

DEFERRED COMPENSATION PLAN BOARD REPORT 09-35



Date: June 8, 2009
To: Board of Deferred Compensation Administration
From: Staff
Subject: Third Party Advice/Trading: Self-Directed Brokerage Option

Members
Eugene K. Canzano, Chairperson
Richard Kraus, First Provisional Chair
Shelley Smith, Second Provisional Chair
Maggie Whelan, Third Provisional Chair
Sangeeta Bhatia
Sally Choi
Michael Perez
Kurt A. Stabel

Recommendation:

That the Board of Deferred Compensation Administration:

- (a) Decline the option of adding Schwab's Advisory Services program to the Self-Directed Brokerage Option (SDBO); but
- (b) Approve authorizing Third-Party-Trading of participant accounts within the SDBO.

Discussion:

In January 2009 the Board requested that staff work with the City Attorney's Office and Plan consultant to develop recommendations with respect to permitting use of **Schwab's Advisory Services** product offering and/or authorizing **Third-Party-Trading** of participants accounts through the Plan's SDBO provider, Charles Schwab. This was a result of participant inquiries requesting the use of these services. Neither service is presently made available to the City's SDBO participants. Staff will address each issue separately.

(A) Schwab Advisory Services

- (1) Background - Charles Schwab Institutional Group provides a trading platform and business services for independent investment advisors who custody and invest their clients' assets at Charles Schwab. Charles Schwab currently provides these services to approximately 5,900 independent advisors. By execution of a Schwab Personal Choice Retirement Account® (PCRA) Limited Power of Attorney (LPOA) for a Schwab Investment Advisor, a participant may grant authority to an independent investment advisor that has a relationship with Schwab to trade in a participant's self-directed brokerage account at Schwab. A participant may also authorize Schwab to pay investment advisory fees to the independent investment advisor from their Schwab self-directed brokerage account.

Charles Schwab also provides an advisory service called "Schwab Advisor Network." This is essentially a referral service for participants directing them to a pre-approved list of independent investment advisors who have a relationship with the Charles Schwab Institutional Group. This is a subset of the 5,900 independent

investment advisors noted above, and would become available as a part of permitting the use of independent investment advisors through the Charles Schwab Institutional Group.

Although Schwab offers a menu of other proprietary advisory services to retail clients, due to legal issues surrounding retirement plans, these services are not available to participants utilizing the Schwab self-directed brokerage account. The only referral service available to retirement plan accounts is the Schwab Advisor Network. Further, the service is only available to participants with investment assets of \$500,000 or more. If the service was made available in the City's SDBO a participant with \$500,000 or more in his/her account would be able to call Schwab and request a referral to a local financial advisor. There are approximately 200 nationwide, including in the Los Angeles area. Those participants who do not qualify for this referral service could independently utilize one of the other advisors who are a part of the Schwab Institutional Group. Schwab indicates that typically the use of an advisor in its SDBO occurs because the participant already has a relationship with the advisor and not through a referral.

The advisors who have a relationship with the Schwab Institutional Group are not employed by Schwab although they do have access to Schwab's administrative infrastructure. Advisors must meet certain qualifications in order to become part of the Schwab Advisor Network, but there is no screening process for those individuals who are part of the Schwab Institutional Group. The screening requirements for the Schwab Advisor Network include the following:

- (a) Being required to provide fee-based services only;
- (b) Seven years of experience providing investment advice;
- (c) Currently managing a minimum of \$50 million of client assets;
- (d) Professional designation such as Certified Financial Planner or 10 years of experience equivalent; and
- (e) Licensed by the Securities Exchange Commission as an investment advisor.

Fees typically range between 1%-1.25%. However, fees are set by the advisor, not by Schwab.

- (2) Prevalence - Schwab indicated that most of its retirement plan clients permit the use of investment advisors who are a part of the Schwab Institutional Group within their plans, but also indicated it does not track this and so could not provide any real data to support their claim. Mercer conducted an independent review through a limited survey effort and determined that generally speaking these services are not provided in other state/local government plans. Organizations eligible to offer the service (because they have a relationship with Schwab) but not offering it include the states of California, Florida, Georgia, Michigan, and Missouri, and Miami-Dade County. The only entities that do offer it include the State of Arizona, Maricopa County (AZ), and the City of Phoenix (AZ). The recordkeeping contact for these

plans indicated that these arrangements were initiated by a broker with a prior working relationship with one of the plan sponsors.

- (3) Indemnification – A participant who utilizes the services of an advisor is required to execute an agreement with the advisor that is a contractual relationship which Schwab indicates it considers completely independent of any services provided by Schwab. As a result, Schwab indicates it does not view itself as having any role or liability with respect to any interaction between the participant and advisor. The City Attorney and Mercer reviewed the agreements executed by Schwab and the investment advisor and determined that no language providing indemnification to the Plan sponsor is provided. Moreover, because this form is standardized across Schwab's entire base, it is not possible to customize the form to provide indemnification to the City, nor is it practical to attempt to build in indemnification through some other route (for example, by having Plan staff execute a separate form with the participant). Although the risks of litigation to a plan sponsor are probably small, the City Attorney's Office indicates that including the indemnification language would be preferable.
- (4) Conclusion & Recommendation – It is the recommendation of the City Attorney, staff and the consultant that the Board not permit activation of Schwab's advisory service within the City's Plan, given the lack of plan sponsor indemnification for an investment advisory network that, in our view, is not well-screened.

(B) Third Party Trading

- (1) Background - Schwab offers a service allowing participants to provide authorization for a third-party to trade the member's account. This would mean the City's SDBO participants could, if they wished, designate individuals other than themselves (financial advisors, family members, etc.) to execute trades on their behalf.
- (2) Prevalence – As with the prior issue, Schwab did not have any data to support the prevalence of this service with its client base. Mercer similarly was not able to identify state/local government plan sponsors offering this service, although it was a feature within the Arizona plans that also allowed the investment advisory service.
- (3) Indemnification – Again as with the prior issue, indemnification of the plan sponsor is not part of any documents executed by the participant with Schwab. Also, the same impracticalities of developing a customized form or separate indemnification agreement apply on this issue as they apply with the advisory service issue. However, the City Attorney's Office has indicated it is more comfortable with permitting this feature because it would be exceedingly difficult to make the argument that the Plan has any connection to the third-party agent (as opposed to use of Schwab's advisory network, which is a professional service offered through Schwab and by extension the plan sponsor).

(4) Conclusion – In consultation with the City Attorney and consultant, staff’s finding is that implementation of this service is an appropriate enhancement with minimal risk to the Plan. Approving it should satisfy those participants who wish to use third parties to actively manage their account. The essential disadvantage to a participant and professional advisor of implementing this service and not the former is that the advisor will not be able to collect fees directly from the participant’s account. However, the participant and advisor are free to make separate arrangements for compensation. The Plan, however, will have provided a means of allowing participants to use outside parties while taking on minimal, if any, exposure.

Submitted by: _____
Steven Montagna

Approved by: _____
Alejandrina Basquez