



**REPORT OF  
THE  
STATE AUDITOR**

**State of Colorado Public Officials' and  
Employees' Defined Contribution Plan and  
457 Deferred Compensation Plan  
Department of Personnel & Administration**

**Performance Review  
October 2008**

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October 20, 2008

Members of the Legislative Audit Committee:

This report contains the results of a performance review of the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the State of Colorado 457 Deferred Compensation Plan. The review was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The State Auditor contracted with Buck Consultants to conduct a portion of this review. The report presents Buck Consultants' and the Office of the State Auditor's findings, conclusions, and recommendations, and the responses of the State Deferred Compensation Committee, Department of Personnel & Administration, and Public Employees' Retirement Association.

*Sally Symanski*

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**State of Colorado Public Officials' and Employees' Defined Contribution Plan  
and 457 Deferred Compensation Plan  
Performance Review  
October 2008**

**Authority, Purpose, and Scope**

This performance review was conducted in response to a request from the State Deferred Compensation Committee (Committee) and pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The purpose of the review, which was performed from February to June 2008, was to ensure that the Committee is meeting its fiduciary responsibilities with respect to the State of Colorado Public Officials' and Employees' Defined Contribution Plan (State DC Plan) and State of Colorado 457 Deferred Compensation Plan (State 457 Plan). The Office of the State Auditor retained Buck Consultants to review the two Plans, including the management and fiduciary oversight of the Plans by the Committee and the Department of Personnel & Administration (Department), the administration of the Plans, and the performance of investment options under the Plans. The Office of the State Auditor reviewed the Department's internal controls over the Plans. We acknowledge the assistance and cooperation provided by the Department, Committee, and Public Employees' Retirement Association (PERA) during the review.

**Overview**

Colorado state employees have many options when it comes to retirement plans. Historically, state employees were required to participate in the PERA Defined Benefit Plan as their primary retirement plan. With the passage of Senate Bill 04-257 the General Assembly expanded the number of primary retirement plan options available to state employees to include the State DC Plan and the PERA Defined Contribution Plan. In addition to the three primary retirement plans, state employees may participate in two supplemental retirement plans: 1) the State 457 Plan and 2) the PERA 401(k) Plan. All state employees, regardless of which primary retirement plan they select, may participate in the State 457 Plan. Employees participating in either the PERA Defined Benefit or Defined Contribution Plans may also participate in the PERA 401(k) Plan. The Committee has fiduciary responsibility for the State DC and State 457 Plans and the Department is responsible for providing administrative and technical support to the Committee for both Plans.

The State DC Plan was originally created in 1999 to provide retirement benefits to public officials and elected employees. Effective January 1, 2006, participation in the Plan was opened to all state employees, except those within the higher education system. As of June 30, 2008, the State DC Plan had almost 1,900 participants and net assets of \$14.7 million. The State 457 Plan was created in 1981 and participation in the Plan is open to all state employees and employees of any city and

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county, city, county, town, or other political subdivision of the State. As of June 30, 2008, the State 457 Plan had about 17,300 participants and net assets of \$377.6 million. Although the Committee and the Department manage both Plans, they contract with three investment providers to administer the State DC Plan and a third-party administrator to administer the State 457 Plan.

## Summary of Key Findings

### Structure of Retirement Plans

Buck Consultants reviewed the Committee's oversight of the State DC Plan and the State 457 Plan and concluded that overall, the Committee is meeting its fiduciary responsibilities with respect to the Plans. However, Buck Consultants identified the following areas where improvements can be made to the structure of the State's retirement plan options:

- **Investment options.** There are gaps in the investment options available under the State DC and State 457 Plans. For the State DC Plan, none of the three investment providers offers lifecycle or mid-cap blend funds, two of the providers do not offer small-cap blend funds, and one provider does not offer a mid-cap value or small-cap growth fund. The State 457 Plan does not offer participants lifecycle or small- or mid-cap blend funds.
- **Investment policy statements.** The Committee has not clearly documented its fiduciary responsibility in the investment policy statement for the State DC Plan because the statement is silent on the Committee's responsibilities related to determining investment options and monitoring Plan performance. In addition, maintaining a separate investment policy statement for the State DC Plan and the State 457 Plan is inefficient and not necessary.
- **Bundled investment providers.** Requiring the Committee to contract with three investment providers to administer the State DC Plan has resulted in increased costs to participants. Each investment provider has to treat its portion of the State DC Plan as a separate stand-alone plan which reduces the size of the plan and therefore, the providers' ability to offer funds with lower fees. These higher fees can have a material impact on a participant's accumulation of capital and ability to achieve retirement objectives. Additionally, the direct administrative costs borne by the Department for having to manage three providers—and subsequently passed on to participants through management fees—are greater than if only one provider administered the Plan.
- **Retirement plan options.** Buck Consultants identified two options for restructuring the State's primary and supplemental retirement plans that could result in lower participant fees and improve the efficiency of plan management. The first option is to evaluate whether to offer only one defined contribution plan to state employees. Participants in the State DC Plan would likely pay lower fees if the Plan was combined with the PERA Defined Contribution Plan. The second option is to evaluate whether it is more efficient and less costly to combine the management of all of the State's primary and supplemental retirement plans under one entity. PERA may be in a better position to manage all of the plans than the

Department because of its investment expertise and the resources that it can dedicate to this function.

### **Plan Administration**

Buck Consultants reviewed the administration of the State DC Plan and the State 457 Plan and identified the following areas where improvements are needed:

- **Service level requirements.** Service level standards contained in the Department's and Committee's contracts with the investment providers for the State DC Plan and the third-party administrator for the State 457 Plan are inconsistent among providers within the same plan and in some instances, insufficient. In addition, many of the penalty amounts contained in the contracts for both Plans are not sufficient to impact provider behavior. Finally, the Department is not actively monitoring provider performance, but instead relies on the providers to self-monitor their own performance and inform the Department if penalties should be applied.
- **Administration documentation.** Some of the investment providers for the State DC Plan and the third-party administrator for the State 457 Plan do not provide sufficient documentation for the Committee and the Department to oversee plan administration.
- **Final distribution forms.** The final distribution election forms for the State DC Plan and the State 457 Plan are incomplete because they do not include a list of all distribution options available under the respective plans.
- **Code limits.** The Department does not have processes in place to ensure that the State DC Plan is complying with Internal Revenue Code limits on contribution and compensation amounts.

Finally, we found that the conduct and ethical standards included in the Committee's Governance Manual do not provide specific guidance for Committee members regarding how they should identify and handle real or perceived conflicts of interest. Additionally, we found that the Committee and the Department do not cover the code of conduct in the orientation provided to new Committee members and do not require Committee members and the Plan Manager to annually sign a statement disclosing real or potential conflicts of interest and their understanding of the code of conduct.

Buck Consultants' and Office of the State Auditor's recommendations and the responses from the State Deferred Compensation Committee, Department of Personnel & Administration, and Public Employees' Retirement Association can be found in the Recommendation Locator and in the body of the report.

