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**BILL NUMBER:** AB 2462 (Mullin) As Amended August 21, 2006

**SUMMARY:**

AB 2462 specifies key components of due diligence that employers in K-12 school districts, community college districts and county offices of education must perform during their selection of a third party administrator (TPA), including CalSTRS. It also provides the Teachers' Retirement Board (Board) the authority to supply, or contract to supply, fiduciary, recordkeeping and administrative services for employer-sponsored deferred compensation plans to school districts, community college districts and county offices of education that elect to contract with California State Teachers' Retirement System (CalSTRS) to provide those services.

**PURPOSE OF THE BILL:**

The Internal Revenue Service (IRS) has finalized new regulations for employer-sponsored 403(b) deferred compensation retirement plans, which beginning January 1, 2008, will result in increased employer involvement in, and administration of 403(b) plans. Many CalSTRS employers, especially small and rural school districts that offer 403(b) plans do not have the expertise to perform these new functions and have asked CalSTRS to establish a program to provide these services on a contract basis.

**BOARD POSITION:**

Sponsor. AB 2462 is consistent with the Board's policy to provide financially sound primary and supplemental retirement plans for California's educators by allowing CalSTRS to provide high-quality 403(b) and 457 compliance services for the lowest possible cost.

**SUMMARY OF AMENDMENTS:**

The most recent amendments of August 7<sup>th</sup> and August 21<sup>st</sup>:

Specifies key components of due diligence that employers in K-12 school districts, community college districts and county offices of education must perform during their selection of a third party administrator (TPA), including CalSTRS. This includes actions to:

- Determine that hiring the TPA is in the best interest of the participants, their beneficiaries, and the employer;
- Require the TPA to provide proof of liability insurance and a fidelity bond in an amount determined by the system to be sufficient to protect the assets of participants;
- Require evidence, if the TPA is affiliated with a provider of investment products, that data generated from the administrator is not accessible to the provider of investment products;
- Require the TPA to disclose to it and participating employees any contractual relationship, fees, commissions, cost offsets, reimbursements, or marketing and promotional items it or its vendors holds or receives from other 403(b) or 457 investment providers; and

- Require the TPA to provide evidence of a safe chain-of-custody of assets process to fulfill fiduciary responsibilities and ensure timely placement of participant investments.

In addition, the amendments also:

- Limit audits of all school employer-sponsored deferred compensation plans to once annually, unless documented problems exist;
- Clarify the authority of a school employer to cover the costs for providing a deferred compensation plans and the associated administrative and compliance services by collecting those costs either directly from the participating employee, the participant's account, an employee organization, or by continuing to pay the costs themselves, and maintains provisions of existing law that prohibit school employers from passing on administrative costs for other services such as life and health insurance and group legal service plans;
- Clarify the descriptions of the compliance and administrative services for employer-sponsored 403(b) and 457 deferred compensation plans that CalSTRS may offer to school employers who wish to contract with CalSTRS, as well as various other technical terms and procedures;
- Address technical concerns identified by the Department of Finance with start-up funding for CalSTRS' to provide these services, caps total funding from employer contributions to the DB Program at a hundredth of a percent of annual teacher earnings, and requires an amount equal to these contributions, with interest, to be deposited in the Teachers' Retirement Fund (TRF) from moneys generated from the programs receiving development funds, as specified ; and
- Add provisions to sections of the Education Code that apply to Community College employers to mirror the requirements placed on employers contracting with TPAs contained in Education Code sections that apply to K-12 and County Office of Education employers.

## **LEGISLATIVE HISTORY:**

Chapter 1095, Statutes of 2002 (AB 2506—Steinberg), requires CalSTRS to establish an Internet registry for vendors who offer tax-deferred 403(b) investment products to employees of school districts, community college districts and county offices of education. The information bank provides school employees a means to search and compare data on investment products including plan features, fees and historical performance.

Chapter 489, Statutes of 1994 (AB 3705—PER&SS), authorizes CalSTRS to develop a 457(b) deferred compensation plan that school employers may offer to their employees who are CalSTRS members.

Chapter 291, Statutes of 1994 (AB 3064—Morrow), authorizes CalSTRS to offer a 403(b) annuity or custodial plan available to all employees of any state or local agency that employs persons in positions eligible for CalSTRS membership.

Chapter 1316, Statutes of 1976 (AB 3056—Gualco), allows CalSTRS school employers to make contributions to the CalSTRS tax-sheltered annuity program on behalf of their employees.

