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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

July 16, 1998

Ms. Linda Angelo and Messrs. Fredrick Jacobs
and Abraham Lackman
Members of the Deferred Compensation Board
Core 1, 2nd Floor, South Swan Street
Empire State Plaza
Albany, NY 12223

Re: Report 97-F-14 Follow up Review of 94-S-96 Deferred Compensation Board, Administration and Oversight of the New York State Deferred Compensation Plan

Dear Ms. Angelo and Messrs. Jacobs and Lackman:

According to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law, we reviewed the actions taken by the Deferred Compensation Board (Board) as of May 11, 1998, to implement the recommendations in our prior audit report 94-S-96. The prior report issued on January 11, 1995, examined the Board's administration and oversight of the New York State Deferred Compensation Plan.

Background

Public employees in New York State may participate in the New York State Deferred Compensation Plan (Plan) and thereby defer a portion of their current pre-tax wages until after retirement. The Plan was enacted by the State Legislature in 1982 and became operational in 1985 when salary deferrals commenced. As currently permitted by recent amendments to federal law, Plan assets are held in trust for the exclusive benefit of Plan participants and their beneficiaries and are no longer subject to claims of the creditors of the State or any other public jurisdiction that participates in the Plan, as was previously required by law. As of January 1, 1999, the assets of all Section 457 plans will be required to be held in trust. The Plan is independent of the New York State Employees Retirement System administered by the State Comptroller. A three-member Deferred Compensation Board (Board) oversees Plan operations. The Governor, Speaker of the Assembly and Temporary President of the Senate each appoint one Board member.

Beginning April 1, 1998, Plan participants can now direct their salary deferrals to any of 22 mutual funds and a Stable Income Fund (SIF). The SIF invests in guaranteed interest contracts (GICs), issued by life insurance companies. GICs are commonly used as investments by all types of deferred compensation and retirement plans. Such GICs, while commonly called "guaranteed," are actually unsecured loans (without collateral) to insurance companies. The loans are to be repaid over a period of years at a fixed interest rate guaranteed by the insurance companies. In addition, to assure diversification and to minimize the exposure of the SIF to insurance companies, as of December 31, 1997, approximately 25 percent of the assets of SIF are invested in so-called “synthetic GICs.” Synthetic GICs are individually managed bond portfolios whose performance is guaranteed by an independent financial institution. The assets in the portfolio are held in trust by the Plan. Finally as of April 1, 1998, approximately $130 million of the assets of the SIF will be managed by an independent investment manager selected by the Board and held in short-term cash equivalent investments. These short-term investments are also held in trust by the Plan. The introduction of short-term investments in the SIF allows daily transfers between the SIF and most of the Plan’s other investment options and gives participants more opportunity to move their SIF account balance in response to market changes.

As of December 31, 1997, the Plan held about $3.3 billion in assets with almost $1.4 billion of participant’s funds invested in the SIF and the remainder in mutual funds. Contributions to the Plan averaged $27.9 million per month for the nine-month period beginning April 1, 1997 through December 31, 1997. Since the Plan's inception there have been about 119,000 Plan enrollments. As of December 31, 1997, over 106,000 individuals have current account balances under the Plan, and over 84,600 of these individuals had made contributions to the Plan in the prior six months.

The Board has no employees and therefore utilizes third party service providers selected through a competitive bidding process to administer the Plan. For example, the Board has separate contracts for a Plan administrator, a trustee, mutual fund providers, insurance companies that provide SIF investments, an investment advisor, and legal and auditing services. The Plan's administrative expenses are estimated to be $3.9 million for the fiscal year ending March 31, 1998. Participant fees, which have gradually been reduced, are collected through semiannual maintenance charges and deductions from gross investment proceeds. Administrative rebates from most of the mutual fund providers also offset Plan operating expenses. These rebates amounted to $2.1 million in 1997-98.