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## RECOMMENDATION LOCATOR

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| Rec. No. | Page No. | Recommendation Summary   | Agency Addressed                         | Agency Response | Implementation Date |
|----------|----------|--|--|-----------------|---------------------|
| 1        | 21       | Ensure the State of Colorado Public Officials' and Employees' Defined Contribution and 457 Deferred Compensation Plans offer a full range of investment options to participants by reviewing the options available for both plans and working with the providers to eliminate any gaps.  | State Deferred Compensation Committee    | Partially Agree | March 2009          |
| 2        | 22       | Revise the investment policy statement for the State of Colorado Public Officials' and Employees' Defined Contribution Plan to clearly state where fiduciary responsibilities lie with respect to monitoring and determining investment options.   | State Deferred Compensation Committee    | Partially Agree | March 2009          |
| 3        | 26       | Assess the impact that having three investment providers administer the State of Colorado Public Officials' and Employees' Defined Contribution Plan has on the cost of the Plan to participants and determine if using one provider would create efficiencies and decrease costs; propose statutory change as necessary.  | State Deferred Compensation Committee    | Agree           | July 2009           |
|          |          |  | Department of Personnel & Administration | Partially Agree | July 2009           |
| 4        | 29       | Continue to evaluate options for streamlining the structure of the primary and supplemental retirement plans offered by the State. This evaluation should consider: (a) combining the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the Public Employees' Retirement Association Defined Contribution Plan, and (b) combining the management of all of the State's primary and supplemental retirement plans under one entity. Report the results of the evaluation to the Governor's Office and General Assembly and work on ways to improve the plans, proposing statutory change as necessary. | State Deferred Compensation Committee    | Agree           | July 2009           |
|          |          |  | Department of Personnel & Administration | Agree           | July 2009           |
|          |          |  | Public Employees' Retirement Association | Agree           | June 30, 2009       |

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## RECOMMENDATION LOCATOR

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| Rec. No. | Page No. | Recommendation Summary   | Agency Addressed                         | Agency Response | Implementation Date |
|----------|----------|--|--|-----------------|---------------------|
| 5        | 36       | Ensure the third-party administrator for the State of Colorado 457 Deferred Compensation Plan and the investment providers for the State of Colorado Public Officials' and Employees' Defined Contribution Plan are held accountable for providing quality services to participants by: (a) identifying and applying appropriate service level standards and penalties across all providers within a plan, and (b) actively monitoring provider performance to ensure compliance with established standards and applying penalties as appropriate. | State Deferred Compensation Committee    | Partially Agree | December 2008       |
|          |          |  | Department of Personnel & Administration | Partially Agree | December 2008       |
| 6        | 38       | Require the third-party administrator for the State of Colorado 457 Deferred Compensation Plan and the investment providers for the State of Colorado Public Officials' and Employees' Defined Contribution Plan to maintain and provide adequate documentation consistent with industry standards to support the administration of the Plans, amending contracts as necessary.  | State Deferred Compensation Committee    | Partially Agree | March 2009          |
|          |          |  | Department of Personnel & Administration | Partially Agree | March 2009          |
| 7        | 40       | Work with the investment providers for the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the third-party administrator for the State of Colorado 457 Deferred Compensation Plan to ensure final distribution election forms accurately reflect all available distribution options.  | State Deferred Compensation Committee    | Agree           | December 2008       |
|          |          |  | Department of Personnel & Administration | Agree           | December 2008       |

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## RECOMMENDATION LOCATOR

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| Rec. No. | Page No. | Recommendation Summary  | Agency Addressed  | Agency Response                        | Implementation Date          |
|----------|----------|---|---|--|------------------------------|
| 8        | 42       | Work with the investment providers to implement mechanisms for monitoring State of Colorado Public Officials' and Employees' Defined Contribution Plan participant contribution and compensation amounts to ensure these amounts comply with Internal Revenue Code limits. Review contributions for prior years and address instances where limits were violated.   | State Deferred Compensation Committee<br><br>Department of Personnel & Administration | Partially Agree<br><br>Partially Agree | March 2009<br><br>March 2009 |
| 9        | 44       | Strengthen safeguards for preventing conflicts of interest by: (a) including guidance in the conflict of interest policies on what constitutes a conflict and holding members liable for violations of the policy, (b) considering including language to require members to recuse themselves from discussions and votes where a conflict exists, (c) working with the Department of Personnel & Administration to include the updated code of conduct in orientation materials and offering refreshers to members on a routine basis, and (d) requiring members and the Plan Manager to annually complete and sign a statement disclosing real and potential conflicts of interest and documenting their understanding of the code of conduct. | State Deferred Compensation Committee   | Agree                                  | March 2009                   |
| 10       | 46       | Revise the summaries for the State of Colorado Public Officials' and Employees' Defined Contribution and 457 Deferred Compensation Plans to ensure they accurately reflect the provisions of their respective plans. Update the summaries to reflect changes made to the Plans in the future.   | State Deferred Compensation Committee<br><br>Department of Personnel & Administration | Agree<br><br>Agree                     | March 2009<br><br>March 2009 |

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## RECOMMENDATION LOCATOR

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| <b>Rec. No.</b> | <b>Page No.</b> | <b>Recommendation Summary</b>   | <b>Agency Addressed</b>               | <b>Agency Response</b> | <b>Implementation Date</b> |
|-----------------|-----------------|---|---------------------------------------|------------------------|----------------------------|
| 11              | 50              | Ensure the State of Colorado Public Officials' and Employees' Defined Contribution and 457 Deferred Compensation Plans comply with federal and state laws by comparing plan documents for both plans to applicable federal and state laws to identify provisions that are not required, amending documents as necessary. File a determination letter application with the Internal Revenue Service (IRS) for the State DC Plan and request a Private Letter Ruling from the IRS for the State 457 Plan. | State Deferred Compensation Committee | Agree                  | March 2009                 |

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# The State DC Plan and State 457 Plan

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## Background

For most people, retirement income comes from three main sources—personal savings, Social Security benefits, and employer-sponsored retirement savings plans. In Colorado, however, most state employees do not contribute to Social Security and therefore do not receive Social Security benefits upon retirement. Instead, state employees have historically been required to participate in the Colorado Public Employees' Retirement Association (PERA) Defined Benefit Plan which has served as the primary retirement plan and source of retirement income for state employees. Traditionally, most employers that provided a retirement savings plan to employees offered a defined benefit plan similar to the PERA Defined Benefit Plan. Under a defined benefit plan, the employee receives a specified monthly benefit amount at retirement that is generally based on factors such as the employee's age, salary, and years with the employer. With a defined benefit plan the employer takes on the risk that assets may not produce sufficient investment returns to support a promised level of retirement benefits.

Beginning in the 1980s, many employers began moving away from defined benefit plans and instead offered employees a defined contribution plan as a means of saving for retirement. Under a defined contribution plan, the level of contribution made to the plan is defined, not the retirement benefit. These plans became more attractive to employers because with a defined contribution plan the employee, not the employer, accepts the risk that the investment result may yield lower-than-expected retirement income. Following the national trend in both the public and private sectors, in 2004 the General Assembly expanded the number of primary retirement plan options available to state employees to include two defined contribution plans in addition to the PERA Defined Benefit Plan. With the passage of Senate Bill 04-257 the General Assembly created the PERA Defined Contribution Plan and opened participation in the State of Colorado Public Officials' and Employees' Defined Contribution Plan (State DC Plan) up to all state employees. Although the State DC Plan was created in 1999 by House Bill 98-1191, participation in the Plan was originally limited to public officials and elected employees (e.g., members of the General Assembly and Public Utilities Commission, executive directors of state departments, and elected officials such as the Governor, Attorney General, and Secretary of State). Effective January 1, 2006, all new state employees, with the exception of employees in the higher education system, must select either the PERA Defined Benefit Plan, the PERA Defined Contribution Plan, or the State DC Plan as their primary retirement plan. If an employee fails to make a selection within 60 days of employment, the employee is automatically enrolled in the PERA Defined

Benefit Plan. Most higher education employees participate in one of the optional retirement plans offered by their institution or the PERA Defined Benefit Plan if they had been a member of the Plan previously. Colorado Community College System employees hired after January 1, 2008, however, are required to participate in either the PERA Defined Benefit Plan or the PERA Defined Contribution Plan.