**PROGRAM BACKGROUND:**

Section 403(b) of the Internal Revenue Code (IRC) provides a means for school employees to save additional funds for retirement on a tax-deferred basis. Under this arrangement, participants do not pay income taxes on the amount contributed or the earnings of the accounts until the funds are distributed, generally after retirement. Historically, 403(b) funds have been invested in insurance-based products, known as tax-sheltered annuities, although federal legislation subsequently permitted the establishment of custodial accounts by which participants could invest in mutual funds.

Many vendors of 403(b) investment products market their products, especially tax-sheltered annuities, directly to school employees. Some school employers have instead established 403(b) programs for their employees. Much like private-sector employers with 401(k) plans and non-educational public-sector employers with 457(b) plan, when a school-employer sponsors a 403(b) investment program, it requests bids from vendors and chooses a list of investment products that will be available to their participating employees. In many cases, an employer will also contract with a third-party administrator (TPA) to process and transfer employee contributions from the employer to the various investment providers.

Currently, school employers are not legally responsible for supervising how an employee's 403(b) assets are handled, with the vast majority doing little more than processing payroll deductions. Many contract with TPAs who distribute 403(b) moneys directly from the employer to insurance companies, in the case of 403(b) tax sheltered annuities, and mutual funds, in the case of 403(b) custodial accounts. However, these TPAs have not historically provided any services beyond recordkeeping and distribution functions.

Existing law requires school districts that offer deferred compensation plans to process the payroll deduction and perform other administrative functions. The method of paying the costs for TPA services vary widely: (1) the employer pays; (2) the TPA provides the services without cost in return for preferred treatment for their own 403(b) investment products; or (3) a fee is automatically deducted from the employee's contributions during the transfer process. The State Attorney General recently issued an opinion regarding this last practice, finding that state law prohibits a school district or TPA from charging employees a fee to cover the school district's costs of administering such deferred compensation plans. In contrast, the State Controller has statutory authority to charge for the costs of providing the Controller's 403(b) program. The California Public Employees' Retirement System currently has similar authority under the 457 deferred compensation plans that it offers to public employers. The practice of charging a fee to cover administrative costs is common for other public sector and private sector employers.

CalSTRS administers a 403(b) deferred compensation plan for school employers, with approximately \$130 million in assets, known as the Voluntary Investment Program (VIP). Approximately 400 out of 1,100 CalSTRS employers offer the CalSTRS VIP to their employees, with most making other 403(b) plans available, as well. CalSTRS contracts with a vendor, CitiStreet, LLC, to provide administrative services and access to the various investment options made available to VIP participants, which are selected and screened by CalSTRS' Investment staff. The investment options available range from high to low risk; however, all feature low fees. VIP participants contact their employer to elect deferral amounts that are automatically deducted from their paycheck, and contact CitiStreet to select their investments and allocation of their contributions. Each participant pays an administrative fee that is based on the value of their

investment account. In addition, the different investment products have associated fees that are also paid by the participant. CalSTRS is authorized under existing law to provide school employees with a 457 deferred compensation plan. However, it does not offer such a plan at the present time.

The IRS has finalized regulations that will go into effect January 1, 2008 and impose additional recordkeeping requirements and fiduciary responsibilities on educational and non-profit employers that make available to their employees 403(b) deferred compensation plans. The regulations will, for the first time, require school employers to retain operational control over their 403(b) plans. These requirements are similar to those imposed upon employers who offer their employees 401(k) and 457(b) deferred compensation plans.

Among other things, these new regulations require employers to:

- Keep records of individual employee's account transactions including contributions, investment returns, distributions, sales or distribution expense charges, transfers and tax withholdings;
- Adopt a written Plan Document, effective January 1, 2007, that details the terms for employee eligibility, benefits, applicable limitations, the contracts available under the plan and the terms for benefit distributions;
- Provide plan participants with automatic enrollment and an annual opportunity to elect, revoke or change a deferral election;
- Supervise catch-up contributions to make sure they do not exceed the IRC dollar limits;
- Monitor payroll deferrals elected by participating employees to ensure contributions do not exceed the maximum limits and ensure deferred contributions go only to specific funding arrangements.

Non-governmental 403(b) plans are subject to the Employee Retirement Income Security Act (ERISA). In most instances, governmental plans, including those sponsored by public schools, are currently exempt from ERISA; however, the Department of Labor, which enforces ERISA, has yet to issue a definitive answer about whether the non-ERISA plans will be exempt from the requirement to have a Plan Document. Nonetheless, public school employers will not be exempt from any and all liability. Specifically, school employers will have the ultimate fiduciary responsibility over the plans they offer and will be expected to substantially conform to the guidelines governing fiduciary responsibility set in ERISA. Because many school employers, especially small and rural school districts that offer 403(b) plans, do not have the expertise to perform these functions, some have contacted CalSTRS seeking compliance information and assistance.

