

# Deferred Compensation Plan BOARD REPORT 11-01

Date: January 10, 2011  
To: Board of Deferred Compensation Administration  
From: Staff  
Subject: Deferred Compensation Plan Trustee

*Board of Deferred  
Compensation Administration  
Eugene C. Canzano, Chairperson  
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## Recommendation:

That the Board of Deferred Compensation Administration (a) receive and file information from staff and the Board's consultant, Mercer Investment Consulting, regarding their review of Plan trustee issues; and (b) direct staff and the consultant to draft an amendment to the current contract with Great-West Retirement Services to include use of its affiliate Wells Fargo to provide passive trustee services, and return to the Board with said draft amendment as well as a review of transition issues related to moving from Orchard Trust to Wells Fargo.

## Background:

At its meeting on **June 15, 2010**, the Board requested that staff develop draft correspondence to the City Attorney's Office requesting clarification of the question of which entity is acting in the capacity of trustee for the City's Deferred Compensation Plan and what that entity's responsibilities are relative to that role. At its meeting on **July 20, 2010**, the Board considered staff's proposed correspondence, discussed some potential changes to the wording of the questions, and asked staff to return the matter to the Board for reconsideration.

At its meeting on **August 17, 2010**, the Board discussed the option of, prior to issuing correspondence to the City Attorney, having its consultant conduct an outside review of this issue. At its meeting on **September 21, 2010**, the Board directed the Plan consultant to (a) evaluate the City of Los Angeles Deferred Compensation Plan's authoritative documents and determine the degree to which they are consistent with best practices for meeting Internal Revenue Code Section 457 trust requirements for governmental plans, and (b) if necessary, make recommendations for modifications/improvements. At its meeting on **October 19, 2010**, the Board referred to the Plan consultant correspondence (and attachments) dated September 20, 2010 from Board member John Mumma for review and consideration relative to its evaluation of Plan trustee issues as requested by the Board.

The Board's consultant, Mercer Investment Consulting, has completed its review/analysis of the Plan's authoritative documents and provided commentary regarding the degree to which they are consistent with best practices for meeting Internal Revenue Code Section 457 trust requirements for governmental plans. In connection with that review, staff is providing the following analysis and recommendation.

## Key Concepts & Terms

Perhaps the most challenging part for staff in addressing these issues relates to the language used to discuss them. Certain terms (e.g. "trust" or "custodian") can be used to mean different things in different contexts, and other terminology (e.g. "fiduciary") can be used to raise issues that are not related to the focus of this report and its companion report, Board Report 11-02 (regarding the Plan's Investment Menu and Trustee Services). Given this, staff will initially attempt to define the key terms or concepts which have arisen in connection with this review and delineate them from one another before proceeding.

The first set of definitions concerns three concepts which have arisen in prior discussions of this topic by the Board. Only one of these is the focus of staff and Mercer's review; the other two are tangential and not required to be examined or resolved in connection with the primary issue.

### Trust Requirement

**"Trust Requirement"** refers to the Federal requirement that Plan assets be placed in trust for the exclusive benefit of Plan participants and their beneficiaries. However, the term does not mean that a "trust" must be established in order to satisfy the trust requirement. As detailed by Mercer's analysis, the trust requirement can be satisfied by use of a trust, custodial account or annuity contract. The question of **whether and how the City has met the Federal trust requirement is the sole focus of this report and of Mercer's analysis.**

### Plenary Authority

**"Plenary Authority"** refers to the degree to which the Board's decision-making authority is or can be independent from City Council oversight or veto. This concept has arisen in connection with the trust requirement issue as well as other issues the Board has recently considered (e.g. in contracting). However, the Board's plenary authority is not directly related to resolving the question about how best to meet the Federal trust requirement. The City's Plan can adopt a best practice around meeting the Federal trust requirement without having to address or resolve issues relating to the Board's plenary authority.

