



**Office of the City Auditor**

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**Report to the City Council  
City of San José**

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**DEFERRED COMPENSATION:  
THE CITY CAN STREAMLINE  
AND IMPROVE THE  
ADMINISTRATION OF ITS  
DEFERRED COMPENSATION  
PROGRAM**

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**Report 13-02  
February 2013**

February 13, 2013

Honorable Mayor and Members  
Of the City Council  
200 East Santa Clara Street  
San José, CA 95113

## **Deferred Compensation: The City Can Streamline and Improve the Administration of its Deferred Compensation Program**

The City has historically maintained two deferred compensation plans (Plans) which allow employees to supplement their retirement savings by deferring a portion of their income. The first plan is a voluntary plan available to all employees who elect to participate; the second (the PTC plan) is a mandatory plan in lieu of Social Security for employees who are not eligible for membership in either of the City's defined benefit plans (e.g., part-time employees).

**The City Can Improve Controls to Ensure Employee Contributions and Credits are Accurate.** Administration of the deferred compensation program requires careful coordination between the City and its third party administrator. Between 1999 and 2007 there were instances of individuals exceeding the IRS' annual contribution limit or participants' accounts being credited more or less than their payroll deductions. Our testing indicates that prior account management problems have been corrected; specifically, that current automated procedures have improved the accuracy of participant deferred compensation account crediting, and that the City's payroll system (PeopleSoft) is effectively limiting against excess IRS annual contributions.

Although prior issues have been corrected, we did find 20 individuals incorrectly credited in the PTC group between 2008 and 2012. Implementing improvements in the interfacing process could reduce errors between the City and its third party administrator. Likewise, HR could more effectively use their resources to investigate individual discrepancies in participant deferrals.

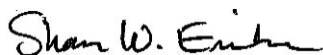
**The City Can Provide Savings to Participants Through Administrative Efficiencies and Reduced Fees.** Plan participants pay the full cost of administering the deferred compensation plans. The City's fees appear to be comparable with other jurisdictions' plans and private 401(k) plans. However, the City can ensure that its administrative fees continue to be reasonable by eliminating activities currently performed by multiple parties, streamlining the process for amending the Plan documents, and clarifying the roles and responsibilities of Human Resources and the Deferred Compensation Advisory Committee.

To provide further savings to participants, the City should consider adopting a policy to (a) reduce the administrative fee when the deferred compensation fund balance exceeds its reserve target and (b) review and adjust the asset-based administrative fee when total Plan assets grow so that the fees

charged to participants do not exceed expected expenditures. The City should also periodically review whether the fee structure equitably allocates program costs and improve fee disclosures for participants.

I will present this report at the February 21, 2013 meeting of the Public Safety, Finance, and Strategic Support Committee and the March 18, 2013 meeting of the Deferred Compensation Advisory Committee. We would like to thank the Human Resources, Finance, and Information Technology Departments, and the City Attorney's Office for their time, information, insight, and cooperation during the audit process. The Administration has reviewed the information in this report and their response is shown on the attached yellow pages.

Respectfully submitted,



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# Introduction

In accordance with the City Auditor's 2012-13 Work Plan, we have completed an audit of the City's Deferred Compensation program. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this report.

The Office of the City Auditor thanks the Human Resources, Finance, and Information Technology Departments, and the City Attorney's Office for their time, information, insight, and cooperation during the audit process.

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## Background

The City maintains two deferred compensation plans (Plans) in accordance with Section 457 of the Internal Revenue Code, which provides authority for public sector employers to offer the equivalent of private 401(k) plans:

- Deferred Compensation Plan (voluntary plan) – The voluntary plan is available to all City employees on a voluntary basis. Participants enroll through a participation agreement, specify the amount of the deferral, and select among offered investment options. As of June 30, 2012, 72 percent of City employees participated in the voluntary plan. Including retired and separated employees, the voluntary plan contained nearly 6,900 individual accounts which held \$634 million dollars.
- PTC Deferred Compensation Plan (PTC plan) – The PTC plan is a mandatory plan in lieu of Social Security for employees who are not eligible for membership in either of the City's defined benefit plans (e.g., part-time employees). Participants are required to contribute 3.75 percent of their salary and the City makes a matching contribution. As of June 30, 2012 there were 2,040 PTC participant accounts with assets totaling \$13 million.

The City also offers two 401(a) programs. The first is a Money Purchase Plan for specified City Council appointees. The second is a new defined contribution plan for new employees of Unit 99 who elect to opt out of the City's defined benefit plan (Tier 3).<sup>1</sup>

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<sup>1</sup> This audit focuses on the City's 457 plans; the two 401(a) plans were not included in our audit tests.

## Deferred Compensation

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In accordance with IRS regulations, the Plans allow employees to defer a portion of their compensation until future years. The deferred portion is not taxable until distributions are made, which occur only in the event of death, retirement, termination, disability, or unforeseen emergencies. Through a recently added Roth 457 feature, participants are also allowed to contribute after-tax income, the earnings on which are tax free if, when withdrawn, the distribution meets IRS criteria.

The City contracts with a third party administrator (TPA) to administer the plan. Currently, the TPA is ING Life Insurance and Annuity Company (ING).

Active employees are eligible to borrow against their voluntary plan accounts. As of June 30, 2012, there were 1,064 loans outstanding with a balance of nearly \$12 million. Loans are made directly through the TPA, and payments toward these loans are made through automatic payroll deductions.

### *Employee Contributions and Investments*

Participants make contributions to their deferred compensation account through biweekly payroll deductions. The Internal Revenue Code limits the amount that can be deferred in any given year.<sup>2</sup> The Internal Revenue Code also allows for rollovers into participants' accounts from another pension or deferred compensation plan.

Each employee's account is credited with the amount withheld from their biweekly paycheck (for PTC members, the account is also credited with the City's matching contribution). Plan participants direct their contributions into investment options offered by the Plans' TPA. Investment options include various publicly traded mutual funds (stocks, bonds, or fixed income assets), annuity investments, and U.S. Government securities. For PTC members, the only investment vehicle available is the Stable Value Option, a diversified fund consisting of guaranteed investment contracts and fixed income securities.

### *Plan Administration*

Municipal Code sections 3.48 and 3.50 contain the Plans' documents, which describe and guide the operations and administration of the Plans. As prescribed in the Municipal Code, the assets of the Plans are held in trust by the City and administered by the Deferred Compensation Advisory Committee (DCAC) and City staff. Specifically, the DCAC is responsible for the operation of the Plans in accordance with the Municipal Code, including making decisions on behalf of the City regarding the choice and nature of investments available under the Plans, and entering into agreements on behalf of the City for the administration of the Plans.

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<sup>2</sup> The maximum annual deferral for 2012 was \$17,000. However, the IRS also allows for higher contributions through catch-up provisions for employees over the age of 50 and during the final 3 years before retirement eligibility (the maximum annual deferrals under these circumstances were \$22,500 and \$34,000 respectively).

The DCAC meets quarterly to provide oversight for the Plans. The Employee Benefits Division of the Human Resources Department (HR) provides the day-to-day administration of the Plans. The Finance Department also assists in this role.