In addition to the three primary retirement plans, state employees may enroll in two supplemental deferred compensation retirement plans: 1) the State of Colorado 457 Deferred Compensation Plan (State 457 Plan) and 2) the PERA 401(k) Plan. All state employees, regardless of which primary retirement plan they select, may participate in the State 457 Plan. However, only those employees who select either the PERA Defined Benefit or Defined Contribution Plans may participate in the PERA 401(k) Plan. Employees may opt to participate in these plans, but they are not required to do so. Supplemental deferred compensation retirement plans allow employees to save a portion of their income on a tax-deferred basis. With both the State 457 Plan and the PERA 401(k) Plan, participants determine how much to contribute to their individual accounts and direct how the money in their accounts will be invested from a menu of investment funds. Income received from both of these plans is meant to supplement the retirement benefits received from the employee's primary retirement plan. The following table shows the number of participants and net assets in each of the three primary retirement plans and two supplemental plans as of June 30, 2008.

| <b>State of Colorado<br/>           Primary and Supplemental Retirement Plans<br/>           Participants and Net Assets<br/>           As of June 30, 2008<br/>           (Dollars in Millions)</b>  |                                   |                       |
|---|-----------------------------------|-----------------------|
| <b>Plan</b>   | <b>Number of<br/>Participants</b> | <b>Net<br/>Assets</b> |
| <b>PRIMARY RETIREMENT PLANS</b>   |                                   |                       |
| PERA Defined Benefit Plan <sup>1</sup>  | 413,300                           | \$41,150.4            |
| PERA Defined Contribution Plan <sup>1</sup>   | 500                               | \$2.5                 |
| State DC Plan   | 1,870                             | \$14.7                |
| <b>Sub-total</b>  | <b>415,670</b>                    | <b>\$41,167.6</b>     |
| <b>SUPPLEMENTAL RETIREMENT PLANS</b>  |                                   |                       |
| PERA 401(k) Plan <sup>1</sup>   | 72,800                            | \$1,730.9             |
| State 457 Plan  | 17,300                            | \$377.6               |
| <b>Sub-total</b>  | <b>90,100<sup>2</sup></b>         | <b>\$2,108.5</b>      |
| <b>TOTAL</b>  | <b>505,770</b>                    | <b>\$43,276.1</b>     |
| <b>Source:</b> Department of Personnel & Administration and financial data warehouse preliminary audited numbers for the State DC Plan and the State 457 Plan. Public Employees' Retirement Association (PERA) Comprehensive Annual Financial Report.<br><sup>1</sup> Asset and participant amounts for PERA are as of December 31, 2007, the last date audited numbers were available.<br><sup>2</sup> The total number of participants in the two supplemental retirement plans may contain duplication because some employees may participate in both plans. |                                   |                       |

This review focuses on the two plans administered by the Department of Personnel & Administration: 1) the State DC Plan and 2) the State 457 Plan.

## Plan Administration

The State Deferred Compensation Committee (Committee) and the Department of Personnel & Administration (Department) are responsible for managing both the State DC Plan and the State 457 Plan. According to statute [Section 24-52-102, C.R.S.], the Committee is composed of nine members, who include:

- The State Treasurer or designee.
- The State Controller or designee.

- Four employees who are participants in the State 457 Plan, one of whom may be a retiree who is a participant in the Plan. These four are elected by participants.
- One participant in the State 457 Plan, appointed by the Governor.
- One Senator or former Senator who is a participant in the State 457 Plan, appointed by the President of the Senate.
- One Representative or former Representative who is a participant in the State 457 Plan, appointed by the Speaker of the House of Representatives.

The Committee has fiduciary responsibility for both plans. Its duties include:

- Establishing rules, regulations, policies, and procedures for the administration of the Plans.
- Selecting all third-party administrators and bundled investment providers that provide investment, marketing, recordkeeping, and consulting services.
- Determining any fees associated with the Plans.
- Conducting periodic reviews of plan operations, investment performance, and budget.

According to statute [Section 24-52-203, C.R.S.], the Department is responsible for providing administrative and technical support to the Committee with respect to both the State DC and State 457 Plans. The Department has allocated 1.5 FTE to the State 457 Plan and 1 FTE to the State DC Plan. This total of 2.5 FTE includes the Plan Manager, who is responsible for providing administrative and technical support to the Committee for both Plans; an administrative assistant; and a part-time accountant.

## **State DC Plan**

The State DC Plan is intended to qualify as a 401(a) defined contribution plan under Section 401(a) of the Internal Revenue Code. As discussed previously, as of January 1, 2006, all new state employees, except those within higher education, are eligible to participate in the State DC Plan. Only state employees are eligible to participate in this Plan. Although the Plan is overseen by the Committee and the Department, statute [Section 24-52-203(3)(c), C.R.S.] requires the Committee to select three separate and distinct bundled investment providers to handle participant investments and contributions. A bundled investment provider is a single vendor that provides all investment, recordkeeping, administration, and education services. Bundled investment providers are able to provide the entire range of administrative services to a plan sponsor from within a “one-stop-shop.” For Fiscal Year 2008 the Committee and the Department contracted with Great-West Life Annuity and Insurance Company (Great-West), the Hartford Life Insurance Company (Hartford), and ICMA Retirement Corporation (ICMA) to serve as bundled investment providers. According to statute [Section 24-52-202,



C.R.S.] and their contracts with the Department, the bundled investment providers are responsible for providing services, including but not limited to:

- Enrolling new participants in the Plan, which includes processing participant elections and contributions.
- Recording payroll deductions into participant accounts.
- Processing participant transfer requests and distributions.
- Recording participants' changes (e.g., changes in the funds selected).
- Preparing and distributing quarterly statements to participants on investment activity, account balances, and transactions.
- Providing ongoing assistance and services to current Plan participants, including a voice response system, website, and customer service center.
- Providing an ongoing reporting of results and a semi-annual review of Plan performance to the Committee.
- Providing a recordkeeping and accounting system for managing participant accounts.

According to statute [Section 24-52-203(9)(a), C.R.S.], the Department may assess each provider a fee to cover the Department's actual and reasonable costs of administering the State DC Plan. Typically the Department charges each of the providers about \$40,000 per year to cover the Department's administration costs. However, in Fiscal Year 2008 the Department charged each provider about \$74,000 due to one-time additional costs incurred by the Department that year. Statute also allows each provider to charge participants a separate administrative fee to cover the cost of administrative expenses charged to the providers by the Department. Currently there is no additional administrative fee charged to participants in this Plan. Additionally, participants pay an investment management fee to their investment company to pay for trading and other management expenses. In Fiscal Year 2008 investment management fees ranged from 0.05 percent to 1.58 percent of a participant's account balance, depending on the funds selected by the participant.

## **Member and Asset Information**

As of June 30, 2008, in total, there were almost 1,900 State DC Plan participants. Under the State DC Plan, with the exception of state troopers, each employee contributes 8 percent of his or her salary and the State contributes an amount equal to 10.15 percent of the employee's salary to the Plan. State troopers contribute 10 percent of their salary and the State contributes 12.85 percent. These contribution percentages are the same as the ones applied to the PERA Defined Benefit and Defined Contribution Plans. According to statute [Section 24-52-205(1)(b), C.R.S.], employees are immediately vested in 100 percent of both the employee and employer share of contributions made to the State DC Plan. Employees are required to select one of the three bundled investment providers to administer their accounts but can change providers each year during

the open enrollment period. Distributions of all contributions can be made from the account when employment terminates, including throughout retirement. In addition to ordinary income tax, distributions made prior to the employee's meeting minimum age requirements (i.e., age 59 1/2) under the Internal Revenue Code are subject to a 10 percent penalty tax. Participants may elect to roll over the funds in their accounts to another qualified retirement plan without penalties or tax implications. The following table shows the number of State DC Plan participants and net assets by investment provider as of June 30, 2008.

| <b>State of Colorado Public Officials' and Employees'<br/>Defined Contribution Plan<br/>Plan Participants and Net Assets by Investment Provider<br/>As of June 30, 2008<br/>(Dollars in Millions)</b> |                                   |                       |
|---|-----------------------------------|-----------------------|
| <b>Investment<br/>Provider</b>  | <b>Number of<br/>Participants</b> | <b>Net<br/>Assets</b> |
| Great-West Life Annuity and Insurance Company   | 600                               | \$4.9                 |
| The Hartford Life Insurance Company   | 820                               | \$6.4                 |
| ICMA Retirement Corporation   | 450                               | \$3.4                 |
| <b>TOTAL</b>  | <b>1,870</b>                      | <b>\$14.7</b>         |
| <b>Source:</b> Department of Personnel & Administration.  |                                   |                       |

## State 457 Deferred Compensation Plan

The State 457 Plan was established in 1981 by Senate Bill 80-120 and is intended to qualify as a deferred compensation plan under Section 457 of the Internal Revenue Code. The State 457 Plan is open to all state employees and employees of any city and county, city, county, town, or other political subdivision of the State. As of June 30, 2008 there were 16 school districts and one local government entity participating in the Plan. The Department contracts with Great-West to serve as the third-party administrator, or recordkeeper of participant accounts, for the Plan. Great-West has the same responsibilities for the State 457 Plan that the bundled investment providers have for the State DC Plan.

