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DEFERRED COMPENSATION PLAN BOARD REPORT 06-21



Date: May 5, 2006

To: Board of Deferred Compensation Administration

From: Staff

Subject: Los Angeles Times Articles

Recommendation:

That the Board of Deferred Compensation Administration receive and file the following information regarding a recent series of articles published in the Los Angeles Times.

Discussion:

The Los Angeles Times ran an in-depth three-part series April 23-25 on retirement plan fees, annuity products and school district defined contribution plans (attached). These articles and the following related comments are provided to Board members in the event that these articles generate any questions from the City's Plan participants regarding Deferred Compensation Plan fees and program oversight.

401(k) Plans/Fee Disclosure - Each of the articles raised concerns regarding the transparency of fees. The April 23rd article may be of particular interest because its focus is on Section 401(k) plans, the features of which in many ways mirror those of Section 457 plans. The article discusses some of the ways in which expensive fee arrangements can be buried within investments, or where a lack of appropriate plan sponsor oversight can result in higher investment management expenses than might otherwise be obtained.

By way of background, it may be helpful for Board members to be aware that the City's Plan has gone through its own evolution with respect to not only the scale of fees but how fees are disclosed to participants. Prior to July 1999, the Plan featured two administrators, Hartford Life Insurance Company and Washington Mutual Bank, each offering a discrete lineup of investment options. Washington Mutual charged an administrative fee of 0.24%, or 24 basis points. Hartford did not have an explicit "administrative fee," but its administrative costs were collected within its mortality and expense risk charges, which over the life of the contract ranged from 75 to 125 basis points. The investment management fees charged by these vendors were separate from and in addition to investment management fees for their various investment products.

When the City's Plan unbundled in July 1999, administrative fees were reduced to 11 basis points. This represented a 54% reduction in administrative fees for Washington Mutual participants, and an approximate 85-87% reduction in administrative fees for Hartford participants. In addition, in 1999 the City substantially reduced the Plan's investment management fees by beginning to directly contract with some investment managers to provide separate accounts, which typically have a lower cost structure.

With respect to disclosure, the City's Plan also began disclosing administrative fees as distinct, specific charges on participant quarterly statements. Previously, when Hartford had been one of the City's Plan administrators, administrative fees were not reflected on Hartford participant statements. In fact, the term "administrative fee" was included on the statements, but every participant had a "zero" amount indicated next to it. This obviously created the misleading impression that Hartford participants were not paying an administrative fee, when in fact those fees were substantial. Now, all Plan participants see exactly what they are paying for Plan administration.

Investment management fees cannot, of course, be recorded as distinct dollar charges because those fees are collected by investment managers out of the investment returns before those returns are credited to the fund. However, each quarterly statement includes not only performance information for the City's investment options but the asset management fees for those options. That fee information is also available on the Plan website.

403(b) Plans - The article on 403(b) plans provides some excellent information on programs designed for another large public sector constituency, school districts and schoolteachers. While 403(b) plans operate very differently from 457 plans, some of the issues raised by the article are nevertheless relevant.

One of the key differences structurally between a 457 and 403(b) plan is that with 457 plans the state or local government entity designs and administers a single program for its employees, while in the 403(b) world the school district typically opens its doors to multiple investment providers, without necessarily having to define substantial expectations of those providers. This means that in 403(b) plans employees have virtually all of the responsibility for protecting their own financial interests.

One of the primary rationales for unbundling the City's Plan was to remove the opportunity for obscure fee arrangements to mask the true and discrete costs of the program. Ongoing, this article makes it clear that it is equally important for the Board and staff to be aware of any potential endorsement or reimbursement arrangements that might cause an interested party to take a position on a vendor's behalf (a subject of questioning to be included in the RFP for administrative services).

More broadly, the article makes clear that without proper diligence and high ethical standards it becomes possible for industry providers as well as other interested parties to place their own financial interests ahead of the interests of employees participating in the programs. This is why staff is committed to working closely with the Board to guard against these situations. And, as demonstrated in 2004, the City's Plan is fortunate in that it has an

energetic and engaged participant population serving as a crucial final check on all decisions affecting their financial interests.

Submitted by: _____
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Approved by: _____
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