DEFERRED COMPENSATION PLAN
BOARD REPORT 08-31

EMPLOYEE BENEFITS DIVISION

Date: August 5, 2008

To: Board of Deferred Compensation Administration

From: Staff

Subject: Expanded Trading in Self-Directed Brokerage Option

Recommendation:
That the Board of Deferred Compensation Administration review the following policy considerations with respect to expanding trading options within the Self-Directed Brokerage Option.

Discussion:
The Board recently requested that staff report back on the topic of trading individual stocks and bonds within the Plan's Self-Directed Brokerage Option (SDBO). The Board's consultant, Mercer Investment Consulting, working with Personnel Department staff, has developed the attached presentation regarding SDBO use in other large plans, including the prevalence of permitting trading of individual stocks and bonds.

The results suggest that, should the City's Plan elect to offer such expanded trading opportunities, it would hardly be the first to do so. Mercer's research focused on state plans because their sizes tend to be more comparable to the City's Plan than most municipal entities. The results indicate that several large plans, including the States of California, Texas and Florida, permit trading of individual securities. In addition, Mercer's research suggests that liability concerns do not appear to be a significant risk for the Plan. There are no regulatory impediments to offering trading of stocks and bonds. As a result, given appropriate disclosures, the Plan should be insulated from hypothetical claims from individuals who experience significant losses in their accounts.

Given that, staff's focus in this report will be on the issues the Board should consider in weighing the merits of adding trading of individual securities. As Mercer's research indicates, plans which offer SDBOs typically have low utilization of the SDBO, and only approximately half of SDBO participants will trade individual securities if they are made available for trading. The Board should keep in mind, then, that the issues to be discussed are likely to only affect perhaps 1-3% of Plan participants who might be inclined to trade individual securities.

Arguments for Adding Trading of Individual Securities

- *Competitive Services* – Once participants separate from service they have the ability to roll their assets out of the Plan. One of the motivations for doing so might be to obtain access to trading of individual securities. If the Plan is conceptualized in the broadest terms, an argument can be made that it is appropriate for it to offer a wider range of financial products and services because it is uniquely positioned to do so in a way that better protects the interests of Plan participants.

  The City's Plan is structured to obtain the best services at the most reasonable cost. The Plan does not have a "profit" incentive and does not structure any of its services to provide opportunities for third parties (e.g. sales staff, brokers, financial planners, etc.) to profit from a participant's selection of any specific investment or the trading frequency thereof. If a participant rolls money outside of the City's Plan as part of a general desire or interest in trading stocks/bonds, it can create opportunities for falling prey to outside service providers with financial incentives impacting the choice of investments and frequency of trading. In effect, then, offering securities trading in the City's SDBO makes our Plan more "competitive" with products available outside the Plan, and in a potentially "safer" way because participants might then be less vulnerable to outside marketing efforts which may not be in their best interest.

- *Philosophy of Self-Direction* – The fundamental premise of a defined contribution plan is that it is "self-directed" by the participant. Participants are given a broad range of choices and the freedom to choose their investments based on what they believe is appropriate for their circumstances.

  This principle is particularly fundamental to the offering of an SDBO. An SDBO is designed to provide participants with the ability to pursue investment strategies and approaches more nuanced than can be created within a defined contribution plan core menu. A mutual funds-only SDBO provides opportunities for investors to attempt to obtain out-performance through use of (a) sector funds; (b) funds with managers who the participant believes can deliver out-performance; and (c) funds permitting frequent trading.

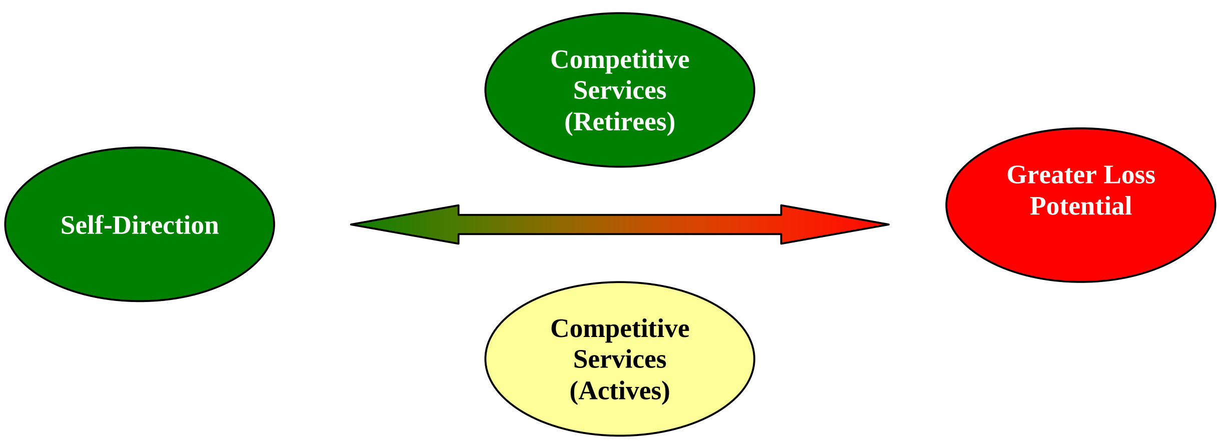
  Adding securities trading can be viewed as an expanded application of this self-direction principle. Stocks and bonds would present opportunities for investors to take advantage of unique investing opportunities that might present themselves at the level of an individual issue. This could include stocks of undervalued firms, stocks uniquely positioned for growth, individual bonds, etc.