The new regulations will result in much greater compliance costs for school employers, which increases the need to allow school districts to recover these costs associated with administering their 403(b) plans. Because current law does not provide the express statutory authority for school districts to charge for the costs of administering deferred compensation plans, the school districts will be forced to bear the costs of the new IRS regulations on their own, which may cause some to abandon the plans or enter into single contractual relationships with 403(b) providers, thereby limiting the investment options available to employees. Furthermore, if employers fail to comply with the regulations, contributions made to a teacher's 403(b) plan may

be ruled by the IRS as nonqualified, thus preventing the deferral of taxes on contributions made to the plan.

## **ANALYSIS:**

Specifically, Assembly Bill 2462:

- Provides that if an employer elects to contract with a third party administrator, including CalSTRS, in order to provide administrative, fiduciary and recordkeeping services for their sponsored deferred compensation programs, to employees, the employer must do the following:
  - a) Determine that hiring the third-party administrator is in the best interest of the participants, their beneficiaries, and the employer.
  - b) Require the third-party administrator to provide proof of liability insurance and a fidelity bond in an amount determined by the employer to be sufficient to protect the assets of participants.
  - c) Require evidence, if the third-party administrator is affiliated with a provider of investment products, that data generated from the administrator is not accessible to the provider of investment products.
  - d) Require the third-party administrator to disclose to it and participating employees any contractual relationship, fees, commissions, cost offsets, reimbursements, or marketing and promotional items it or its vendors holds or receives from other 403(b) or 457 investment providers.
  - e) Require the third-party administrator to provide evidence of a safe chain-of-custody of assets process to fulfill its fiduciary responsibilities and ensure timely placement of participant investments;
- Allows the school employer to charge participants a fee to cover the costs of deferred compensation plan administrative and compliance services – they will continue to be unable to charge participants for payroll deduction costs associated with life insurance, health care and legal service plans;
- Requires all employers and their third-party administrators to protect employees' personal and investment information;
- Limits audits of all school employer-sponsored deferred compensation plans to once annually, unless documented problems exist.
- Stipulates that school employees' ability to select a 403(b) annuity product of their choosing not be impaired by an employer or its third-party administrator.

AB 2462 also permits CalSTRS to provide, or contract to provide, fiduciary, recordkeeping and administrative services for 403(b) and 457 deferred compensation plans to K-12 school, community college and county office of education employers that elect to contract with CalSTRS to provide those services. As an administrator providing compliance services, CalSTRS (or the outside vendor with whom CalSTRS contracts) would be allowed to:

- Administer and maintain the written document governing the employer's deferred compensation plan;
- Review and authorize various distribution requests;

- Review and determine qualified domestic relations orders;
- Notify employees of their eligibility to participate in the employer's plan;
- Administer and maintain salary reduction agreements;
- Monitor contributions to ensure none exceed maximum contribution limits;
- Calculate employer contributions for vesting purposes;
- Identify and notify employees that are required to take minimum distributions; and
- Coordinate responses to the IRS, as necessary.

In addition, the administrative services supplied by CalSTRS may include:

- Common remitting services;
- General education to employees about the employer's deferred compensation plan;
- Preparation of internal reports;
- Consulting services related to plan design, operation and administration; and
- Assistance with performing internal audits.

Finally, the bill further defines the terms and conditions under which CalSTRS is able to provide those TPA services, including:

- Stipulate that if CalSTRS does not contract with a vendor to provide TPA services to school employers on its behalf, it must provide assurances to contracting employers similar to what the bill requires of CalSTRS-contracting TPA vendors and other TPA vendors, including:
  - (1) Evidence of liability insurance and a fidelity bond in an amount determined by the employer to be sufficient to protect the assets of participants and beneficiaries;
  - (2) Evidence of a safe chain-of-custody of assets process fulfill its fiduciary responsibilities and ensure timely placement of participant investments; and
  - (3) Evidence that data generated from the TPA services it provides are maintained to prevent a provider of investment products from accessing that data unless access is required to provide the contracted services.
- Establish the continuously appropriated Teachers' Retirement Program Development Fund (TRPDF) within the State Treasury to pay any costs related to the development of programs authorized by statute that enhance the financial security of members or beneficiaries of CalSTRS, the first being establishing a contract-based program to provide school employers with compliance services;
- Allow CalSTRS to temporarily divert a portion of the employer's Defined Benefit (DB) Program contributions to the TRPDF, and requires an amount equal to these contributions, with interest, to be deposited in the Teachers' Retirement Fund (TRF) from moneys generated from the programs receiving development funds;
- Provide for recovery of the diverted funds through the fees paid by contracting employers and/or participating employees.
- Caps total funding of the TRPDF at a hundredth of a percent of annual teacher earnings, which is approximately \$5 million.