Since our prior audit, the entire membership of the Board has changed. The new Board has made significant improvements to Plan operations in the areas of investment options, responsiveness to participants and timeliness of contract information that relates to the bidding of services. The Board, through its legal advisor, has negotiated administrative rebates from most of the mutual funds, thereby offsetting Plan operating costs. Additionally, the Board initiated an amendment to Section 5 of the State Finance Law which resulted in the amendment of the Plan and model plan available to public jurisdictions within the State to implement the maximum flexibility now permitted by federal laws. Also, the Board is in the process of amending its Rules and Regulations to comply with the Small Business Job Protection Act of 1996 that mandates certain changes be made to 457 Deferred Compensation Plans. Effective October 1, 1997, the Plan’s assets were placed in a Trust, more than a year before the IRS’ deadline of January 1999.

Summary Conclusions

In our prior audit, we concluded that changes in the Board's structure and operations could improve the Plan; that the Board make-up should include representation for groups such as employees, management and retirees; and that the Board should consider alternative types of administration that may be cost effective. We found that additional disclosure was needed concerning SIF's investment in GICs and that several of the Plan's GICs insurers were not in complete compliance with the Board's investment guidelines, although the SIF was in substantial compliance, and the Board had taken steps to ensure that contracts were in compliance by the end of the transition period in March 1998. We found that contracts were not submitted timely to the Comptroller for approval. In addition, the Board needed to increase information provided to participants, to encourage Plan members to attend Board meetings and to periodically review and assess the complaint resolution process.

Our follow-up review found the Board has made and is making improvements in Plan operations. The Board does not believe it is necessary to change the structure of the Board. Data provided indicates the Board has taken steps to improve the cost effectiveness of the Plan. The Board provided additional disclosure regarding GICs and monitors GIC compliance with the Board's investment guidelines. The Board has worked with the Office of the State Comptroller (OSC) to ensure more timely submission of contracts. While the Board has taken steps to increase information provided to participants, additional improvements are needed in this area and in assessing the complaint resolution process.

Summary of Status of Implementation

Of the fourteen prior audit recommendations, seven have been fully implemented, three have been partially implemented, two have not been implemented and two recommendations are no longer applicable.

Follow-up Observations

Recommendation 1

Reassess the current structure of the Board and determine whether broader representation is desirable and beneficial. Advise the Governor and the State Legislature whether a change in the current Board's representation is needed.

Status - Not Implemented

Agency Action - The present Board's position has not changed since that expressed in the 90-day response to our prior audit. The Board does not feel it is necessary to change the composition which is set by law. The Board believes it has been successful in implementing and administering the Plan and does not believe any change to the number of members or the manner in which members are appointed is either necessary or advisable. Further, the Board is not aware of any study or other empirical information that positively correlates Plan performance with expanded members of an administrative board.

Auditors' Comments - As we indicated in our prior audit, we found that several other plans had boards or review committees with a wider range of representation than the Board of the New York Plan. The current make-up of the Board, consistent with current legislation, does not include any representation for Plan participants. Broader representation could allow the Plan to be more responsive to participant's views concerning Plan direction, operations, and investments.

Recommendation 2

Expand the process of encouraging periodic input from Plan participants concerning Plan direction and operations.

Status - Partially Implemented

Agency Action - The Board has taken steps to increase communications with Plan participants. Some examples include:

- In August 1996, the Board conducted a survey of Plan participants to obtain input regarding investment options and other facets of the Plan. In response to this survey, the Board decided to increase the investment options available to participants and make other improvements. Effective April 1, 1998, Plan participants have 22 mutual funds in which to invest.

- The latest contract with the Plan's administrator (The Copeland Companies), specifies that Copeland increase the number of people servicing the HELPLINE. In addition, HELPLINE operating hours have been increased from the former schedule of Monday - Friday from 8:00 a.m. to 6:00 p.m. to Monday - Friday from 8:00 a.m. to 11:00 p.m. and Saturday from 9:00 a.m. to 6:00 p.m.