The investment options offered to participants by the TPA are guided by the Plans' Investment Policy as established by the DCAC. The Investment Policy is reviewed annually, most recently in March 2012. According to the policy, "investment options are selected to provide participants with an opportunity to diversify their accounts across a reasonable risk and reward spectrum." In addition, the policy states that the "number and types of investment options and the investment fund managers retained to manage the investment options are subject to change based upon [DCAC] on-going review and evaluation of the investment menu offered to participants."

In addition to the agreement with the TPA, the DCAC utilizes an investment consultant (currently Buck Consultants, LLC) to assist in developing the Plans' investment menu; evaluate the return, risk, and characteristics of each of the funds within the menu compared to appropriate indexes; and provide other non-investment services, such as developing requests for proposals, reviewing the Plan documents, overseeing day-to-day contract administration of the TPA, and other services as necessary.

The DCAC is comprised of seven members – one member representing management employees, one representing sworn police department employees, one representing sworn fire department employees, two representing the other employee organizations, and two appointed by the City Manager.

#### *Account Handling and Crediting*

New deferred compensation accounts are opened in one of two ways. For voluntary plan participants, new accounts are opened directly with the TPA, and the information is transmitted to HR to be uploaded electronically into PeopleSoft, the City's payroll system. For PTC plan participants, employees submit a paper PTC enrollment form during new employee orientation, and the account information is faxed to the TPA to update their database.

Every two weeks HR receives the following from the TPA:

- *Change/Add file* including new enrollees with their deduction amounts and enrolled participants with updated deduction changes
- *Waive file* including those participants opting to cease deductions
- *Loan file* including new or updated loan information



## Deferred Compensation

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These files are uploaded directly to the City's payroll system (PeopleSoft), which automatically updates employee's contribution settings and payroll deductions. In addition, HR sends the TPA a biweekly *rehire and termination report* authorizing the TPA to allow employees to set up a new account or begin distribution upon separation from the City.

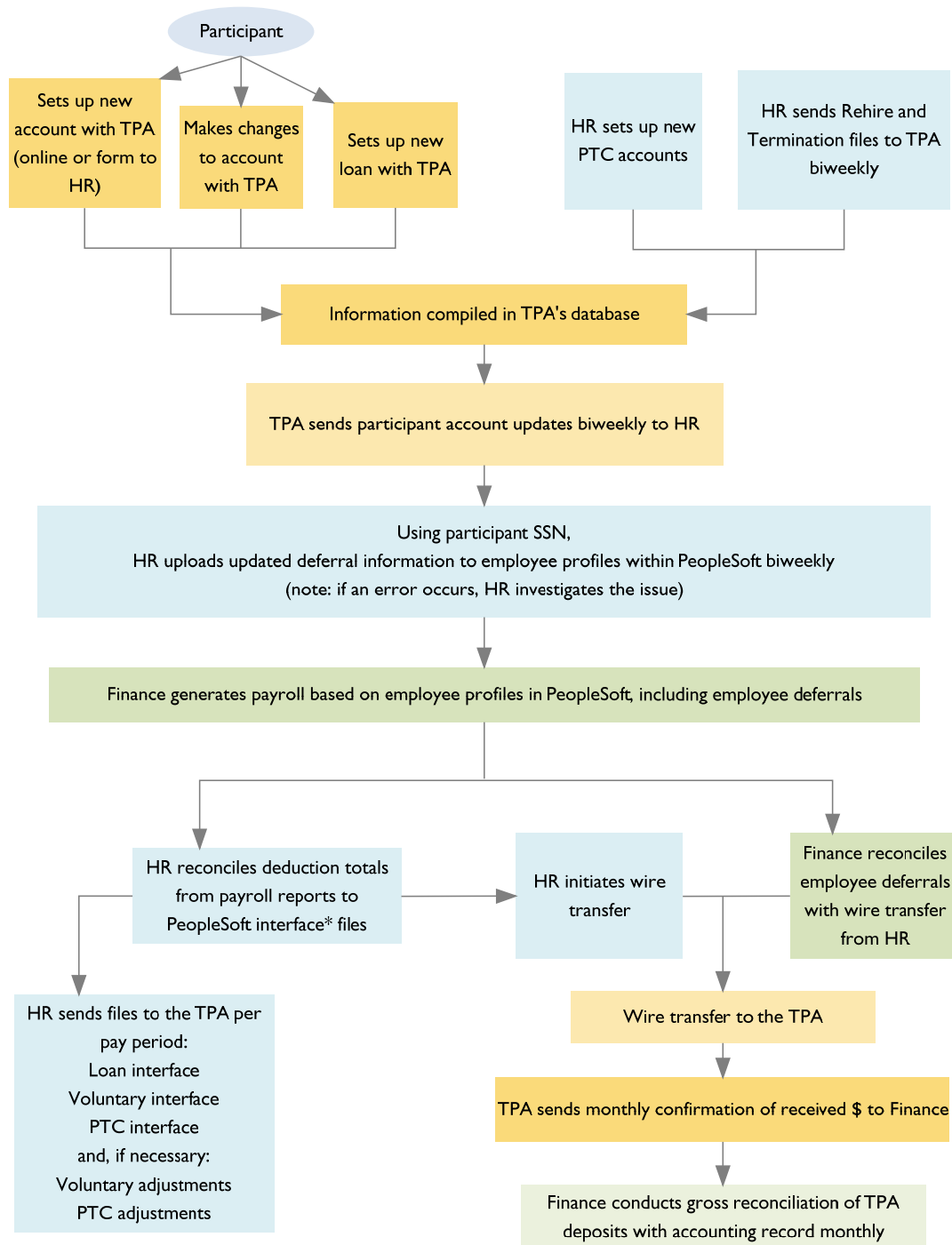
At the close of a pay period, Finance generates a *payroll summary report* detailing total deferred compensation deductions for voluntary, PTC, and loan plans. HR uses this report to reconcile against the deduction totals from PeopleSoft-generated interface reports which are used to communicate individual contribution information to the TPA.<sup>3</sup> The reconciliation compares gross deductions from payroll to gross contributions to be wired to the TPA. In particular, HR calculates the total from the payroll summaries, which are automatically generated by Finance, and cross checks against the totals automatically generated from PeopleSoft. If payroll adjustments are necessary which impact an employee's deferral, HR must manually generate an adjustment interface file to append to the other PeopleSoft-generated interface files. Payroll adjustments typically include timecard corrections or leave payouts.

Once the payroll summary reports have been reconciled against the PeopleSoft deduction totals and the wire transfer amounts are calculated, HR initiates the wire transfer to the TPA. During this time, Finance also reconciles gross employee deferrals from the payroll summary reports to the wire transfer calculated by HR. Each month, Finance conducts a monthly reconciliation comparing the TPA's receipt of deposits to the City's accounting record. Exhibit I summarizes these processes.

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<sup>3</sup> HR always sends at least three files (voluntary, PTC, and loan interfaces) and up to two additional interfaces (voluntary and/or PTC adjustments if any) to the TPA every pay period.

**Exhibit I: Deferred Compensation Flow of Information and Transfer of Payroll Deductions**



\* interface reports are used to communicate individual participant contributions to the TPA.