### Fiduciary Obligations

**"Fiduciary Obligations"** refers to whether and in what capacity those entities/individuals affiliated with the Plan are acting in a fiduciary capacity. Acting in a fiduciary capacity means exercising discretion over Plan assets and participant interests. This concept has arisen in connection with the trust requirement issue as well as other issues the Board has

recently considered (e.g. fiduciary liability insurance). However, the question of when fiduciary obligations are assumed and the consequences thereof is not directly related to resolving the question about how best to meet the Federal trust requirement. The City's Plan can adopt a best practice around meeting the Federal trust requirement without having to address or resolve issues relating to the exercise of fiduciary discretion in all situations and all contexts - however, resolving the trust requirement issue will certainly provide more clarity regarding the fiduciary responsibilities involved in meeting the trust requirement, a key feature of defining a best practice.

The second set of definitions concerns the terminology used to describe the differences between a trustee and custodian.

### Trustee Services

For the purpose of this report, "**Trustee Services**" refers broadly to acting in the capacity of meeting the Federal "Trust Requirement." Acting in this capacity means holding assets in trust for the exclusive benefit of Plan participants and their beneficiaries. It may also include certain banking functions related to the proper administration of the Plan, including issuing payments to Plan participants.

### Custodial Services

For the purpose of this report, "**Custodial Services**" also refers broadly to acting in the capacity of meeting the Federal "Trust Requirement." Acting in this capacity means holding assets in a custodial account for the exclusive benefit of Plan participants and their beneficiaries. It may also include certain banking functions related to the proper administration of the Plan, including issuing payments to Plan participants.

Broadly speaking, the distinction between a trustee and a custodian is generally that between an entity which owns or holds title to an asset (trustee) vs. an entity which monitors or protects an asset without having ownership or title (custodian). However, as these two terms relate to the specific duties of meeting the Federal trust requirement, those duties are virtually indistinguishable.

The third set of definitions concerns the specific types of trustee or custodial roles that can be used not only to satisfy the Federal trust requirement but provide other types of services that will be discussed in Board Report 11-02.

### Passive Trustee

A "**Passive Trustee**" is an entity acting exclusively in the capacity of meeting the Federal "Trust Requirement." The term "passive" is used because the trustee's duties are limited to this function only and are performed entirely at the direction of the Plan sponsor.

### Fund Custodian

A "**Fund Custodian**" is an entity providing unitization services for certain types of Plan assets in certain limited

circumstances. Unitization services are an investment function that will be defined in Board Report 11-02. These services are not the focus of this report.

### **Master Custodian**

A “**Master Custodian**” is an entity providing unitization and/or other directed reporting/administrative services for all Plan assets. Master custodian services are an investment function that will be defined in Board Report 11-02. These services are not the focus of this report.

### Key Findings

Having defined these key concepts/terms, staff will now discuss the most crucial points detailed in the consultant’s report. Staff’s further research and subsequent discussions with Mercer and Great-West have identified the following primary areas of inquiry and staff’s resulting findings/recommendations:

**Question: How is the City’s Plan Currently Meeting the Federal Trust Requirement?**

**Answer: By Self-Trusteeing, i.e. Establishing the City of Los Angeles as the Plan Trustee**

- Meeting the Federal trust requirement (pursuant to the 1996 Small Business Job Protection Act, which required that Section 457 assets be held in trust for the exclusive benefit of Plan participants) can be accomplished through the creation of a trust, annuity contract, or bank/non-bank custodial account.
- The City’s current Administrative Code provisions state that Plan assets “shall be held in trust for the exclusive benefit of Participants and their Beneficiaries.” This language implies that the City has self-trusted the Plan without explicitly stating such, and the language does not provide details or instruction as to how the trustee role is to be fulfilled.
- The City’s primary third-party-administration contract with Great-West Retirement Services and its subsidiary Orchard Trust Company provides that Orchard Trust provides custodial services for all Plan assets held in cash pending investment or disbursement. Because most Plan assets, most of the time, are not held “pending investment or disbursement,” these services should not be viewed as duplicative of the role the City has taken on for itself by self-trusteeing the Plan.
- Custodial services through Great-West can be replaced with trustee services which could be expanded **to cover all Plan assets at all times**; this would be a relatively simple way to immediately expand the level of protection, provide greater clarity regarding how the City is meeting the Federal trust requirement, and shift the emphasis on satisfying that requirement away from self-trusteeship and towards use of a blanket trust account.