According to statute [Section 24-52-102(5)(a), C.R.S.], the Committee may assess each participant a fee for administering the State 457 Plan and that fee shall not exceed 1 percent of the participating employee's assets in the Plan. Until July 1, 2006, there was a quarterly account maintenance fee of \$5. However, the Committee waived this fee for Fiscal Years 2007 and 2008. Additionally, participants pay an investment management fee to their investment company to pay for trading and other management expenses. In Fiscal Year 2008 investment

management fees ranged from 0.05 percent to 1.58 percent of the participant's account balance, depending on the funds selected by the participant.

### Member and Asset Information

As of June 30, 2008 there were about 17,300 employees enrolled in the State 457 Plan, with almost 11,000 actively contributing. Under the State 457 Plan, participants can contribute a minimum of \$25 per month up to a maximum of \$15,500 per year, or \$20,500 per year if the participant is age 50 or older. The State does not provide any matching funds for state employees. State 457 Plan participants can choose among 14 different investment options selected by the Committee. Distributions can be made from the account when employment terminates, including throughout retirement, and are subject to ordinary income tax, but no penalties. The following table shows the number of State 457 Plan participants and net assets for the past four fiscal years.

| <b>State of Colorado 457 Deferred Compensation Plan<br/>Plan Participants and Net Assets<br/>As of the End of Fiscal Years 2005 through 2008<br/>(Dollars in Millions)</b> |             |             |             |             |
|--|-------------|-------------|-------------|-------------|
|  | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> |
| <b>Participants<sup>1</sup></b>  | 15,380      | 14,370      | 15,100      | 17,300      |
| <b>Net Assets</b>  | \$303.8     | \$325.3     | \$381.2     | \$377.6     |
| <b>Source:</b> Fiscal Years 2005 through 2007 audited financial statements, Fiscal Year 2008 preliminary audited financial statements, and data provided by Great-West.    |             |             |             |             |
| <sup>1</sup> Includes both active and inactive participants.   |             |             |             |             |

Participants in the State 457 Plan may also receive financial hardship distributions in certain financial emergencies resulting from unforeseeable events. According to the Department, most hardship distributions are made due to loss of income, imminent foreclosure, and unpaid medical bills. The Deferred Compensation Hardship Committee, which consists of three members of the State Deferred Compensation Committee, reviews hardship applications and determines if a distribution is eligible under Plan requirements and the Internal Revenue Code.

Additionally, the State 457 Plan offers loans to all participants who are currently employed by the State. There are two different types of loans available to participants—a general purpose loan and a principal residence loan. For both types of loans, the minimum loan amount is \$1,000 and the maximum is \$50,000 or 50 percent of the participant's vested account balance, whichever is less. For both types of loans, there are loan origination and annual maintenance fees, and interest is charged at a rate of 1 percent over the prime rate. There were about 540 new loans issued in Fiscal Year 2008 and the average loan amount was approximately \$3,600. As of June 30, 2008 there was about \$3.5 million in loans

and corresponding interest receivable outstanding on approximately 1,250 participant loans.

### **Scope and Methodology**

This review was performed in response to a request from the State Deferred Compensation Committee. The purpose of the review was to ensure that the Committee is meeting its fiduciary responsibilities with respect to both the State DC Plan and the State 457 Plan. The Office of the State Auditor retained Buck Consultants to review the two Plans, including the management and fiduciary oversight of the Plans by the Committee and the Department, the bundled investment providers' and third-party administrator's administration of the Plans, and the performance of investment options under the Plans. The Office of the State Auditor reviewed the Department's internal controls over the two Plans.

During the review, Buck Consultants and Office of the State Auditor staff analyzed data; reviewed applicable federal laws and state statutes, rules, and policies; and interviewed Department, PERA, Great-West, Hartford, and ICMA staff. Buck Consultants also obtained data on other states' practices related to defined contribution and deferred compensation plans. The report includes issues identified related to the structure of the State's retirement plans and plan administration. This report includes the results of Buck Consultants' and the Office of the State Auditor's review of the State DC Plan and the State 457 Plan.

# Structure of Retirement Plans

## Chapter 1

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### Background

A strong benefits package that includes a retirement plan can be an important tool for recruiting and retaining qualified employees. The goal of any retirement plan should be to provide meaningful retirement income to participants. To further this goal, many employers offer different options with respect to retirement plans so that employees can choose the plans that best meet their needs. As discussed previously, Colorado state employees have several options when it comes to retirement plans and benefits. Because state employees, except for some higher education employees, are exempt from paying Social Security, employees must rely upon their primary retirement plan to provide sufficient retirement income. As of January 1, 2006 state employees must choose from one of three primary retirement plans: 1) the State of Colorado Public Officials' and Employees' Defined Contribution Plan (State DC Plan), 2) the Public Employees' Retirement Association (PERA) Defined Benefit Plan, or 3) the PERA Defined Contribution Plan. In addition, employees have the option of participating in two supplemental retirement plans: 1) the State of Colorado 457 Deferred Compensation Plan (State 457 Plan) and 2) the PERA 401(k) Plan. The purpose of these two optional plans is to supplement the employee's retirement income received from the primary plan. Employees selecting the State DC Plan as their primary retirement plan must choose from one of three bundled investment providers to administer their account. When participating in the State DC Plan, the PERA Defined Contribution Plan, or the two supplemental plans, employees must also choose from among the different investment options offered by each of the plans and providers.

Buck Consultants reviewed the State Deferred Compensation Committee's (Committee's) oversight of the State DC Plan and the State 457 Plan and concluded that overall, the Committee is meeting its fiduciary responsibilities with respect to the Plans. However, Buck Consultants identified several areas where improvements can be made to the structure of the State's retirement plan options. These include issues related to the adequacy of the investment and distribution options available to State DC Plan and State 457 Plan participants, the Committee's investment policy statements for the two Plans, and the bundled investment providers for the State DC Plan. In addition, Buck Consultants identified possible alternatives for restructuring the State's retirement plans that could lower costs to participants and the State as a whole. Each of these issues is

discussed in this chapter. Chapter 2 describes administrative improvements in the two plans identified by Buck Consultants.

## Investment Options

In defined contribution and deferred compensation plans the investment risks and rewards lie with the participants. The ability of a participant to do well on investments in these types of plans depends on a number of factors, including the availability of a high quality line-up of investment options from which participants may choose. According to Buck Consultants, a quality line-up should include a range of investment options, from less risky money market or fixed income and bond options, to moderate risk options such as lifestyle and lifecycle funds, to higher risk equity investments. Lifestyle, or balanced funds provide a mix of stocks and bonds where the percentage invested in either remains static over the life of the fund. For example, a lifestyle fund may be composed of 70 percent stocks and 30 percent bonds. This same allocation between stocks and bonds will remain for the life of the fund. Similarly, lifecycle, or target-date, funds also provide a mix of stocks and bonds. With lifecycle funds, however, the allocation between stocks and bonds changes over the life of the fund. For example, the fund may start out composed of 70 percent higher-risk stock and 30 percent lower-risk bonds. However, as the participant nears retirement, the allocation will shift more into lower-risk bonds and have a 60/40 or 50/50 split between stocks and bonds. Lifestyle and lifecycle funds are designed to serve as one-fund investment solutions, particularly for less experienced investors.

