



Memo

To: Steven Montagna
Date: January 5, 2011
From: Andrew Ness, Beverly Orth
Subject: Trustee Services for Deferred Compensation Plan

The City of Los Angeles asked Mercer for research with regard to which entity is and should be acting in the capacity of trustee of the City of Los Angeles Deferred Compensation Plan (the Plan).

The following summarizes key points of historical background, the current legal environment and existing plan documentation and suggests recommendations on best practice. Attachments/exhibits accompanying this memo offer perspective on what other California governmental employers are doing.

What are the trust requirements?

Historically, all amounts deferred under an eligible 457 plan remained the property of the employer. After the bankruptcy of Orange County, California, the rules changed for governmental 457 plans. Congress decided that benefits under eligible 457 plans maintained by state and local governments should be protected from the claims of the employer's creditors. Internal Revenue Code (IRC) sec. 457(g), added by the Small Business Job Protection Act (SBJPA) in 1996, requires that all "assets and income" of such plans be held in trust for the exclusive benefit of participants and beneficiaries. Subsequently, California Government Code sec. 53213.5 required plans to conform to SBJPA trust requirements.

Methods of Satisfying IRC Sec. 457(g) Trust Requirement

Section 457(g) provides that annuity contracts and certain custodial accounts will be treated as trusts for purposes of satisfying the 457(g) trust requirement, similar to the rules under IRC sec. 401(f). In Notice 98-8, the IRS provided some guidance regarding the trust requirements that must be met by plans using annuity contracts, bank custodians and nonbank custodians.

Section VII of Notice 98-8 provides that an annuity contract is treated as a trust under sec. 457(g)(1) if the contract is an annuity contract that has been issued by an insurance company qualified to do business in the state and the contract meets the requirements of Section VI of Notice 98-8 (pertaining to trusts), other than the requirement that it be a trust. Thus, the annuity contract must contain terms that make it impossible, prior to satisfaction of all plan liabilities with respect to participants and beneficiaries, for any part of the annuity assets and income to be used for or diverted to purposes other than for the exclusive benefit of participants and beneficiaries. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

Section VII of Notice 98-8 also provides that a custodial account will be treated as a trust under sec. 475(g)(1) if the custodian is a bank (as defined in IRC sec. 408(n)), or a person who meets the nonbank trustee requirements of sec. VIII of the notice, and the custodial account meets the requirements of sec. VI of the notice pertaining to trusts (as described above), other than the requirement that it be a trust.

Section VIII of Notice 98-8 provides that the custodian may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner of Internal Revenue that the manner in which the person will administer the custodial account will be consistent with the requirements of IRC secs. 475(g)(1) and (3) – that is, all assets and income of the plan be held in trust for the exclusive benefit of participants and beneficiaries. To do so, the person must submit a written application to the Commissioner.

Unless all assets and income of the 457 plan are held in one or more trusts, custodial accounts, or annuity contracts that satisfy sec. VI or VII of Notice 98-8, the plan is not an eligible sec. 457(b) plan because the requirements of sec. 457(g) are not met.

Does the City 457 Plan meet the trust requirements?

The City's Administrative Code sec. 4.1404 states that the Employer shall establish a separate fund to hold all assets and income of the Plan, including amounts, assets and income held in custodial accounts or annuity contracts described in IRC sec. 401(f). The Administrative Code also provides that such fund shall be held in trust. The Administrative Code defines "Employer" (or "City") to mean all offices, bureaus, and departments of the City of Los Angeles, including departments which have control of their own definite revenues.

This presents a clear requirement for Plan assets to be held in a separate fund, with the onus placed on the City to establish the trust.

The City has a custodial agreement in place with Orchard Trust Company. The agreement indicates Orchard Trust is the custodian solely for assets held in a bank account pending investment or disbursement. The custodial agreement also indicates that the City, or certain employees of the City, is the Trustee of the Plan.

From a historical perspective, the City attempted to further document itself as trustee of the Plan approximately 10 years ago. At that time, the City Attorney took the position that the Board of Deferred Compensation Administration (the Board) did not have the legal status necessary to enter into a contractual relationship with the City and be established as trustee for the Plan. Since the current plan documentation and the City Attorney's opinion are in contradiction, Mercer would recommend revisiting this issue with the City Attorney. Mercer's observation is that the Plan likely meets the trust requirements based on the documentation in place, but that additional trust documentation and resolution of this issue would be prudent.

What are other plans doing?