AB 2462 does not require or compel California school employers to utilize CalSTRS' TPA services, or any other provider of TPA services, it only specifies the minimum standards of due diligence they must perform before contracting with an outside entity to provide those services. School employers who offer 403(b) or 457 plans to their employees will be able to contract with

CalSTRS for these services to ensure their compliance with the new IRS requirements. California school employers will be able to select from a range of services and contract with CalSTRS for the level of service that best meets their needs. In administering its TPA CalSTRS, or the vendor it contracts with, will be operating under the direction of the employer.

In contracting with CalSTRS, some of the employer's fiduciary and administrative responsibility will shift to CalSTRS. In addition, if CalSTRS obtains the services of an outside vendor to act as the plan administrator, the outside vendor will also assume some of the liability. If CalSTRS decides to use an outside vendor, selection the vendor must be in the best interest of the deferred compensation plans offered by the employers who contract with CalSTRS. The vendor selected will be required to maintain liability insurance and a fidelity bond to protect the assets of the plan participants and beneficiaries. In addition, if the outside vendor is associated with a company that provides 403(b) or 457 investment products, the vendor will be required to ensure the data related to CalSTRS' administrative and compliance services cannot be shared or accessed by the company selling investment products. These additional requirements imposed on the outside vendor will help to protect the integrity of the services provided to the employers, the personal information of the employees participating in the employer's deferred compensation plan and the participants' investments.

Money to initially develop the CalSTRS deferred compensation administrative and compliance services program will come from a portion of the 8.25 percent of creditable compensation contributed by employers to the Teachers' Retirement Fund (TRF) for the DB Program and the Teachers' Health Benefits Fund (THBF). A portion of the employer contributions will be diverted to the Development Fund and will be held separately from the TRF and the THBF for the purposes of developing programs that enhance member financial security. Idle funds held in the Development Fund will be invested similarly to those in the TRF and THBF. The Board's primary focus is providing benefits to members and beneficiaries while administering the Teachers' Retirement Plan (Plan) in a prudent and fiscally responsible manner. Therefore, Board policy and its fiduciary responsibility prevent it from proceeding with any additional programs outside the Plan that are funded either directly or indirectly from the TRF unless there is a reasonable possibility of paying back the TRF in full.

Assets used for program development will be returned to the TRF from revenues generated by the CalSTRS administrative and compliance services program, with interest calculated on the 8 percent actuarially assumed rate. CalSTRS will charge contracting employers a nominal fee commensurate with the level of service provided to the employer. The employer can include the price of the administrative and/or compliance services as part of the cost for performing participant payroll deductions made for the 403(b) or 457 deferred compensation plan. The employer's governing board may pay the fees itself, or collect these fees directly from the participating employee, the participant's deferred compensation account, an employee organization or the employer.

#### **FISCAL IMPACT:**

**Benefit Program cost/savings:** None. Assuming the compliance program generates sufficient revenues to offset the amount of funds diverted from the TRF, the TRF will be repaid at the 8 percent actuarially assumed rate of return.

**Administrative costs/savings:** The start-up cost for analyzing the market needs, establishing appropriate contract requirements, selecting the best-qualified third party vendor, database modifications to capture a portion of employer contributions and divert to the new Development Fund, and other implementation costs are estimated to be approximately \$310,000. In addition, CalSTRS' annual audit costs will increase to accommodate auditing the new Development Fund. Administrative costs will be paid by contracting employers and/or their participating employees.

## **SUPPORT/OPPOSITION**

**Support:** Teachers' Retirement Board, CSEA, CTA, FACCC, Los Angeles Community College Faculty Guild, Los Angeles Community College District, West Kern Community College District, AIG/VALIC; California Association of Life and Health Insurance Companies; TIAA-CREF

**Opposition:** Department of Finance.

## **ARGUMENTS IN SUPPORT/OPPOSITION:**

**Pros:** AB 2462 will leverage CalSTRS' expertise and relationships to provide employers with low-cost, high-quality recordkeeping and compliance services for their deferred compensation plans.

**Cons:** By diverting money from the TRF to the new Development Fund and then paying that money back at the actuarially assumed rate of return, the TRF may have less of an opportunity to earn a *greater* rate of return.