A quality investment line-up should also include international equity funds and stock funds that offer a combination of large-, mid-, and small-capitalization (cap) funds with growth, value, and blend styles. These categories separate companies based on their size and the rate at which earnings are expected to grow, as described below:

- **Capitalization** measures the equity market size of a company as calculated by the number of shares outstanding times current price per share. Larger, more established companies are generally considered a more conservative way of investing, while smaller companies provide a greater opportunity for faster growth, but with greater risk.
- **Growth** funds include stocks for companies that have exceptionally high projected earnings growth. These stocks typically are for “younger” or technical-oriented companies where instead of paying a dividend, earnings are reinvested back into the company. Growth stock typically costs more than value stock because of the potential for the companies to grow rapidly.

- **Value** funds include stocks for companies that are more established and have a long track record of paying dividends consistently. Value stock typically costs less than growth stock because the companies are not expected to grow significantly.
- **Blend** funds include a combination of growth and value stock.

Finally, a quality fund line-up will include a self-directed brokerage account option which allows a participant to buy and sell stocks, bonds, and other securities through a broker. With a self-directed brokerage account, a participant has more flexibility and a broader range of investment options available and is not limited to the specific investment options offered by the provider.

Buck Consultants reviewed the number and type of investment options offered to participants in the State DC and State 457 Plans and found that, in general, both plans offer a wide range of investment options, such as those described above. However, Buck Consultants identified areas where both Plans could strengthen their investment options as discussed below.

### **State DC Plan**

As discussed previously, the State DC Plan is administered by three bundled investment providers. These providers are responsible for all investment, recordkeeping, administration, and education services for the Plan. For Fiscal Year 2008 the Committee and the Department of Personnel & Administration (Department) contracted with Great-West Life Annuity and Insurance Company (Great-West), the Hartford Life Insurance Company (Hartford), and ICMA Retirement Corporation (ICMA) to serve as the bundled investment providers for the Plan. Participants in the State DC Plan must choose from one of these three providers, each of which offers a different fund line-up.

As part of its review, Buck Consultants evaluated whether the three providers had gaps or redundancies in their fund line-ups and identified several areas of concern. First, Buck Consultants found that none of the three providers offers lifecycle or mid-cap blend funds. In addition, Buck Consultants found that neither Great-West nor Hartford offers a small-cap blend fund, and ICMA does not offer a mid-cap value or small-cap growth fund.

### **State 457 Plan**

Buck Consultants also reviewed the investment options offered to State 457 Plan participants. Great-West, as the third-party administrator, offers the same fund line-up for the State 457 Plan as it does for the State DC Plans. Therefore, similar to the State DC Plan, Buck Consultants found gaps in the options to state employees in that the State 457 Plan does not offer participants lifecycle, or small- or mid-cap blend fund investments.

The following table shows the investment options available under both the State DC Plan and the State 457 Plan.

| <b>State of Colorado<br/>Public Officials' and Employees' Defined Contribution Plan<br/>and 457 Deferred Compensation Plan<br/>Investment Options<br/>As of March 31, 2008</b> |   |  |   |
|--|---|--|---|
| Investment Category  | Provider  |  |   |
|  | Great-West <sup>1</sup>                         | Hartford                                 | ICMA  |
| <b>Money Market / Stable Value</b>   | Stable Value                                    | SEI Stable Asset                         | Plus Stable Value   |
| <b>Fixed Income / Bond</b>   | Vanguard Total Bond Index                       | Hartford Total Return                    | Pimco Total Return  |
| <b>Lifestyle /<br/>Balanced</b>  | Conservative Portfolio                          | Conservative Portfolio                   | Vantagepoint Savings Oriented<br>Vantagepoint Conservative Growth |
|  | Moderate Portfolio                              | Moderate Portfolio                       | Vantagepoint Traditional Growth                                   |
|  | Aggressive Portfolio                            | Aggressive Portfolio                     | Vantagepoint Long Term Growth                                     |
| <b>Lifecycle /<br/>Target-Date</b>   | Option Not Available                            | Option Not Available                     | Option Not Available  |
| <b>Domestic Equity</b>   |   |  |   |
| Large-Cap Value  | Hotchkis Wiley Large-Cap Value I                | Hotchkis Wiley Large-Cap Value A         | American Century Value Inv<br>Vantagepoint Equity Inc.            |
| Large-Cap Blend  | Vanguard Institutional Index                    | SSgA S&P 500 Index<br>Davis NY Venture A | Vantagepoint 500 Stk II   |
| Large-Cap Growth   | Amer Funds Growth Funds R5                      | Amer Funds Growth Funds R4               | Vantagepoint Growth   |
| Mid-Cap Value  | Artisan Mid-Cap Value                           | Artisan Mid-Cap Value                    | Option Not Available  |
| Mid-Cap Blend  | Option Not Available                            | Option Not Available                     | Option Not Available  |
| Mid-Cap Growth   | Munder Mid-Cap Growth Y                         | Munder Mid-Cap Growth A                  | Ranier Small-/Mid-Cap   |
| Small-Cap Value  | Veracity Small-Cap Value                        | American Beacon Small-Cap Value          | Fidelity Small-Cap Rtmt   |
| Small-Cap Blend  | Option Not Available                            | Option Not Available                     | T. Rowe Price Small Value Adv                                     |
| Small-Cap Growth   | TCM Small-Cap                                   | Baron Small-Cap                          | Option Not Available  |
| <b>Global/International Equity</b>   | Dodge & Cox Int'l Stock<br>Amer Funds EuroPac A | Hartford Int'l Growth HLS<br>IA          | Fidelity Diversified Int'l  |
| <b>Self-Directed Brokerage Account</b>   | Option Available                                | Option Not Available                     | Option Available  |
| <b>Source:</b> Great-West, Hartford, and ICMA websites.  |   |  |   |
| <sup>1</sup> This column represents Great-West's investment options for both the State DC Plan and the State 457 Plan.   |   |  |   |



Due to the gaps identified in fund line-ups for the State DC and State 457 Plans, participants in both Plans are not provided with a full range of investment options to address their risk tolerance and retirement needs. The Committee should review the investment options available for both Plans and consider making changes to fill identified gaps in current offerings, working with the providers as necessary. As part of this review, the Committee should also consider offering lifecycle, or target-date, funds options for both Plans.

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### **Recommendation No. 1:**

The State Deferred Compensation Committee should ensure the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the State of Colorado 457 Deferred Compensation Plan offer a full range of investment options to participants by reviewing the fund options available for both plans and working with the providers, as necessary, to eliminate any gaps in offerings.

#### **State Deferred Compensation Committee Response:**

Partially agree. Implementation date: March 2009.

The Committee works diligently to provide a full complement of options. It will continue to meet with the Plans' investment advisor on a semi-annual basis and review any gaps in the offerings when conditions change and make changes as appropriate. Participants do have the opportunity to participate in the self-directed brokerage option to accommodate any perceived gaps in the investment options offered.

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## **Investment Policy Statements**

Plan sponsors have a fiduciary responsibility to ensure that retirement plans have an investment policy statement outlining how the plan sponsor will select and monitor investments within the plan. Investment policy statements should provide the investment goals and objectives of the plan and describe the strategies that the plan sponsor will use to meet those objectives. The investment policy statements should also provide clearly written guidelines that can help the plan sponsor maintain a long-term investment philosophy and manage the plan in the best interest of the participants. Finally, the investment policy statement should be the most succinct document possible that still captures the information required to adequately provide structure to a plan.