- On April 1, 1998, a Plan website became operational. The website includes descriptions of investment options, enables members to check account balances and obtain various forms. The website will allow Plan participants to communicate to the Board via E-mail through Copeland and will indicate the dates and times of the Board's public hearings and meetings. A pilot kiosk in Empire State Plaza will give participants access to the same information as that offered through the website.

- The Board directed Copeland to redesign all of the enrollment and marketing materials to encourage increased membership.

- The Board has increased the number of Copeland field representatives from six to ten.

- The Board has substantially improved the format and content of the quarterly newsletters and quarterly participant statements.

- Effective April 1, 1998, the Board added performance criteria in the Copeland

contract that requires Copeland to improve its communications with Plan participants. The contract contains penalties if Copeland fails to meet these criteria. Among the communications areas targeted in the contract are: timely delivery of quarterly newsletters and account statements, HELPLINE and voice response unit (VRU) responsiveness, prompt review of claims and hardship benefit payment requests and implementation of the website and kiosk. Compliance with the performance criteria will be audited by an independent public accounting firm.

- Officials indicated that employee unions have provided input to the Plan on an informal basis through contact with Board members but there are no plans for anything more formal.

Auditors' Comments - The Board has taken several steps to improve communication with Plan participants, however most of these communication initiatives provide additional information about the Plan to Plan participants. As we indicated in our prior audit, we believe the Board should expand its process for obtaining input from participants, either directly or through advisory groups. We had contacted the leadership of the largest public employees' unions representing Plan participants and they indicated that the Board does not formally request their input concerning employee satisfaction with the Plan and how it operates. Such occasional solicitation would be useful. While the Board indicated that it had informal contacts with union representatives, the Board should adopt formal methods so union representatives can provide their comments on Plan operations.

Recommendation 3

Consider studying the cost effectiveness of various alternatives to the current Plan's administration. If necessary, seek legislative authorization to conduct or fund such a study.

Status - No Longer Applicable

Agency Action - The Board's position has not changed since their 90-day response to our prior audit. The Board indicated that over the 10-year history of the Plan, the number of Plan participants and participating employers has increased dramatically while per participant administrative costs have declined. The Board will continue to explore administration cost reduction alternatives and does not plan to seek funds from the Legislature to conduct a study of administrative alternatives. It is the Board's position that although the Board has not sought funds for a legislative study, the Board has implemented policies on cost containment that appear to have made the Plan one of the most cost efficient plans relative to plans of comparable asset size. The Board indicated that:

- since our prior audit, the annual fee charged participants has been reduced from $12 to $8 and the Board expects this to decline further in the future.

-the Plan was one of the first of its kind to negotiate administrative rebates from mutual fund companies. In 1998-99, it estimates these rebates will be $2.72 million which will offset administrative costs.

- The projected administrative expenses for 1998-99 are $4.1 million against current assets of $3.3 billion. This equates to an asset charge of 0.0012 percent of Plan assets. This is a decrease of almost 50 percent from the time of our prior audit when in was 0.0022 percent.

- Statistics provided in the Board's 1997 fourth quarter newsletter indicate that the Plan's annual fees are the lowest among the six states compared. The annual fee charged on an account balance of $10,000 was as follows:

State	No. of Members	Total Assets ($ Billions)	Annual Fee
NY	**100,000**	**$ 3.2**	**$12.20**
Ohio	127,000	2.1	20.00
Calif.	95,443	3.4	26.50
Mass.	160,000	1.8	30.00
Virginia	12,000	0.25	35.00
Penn.	35,000	0.50	35.00

Recommendation 4

Provide additional information to participants concerning the risks associated with GICs.

Status - Fully Implemented

Agency Action - The Plan has revised its enrollment and other materials provided to Plan participants relative to GICs. The enrollment materials provide information to participants concerning the risks associated with GICs as suggested in the prior audit.