The attachment to this memo contains observations from other 457 plans. There is some prevalence of plans using a self-trusteed model, but most mature plans generally use a bank as trustee for the plan.

Mercer observations regarding the Beall memo

The City of LA asked Mercer to address conclusions presented in the September 13 memo from James S. Beall to John R. Mumma:

- That City Council amend the Administrative Code to declare in express terms that the City creates the Deferred Compensation Plan Trust;
- That City Council further amend the Administrative Code to designate the City, by and through its Board of Deferred Compensation Administration, as trustee of the Trust;
- That City Council further amend the Administrative Code to waive Council's veto power over a range of administrative decision-making, such as selecting and monitoring service providers; selecting and monitoring investments with the assistance of appropriate service providers; interpreting all questions of eligibility and benefits under the Plan; and adjudicating claims and appeals.

Whether the City Council Should Amend the Administrative Code to Declare in Express Terms that the City Creates the Deferred Compensation Plan Trust

SBJPA and the California Government Code clearly require assets of the Plan to be held in trust. As such, Mercer recommends that the City resolve the open issues regarding trust establishment and trustee designation. California Probate Code rules on creation of trusts are fairly informal, but from a risk management perspective, more clarity and documentation would be appropriate.

Whether the City Council Should Further Amend the Administrative Code to Designate the City, by and through its Board Of Deferred Compensation Administration, as Trustee of the Trust

This is not necessary. Various provisions of the California Probate Code address the creation and validity of trusts, and provide limitations on who may serve as a trustee. The Probate Code also includes definitions for “trustee” and “fiduciary,” but none of these are dispositive regarding the type of entity that should be acting in the capacity of the Plan’s trustee.

Whether the City Council Should Further Amend the Administrative Code to Waive Council’s Veto Power over a Range of Administrative Decision-Making

Case law we have researched does not strictly support a conclusion on whether veto power gives rise to fiduciary status. For example, we reviewed ERISA case law for parallels, as ERISA’s fiduciary standards are recognized as some of the highest under law. Cases focusing on service providers are split on whether a provider’s veto power would result in fiduciary obligations.

However, as part of this review process, the City may want to revisit certain sections of the Administrative Code and plan document to add specificity regarding roles and responsibilities. Certain functions are assigned to the “Employer,” for example, trust establishment and plan amendments. But “Employer” is broadly defined as “all offices, bureaus, and departments of the City of Los Angeles and includes therein departments which have control of their own definite revenues.”

Allocating responsibilities to a more specific party or entity may help ensure that actual governance practices align and are consistent with the terms stated in the Administrative Code and plan document. Employers that have not clearly defined and documented an accountability structure for retirement plan governance functions will often experience

uncertainty about who is responsible for the various duties pertaining to their retirement plans. In the absence of well-defined accountabilities, tasks are likely to be ineffectively or inefficiently handled by someone who lacks the required expertise, thus risking the success of the plans, and risking a legal challenge to plan fiduciaries.

Mercer's recommendations

Bank Trustee or City as Trustee?

Meeting trust requirements can be accomplished with the City as trustee or by using a corporate/bank trustee. While either approach is acceptable, there may be some advantages to using a corporate trustee over individual trustees. Corporate trustees, such as banks, have specialized departments that are professionally trained to handle all the legal requirements related to trust maintenance, including holding legal title to and custody of all plan assets, periodically valuing the assets, and preparing quarterly financial reports accounting for all trust transactions. Individual trustees, in general, do not have the training or expertise to perform all of these functions and will typically engage experts to assist in one or more of these areas.

Often there is a perceived cost savings in naming one or more individuals as trustee. However, individual trustees often do not find it convenient or practical to hold the trust assets and conduct the financial reporting required of a trustee. In these situations, a custodian is frequently retained for the purpose of holding the assets and preparing the financial reports for the trust. In this respect, the custodian is acting in a capacity that is similar to that of a "directed" trustee, that is, a trustee that has no discretionary authority over the assets and is not acting in a fiduciary capacity. Fees for custodial or directed trustee services are typically lower than fees charged by a trustee that has fiduciary liability. (See DOL Field Assistance Bulletin 2004-03 for the Department of Labor's guidance on the scope of a directed trustee's fiduciary obligations to an ERISA plan.)

Advantages of Using a Trust over a Custodial Account or an Annuity Contract

There is some concern in the industry that custodial accounts and annuity contracts that are not held in trust may have potential creditor protection issues. Custodial accounts might be subject to the claims of an employer's general creditors under applicable state law. In contrast, the use of a trust may offer more protection against creditors of either the employer or a participant.