The Committee, as plan sponsor, has created separate investment policy statements for the State DC Plan and the State 457 Plan. Buck Consultants reviewed the investment policy statements for both Plans to determine if these statements accurately reflect the Committee's fiduciary management responsibilities related to the Plans and to assess the Committee's processes for selecting and monitoring investments within the Plans. Although statute [Section 24-52-102, C.R.S.] designates the Committee as the fiduciary for the two Plans, Buck Consultants found that the Committee has not clearly documented this responsibility in the investment policy statement for the State DC Plan. Specifically, Buck Consultants found that the investment policy statement is silent on the Committee's responsibilities related to determining investment options and monitoring Plan performance. Additionally, Buck Consultants found that maintaining a separate investment policy statement for the State DC Plan and the State 457 Plan is inefficient and not necessary.

The Committee should revise the investment policy statement for the State DC Plan to ensure it clearly states where fiduciary responsibilities lie with respect to monitoring plan performance and determining investment options. The Committee may also want to consider combining the investment policy statements for the State DC and State 457 Plans into one statement. Currently the language in the two statements is virtually identical, with only small differences to reflect the two types of plans. A better approach would be to use one document as the investment policy statement for both Plans, with separate sections, as necessary, to acknowledge differences in the two plans.

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## **Recommendation No. 2:**

The State Deferred Compensation Committee should revise the investment policy statement for the State of Colorado Public Officials' and Employees' Defined Contribution Plan (State DC Plan) to clearly state where fiduciary responsibilities lie with respect to monitoring and determining investment options for the Plan. In addition, the Committee should consider combining the investment policy statements for the State DC Plan and the State of Colorado 457 Deferred Compensation Plan into one document.

### **State Deferred Compensation Committee Response:**

Partially agree. Implementation date: March 2009.

The Committee believes that the Plans serve different purposes; one is a tax-deferred savings plan and the other is an alternative to PERA. However, the Committee in conjunction with the investment advisor, will review the investment policy statements, including fiduciary

responsibilities for monitoring and determining investment options, and consider combining those items in the policy statements that are similar into one document.

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## Bundled Investment Providers

As discussed previously, statute [Section 24-52-203, C.R.S.] requires the Committee to select three separate and distinct bundled investment providers to supply all investment, recordkeeping, administration, and education services for their respective participants in the State DC Plan. Buck Consultants reviewed the administration of the State DC Plan and found that requiring the Committee to contract with three providers has resulted in increased costs to participants.

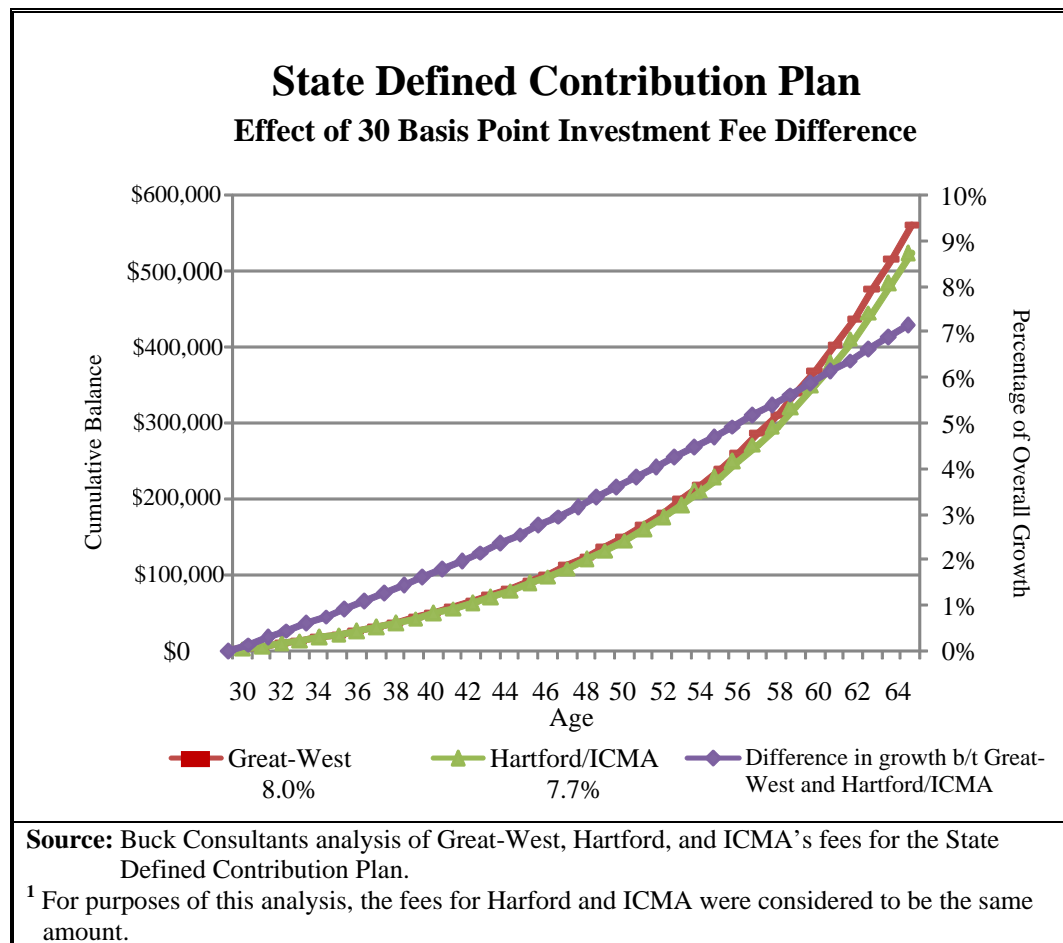
The potential for administrative cost efficiencies and lower costs per participant is directly related to the number of plan participants and the size of a plan's assets. This is because fund providers offer discounted fees to those organizations that invest large amounts of money with them. Therefore, larger plans with more participants and assets have greater access to funds with lower administrative expenses and fees than smaller plans. When determining the size of a plan, industry practice is for fund providers to include all plans administered by a single investment provider that offer the same fund line-up, or platform. From this perspective, the State DC Plan is significantly more expensive to operate with three separate providers than it likely would be with just one provider. Each investment provider has to treat its portion of the State DC Plan as a separate, stand-alone plan. As discussed previously, each of the three providers currently has less than \$6.4 million in assets and less than 850 participants enrolled in its plan. If the State DC Plan used only one provider, that provider would have over \$14 million in assets and more than 1,800 participants and thus, access to funds with lower fees for participants. The ability of larger plans to offer funds with lower fees is illustrated by the fact that Great-West has the lowest fees among the three providers for the State DC Plan. Great-West's ability to offer funds with lower fees is due to the fact that it is the third-party administrator for the State 457 Plan and offers the same platform for its portion of the State DC Plan as it does for the State 457 Plan. Therefore, Great-West is able to leverage the almost \$400 million in assets of the much larger State 457 Plan with the assets of its portion of the State DC Plan to offer a fund line-up with lower fees to its participants.