The Board has also diversified the SIF into Synthetic GICs and, as of April 1, 1998 allowed participants to make daily transfers between SIF and most of the other investment options. This information has also been communicated to participants.

Recommendation 5

Determine whether proposed legislation, which would substantially reduce or eliminate participant risks related to GICs, should be actively supported.

Status - No Longer Applicable

Agency Action - The Board's position relative to this recommendation has not changed since the 90-day response to our prior audit. The Board believes taking a lead role in assessing and evaluating proposed legislation, is beyond the scope of the Board's authority and purpose. The Board will cooperate with any organization, authorized by the Governor or the Legislature, to assess or formulate any such legislation and would be willing to share information with such organization about the Plan's experiences in purchasing and negotiating

GICs. The proposed legislation was never enacted. The present Board has not reviewed any proposed legislation relative to financial guaranty insurance for GICs. In addition, because the Board does not have any staff, it would not be possible to pursue such actions.

Officials indicated that legislation of this type is monitored by the National Association of Government Deferred Compensation Board Administrators (NAGDA) for their membership. New York is a member of NAGDA and will work through that organization to effectuate changes in Federal law that the Board deems desirable.

The Board will continue to carefully monitor SIF investments and amend its investment guidelines in order for SIF to adhere to the highest possible commercially reasonable standards for SIF.

Auditors' Comments - During our prior audit, legislation was proposed which would increase Insurance Guaranty fund coverage for participants in such plans in case of an insolvency. Legislation was also introduced that would allow certain insurers to provide financial guaranty insurance for GICs, in a fashion similar to municipal bond insurance coverage. Such legislation could substantially reduce or eliminate participant risks.

We did not suggest that the Board incur expenses to lobby for proposed GIC legislation to reduce participant risks. However, the Board, in its Plan oversight capacity, should review the possible merits of any such future proposed legislation and provide comments to State lawmakers on behalf of Plan participants.

Recommendation 6

Continue to use the investment guidelines for the SIF and direct new investments and cash flow accordingly.

Status - Fully Implemented

Agency Action - Investment guidelines were adopted in September 1994. Since then, all new placements with insurers met the guidelines, at the time of placement. On a formal basis, the Board's investment advisor reviews compliance semiannually with all traditional GIC carriers. Also, twice a year, the Board's investment advisor receives copies of investment portfolios from the synthetic GIC carriers and reviews these for compliance and communicates its findings to the Board.

In 1997, one GIC carrier fell out of compliance as Standard and Poors downgraded it one level from AA- to A+. This company was then removed from consideration for future placements. The company is still considered to be very high quality. The Board does not feel Plan assets are in jeopardy nor do they think the penalties for early termination of the contract are warranted. As of September 1997, the exposure of this company represents approximately 10 percent of the SIF assets.

Recommendation 7

Work closely with the Comptroller's Contract Approval Unit to establish procedures which help ensure that selection results for proposed guaranteed interest contracts are submitted timely to the Comptroller's Office for review and approval.

Status - Fully Implemented

Agency Action - A form was developed to assure that OSC is forwarded all bid information before receipt of an actual contract. By the time the contract is signed by all parties, cleared through the State Insurance Department, and forwarded to OSC, OSC staff has reviewed much of the bid information. OSC staff indicated they are being kept properly informed.

Since the last audit, the Board has placed the Plan's assets in trust in accordance with the requirements of the Small Business Job Protection Act. Because the Plan's assets have been placed in trust, it is the Board's position that Comptroller approval is no longer required for Plan contracts and expenditures. The Board will continue, on a voluntary basis, submitting contracts to the Comptroller for review.

Recommendation 8

Ensure that all guaranteed interest contracts are awarded based on competitive bidding that corresponds with GIC maturity dates.

Status - Fully Implemented

Agency Action - All GIC contracts are awarded through a competitive bidding process. The Board intends to continue its longstanding practice of awarding GICs through competitive bidding and placing new GIC awards as close as possible to the date on which existing GICs mature.