**Question: What Represents the Best Practice for Meeting the Federal Trust Requirement?**

**Answer: Corporate/Bank Trustee**

- As previously stated, a Section 457 Plan can satisfy the Federal trust requirement by use of a trust, custodial account or annuity contract.
- Mercer concludes that use of a trust may offer a higher level of asset protection than use of either a custodial account or annuity contract.
- There are two primary ways to create a trust to satisfy the trust requirement: (1) self-trustee or (2) use of an outside corporate/bank trustee.
- Use of an outside corporate/bank trustee is optimal because corporate/bank trustees are professionally trained to handle all the legal requirements related to trust maintenance, whereas in a self-trustee model the individuals acting in that capacity would typically not have a high level of expertise in performing that function, and at any rate would need to use a trustee or custodian to meet certain obligations like processing distributions (the latter status comes closest to representing the City's current situation, in which "the City" has assumed the role of meeting the Federal requirement but is using the Great-West subsidiary Orchard Trust to provide certain banking services like issuing checks to Plan participants).
- A review of other state/local government plans suggests that using an external corporate/bank trustee is the most prevalent model for meeting the Federal trust requirement among mature Section 457 plans.

**Question: How Can the City's Plan Move Towards a Best Practice?**

**Answer: Use Trustee Services Available Through Great-West**

- Great-West works with two entities to provide custodial and/or trustee services for its wide array of state/local clients: Orchard Trust Bank and Wells Fargo Bank.
- Orchard Trust can provide custodial duties but cannot provide trustee duties (as a result of being chartered by the State of Colorado and being limited by State law) but Wells Fargo can provide custodial as well as trustee services.
- The City's 2006 Request for Proposal for Plan Administrative services included a solicitation for "trustee/custodial services for the Plan or arrange for trustee/custodial services with an outside party." Thus, while the current contract with Great-West only includes the narrow range of services presently provided by Orchard Trust, there is no obstacle to amending the contract to provide the more comprehensive services of a "passive trustee" for all Plan assets all the time.
- Great-West is currently preparing information regarding the fees for these services but it was not available at the time of completing this report. It will be available at the Board meeting. However, preliminary indications are that the costs will be modest and charged as a flat dollar amount rather than a percent of Plan assets.

**Question: Do Plan Governing Documents Need to be Amended?**

**Answer: No**

- The Board's legal counsel has reviewed the Plan's governing documents and determined that revisions are not required in order to satisfy Federal trust

requirements, but that minor improvements to Los Angeles Administrative Code Division 4, Chapter 14, Sec. 4.1404 can nevertheless be made in order to provide greater clarity and transparency.

- Sec. 4.1404 presently reads, “*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 Internal Revenue Code Section 401(f). Such **fund** shall be held in trust for the exclusive benefit of Participants and their Beneficiaries...*” The word “fund” appears to be a slight misnomer and a holdover from the Plan’s inception in 1983. It could be replaced with language relating more specifically to how the Plan is satisfying the federal Trust requirement.
- The Board’s “Plan Document” does not presently make reference to satisfying the trust requirement and is not required to; therefore no amendment of this document is required.

Findings/Next Steps

Based on the consultant’s review and staff’s research, staff finds that the best practice for meeting the Federal trust requirement would be using a corporate/bank trustee to provide passive trustee Services. Staff further finds that such action is all that is necessary in order to meet the Federal trust requirement.

Staff therefore recommends that the Board direct staff and the consultant to draft an amendment to the current contract with Great-West Retirement Services to include use of Wells Fargo to provide passive trustee services. There may be certain logistical issues that will need to be addressed as part of making the transition from Orchard Trust to Wells Fargo. As a result, staff recommends that when the draft amendment is returned to the Board for review that it be accompanied by a report/analysis of any issues related to the transition.

Submitted by: \_\_\_\_\_  
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