Fund providers charge a specific percentage against each participant's account on an annual basis. As the following table shows, Great-West's investment fees for funds in three of the four fund categories listed below are lower than Hartford's and ICMA's fees. These categories correspond to the different types of investment options (e.g., fixed income/bonds, lifestyle, and domestic and international equity) offered by each of the providers.

| <b>State of Colorado<br/>Public Officials' and Employees' Defined Contribution Plan<br/>Investment Fees for Investment Options<br/>As of December 31, 2007</b>   |  |   |  |  |
|--|--|---|--|--|
| <b>Provider</b>  | <b>Range of Fees<sup>1</sup></b>             |   |  |  |
|  | <b>Fixed Income/<br/>Bond/<br/>Lifestyle</b> | <b>Actively<br/>Managed<br/>Domestic<br/>Equity<sup>2</sup></b> | <b>Domestic<br/>Equity<br/>Index<sup>3</sup></b> | <b>Actively Managed<br/>Global/<br/>International<br/>Equity</b> |
| Great-West   | 0.07%  | 0.38% - 1.58%   | 0.05%  | 0.66% - 0.79%  |
| Hartford   | 0.50%  | 0.68% - 1.33%   | 0.16%  | 0.88%  |
| ICMA   | 0.68%  | 0.88% - 1.18%   | 0.25%  | 1.01%  |
| Source: Data provided by Great-West, Hartford, and ICMA.<br><sup>1</sup> Percentage charged against participant's account balance on an annual basis.<br><sup>2</sup> This category includes all domestic equity funds that are actively managed by the fund provider. These funds require more action by the fund provider than index funds and thus, have higher fees.<br><sup>3</sup> This category includes all domestic equity index funds that are managed by the fund provider. These funds are managed passively by the fund provider and have lower fees than actively managed funds. |  |   |  |  |

Hartford and ICMA, which have much lower asset balances than Great-West, charge higher fees. These higher fees can have a material effect on a participant's accumulation of capital and ability to achieve retirement objectives. Buck Consultants estimated that Hartford's and ICMA's higher fees result in a 30-basis point fee difference over time compared with Great-West. (Note: This is equivalent to 0.30 percent, since a basis point is one-hundredth of a percent. On \$10,000, 30 basis points would equal \$30.)

The following chart provides an example of how this fee difference can significantly impact an employee who invests 6 percent of a \$50,000 annual income each year from age 30 to age 65. In this example, the employee at age 65 under Great-West would have an 8 percent rate of return and an account balance of \$560,000. Comparatively, if this employee had selected ICMA or Hartford, the employee would have a 7.7 percent rate of return and an account balance of \$520,000, or \$40,000 less than under Great-West. This is about a 7 percent difference in overall retirement savings. This difference is because the employee under ICMA or Hartford has to pay more of their account balance in fees than the employee under Great-West. As a result, the employee has less capital to invest and thus, less potential for growth.



Buck Consultants also found that the direct administrative costs borne by the Department for having to manage three providers are greater than they would be if only one provider administered the Plan. From an administrative perspective, the State DC Plan is three separate plans, each with its own organizational structure, administrative system, operational rules, interpretation of plan rules, problem resolution process, quality standards, and controls. Managing three separate plans places an increased oversight and administrative burden on the Department, resulting in increased costs to the Department and therefore to Plan participants. According to the Department's contracts with the providers, the providers are required to reimburse the Department for administrative expenses incurred while managing the Plan. In Fiscal Year 2008 the Department's actual administrative expenses for managing the State DC Plan were about \$177,000, or an average of \$95 per Plan participant. As authorized under statute, the providers recoup these expenses through management fees charged to Plan participants. These management fees support the investment and administrative costs incurred by the fund providers. Comparatively, the Department's Fiscal Year 2008 administrative expenses for the State 457 Plan were about \$1 million, or an average cost of \$58 per Plan participant.

Historically, contracting with a single investment provider meant that a defined contribution plan was limited to the proprietary investments offered by that provider. To offer a broader range of investment options, the plan had to contract with multiple providers. However, today providers such as Great-West, Hartford, and ICMA offer a wide range of investment options, both proprietary and non-proprietary from many other investment providers. As a result, there is no longer a need for the State to contract with three separate providers in order to offer a well-diversified portfolio. The Committee and the Department should perform their own assessment of the impact that having three bundled investment providers administer the State DC Plan has on the cost of the Plan to participants and determine if using one provider would create efficiencies and decrease costs. This analysis should include an evaluation of all management and investment fees charged to plan participants. If the decision is made that using one provider would be more efficient and not impair the range of investment options available to participants, the Committee and the Department should propose statutory change to eliminate the requirement that three providers administer the State DC Plan.

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### **Recommendation No. 3:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should perform an assessment of the impact that having three bundled investment providers administer the State of Colorado Public Officials' and Employees' Defined Contribution Plan has on the cost of the Plan to participants and determine if using one provider would create efficiencies and decrease costs. If the determination is made that using one provider would be more efficient and not impair the range of investment options available to participants, the Committee and the Department should propose statutory change to eliminate the requirement that three providers administer the Plan.

### **State Deferred Compensation Committee Response:**

Agree. Implementation date: July 2009.

The Committee has received a report from its investment advisor strongly recommending the use of a single provider for the State Defined Contribution Plan and concluded that the use of a single provider would be more efficient without impairing the range of available investment options. The Committee will work with the Department to recommend legislation to make this suggested change possible.

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## **Department of Personnel & Administration Response:**

Partially agree. Implementation date: July 2009.

The Department believes that offering a broad range of investment options and strategies to participants in the primary and supplemental retirement plans is critical. Therefore, the Department has encouraged the Committee to consider ways of providing additional investment strategies, and thus, supports Recommendation No. 1 above. Similarly, the Department supports ensuring efficient and effective operations. As discussed in the next section, the Department believes that the State's primary and supplemental retirement plans should be streamlined by consolidating them under the administration of the Public Employee's Retirement Association (PERA). The Department believes that a myriad of factors supports this conclusion, including ensuring investment choice, improving financial accountability and internal control environment, providing administrative efficiencies, and enhancing customer service levels. Therefore, the Department believes that efforts should be directed to facilitating this consolidation rather than reviewing the structure of the administration within the Department. If the consolidation with PERA does not occur, the Department agrees to perform an assessment to determine if using one provider to administer the State DC Plan would be more efficient and not impair the range of investment options available to participants.

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## **Retirement Plan Options**

Buck Consultants reviewed the current structure of the State's primary and supplemental retirement plans, including the defined contribution and 401(k) plans offered by PERA, and identified two options for restructuring the plans. Both options could result in lower participant fees and improve the efficiency of plan management. These options are discussed below.

### **Combining Defined Contribution Plans**

One option that the Committee and the Department should evaluate is whether to offer only one defined contribution plan to state employees. Buck Consultants found that participants in the State DC Plan would likely pay lower fees if the Plan were combined with the PERA Defined Contribution Plan. The State DC Plan and the PERA Defined Contribution Plan both qualify as 401(a) plans under the Internal Revenue Code, and both serve the same function of allowing

employees to determine how their primary retirement savings will be invested. However, Buck Consultants found that PERA's Defined Contribution Plan is able to offer participants investment options with lower fees than the State DC Plan because PERA offers the same fund line-up for its Defined Contribution and 401(k) Plans. As discussed previously, the larger the plan in terms of the amount of assets and the number of participants, the more access the plan has to investment options with lower fees. Buck Consultants found that the funds in the PERA investment line-up have lower fees than the funds in the State DC Plan line-up. Specifically, investment fees for the PERA Defined Contribution Plan fees ranged from 0.05 percent to 0.90 percent annually, while fees for the State DC Plan ranged from 0.05 percent to 1.58 percent annually. Further, of the seven most important funds in the PERA Defined Contribution Plan line-up, five had performance growth equal to or better than comparable funds in the State DC Plan during Fiscal Year 2007. Colorado is currently the only state in the country that offers employees the choice between two different defined contribution plans for their primary retirement plan.

### **Combining Management for All Retirement Plans**

The second option that the Committee and the Department should evaluate is whether it is more efficient and less costly to the State overall to combine the management of all of the State's primary and supplemental retirement plans under one entity. Buck Consultants identified several reasons that PERA may be in a better position than the Department to manage all of the State's primary and supplemental retirement plans. The sole purpose of PERA as an organization is to manage retirement plans, and thus PERA dedicates its resources to this function. PERA has more than 200 staff, many of whom have specific investment expertise, dedicated to managing the various plans, including the PERA Defined Benefit, Defined Contribution, and 401(k) plans. By contrast, managing the State DC Plan and the State 457 Plan are a very small portion of the Department's responsibilities. The Department is responsible for managing the state personnel system and providing a variety of support services to state agencies, such as procurement, payroll, and fleet management. As a result, the Department is only able to allocate limited resources to overseeing the Plans under its purview.