Also, with the addition of the “cash manager” in the SIF, the Board will have more flexibility in determining the timing and placement of GIC contracts and will be in a better position to manage the cash needs and cash flow into and out of the SIF.

Recommendation 9

Ensure that future mutual fund changes can be accomplished in a way that minimizes additional participant fees.

Status - Fully Implemented

Agency Action - New mutual fund contracts took effect April 1, 1998. Securities and Exchange Commission regulations prevent the Board from compelling mutual fund companies to redeem assets in cash. The Board's legal counsel has tried to negotiate a “cash only” redemption provision into the contracts with mixed success. Effective April 1, 1998, the Plan has 22 mutual funds. Ten of these funds will have some ability to relinquish assets as securities.

As a hedge against a redemption in the form of securities, the Board recently contracted with Morgan Stanley to act as a broker dealer in case of a redemption of securities. The objective of this arrangement is to have a broker/dealer available to represent participant interests should termination of a mutual fund contract give rise to a distribution of securities instead of cash. This will minimize any transaction fees to participants and give the Board a means for the orderly liquidation of securities.

Recommendation 10

Periodically make more detailed information, concerning Plan financial operations and administrative fees, available to participants.

Status - Fully Implemented

Agency Action - Enrollment materials describe in more detail the administrative fees associated with the Plan. A recent quarterly newsletter included an article discussing Plan fees. The Board also provided the Plan's annual financial statements as an addendum to one of the Board's recent newsletters (1997, Third Quarter).

Recommendation 11

Periodically disclose to participants data relating to all GICs in the SIF.

Status - Fully Implemented

Agency Action - The enrollment package includes an insert that provides detailed information on the Stable Income Fund. Participants are also periodically provided information regarding all materials available and can request a copy of the insert at any time. The quarterly newsletter lists Fund performance information and includes a narrative on the components of the Stable Income Fund.

In addition, the financial statements provided with the 1997, third quarter newsletter contained detailed information on the GIC contracts including the investment manager, contract period, interest rate, annual effective yield, and current amount of funds invested.

Recommendation 12

Encourage Plan participants to attend public Board meetings by disclosing meeting dates in the quarterly newsletter.

Status - Partially Implemented

Agency Action - Since our prior audit, there have been 15 public meetings and 31 non-public meetings. Prior to public meetings, notices are posted throughout the Concourse in the Empire State Plaza. The Board will also post notices of public meetings on its new website. A pilot kiosk in Empire State Plaza will give participants access to the same information as

that offered through the website.

Officials indicated that there are inherent limitations preventing the Board from giving advance notice of meetings. Although the Board meets many times a year, the meeting schedule is not set in advance for the full year and, given the full-time work schedule of the Board members, meeting dates are often not finalized until a few weeks prior to the actual meeting date. In addition, there is no regular schedule of public meetings, which are typically set in response to the need for formal action by the Board.

In connection with the proposed amendments to the Board's Rules and Regulations, the Board held one public hearing in April 1997 and held a second in April 1998. These hearings are not required by State law, but were undertaken to give Plan participants and other members of the public an opportunity to provide feedback on the Board's regulatory initiative. Notice of these hearings was published in advance in accordance with State guidelines.

Auditors' Comments - Posting notices of public meetings on its new website will be an improvement over present procedures. However, many Plan participants may not have access to the web page. As we indicated in our prior audit, to help increase the level of public attendance at Board meetings and to make meetings more effective and useful to Plan participants, the Board should disclose scheduled meeting dates in the quarterly newsletter and invite participants to attend.

Recommendation 13

Provide more information concerning Plan decisions at public meetings.

Status - Not Implemented

Agency Action - Officials indicated that in the past, the Board used the newsletter to inform participants of significant developments and Board action related to the Plan. In the future, the Board will also use the newsletter as a way of periodically informing participants of the more routine actions taken by the Board. Officials also indicated that Board actions will be posted on the website.

