a. Verify whether the classification of Alkeon Growth Offshore Fund and NBW Capital as U.S. equity products meet IPS or industry definitions and either reclassify to alternative investments or update the IPS definitions as appropriate.
- b. Assess the current allocation amounts of the Fund across asset classes and determine the investment approach to accept, monitor, or rebalance to move toward the IPS target ranges.
- c. Require additional disclosure from the managers or consultants on the underlying investment holdings across each asset class and include within the report (or as an appendix) so the manager's underlying investment allocations are evident.
- d. Include the relevant allocation targets defined in the Fund's IPS in future performance reports to the Board.

## 5. Board Administration and Record Keeping

We identified administrative issues related to information security, efficiency, and record keeping that impact the effectiveness of the governance structure and transparency to members. The more critical of the issues relate to information security and Board decisions as more discussed further below:

- a. *Conducting Fund Business on Personal Email*: The current Chairman of the Board regularly conducts Fund business using personal, rather than City of Midland email. Additionally,

the citizen Trustees are not provided City of Midland email accounts and use either business or personal accounts. This greatly increases the risk of data breaches occurring and does not provide for strong data and records governance for the Fund.

- b. *Circumvention of Board Decisions:* In the November 18, 2021 Board meeting, the Trustees debated hiring an outside firm to complete consolidated aggregate portfolio reporting, with a resolution to take “no action” on selecting a consultant. However, a contract with MTO to provide this service was signed the next business day at the direction of the current Chairman. While the Fund had a clear need for consolidated portfolio reporting, this action appears to be in direct conflict with the recommendation of the Board.

Additionally, the Board never provided a resolution on the roles and responsibilities of Parenteau Analytics with respect to determining whether they are the best firm to serve the Fund based on the nature of the services provided (as discussed in Finding 2c) prior to the firm's resignation as a consultant to the Fund.

- c. *Timely Reporting:* Board meeting materials are not provided to Trustees timely when making investment decisions or with sufficient time to review prior to Board meetings. Industry practice would be to provide materials five to 10 business days before Board meetings, especially when investment decisions are made regarding complex alternative asset strategies. We did note, however, that materials are usually provided in hard copy on the day of the meetings.
- d. *Board and Investment Committee meetings:* Board materials have not been consistently retained by the Administrator in a manner that demonstrated what was reviewed and discussed. We were informed that all records maintained are separated after the meetings into specific folders for managers related to expenses, administration, etc. This process was recently modified by the Administrator to retain specific packets of all materials. Additionally, Board minutes historically have not provided supporting documentation with respect to investment decisions, although this has improved in recent meetings.

Recommendations:

The Board should review its current administrative practices to address the following:

- a. Discontinue and prohibit use of personal email addresses to conduct Board and Fund business. This includes current members of the Board, and citizen members, as they should be provided a secure City email address.
- b. The Board should review the appropriateness of the contract with MTO Financial Services and either pass resolution to hire or conduct a formal search for a vendor. The Board should also review the roles and responsibilities of Parenteau Analytics, as designated by the Investment Committee, to determine whether action is required to approve the investment consultant or conduct a request for proposal process as discussed in Finding 2c.

As Fund policies do not currently address what actions should be taken when there has been circumvention of resolutions by a Trustee, the Board should update Fund policies to include the actions when this occurs.

- c. The Fund Administrator should provide copies of Board materials five to 10 business days in advance of any planned Board or Investment Committee meeting using the secure portal available. This will also facilitate transfer of large files, reports, and documentation so they can be easily disseminated and organized for review by Trustees.
- d. The Fund Administrator should document how Board packets are created, presented, retained and eventually posted to the website for member disclosure. Where technology or support issues exist, this should be raised to the Trustees so that appropriate resources and support can be provided.

6. Enhancements needed to the Code of Ethics Policy

The 2011 Midland FRRF Ethics Policy that applies to the Board was written as a “summary code of ethics” that commits volunteers of the Fund to the highest standards of ethical conduct. However, the Policy does not address key elements that are expected to be covered in a Code of Ethics, including:

- a. Personal use of Fund resources by Trustees and Staff
- b. Requirements of voting members to have experience, education, or background in financial management
- c. Restrictions on use or sharing of confidential or non-public information for insider trading, front running, or personal gain

- d. Restrictions and reporting on the acceptance of gifts, entertainment or outside compensation as a result of their position with the Fund
- e. Procedures for reporting and addressing violations of the Code of Ethics
- f. Procedures for voting if conflicts of interest exist with members of the Board

While we are not aware of any current violations of the Ethics Policy, no specific testing was done in this area during the Governance Review.