Source: Auditor analysis based on interviews with HR and Finance staff

### *Prior Account Management Issues*

In April 2008, HR initiated a reconciliation project of deferred compensation accounts. The project stemmed from Finance's discovery of a net variance in the control account for the Plans, which developed from 1999 through 2007.<sup>4</sup> HR and Finance reviewed historical transfers over that period and found over 700 errors, including participants receiving more or less than the amount deducted from their pay, participant contributions exceeding the IRS' maximum allowable annual limit, and record keeping errors in participant's personal information. According to Finance and HR, these errors were the result of a high degree of manual data input. It is our understanding that the City made a good faith effort to contact the former participants and correct outstanding issues.

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### **Audit Objective, Scope, and Methodology**

The objective of our audit was to review the current administration of the City's Deferred Compensation Program with a focus on the crediting and handling of employee accounts. We sought to understand the administration and operation of the deferred compensation program through various interviews, reviews of documentation, and a review of data generated from PeopleSoft and provided by ING (the City's TPA). These included:

- Interviews with staff from HR, Finance, Information Technology and the City Attorney's Office, including job shadowing HR procedures related to reconciling biweekly deferred compensation deductions and wire transfers. Staff also interviewed staff from the Plans' TPA and investment consultant.
- Review of the applicable sections of the City's Municipal Code, the approved Deferred Compensation Advisory Committee's Rules of Order and Investment Policy, and other applicable guiding documents.
- Review of Deferred Compensation Advisory Committee meeting agendas and minutes, as well as documents prepared by City and consultant staff for the Committee's consideration.
- Research and interviews of staff from other jurisdictions' deferred compensation plans. Benchmarked jurisdictions included San Francisco, San Diego, Los Angeles, Oakland, Sunnyvale, Alameda County, Contra Costa County, San Diego County, San Mateo County, and Santa Clara County.

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<sup>4</sup> The control account is an employee benefits fund which accounts for withholding of deferred income from employee paychecks and associated remittances to the third party administrator for deposit into participant accounts. With the exception of timing differences, there should not be a variance in this account (i.e., deferred income withheld should equal remittances).

- Research on best practices and other guidelines, including those from the National Association of Government Defined Contribution Administrators and the Government Finance Officers Association.

We also tested PeopleSoft's payroll deductions against account transaction data provided by the Plans' TPA for voluntary, PTC, and loan participants in four randomly selected pay periods from February 2011 through October 2012. We conducted three tests to determine whether: (1) employee contributions matched corresponding payroll deductions, (2) annual contributions did not exceed IRS limits, and (3) participant personal information was accurate and up to date. Upon discovery of potential errors associated with PTC plan members with the same name, we conducted additional testing of PeopleSoft payroll data for the PTC plan from 2006 to 2012 to locate other instances in which such an error could have occurred. This situation is discussed in more detail in Finding I of this report.

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# **Finding I The City Can Improve Controls to Ensure Employee Contributions and Credits are Accurate**

## **Summary**

Administration of the deferred compensation program requires careful coordination between the City and the Plans' TPA. Between 1999 and 2007 there were instances of individuals exceeding the IRS' annual contribution limit or participants' accounts were credited more or less than their payroll deductions. Our testing indicates that prior account management problems have been corrected; specifically, that current automated procedures have improved the accuracy of participant deferred compensation account crediting, and that the City's payroll system (PeopleSoft) is effectively limiting against excess IRS annual contributions.

Although prior issues have been corrected, we did find 20 individuals incorrectly credited in the PTC group between 2008 and 2012. Implementing improvements in the interfacing process could reduce errors between the City and the City's TPA. Likewise, HR could more effectively use their resources to investigate individual discrepancies in participant deferrals.

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## **Prior Account Management Problems Have Been Corrected**

As described in the Background, between 1999 and 2007 HR found a number of instances where individuals exceeded the IRS' maximum allowable contribution limit or amounts deposited in participants' accounts were more or less than what had been deducted from their pay.

As part of this audit, we tested to ensure that no individual in the past two years exceeded IRS limits, including age-related extensions or catch-up provisions.<sup>5</sup> These results were verified by a report generated by the Plans' TPA showing that employees who had reached their annual IRS deferral limit did not receive a deduction from pay thereafter. The mechanism for limiting excess contributions is a hard stop on deferrals in PeopleSoft once a participant reaches the contribution limit. This was put in place by the Information Technology Department (IT) to stop PeopleSoft from taking a deduction once the annual IRS threshold is reached.

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<sup>5</sup> Age-related extensions allow for increased annual deferrals for employees aged 50 (for federated) or 47 (for non-federated). Catch-up provisions also allow for increased annual deferrals, and can be taken during the final three years prior to retirement.

According to Finance, past discrepancies between payroll deductions and contributions into deferred compensation accounts were related to timecard corrections or final payouts for separating employees. In the past, these required a manual fix and additional follow-up with the TPA. Further, the TPA did not previously accept off-cycle reports which led to the need for manual adjustments. These procedures have since been automated, and the automation appears to have remedied past problems. Specifically, our analysis of a sample of PeopleSoft and TPA data produced no discrepancies between contributions and deductions for either the voluntary or loan programs. Testing also verified that payroll adjustments were correctly credited to the corresponding ING accounts.

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### **A Few Individual's Contributions in the PTC Plan Were Not Credited Accurately**

Although the prior account management problems described above have been corrected, we did find 20 individuals in the PTC plan whose deferrals were not credited accurately between 2008 and 2012. Problems occurred when two PTC participants had the same name. In these cases, the TPA records showed a single entry with all deductions going to one of the two participants. This occurred because of a faulty PTC interface report first put in place in 2006.

On a bi-weekly basis, the City remits PTC plan contributions (including both employee and matching City contributions) to the TPA. The PTC interface report communicates the total contribution to the TPA by summing the employee and employer deductions. The error arose from a faulty formula, which aggregated the employer and employee contribution based on name rather than a unique identification number such as Social Security number or employee ID number. In cases where two PTC participants had the same name, the employer and employee contributions for the two participants (a total of four amounts) were aggregated into a single entry for one of the two participants.

In total, we found 10 duplicate names (equating to 20 individuals) between 2008 and 2012. HR has been alerted of the issue and is working with IT to fix the interface file and with the TPA to fix the contributions on a go forward basis.

**Recommendation #1: To correct PTC duplicate name issues, Human Resources should:**

- (a) Work with the Information Technology Department to fix the PTC interface file.**
- (b) Work with the third party administrator to notify the affected PTC participants and remedy erroneous contributions plus associated gains/losses.**

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**Improved Procedures Can Reduce Risk of Errors****Interface Process Could be Fully Automated to Reduce Risk of Error**

As detailed previously, HR prepares a wire transfer and multiple interface files for the TPA to direct funds to the appropriate deferred compensation account. The wire transfer amount is calculated based on totals from the four automated interface files and up to two additional adjustment files which are not generated by PeopleSoft (one each for the voluntary and PTC plans). HR produces the adjustment files manually from information in a separate payroll summary report.

Automating the adjustment interface would reduce the risk of manual error in calculating the wire transfer and ensure that the TPA's receipt of adjustment entries is properly handled.