Auditors' Comments - Documentation provided indicates that between January 1996 and November 1997, the Board met 34 times (10 public meetings and 24 non-public meetings). Our review of the quarterly newsletters issued in 1996 and 1997 indicated the following: in the first three 1996 quarterly newsletters, information was provided regarding 12 Board meetings (4 public and 8 non-public); and no information was provided in either the 1996 fourth quarter newsletter or in any of the 1997 quarterly newsletter relative to Board meetings.

To provide Plan participants with information regarding Board activity, the Board should communicate the results of Board meetings to Plan participants through the quarterly newsletter and its website.

Recommendation 14

Instruct the administrator to provide more specific information concerning participant inquiries, complaints and resulting action. Periodically review and assess the complaint resolution process by analyzing available complaint data and taking corrective action when necessary.

Status - Partially Implemented

Agency Action - Since the date of our last audit, the Board has taken a number of significant steps to assure that the Plan's administrative service agency deals promptly and appropriately with participant complaints, inquiries and concerns and that the Board is informed on a timely basis of participant concerns and the steps that Copeland has taken in addressing these concerns. Some of the changes noted below became effective April 1, 1998, because these changes required the negotiation of a new contract with Copeland which goes into effect on that date.

The Board required Copeland to implement a new claims procedure and hardship withdrawal procedure that standardizes and expedites the review process and requires an internal appeals process at Copeland. The Board also required Copeland to revise the content of the Board's quarterly newsletters to focus more attention on frequently asked participant questions.

In connection with the negotiation of Copeland's new contract, the Board has: (1) expanded the hours that the HELPLINE is available to participants to give participants evening and weekend hours during which they can contact Copeland, and added requirements related to Copeland's response time on both the VRU and HELPLINE; (2) added a website on which participants will be able to communicate directly with Copeland; (3) required Copeland to submit a monthly report to the Board summarizing participant inquiries that Copeland receives each month and the manner in which Copeland has dealt with these inquiries; (4) increased the number of field representatives; (5) required Copeland to prepare a management plan in advance of each plan year which will outline Copeland's participant outreach effort for the year and the steps that Copeland will take to correct and deficiencies in its performance from any prior year. All of these steps are intended to increase the ability of participants to communicate with Copeland and the Board, and to assure that the Board is informed in a timely manner of participant concerns and the manner in which Copeland is addressing these concerns.

The Board has also included Objective Performance Criteria in its new contract with Copeland that include substantial economic penalties (in the form of fee reductions of up to 15%) if Copeland does not meet the standards set by the Board. Many of these Objective Performance Criteria relate directly to the way Copeland communicates with participants and handles participant complaints. The Board has also modified its contract with the Plan auditor to require the auditor to evaluate Copeland's success in meeting the Objective Performance Criteria and in determining the amount of any penalties to be assessed against Copeland for a plan year.

Auditors' Comments - We reviewed contract information provided by officials and could not find any performance incentive tied to complaint resolution. We also reviewed the new monthly status report to be supplied by Copeland. The report is similar in content to the reports that

they supplied to the Board regarding complaints at the time of our prior audit.

As we indicated in our prior audit, we believe the system does not give the Board adequate data for judging independently the administrator's performance. This report does not provide data which would allow Board members to determine whether there are large numbers of similar ongoing complaints. In addition, the monthly report does not contain any indication whether specific participant complaints had carried over from previous months or were not resolved appropriately.

Contributors to this report were Frank Russo, Fred Perlmutter and Tom Kulzer.

We would appreciate your response to this report within 30 days, indicating any actions planned or taken to address any unresolved matters discussed in this report. We also thank the management and staff of the Board for the courtesies and cooperation extended to our auditors during this review.

Yours truly,

Carmen Maldonado
Audit Director

cc: Robert L. King, DOB
Paul Shatsoff, GOER