The legal holder of an annuity contract may be either the employer or the plan participant. If the contract holder is the participant and a judgment against a participant is exercised against the participant's interest in an annuity contract, the employer might have to incur legal costs to protect plan assets. It is not certain that having the employer hold the contract would completely protect the assets from the exercise of a judgment against a participant.

Role of the Board

California law includes provisions regarding the boards of public retirement systems. Subsections (a), (b) and (c) of Article XVI, sec.17 of the California Constitution outline the fiduciary duties for the administration of public pension and retirement systems. Section 53609 of the Government Code provides that deferred compensation funds are "public pension or retirement funds" for purposes of Article XVI, sec.17.

So if a plan includes deferred compensation funds, sec. 53609 would seem to apply the requirements of Article XVI, sec.17 to the fiduciaries of the plan. However, the City has indicated that the deferred compensation plan is not subject to these governance rules. The City has taken the position (see, e.g., the City's brief in the Nationwide lawsuit) that sec. 17 does not apply in this context. The City noted that while the City Charter does establish public pension and retirement systems and the boards that manage them, Prop. 162 does not apply because the phrase "deferred compensation" is not found anywhere in Prop. 162's definition of "retirement board."

However, under Administrative Code sec. 4.1401(j), the Board is responsible for administration of the Plan. The Administrative Code states that the Board shall have the sole authority for the operation of the Plan in accordance with its terms and shall rule on all questions arising out of the administration, interpretation and application of the Plan.

Similarly, Administrative Code sec. 4.1407 states that the Board shall select and contract with organizations to assist in the administration of the Plan and to provide investment options, consulting and auditing services. The Administrative Code states that the contractor(s) "shall be governed by the Board." The Board is authorized to approve (and the chair of the Board to execute) amendments to contracts when the amendments result in no new costs to the City or participants.

In addition, actions of the Board are subject to the provisions of City Charter sec. 245. The City Charter sec. 245 addresses the City Council's veto power. Actions of certain retirement

boards are specifically exempt, but the Board of Deferred Compensation Administration is not mentioned.

The following best practice steps would also help strengthen plan governance in this area:

- Develop an accountability chart or similar document to clearly define roles and responsibilities for important plan functions.
- Consider more clarity in documentation around vendor selection and monitoring. For example, Administrative Code and plan document provisions indicate the Board will “govern” contractors, but City Council’s veto power may also mean fiduciary exposure for the City Council.
- Consider more clarity in documentation around plan amendments. The plan document grants the Board the power to amend the document at any time “consistent with applicable law and consistent with the governing provisions of the Plan as contained in the City of Los Angeles Administrative Code.” But the Administrative Code only says the Plan may be amended or terminated by the City.

Attachment – Observations from Other Plans

Governmental 457 plans are required to hold assets in trust for the benefit of participants and beneficiaries. Vehicles that may be used to accomplish this include a trust, custodial account, or annuity contract. Below is data gathered outlining the vehicles used by several large state, city and county 457 plans. Sources for the data include a survey via NAGDCA, plan sponsor websites, and plan sponsor inquiries.

457 Plan Sponsor	Trust Type (Trust, Custodial Account, or Annuity Contract)	Provider
Alabama	Trust	Wells Fargo
California	Trust	JP Morgan Chase
Florida	Trust	State Chief Financial Officer
Georgia	Trust	State Street
Hawaii	Custodial Account	State Street
Maryland	Trust	Board of Trustees
Michigan	Trust	State Street
New Mexico	Trust	JP Morgan Chase
New York	Trust	Bank of New York Mellon
North Carolina	Trust	Prudential Trust Company
Oregon	Trust	State Street
Virginia	Trust	State Street
Washington	Trust	JP Morgan Chase
West Virginia	Trust	ING National Trust
Wisconsin	Trust	Board of Trustees
County of Los Angeles, CA	Trust	Wells Fargo
City and County of San Francisco, CA	Custodial Account	Wells Fargo
Kansas City, MO	Trust	Nationwide Trust Company
Maricopa County, AZ	Trust	Nationwide Trust Company
Monterey County, CA	Custodial Account	Wells Fargo
New York City, NY	Custodial Account	Bank of New York Mellon
New York MTA, NY	Trust	Prudential Trust Company
Orange County, CA	Trust	Wells Fargo
Sanitation District of Los Angeles County, CA	Trust	Vantage Trust Company

Shading Key:

External Trustee/Custodian

Internal Trustee/Custodian