**Current Procedures Do Not Include Investigating Individual Exceptions Showing on Payroll Balancing Report**

During HR's biweekly reconciliation, a balancing report is generated in addition to the four interface files. The balancing report aggregates deductions found in each of the four interface files and produces an individual-level detail list of deductions. HR uses the report solely for the final page which sums the totals for each plan; these totals are used to calculate the wire transfer to the TPA. The preceding pages of the report contain the individual breakdown of each participant's corresponding deferrals.

If no deduction was taken, although the participant had elected for one to be taken, the balancing report places an asterisk as indication of an error. The majority of these instances are not errors, but the result of a participant reaching their annual IRS contribution limit, and the lack of a deduction illustrates that the hard stop in PeopleSoft is working effectively.

Less often, the error may indicate if a participant mistakenly elected to defer more than their total paycheck. In one instance, a participant had entered their intended annual allowance in their deferral election, rather than the biweekly amount. The result was a zero-deduction for six weeks before the participant was alerted of the issue. If these errors more easily identified through an automated solution, HR could investigate and resolve such cases more quickly.

**Recommendation #2: To further reduce the risk of error, Human Resources should work with the Information Technology Department to:**

- (a) Implement an automatic adjustment interface.**
- (b) Develop automated solutions to identify participants in the Deferred Compensation Balancing Report with a potentially erroneous zero-deferral.**



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## **Finding 2 The City Can Provide Savings to Participants Through Administrative Efficiencies and Reduced Fees**

### **Summary**

Plan participants pay the full cost of administering the deferred compensation plans. The City's fees appear to be comparable with other jurisdictions' plans and private 401(k) plans. However, the City can ensure that its administrative fees continue to be reasonable by eliminating activities currently performed by multiple parties, streamlining the process for amending the Plan documents, and clarifying the roles and responsibilities of Human Resources and the Deferred Compensation Advisory Committee.

To provide further savings to participants, the City should consider adopting a policy to (a) reduce the administrative fee when the deferred compensation fund balance exceeds its reserve target and (b) review and adjust the asset-based fee when total Plan assets grow so that fees charged to participants do not exceed expected expenditures. The City should periodically review whether the fee structure equitably allocates program costs and improve fee disclosures for participants.

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### **Fees Have Been Reduced in Recent Years and Appear to be Comparable with Other Jurisdictions and Private 401(k) Plans**

Plan assets are held in trust for the exclusive benefit of participants and beneficiaries under the Plans. Plan participants pay the full cost of administering the Plans and are charged two types of fees for participation:<sup>6</sup>

- Investment management fees charged by mutual funds within the plan investment menu (referred to as net fund expenses). These are set by the mutual fund companies based on their costs to manage the fund.
- Administrative fees to fund administrative services provided by the TPA and City staff.

In 2011, the City sought a new investment and administrative services provider through a competitive request for proposal (RFP) process. Although the City received bids from a number of other firms, ING was selected to continue as the third party administrator and record keeper of the voluntary and PTC plans. Among the selection criteria for consideration by the RFP evaluation committee

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<sup>6</sup> Participants may also be assessed additional fees if they opt for individual investment advice through Morningstar or take out a loan against their deferred compensation account balance.

was administrative fees. The proposal by ING resulted in administrative fees being reduced from 0.28 percent of Plan assets to 0.17 percent of assets. On a per participant basis, this was a reduction from \$28 to \$17 for every \$10,000 of assets in the plan.

The City's current administrative fees are within the range of other plans we reviewed, although there appears to be some variation across jurisdictions based on the size of plans. According to the Plans' investment consultant, this may be a result of larger plans being able to spread costs across a larger population of participants than smaller plans, and thus have a lower fee. However, the investment consultant believes that ING's administrative fee is low compared to those for third party plan administrators for other jurisdictions' plans.<sup>7</sup>

In 2011, Deloitte Consulting and the Investment Company Institute compared total administrative and investment fees (which they called the "all-in" fee) for 401(k) plans. Among the surveyed plans with assets ranging from \$500 million to \$1 billion, the average all-in fee was 0.51 percent, with a range of 0.46 percent to 0.58 percent. The comparable all-in fee for the City's voluntary plan is estimated to be 0.53 percent (or \$53 per \$10,000 invested). Prior to the 2011 RFP process, the estimated all-in fee was 0.71 percent (\$71 per \$10,000 invested). The largest factor in the drop was a decline in the fees for the Stable Value Option from 0.80 percent to 0.47 percent.

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### **The City Can Achieve Efficiencies by Eliminating Redundant Administrative Activities**

#### **There are Functions Performed by Both City Staff and the Plans' Third Party Administrator**

Currently, there are administrative functions which are performed by both City staff and the Plans' TPA. For example, HR monitors annual employee deferrals to identify participants nearing the annual IRS limit. Although the payroll system will not allow an employee to defer more than the IRS limit in the voluntary or the PTC plans, an employee who has accounts in both plans could exceed the limit when deferrals across both plans are aggregated. The TPA also monitors employee deferrals to identify participants approaching the IRS limits. If the TPA notes that an individual is approaching the limit (in either the voluntary or PTC plan or in the aggregate), they will notify HR who in turn will instruct the employee to adjust the amount of their elected deferral.

Another example concerns education and counseling services for participants. HR currently provides such services to separating employees. For example, HR sends a letter to the separating employee that details the options available for

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<sup>7</sup> Although the investment consultant is paid from the City's portion of the administrative fee, their compensation is not based on the amount of administrative fees generated by the Plan.

their account (such as maintaining it with the TPA, rolling it over to a 401(k) or other qualifying plan, or distributing the assets). The TPA also offers education and counseling services to Plan participants. In addition, separated employees work directly with the TPA rather than the City when determining what to do with their accounts post-employment.

### **Human Resources and Finance Both Reconcile Payroll Deferrals with Wire Transfers to Third Party Administrator**

The Payroll Division within the Finance Department maintains a control account to track employee deferrals and related wire transfers. Each payroll period, a payable is created in this account reflecting the amounts withheld from employees' paychecks for deferred compensation. When funds are remitted to the TPA (through the wire transfer) a corresponding entry is recorded to reduce the payable. As the amounts withheld should equal the remittances to the TPA, at the end of each pay period the balance of the payable should be zero.<sup>8</sup>

At June 30, 2012, this account had a variance which resulted from a small number of discrepancies between the recorded payable and associated wire transfer between April 2011 and 2012 (ranging from less than \$1 to \$761). Finance and HR reviewed the discrepancies and found that they were primarily payroll adjustments which were reflected correctly in the wire transfer to the TPA but not accounted for correctly in this fund. They also found that the discrepancies did not result in errors in individual participant accounts. Because this account should equal zero at the end of each payroll, Finance staff has begun reconciling participant deferrals reflected in PeopleSoft (which creates the original payable) to the wire transfer to the TPA prepared by HR.

On a biweekly basis (as described in the background section of this report), HR (1) prepares multiple interface reports from PeopleSoft to communicate individual contribution information to the TPA and (2) initiates a wire transfer which transmits funds to be credited to participant accounts. As part of this process, HR also prepares a biweekly reconciliation to ensure that the amounts wired to the TPA equal employee deferrals.

In our opinion, it is appropriate for Finance to conduct this biweekly reconciliation as an independent check on whether the wire transfer that is initiated by HR accurately reflects participant deferrals.

