



## Board Report 21-47

Date: September 21, 2021

To: Board of Deferred Compensation Administration

From: Staff

Subject: Self-Directed Brokerage Option – Trading of Foreign Securities on the US Over-the-Counter Market and on Foreign Exchanges

### Board of Deferred Compensation Administration

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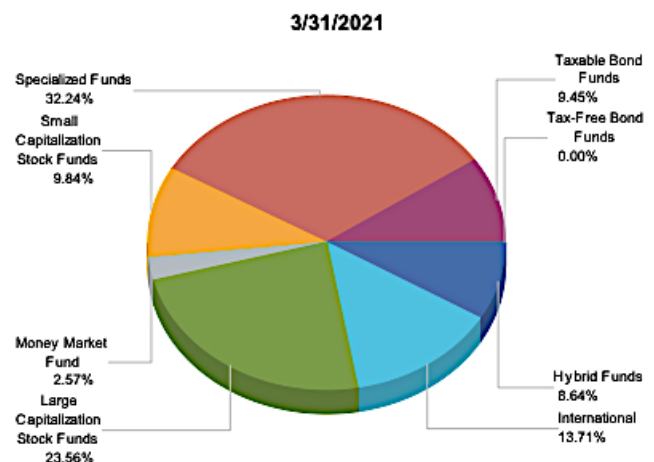
### Discussion:

Following is a discussion regarding the trading of foreign securities on the US Over-the-Counter (OTC) market and on foreign exchanges.

#### A. Background

The Deferred Compensation Plan (DCP) includes a Self-Directed Brokerage Option (SDBO) which provides participants with access to a wide universe of additional investment choices including stocks, bonds, exchange traded funds, and mutual funds. The Board created the SDBO for participants who wish to take a more active role in managing their accounts and/or who wish to have access to more specialized investment choices than would be appropriate for the DCP's core investment menu.

The SDBO was introduced to the DCP in 1999 with a mutual funds only provider. That provider was subsequently replaced with the current provider, Charles Schwab, at which time the Board elected to expand the choices open to participants to include stocks, bonds and exchange-traded-funds (ETFs). As of 03/31/21, 5,697 participants held accounts in the SDBO (11.3% of all participants) with \$1.13 billion in assets (13.5% of DCP assets). Assets are held in a wide variety of investment vehicles. For mutual fund holdings, 13.7% of those holdings were in international funds as of 03/31/21.



## B. Trading of Foreign Securities on the OTC and Foreign Exchanges

Staff was recently contacted by a participant who had attempted to purchase a foreign security that trades on the OTC. Presently the SDBO only permits trading of foreign securities that are American Depositary Receipts (ADRs) and foreign securities that trade on a domestic equity market exchange (e.g. NYSE or AMEX).

### **Background on ADRs**

- ADRs were introduced in the 1920s specifically to provide American investors with the ability to purchase shares of a non-US listed companies without having to navigate the complexities of transacting on international exchanges.
- An ADR has the following characteristics:
  - It is a certificate issued by a US bank representing shares of a foreign company's stock.
  - It trades on US stock markets as any domestic shares would.
  - It is denominated in US dollars.
  - The underlying security is held by a US financial institution.
- There are two types of ADRs – sponsored (currently allowed in the SDBO) and unsponsored (not currently allowed in the SDBO):
  - Sponsored ADRs are issued by US banks on behalf of the foreign company. The bank and company enter into a legal arrangement in which typically the company pays the costs of issuing the ADR while the bank handles investor transactions. Sponsored ADRs are categorized by the extent to which the foreign company complies with Securities and Exchange Commission (SEC) regulations and US accounting procedures; US banks require that foreign companies provide them with detailed financial information.
  - Unsponsored ADRs do not have to provide the detailed financial information required for sponsored ADRs. They have no direct involvement, participation, or even permission from the foreign company, and could potentially be issued by different banks. They may also offer varying dividends. Unsponsored ADRs trade only on the OTC. Also, unsponsored ADRs do not include voting rights.

### **Non-ADR foreign securities**

The purchase of non-ADR foreign securities available on the US OTC market, or foreign securities on a foreign exchange, are not presently permitted. Charles Schwab indicates that plan sponsors have the option of permitting these trades but that they are linked together (plans cannot restrict one but permit another). Charles Schwab indicated that approximately 66% of their governmental and non-governmental plan sponsor clients, and 47% of governmental clients alone, allow trading of all foreign securities, including those traded on the OTC market and on foreign exchanges.

Staff subsequently reached out to the Board's investment consultants at Mercer Investments (Mercer) to help develop findings for the Board with respect to whether a change should be

contemplated for permitting trading of such securities. As a result of staff's and Mercer's considerations, the following findings were reached:

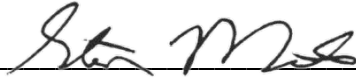
- The question of permitting trading of non-ADR foreign securities available on the US OTC market, or foreign securities on a foreign exchange, has not been previously assessed by staff or the Board.
- The Board has historically and philosophically approached the brokerage window as an investment platform offered to knowledgeable investors who, as a condition of participation, acknowledge that they are solely responsible for their investment choices within the SDBO.
- Notwithstanding this fact, however, plan sponsors may evaluate certain parameters for permitted and restricted trading, and trading of foreign securities is a reasonable parameter for the plan sponsor to evaluate.
- Trading of non-ADR foreign securities and trading on foreign exchanges both carry with them certain additional levels of complexity beyond those that attend to ADR securities and US exchanges.
- Although the SDBO is intended for knowledgeable investors who are solely responsible for their investment choices within the SDBO, it is reasonable for the City as plan sponsor to place parameters around certain trading options within the SDBO based on the unique characteristics and risks of those options. Purchasing shares on international exchanges carries unique risks, including (a) currency-exchange risks (since the shares are not denominated in US dollars); (b) disclosure risks (due to differences in regulatory requirements between US exchanges and foreign exchanges); and (c) accountability risks (e.g., unsponsored ADRs do not include voting rights and accounting standards in other geographies may be less stringent than in the US). The complexity involved in understanding and navigating the myriad variances in foreign exchange rates and differing foreign exchange rules places unique burdens that even highly knowledgeable investors may have difficulty meeting.
- However, given Schwab's indication that 66% of governmental and non-governmental plan sponsor clients, and 47% of governmental clients alone, allow trading of all foreign securities, the City's DCP would not be out of alignment with other plan sponsors regardless of its position on this matter.

### C. Conclusion

Trading of non-ADR foreign securities available on the US OTC market, or foreign securities on a foreign exchange, requires an affirmative election on the part of the DCP to make them available on the SDBO. Staff's evaluation focused on how the complexity and risks of this type of trading are distinct from trading of other instruments on the SDBO (e.g. stocks, bonds, ETFs, and mutual funds) because they are not contained within the universe of US regulatory requirements and require that investors master a vastly larger and more complex set of rules and variations. Even if certain highly knowledgeable investors are able to address that complexity for the particular securities they're considering, other SDBO investors could conceivably become involved in

transactions for which they are inadequately prepared because they do not understand the distinctions between foreign and US trading. As a result, staff is not prepared at this time to recommend including this type of trading in the DCP SDBO. However, the Board also has the option to request that staff develop a recommendation to permit such trading (e.g. within the context of ensuring adequate disclosure of risks is provided to DCP participants where practical).

Submitted by:



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