Argument for Not Permitting Trading of Individual Securities

- *Greater Loss Potential* – The potential for losses in individual stocks is much greater than is the case for mutual funds. Given this potential, it is inevitable that some participants trading individual stocks will incur substantial losses. These losses can occur in trading of smaller, relatively unknown stocks, and can also occur in stocks of large, well-established firms. The recent credit crisis has resulted in a number of financial services firms (e.g. Bear Sterns and IndyMac) having their shareholder values essentially wiped out, and many others having suffered significant and dramatic stock price declines. A number of these firms would have been considered “blue chip” before the credit crisis began.

An argument can be made that the potential losses outweigh the potential benefits of out-performance. Indeed, given that most professional money managers are incapable of beating market indices, it is probably reasonable to surmise that for most participants who end up trading individual stocks, having that capability will only magnify the degree of their under-performance vis-à-vis a benchmark index (even if they use professional advice).

Tradeoff – Greater Freedom vs. Greater Loss
In considering the question of whether the SDBO should be expanded to include trading of stocks and bonds, the essential tradeoff in play is the *self-direction principle* vs. the *greater loss potential*. The competitive services principle “trumps” this tradeoff for participants who have separated service, since those participants have the ability to roll their money out of the Plan anyway, but is more of a neutral argument for active employees since they don’t have the option of rolling their funds out of the Plan (although a modest incentive may exist to save outside of the Plan if trading individual stocks is extremely important to the individual).



Exchange Traded Funds – Introducing Exchange Traded Funds (ETFs) may present either an alternative to, or a potentially interim step towards, trading of individual stocks and bonds. ETFs are essentially mutual funds packaged like individual stocks for trading purposes. They are “baskets” of stocks typically organized a market index but which can be traded throughout the day.

As an example, the State Street Global Advisors ETF for the S&P 500 (ticker symbol: SPY) contains the 500 stocks that make up the S&P 500, a commonly used benchmark for large-company stocks. In that sense, what it invests in is identical to the holdings of our Plan's Vanguard Institutional Index Plus Fund (VIIIX), a mutual fund. The difference between the two is that "SPY," an ETF, can be bought and sold like a stock throughout the trading day, while "VIIIX," a mutual fund, can only be purchased and redeemed at the close of a trading day (and has further restrictions on frequent trading). As a result, an active trader could execute frequent buy and sell orders for shares of "SPY" as part of a trading strategy designed to generate excess return.

Charles Schwab has indicated that it will soon have the ability to permit plan sponsors to open up a special window to ETF trading without opening up trading to individual stocks and bonds. As a result, the Board could elect to introduce ETF trading as either an alternative to trading of individual stocks or as an interim step towards stock trading.

One benefit of this approach is that permitting trading of ETFs would open up another opportunity for self-direction but without creating a significantly greater potential for loss. ETFs have been developed for all sectors and strategies but these sector and strategy approaches merely replicate those already used in mutual funds. Thus, they would provide new opportunities for active traders, although they would not meet the desires of investors looking for much larger potential gains that might occur by concentrating their investments in one or a handful of individual companies.

The ETF industry has been growing rapidly in recent years. One of the attractions for investors is that they provide an opportunity for active trading strategies (one of the appeals of trading individual stocks) without having the same risk level (because an ETF, as a pooled fund, cannot be "wiped out" in the same way that an individual stock value could). A secondary benefit of an ETFs-first approach is that participants interested in stock trading but unfamiliar with ETFs might find that ETFs largely meet their needs. As a result, those participants might be less inclined to trade individual stocks if and when such trading is allowed.

Conclusion

Consideration of whether to open up the SDBO to securities trading is a challenging Plan design issue. Other comparable defined contribution plans have permitted it while others have not. Although the decision is likely to ultimately impact very few participants, the principles and interests at stake have great significance for those affected. As a result, staff believes it is important to frame the issue appropriately and review it thoroughly before moving forward with a decision.

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