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<sup>8</sup> It was a variance found in this account in 2008 which alerted Finance and Human Resource that there was an issue to be addressed and thus began the account reconciliation project which was described in the Background.

**Recommendation #3: To eliminate duplication of effort, Human Resources should:**

- (a) Delegate to its third party administrator responsibility for monitoring annual employee deferrals to identify those participants nearing IRS limits, and counseling and education for participants separating from City employment.**
- (b) Eliminate its biweekly deferred compensation reconciliation process, a procedure also performed by Finance.**

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### **The City Can Streamline Plan Administration**

The National Association of Government Defined Contribution Administrators (NAGDCA) notes that plan fiduciaries, in performing their duties prudently and in the best interest of plan participants, should ensure that participants are paying only reasonable expenses. To this end, it is incumbent upon the City to ensure that the Plans are administered as efficiently as possible.

#### **The City Can Streamline the Process for Amending the Plan Documents**

In November 2011 and August 2012, the Plan documents were amended to comply with changes to the Internal Revenue Code resulting from the federal Pension Protection Act of 2006 and the Heroes Earnings Assistance Relief Tax Act (HEART Act). In addition, the 2012 amendments included changes to the Plan to incorporate a new Roth 457 option and allow participants to remain in the plan after ending employment with the City.

Despite these amendments, the Plan documents have not been changed to fully reflect the evolving nature of the Plan's operational environment. For example, the Plan documents describe a paper-based enrollment and deferral change process, with employees executing written participation agreements and filing them with the City. In practice, employees can enroll and make deferral changes directly with the TPA online through its San José deferred compensation web portal. Similarly, the Plan documents call for participants to apply to the DCAC for withdrawals for unforeseen emergencies. The DCAC is the only party named with the discretion to permit such withdrawals. In practice, this function was delegated to the TPA in 2007.

Because the Plan documents are embedded within the Municipal Code, amending the Plan documents requires coordinating with the City Attorney's Office to draft an ordinance to be heard and accepted by the City Council. This is in addition to multiple levels of review by City staff, consultants, and the DCAC. All of the steps in this process add costs which must be borne by Plan participants.

In our opinion, the process can be made more efficient by extracting the Plan documents from the Municipal Code. Among jurisdictions surveyed about their deferred compensation organizational structure, the City was alone in having its plan documents embedded in its municipal or administrative code. In those other jurisdictions, the municipal or administrative code provided the authority for the deferred compensation program; the plan documents which detailed the rules and procedures for administering the plan were stand-alone documents.<sup>9</sup> The authority to amend plan documents varied across those jurisdictions, with some providing that authority to the employer and others to a designated oversight body.

### **The City Should Clarify the Roles and Responsibilities of Human Resources and the Deferred Compensation Advisory Committee**

#### *The DCAC Conducts Both Oversight and Administrative Activities*

The Municipal Code names the DCAC as the Plans' administrator and has provided it with broad administrative and oversight responsibilities. Most of the day-to-day administrative functions are performed by City staff or the TPA, and the DCAC focuses much of its work on its oversight responsibilities, including reviewing the performance of the various investment options available to participants. For this latter work, the DCAC relies upon the Plans' investment consultant to monitor performance and provide recommendations on whether to add or remove mutual funds from the Plan's investment menu.

NAGDCA describes oversight as developing rules and procedures for operating a plan, whereas administration is described as implementing the terms of the Plan in accordance with the rules and procedures adopted. Although the DCAC has delegated many administrative functions, in its quarterly meetings it conducts a range of oversight, administrative, and other activities. Examples include:

- Oversight functions such as approving deferred compensation budgets, developing the Plan investment policy, and approving changes to the Plan documents
- Administrative functions such as contract monitoring (e.g., reviewing the TPA's service and activity logs detailing education efforts, quarterly enrollments, and other activities) and reviewing quarterly financial activity (such as the TPA's administrative reimbursements, quarterly contributions, rollovers, and other activities)

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<sup>9</sup> This is also how the new Tier 3 401(a) program for new Unit 99 employees is structured.

- Monitoring investment performance such as reviewing the quarterly performance of the Stable Value Option and funds included on the Watch List.<sup>10</sup> On a semiannual basis, the DCAC also reviews performance of all of the funds in the Plan's investment menu. These reviews are conducted and presented by the TPA and the investment consultant.

### *Frequent DCAC Meetings Add Costs for Plan Participants*

HR and Finance prepare multiple reports and memos for DCAC consideration at its quarterly meetings, while at the same time coordinating the work of the Plans' TPA and its investment consultant. In addition, multiple staff members from HR and Finance attend each meeting, along with staff from the Plans' TPA and its investment consultant (who must travel from out of state). All of this staff time and work adds to the Plans' costs. It was for this reason that the DCAC opted to reduce the frequency of its meetings from monthly to bimonthly in 2010 and then to quarterly beginning in June 2012.

### *HR is the Delegated Administrator for the New 401(a) Plan and Other Employee Benefits*

The newly established Tier 3 401(a) deferred compensation program for new Unit 99 employees assigns administrative responsibility for the plan to the City Manager or her designee. Other benefit programs provided by the City, such as health and dental benefits or flexible spending accounts, are administered by HR and do not have a separately designated oversight or administrative body. The deferred compensation program is similar to these other benefits in that although the DCAC and HR administer the plans, employees work directly with the TPA when signing up for or utilizing the program.<sup>11</sup>

### *Administrative and Oversight Roles and Responsibilities Differ Across Jurisdictions*

Currently, other jurisdictions structure the administration and oversight of their deferred compensation plans differently than the City. For example, the County Treasurer is the named plan administrator in both Alameda and San Diego County. In Alameda County, the oversight body is an ad hoc committee, comprised of county employees, who provide a review and advisement role to the Treasurer regarding changes or issues that need to be resolved affecting the

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<sup>10</sup> The Watch List contains funds which have underperformed their benchmark indexes as specified in the DCAC-approved Investment Policy and may be considered for replacement. The Plans' investment consultant makes recommendations about whether funds should be included on the Watch List and whether they should be replaced. The Investment Policy states that the Watch List funds should be reviewed semiannually; however the DCAC has decided to review the Watch List funds quarterly.

<sup>11</sup> The exceptions to the above are the City's two defined benefit pension plans, which are governed by *independent* retirement boards. However, the defined benefit plans differ from deferred compensation in that the retirement boards have responsibility for overseeing plan investments. The DCAC's responsibility is to ensure choices are available for participants, who make individual decisions regarding how much to defer and where to direct their investments.

plan document, the investment policy, or investment options offered under the plan. In San Diego County, the oversight body is an Investment Advisory Committee and reviews investment-related topics and does not oversee other administrative activities.

In San Francisco, the oversight body is the named administrator; however it meets only on a semiannual or as-needed basis and focuses on oversight functions such as reviewing RFPs or contracts and proposed changes to the investment options available under the plan.

*Roles and Responsibilities Should be Delineated in the Municipal Code or Plan Documents*

In our opinion, the City should consider administering and overseeing the Plans in a similar manner as these other jurisdictions as well as the City's other employee benefits programs. This would mean a clearly delineated delegation of responsibility for day-to-day plan administration to the City Manager, and refocusing the role of the DCAC to its oversight responsibilities, which could enable them to further reduce the frequency of their meetings and provide savings to participants. These important DCAC oversight responsibilities include reviewing and advising on annual budgets and changes to the Plans documents, Investment Policy, and investment menu.