Recommendations:

The Board should review the current guidance from the GFOA and CFA Institute and draft an updated Code of Ethics policy to stay current on standard industry practices and regulatory expectations. The policy should include specific detail to address known conflicts of interest, including:

- a. Personal use of Fund resources by Trustees and Staff
- b. Requirements of voting members to have experience, education, or background in financial management
- c. Restrictions on use or sharing of confidential or non-public information for insider trading, front running, or personal gain
- d. Restrictions and reporting on the acceptance of gifts, entertainment or outside compensation as a result of their position with the Fund
- e. Reporting and addressing violations of the Code of Ethics
- f. Voting procedures if conflicts of interest exist with members of the Board

## 7. Funding Policy

The Board has not established a stable Funding Policy that defines the key elements required for long-term administration and stability of the Fund outlined below. The Board has chosen to utilize the TLFRA Statute rather than adopt a specific Policy, and as a result, has not clearly articulated the Board's responsibility, accountability and authority over this process.

- a. Establishing a target funding ratio that provides for stability over time and manages the actuarial determined contribution volatility effectively
- b. Stipulation of employee funding and employer contributions made at regular intervals and determined by an actuarial valuation that is integrated with investment and asset allocation policies

- c. Requirements for conducting actuarial valuations, actuarial experience studies, and independent comprehensive actuarial audits on a consistent, long-term schedule
- d. Periodic evaluation of the Fund to address calculation abuses of retirement benefits such as salary spiking

Recommendations:

The Board should establish a funding policy in collaboration with the City that follows industry guidance provided by the GFOA and CFA Institute. This should include, at a minimum, the areas identified above in 7(a) through 7(d).

Establishing a funding policy will mitigate the risks that the current issues facing the Fund would be repeated by the next generation of Trustees responsible for governance.

#### Moderate Risk Findings

- 8. Compliance of the Midland FRRF Plan Document with the requirements of Texas Local Fire Fighters Retirement Act (TLFFRA)

The Board established the Midland FRRF Plan Document ("Plan Document") to ensure the practices of the Fund conform with TLFFRA requirements; however, the Plan Document fails to sufficiently address a number of key areas required under the Act, including:

- a. actuary participation
- b. recovery of misapplied benefits
- c. membership requirements
- d. service credits
- e. vesting
- f. death benefits
- g. reduction of benefits
- h. professional services
- i. expenses
- j. policies
- k. contributions
- l. termination
- m. confidentiality

Recommendation:

The Board should work with the Administrator or a third party to conduct a thorough review of the current Midland Plan document against the TLFFRA Statute to determine which specific revisions are needed based on the current regulations and structure of the Fund.

## Appendix: Risk Rating Definitions

The areas under review have been assessed from a residual risk level using the risk management classification system below.

Residual risk is the risk derived from the environment after considering the mitigating effect of internal controls.

High Risk	High risk findings have qualitative factors that include, but are not limited to: <ul style="list-style-type: none"><li>• Events that threaten the Fund's achievement of strategic objectives or continued existence</li><li>• Impact of the finding could be felt by members of the Fund and may require disclosure to members or regulators</li><li>• <b>Potential material impact to operations or the Fund's finances</b></li><li>• Remediation requires significant involvement by the Trustees</li><li>• Regulatory concerns that are systemic</li><li>• Processes that deviate significantly from regulator guidance and/or industry best practice</li></ul>
Moderate Risk	Moderate risk findings have qualitative factors that include, but are not limited to: <ul style="list-style-type: none"><li>• Events that could threaten financial or operational objectives of the Fund</li><li>• Noticeable and possibly material impact to the operations or finances of the Fund</li><li>• Remediation efforts that will require the direct involvement of Trustees and Administrator</li><li>• May require disclosure to members</li><li>• <b>Regulatory concerns or exceptions that increase the Fund's risk of legal, financial, or reputational risk</b></li><li>• Processes that deviate from regulator guidance and/or industry best practice</li></ul>
Low Risk	Low risk findings have qualitative factors that include, but are not limited to: <ul style="list-style-type: none"><li>• <b>Events that do not directly threaten the Fund's strategic priorities</b></li><li>• Regulatory concerns that do not have a monetary impact on the Fund or its members</li><li>• Processes that are require additional refinement to conform with regulatory guidance and/or industry best practices</li><li>• Regulatory concerns that are unlikely to have a financial impact to the Fund or its members</li></ul>