**Recommendation #4: The City Attorney's Office and Human Resources should review the Deferred Compensation Plans and draft amendments to the Municipal Code as follows:**

- (a) Assign responsibility for administering the Plans to the City Manager or her designee, including the operation and interpretation of the Plans in accordance with their terms and contractual authority to enter into contracts for the administration of the Plans.**
- (b) Clarify the oversight role and responsibilities of the Deferred Compensation Advisory Committee, including reviewing and advising on annual budgets and proposed changes to the Plan document, the Investment Policy, and the investment menu, and reduce the Committee's required meeting frequency to a semiannual or as-needed basis.**
- (c) Leave the basic provisions of the Deferred Compensation Plans in the Municipal Code (Name, Purpose, Establishment of Trust, Definitions, Deferral of Compensation, Participation in the Plan, and Administration of the Plan, etc.), and remove the specifics of the Plans so that they can be put in stand-alone Plan documents.**



**(d) Authorize the City Manager or her designee to prepare and adopt the stand-alone Plan documents and update the Plan documents as necessary to conform with necessary legal or operational changes (while requiring any benefit changes to be approved by the City Council).**

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### **The City Can Further Reduce Fees Charged to Participants**

As noted previously, Plan members are charged two types of fees for participation in the Plans:

- Investment management fees charged by mutual funds within the plan investment menu (referred to as net fund expenses). These are set by the mutual fund companies based on their costs to manage the fund.
- Administrative fees to fund administrative services provided by the TPA and City staff.

Administrative fees are funded through revenue-sharing agreements between the TPA and mutual fund companies, whereby a portion of the mutual funds' investment fees are shared with the TPA. This type of agreement is common industry practice. The TPA keeps 0.08 percent for their costs; 0.09 percent is remitted to the City to cover its administrative costs. For funds where there is not a revenue-sharing agreement in place, there is an add-on fee charged to ensure all Plan participants share the costs of Plan administration. The add-on fee is calculated as the difference between 0.17 percent and the agreed upon revenue share.

Administrative fees are charged as a percentage of assets. For participants, this means that they will be paying more in administrative costs as their account grows over time. Other plans utilize a flat per participant fee to fund their administrative costs (or a combination of a flat fee plus a percentage of assets based fee). Others utilize a capped asset-based fee so that participants with high account balances are not charged a disproportionate amount of administrative costs.

**Recommendation #5: The City should work with its investment consultant to periodically review whether its administrative fee structure equitably allocates deferred compensation program costs across participants.**

### **The City's Administrative Fee Should Only Cover Administrative Costs and a Reasonable Reserve**

The City maintains a separate fund to track the City's deferred compensation administrative expenditures. The source of funding for these costs is the aforementioned administrative fee charged to participants. The administrative fee is set to generate enough revenue to cover annual budgeted administrative costs and also maintain a reserve based on a DCAC-established reserve policy.

#### *Deferred Compensation Fund Balance Nearly Three Times the Reserve Policy*

The reserve policy sets a fund balance target of 25 percent of annual administrative costs, plus \$50,000 to fund, if the need arises, an off-cycle RFP for any of the Plans' multi-year contracts, such as investment management and record keeping services. Based on these guidelines, the total required reserve as of June 30, 2012 should have been \$203,000. The actual fund balance was more than \$606,000, or nearly three times the amount called for by the reserve policy. Including voluntary and PTC plan members, this excess comes to about \$45 per participant.

The reserve balance has increased for two primary reasons. First, there have been staff vacancies in HR in each of the past two years which have resulted in more than \$200,000 in savings. Second, upon exercising an option to renew the TPA contract in January 2010, the City required the TPA to increase its FY 2010-11 annual administrative reimbursement to the City by \$200,000. This additional remittance was reduced to \$100,000 for FY 2011-12. Despite these increased reimbursements, actual expenditures only increased by about \$24,000 from FY 2009-10 to FY 2011-12.

#### *The DCAC Should Review its Percentage of Assets Based Fee as Total Plan Assets Grow*

Prior to January 2012, the City's administrative costs were funded through a flat reimbursement from the TPA out of the fees they received through their revenue sharing agreements with the Plan's offered mutual funds. This fee was adjusted annually for changes in the Bay Area Consumer Price Index. In January 2012, this fee changed from a flat fee to a percentage of assets based fee (0.09 percent of plan assets).

Using a percentage of asset based fee can make budgeting difficult as the value of assets is constantly changing as a result of employee deferrals, withdrawals, and market fluctuations. For example, staff estimated asset-based fees from January through June 2012 of \$274,000 based on the value of assets at the time of the adoption of the FY 2012-13 budget. However, because of a growth in Plan assets, actual fees totaled \$298,000. As the asset base grows, the fee percentage should be adjusted so that the growth in budgeted reimbursements does not outpace administrative expenditures.

**Recommendation #6: To inform its annual budget adoption for the deferred compensation fund, the City should adopt a policy to:**

- (a) Reduce the administrative fee when the deferred compensation fund balance exceeds its reserve target.**
- (b) Review the percentage of asset-based fee so that budgeted administrative fees equal expected expenditures.**

### **The Plan May Not be Fully Taking Advantage of its Position as an Institutional Investor**

The Plan's investment menu contains a range of mutual fund options across asset classes. In many cases, the plan is utilizing its position as an institutional investor to purchase institutional class shares which have a lower net fund expense than regular shares. In at least two instances, it does not appear that the City is taking advantage of its role as an institutional investor. In one case, if the plan had purchased institutional shares, the roughly 100 participants investing in that fund could have saved about \$15 per participant in annual fees.

Qualifying as an institutional investor requires a higher minimum investment than purchasing ordinary shares. In at least one of the instances noted above, the Plan has not always had sufficient funds invested to qualify as an institutional investor. A third fund also appears to offer institutional class shares which the Plan is not utilizing; in this case, there was not enough participation to reach the minimum investment to qualify as of June 30, 2012.

**Recommendation #7: To ensure that participants are fully benefiting from the Deferred Compensation Plan's institutional purchasing power, the City should work with its investment consultant to review the Plan's investment menu for savings opportunities by moving fund shares into institutional classes.**

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### **The City Can Improve Fee Disclosures to Participants**

#### **The TPA Provides Participants with Information on Fees in Multiple Ways**

Currently, the TPA provides information on fees in multiple formats, including electronic and hard copy. These include handouts and fund prospectuses which detail total fees. For example, the TPA has a link on its San José custom website to a handout titled *What does it cost to participate?*, which details mutual fund fees as both a percentage of assets as well as the dollar equivalent. However, the handout does not disclose administrative and management expenses individually; the total annual expenses are expressed as a single fee.

The TPA also provides participants with quarterly statements (either mailed or accessed online) with quarterly account activity. Actual expenses and fees paid by the participant are not specifically shown; investment earnings are shown net of expenses. Investment management fees are only shown in a table (along with all offered funds) as a percentage and the administrative fees are noted in a footnote.

### **New Rules Require Additional and More Robust Fee Disclosures for Private 401k Administrators**

In early 2012, the Department of Labor issued new Employee Retirement Income Security Act (ERISA) rules which require 401(k) administrators to provide more disclosure of administrative fees and plan expenses than had previously been required. Under the new rules, plan participants are to receive a quarterly statement indicating the dollar amount of plan-related fees and expenses deducted from their account with a description of the services for which the deduction was made.

Although the City's Plans are not covered by the ERISA rules, NAGDCA recommends following these rules as a best practice for deferred compensation plans, noting that "it is important for plan sponsors and service providers to be transparent when it comes to disclosing fees and related services .... to allow for a thorough understanding of plan fees and services." Such an understanding could allow participants to make more informed decisions about their investment choices and other deferred compensation questions.

According to HR, the TPA intends to improve its reporting of fees in the future to incorporate the new ERISA guidelines.

**Recommendation #8: The City should require the Deferred Compensation Plans' third party administrator to include a detailed list of participant fees on printed and electronic quarterly statements. These fees should convey both the administrative and management expenses as individual items as both a percent as well as the actual dollar amount of fees paid by the participant.**

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# Conclusion

The City maintains two deferred compensation plans which allow employees to defer a portion of their compensation until future years. Administration of the program can be improved to ensure employee contributions and credits are accurate by implementing procedures to reduce error and more effectively use current resources. The City can also provide savings to participants by streamlining Plan administration and further reducing fees. The City should also periodically review whether the fee structure equitably allocates program costs and improve fee disclosures for participants.

## RECOMMENDATIONS

Recommendation #1: To correct PTC duplicate name issues, Human Resources should:

- (a) Work with the Information Technology Department to fix the PTC interface file.
- (b) Work with the third party administrator to notify the affected PTC participants and remedy erroneous contributions plus associated gains/losses.

Recommendation #2: To further reduce the risk of error, Human Resources should work with the Information Technology Department to:

- (a) Implement an automatic adjustment interface.
- (b) Develop automated solutions to identify participants in the Deferred Compensation Balancing Report with a potentially erroneous zero-deferral.

Recommendation #3: To eliminate duplication of effort, Human Resources should:

- (a) Delegate to its third party administrator responsibility for monitoring annual employee deferrals to identify those participants nearing IRS limits, and counseling and education for participants separating from City employment.
- (b) Eliminate its biweekly deferred compensation reconciliation process, a procedure also performed by Finance.

Recommendation #4: The City Attorney's Office and Human Resources should review the Deferred Compensation Plans and draft amendments to the Municipal Code as follows:

- (a) Assign responsibility for administering the Plans to the City Manager or her designee, including the operation and interpretation of the Plans in accordance with their terms and contractual authority to enter into contracts for the administration of the Plans.
- (b) Clarify the oversight role and responsibilities of the Deferred Compensation Advisory Committee, including reviewing and advising on annual budgets and proposed changes to the Plan document, the Investment Policy, and the investment menu, and reduce the Committee's required meeting frequency to a semiannual or as-needed basis.

## Deferred Compensation

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- (c) Leave the basic provisions of the Deferred Compensation Plans in the Municipal Code (Name, Purpose, Establishment of Trust, Definitions, Deferral of Compensation, Participation in the Plan, and Administration of the Plan, etc.), and remove the specifics of the Plans so that they can be put in stand-alone Plan documents.
- (d) Authorize the City Manager or her designee to prepare and adopt the stand-alone Plan documents and update the Plan documents as necessary to conform with necessary legal or operational changes (while requiring any benefit changes to be approved by the City Council).

Recommendation #5: The City should work with its investment consultant to periodically review whether its administrative fee structure equitably allocates deferred compensation program costs across participants.

Recommendation #6: To inform its annual budget adoption for the deferred compensation fund, the City should adopt a policy to:

- (a) Reduce the administrative fee when the deferred compensation fund balance exceeds its reserve target.
- (b) Review the percentage of asset-based fee so that budgeted administrative fees equal expected expenditures.

Recommendation #7: To ensure that participants are fully benefiting from the Deferred Compensation Plan's institutional purchasing power, the City should work with its investment consultant to review the Plan's investment menu for savings opportunities by moving fund shares into institutional classes.

Recommendation #8: The City should require the Deferred Compensation Plans' third party administrator to include a detailed list of participant fees on printed and electronic quarterly statements. These fees should convey both the administrative and management expenses as individual items as both a percent as well as the actual dollar amount of fees paid by the participant.

# Memorandum

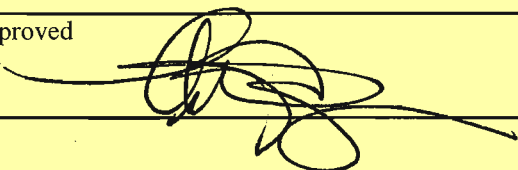
**TO:** Sharon Erickson  
City Auditor

**FROM:** Alex Gurza

**SUBJECT: RESPONSE TO THE AUDIT  
OF "DEFERRED COMPENSATION:  
THE CITY CAN STREAMLINE AND  
IMPROVE ADMINISTRATION OF  
ITS DEFERRED COMPENSATION  
PROGRAM"**

**DATE:** February 12, 2013

Approved



Date

2/12/13

The Administration has reviewed the Audit of "Deferred Compensation: The City Can Streamline and Improve Administration of its Deferred Compensation Program" and is in general agreement with the recommendations identified in the report. The following are the Administration's response to each recommendation.

## **BACKGROUND**

The Audit identifies ways the City can improve controls in the administration of the City's two Deferred Compensation Plans and potentially provide savings to participants by streamlining Plan administration and further reducing fees. Key issues and facts about the Deferred Compensation Program include:

- Employees contribute in excess of \$1,000,000 every pay period to the City's two deferred compensation plans. Administration of this program requires careful coordination between the City and the Plans' third party administrator.
- Automation of administrative processes on the part of the City and the third party administrator in the last 5 years has significantly reduced the rate of error. There are remaining processes where further automation may be possible. An interface error resulting in inaccurate crediting in a small number of PTC plan participants' accounts in the past 4 years was discovered.
- The City's last RFP process in 2011 resulted in a significant reduction in Plan fees from 0.28% to 0.17% of Plan assets. Suggested process improvements for increased efficiency and other ways to potentially further lower fees paid by participants are possible.
- The Plan is currently administered by the Deferred Compensation Advisory Committee (DCAC) per the Municipal Code and the Plan documents are embedded within the Code. The audit identifies opportunities to gain efficiencies through clarifications of the roles of the DCAC and Human Resources staff.



## **RECOMMENDATIONS AND RESPONSE**

**Recommendation #1:** To correct PTC duplicate name issues, Human Resources should:

- (a) Work with the Information Technology Department to fix the PTC interface file.
- (b) Work with the third party administrator to notify the affected PTC participants and remedy erroneous contributions plus associated gains/losses.

**Administration Response:** The Administration agrees with this recommendation. The interface problem has been corrected by Information Technology staff. Human Resources staff has determined that fifteen participant accounts require adjusting. The total dollars that were under credited is \$1,953.00. The majority of that money will be deducted from the accounts that were over credited. Lost earnings for all fifteen accounts totaled \$205.00 calculated based upon the earliest date of the improper crediting. Notifications to the affected participants are in progress and account corrections are scheduled to take place in March 2013.

**Recommendation #2:** To further reduce the risk of error, Human Resources should work with the Information Technology Department to:

- (a) Implement an automatic adjustment interface.
- (b) Develop automated solutions to identify participants in the Deferred Compensation Balancing Report with a potentially erroneous zero-deferral.

**Administration Response:** The Administration agrees with this recommendation. Human Resources staff is working with the Information Technology Department to determine the feasibility of an automatic adjustment interface and an automated solution to identify participants with a potentially erroneous zero-deferral. As mentioned in the report, the majority of these instances are the result of a participant reaching their IRS annual contribution limit. However a few cases have been the result of the participant entering a deferral amount for the year instead of per paycheck, thus causing a zero-deferral. Human Resources staff has recently implemented a change to the online enrollment form that will minimize the incidence of employee error.

**Recommendation #3:** To eliminate duplication of effort, Human Resources should:

- (a) Delegate to its third party administrator responsibility for monitoring annual employee deferrals to identify those participants nearing IRS limits, and counseling and education for participants separating from City employment.
- (b) Eliminate its biweekly deferred compensation reconciliation process, a procedure also performed by Finance.

**Administration Response:** The Administration is in agreement that additional tasks can be delegated to its third party administrator (currently ING) including monitoring of employees

nearing their IRS deferral limits. The local ING representatives currently handle any counseling the participants might need, such as: enrollment, fund options, service credit buy backs, loan options, and retirement/separation from City service counseling. The Administration also agrees that the biweekly reconciliation performed by Human Resources staff should be conducted by Finance to separate the function of creating the wire transfer from the control of reconciling the wire transfer to participant deferrals and to reduce the redundancy of administrative duties. Human Resources staff has begun eliminating the reconciliation process from their bi-weekly wire process.

**Recommendation #4:** The City Attorney's Office and Human Resources should review the Deferred Compensation Plans and draft amendments to the Municipal Code as follows:

1. Assign responsibility for administering the Plans to the City Manager or her designee, including the operation and interpretation of the Plans in accordance with their terms and contractual authority to enter into contracts for the administration of the Plans.
2. Clarify the oversight role and responsibilities of the Deferred Compensation Advisory Committee, including reviewing and advising on annual budgets and proposed changes to the Plan document, the Investment Policy, and the investment menu, and reduce the Committee's required meeting frequency to a semiannual or as-needed basis.
3. Leave the basic provisions of the Deferred Compensation Plans in the Municipal Code (Name, Purpose, Establishment of Trust, Definitions, Deferral of Compensation, Participation in the Plan, and Administration of the Plan, etc.), and remove the specifics of the Plans so that they can be put in stand-alone Plan documents.
4. Authorize the City Manager or her designee to prepare and adopt the stand-alone Plan documents and update the Plan documents as necessary to conform with necessary legal or operational changes (while requiring any benefit changes to be approved by the City Council).

**Administration Response:** The Administration agrees with this recommendation. Preparing for and attending fewer committee meetings would reduce the amount of time currently spent by Human Resources staff, Finance staff, consultants and committee members. The frequency of the committee meetings should correspond to the level of responsibility and decision making of the DCAC. Much of the Committee's current authority requires careful communication and coordination, often on a tight timeline. If service provider selection for example, was managed via the process currently utilized by Human Resource staff for all other City benefits, rather than resting solely on the Committee, the process could be more streamlined, thus providing a more cost effective service to the Plan participants. Placing the specifics of the plan in a stand-alone Plan document would further reduce staff work load when changes need to be made.

**Recommendation #5:** The City should work with its investment consultant to periodically review whether its administrative fee structure equitably allocates deferred compensation program costs across participants.

**Administration Response:** The Administration agrees with this recommendation. The Deferred Compensation Advisory Committee has taken steps to spread fees more equitably across participants leveling the revenue sharing and add-on fees associated with different

investment options. It is very common among 457(b) plans to charge fees according to an asset-based methodology, as is the case in the City's plan. This method is more favorable for newer participants, or those with relatively low account balances. This topic is scheduled for discussion at the upcoming March 2013 Deferred Compensation Advisory Committee retreat and is part of the annual plan review performed by the investment consultant.

**Recommendation #6:** To inform its annual budget adoption for the deferred compensation fund, the City should adopt a policy to:

- (a) Reduce the administrative fee when the deferred compensation fund balance exceeds its reserve target.
- (b) Review the percentage of asset-based fee so that budgeted administrative fees equal expected expenditures.

**Administration Response:** The Administration agrees with this recommendation. The City's investment consultant has made recommendations on an investment lineup structure that generates a target level of revenue sharing to match a budget estimate of the cost to administer the plan. The City's current investment policy does not contain specific language relating to these fee topics. This is a somewhat recent development in the industry, and the administration agrees it would be a good addition to the City's current Investment Policy.

Due to staff vacancies in Human Resources and increased efficiencies in administering the Plan, administrative costs are decreasing. At the March 2013 meeting of the DCAC, Human Resource staff will present the budget for fiscal year 2013-2014 along with a recommendation to lower the administrative fees to begin to reduce the fund balance and better align the plan fees being generated with expected expenditures.

**Recommendation #7:** To ensure that participants are fully benefiting from the Deferred Compensation Plan's institutional purchasing power, the City should work with its investment consultant to review the Plan's investment menu for savings opportunities by moving fund shares into institutional classes.

**Administration Response:** The Administration agrees with this recommendation. Many similar plans intentionally do not use institutional share classes because they want to capture revenue sharing in order to pay for plan expenses and these classes generate little or no revenue. Currently, 14 of the 34 Plan investment options offered by the City are institutional. As mentioned above, the current investment options and associated administrative fees are carefully selected to generate the amount of revenue needed to administer the plan while adhering to the City's Investment Policy. In conjunction with the investment consultant, the Administration will continue to monitor the investment offerings to keep the plan fees down, while still generating enough revenue to effectively administer the plan.

**Recommendation #8:** The City should require the Deferred Compensation Plans' third party administrator to include a detailed list of participant fees on printed and electronic quarterly statements. These fees should convey both the administrative and management expenses as

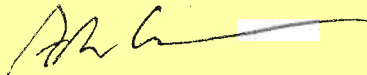
individual items as both a percent as well as the actual dollar amount of fees paid by the participant.

**Administration Response:** The Administration agrees with this recommendation. As of this year, the Department of Labor requires plan sponsors governed by the Employee Retirement Income Security Act (ERISA) to provide more detailed fee disclosures to plan participants. Public plans, such as the City's are not subject to ERISA, however, the third party administrator has committed to comply with the new regulations in January of 2014. These new disclosure statements will include a description of all direct and indirect compensation received by the Plan provider and fee and expense information paid by the participant.

### **CONCLUSION**

This Audit makes valuable recommendations for increasing staff and program efficiencies and for ensuring that the participants in the City's Deferred Compensation Program are well served. The Administration, in conjunction with the City Attorney, will bring forward to the City Council recommended ordinances amending the Municipal Code in order to implement the audit recommendations.

The City Manager's Office thanks the City Auditor's Office for its informative review of the City's Deferred Compensation Program.



Alex Gurza  
Deputy City Manager