Additionally, PERA may be in a better position to oversee the State 457 Plan, which has participants outside of the state system. As discussed previously, there are 16 school districts and one local government entity participating in the State 457 Plan. As discussed further in Chapter 2, the Department as plan sponsor is responsible for monitoring participant compensation and contributions to ensure the State 457 Plan complies with Internal Revenue Code limits on these amounts. The Department, however, does not have access to salary information needed to monitor these limits for participants employed outside of state government. PERA, on the other hand, with more than 400 participating employers across Colorado government, is structured to work with local governments, including



school districts, and has access to salary information for the employees of all participating employers. Issues surrounding the Department's inability to access salary information for participants employed outside of state government were also raised in the Fiscal Year 2007 Financial Audit of the State 457 Plan.

The goal of any retirement plan should be to provide adequate retirement income to attract and retain the most qualified employees. To accomplish this goal, the State's retirement plans must be structured in such a way to provide high quality investment options at a low cost to state employees. Although employees benefit from being able to make choices with respect to how they want to save for retirement, too many choices can be overwhelming and confusing, particularly for employees who have limited experience with retirement plan concepts and managing investments. Additionally, as discussed throughout this chapter, too many retirement plan options can decrease the State's purchasing power and result in higher fees to participants. Finally, having two different state entities manage the retirement plans may not be an efficient use of state resources. According to the Committee, Department, and PERA, they have begun to evaluate options for streamlining the structure of the State's retirement plans. The scope of Buck Consultants' review did not include a comprehensive assessment of the State's retirement system or possible options. Therefore, the Committee, Department, and PERA should continue with their evaluation to identify the most effective options for reducing redundancies and costs and increasing efficiencies and participants' return on contributions, while maintaining an appropriate array of investment choices with an enhanced level of service. After completing this evaluation, the Committee, Department, and PERA should report their findings and conclusions to the Governor's Office and the General Assembly and work with both on ways to improve the State's primary and supplemental retirement plans, proposing statutory change as deemed necessary.

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#### **Recommendation No. 4:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should work with the Public Employees' Retirement Association (PERA) to continue to evaluate options for streamlining the structure of the primary and supplemental retirement plans offered by the State to reduce redundancies and costs and increase efficiencies and the return on contributions for state employees, while ensuring employees have a full range of investment choices with an enhanced level of service. This evaluation should include, but not be limited to, consideration of the advantages and disadvantages of:

- a. Combining the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the PERA Defined Contribution Plan and placing the combined plan under one entity.

- b. Combining the management of all of the State's primary and supplemental retirement plans under one entity.

After the Committee, Department, and PERA have completed this evaluation, they should report their conclusions to the Governor's Office and the General Assembly and work with both on ways to improve the State's primary and supplemental retirement plans, proposing statutory changes deemed necessary.

### **State Deferred Compensation Committee Response:**

Agree. Implementation date: July 2009.

The Committee and the Department are currently engaged in conversations with PERA regarding both the State Defined Contribution Plan and the supplemental retirement plan (State 457 Plan). As fiduciary, the Committee must ensure that such a change is in the best interests of its participants considering more than just return and investment choice. For participants in the State Defined Contribution Plan, a key issue is whether PERA will allow new enrollees to retain the option of immediate vesting. For participants in both the State Defined Contribution Plan and the State 457 Plan, important considerations include fees and costs at least as low as those currently charged, the quality of customer service, reporting formats, and informational efforts. If a consolidation proves advantageous to participants, the Committee will work with PERA to develop legislation to move the plans to PERA.

### **Department of Personnel & Administration Response:**

Agree. Implementation date: July 2009.

The Department fully supports streamlining the State's primary and supplemental retirement plans under the administration of the Public Employees' Retirement Association (PERA). The Department believes that it is unable to provide adequate administration and day-to-day plan oversight for the plans. For example, the Department does not have adequate staffing or the available infrastructure or authority to ensure funds within the multiple state agencies and school districts are properly managed. PERA has a substantial infrastructure in place to ensure fiscal accountability for these funds. In addition, PERA's staff and Board are better positioned to provide dedicated professional support for these plans. Therefore, we believe the General Assembly should consider transferring responsibilities for these plans to PERA in the 2009 Session.

If the Plans remain with the Department, it will be necessary to pursue additional staffing. While the resources available to support these plans could be expanded with approval from the General Assembly, it would result in further duplication and inefficiencies.

## **Public Employees' Retirement Association Response:**

Agree. Implementation date: June 30, 2009, assuming appropriate legislation is secured in the upcoming session of the General Assembly.

Colorado PERA has worked extensively with the State's Deferred Compensation Committee and the Department of Personnel & Administration to evaluate the options for streamlining the primary and supplemental retirement plan offerings of the State by placing all of these options under the management of Colorado PERA. We are confident that in the event the General Assembly and the Governor determine that the public interest would be furthered by such an action, we will successfully reduce redundancies and costs and increase efficiencies and the return on contributions for state employees, while ensuring employees have a full range of investment choices with an enhanced level of service. The Colorado PERA Board of Trustees has indicated it is supportive of this action generally, recognizing that this will require certain statutory changes. Colorado PERA will continue its work with the Committee and the Department and participate in appropriate reporting pursuant to the recommendation.

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# Plan Administration

## Chapter 2

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### Background

As discussed previously, the Department of Personnel & Administration (Department) and the State Deferred Compensation Committee (Committee) are responsible for managing the State of Colorado Public Officials' and Employees' Defined Contribution Plan (State DC Plan) and the State of Colorado 457 Deferred Compensation Plan (State 457 Plan). In Fiscal Year 2008, the Department contracted with Great-West Life Annuity and Insurance Company (Great-West), the Hartford Life Insurance Company (Hartford), and ICMA Retirement Corporation (ICMA) to serve as bundled investment providers to administer the State DC Plan. Statute [Section 24-52-203, C.R.S.] allows each provider to charge participants a fee to cover administrative costs as well as investment management fees. During Fiscal Year 2008 investment management fees ranged from 0.05 percent to 1.58 percent of the participant's fund balance, depending on the funds selected by the participant.

In addition, the Department contracted with Great-West to serve as the third-party administrator for the State 457 Plan. Although statute [Section 24-52-102(5)(a), C.R.S.] allows the Committee to assess each participant a fee for administering the State 457 Plan, the Committee waived this fee for Fiscal Years 2007 and 2008 because of an excess fund balance resulting from participants' investments and the fees associated with those investments. Participants paid investment management fees to their investment company during Fiscal Year 2008 that ranged from 0.05 percent to 1.58 percent of the participant's fund balance, depending on the funds selected by the participant.

Buck Consultants reviewed the administration of both the State DC and State 457 Plans and identified several areas where improvements are needed. Specifically, Buck Consultants identified issues related to service level requirements, administration documentation, final distribution forms, monitoring of Internal Revenue Code limits related to contributions and compensation, policies related to conflicts of interest, plan summaries, and plan compliance with federal law and state statutes. Each of these issues is discussed in this chapter.

## Service Level Requirements

The Committee's and the Department's contracts with the three bundled investment providers include service level standards for some of the primary administrative functions required by the contracts and penalty amounts for failure to comply with those standards. These service level standards detail specific goals for the providers in the areas of administration, recordkeeping, reporting, and interactive services. For example, Great-West's contracts for both the State DC Plan and the State 457 Plan include a service level standard requiring Great-West to mail all distribution payments to participants within two business days of receipt of the requests.

Buck Consultants reviewed the Committee's and the Department's contracts with each of the providers for both the State DC and State 457 Plans and found the service level standards and penalties for these contracts are inconsistent and insufficient to impact provider behavior. Buck Consultants also identified concerns with the Department's monitoring of provider compliance with established standards. These issues are discussed below.

### Service Level Standards and Penalties

Standard industry practice is for investment provider contracts to contain service level standards that are consistent among all providers within a plan and penalty amounts that are sufficient to impact provider behavior. Buck Consultants reviewed the service level standards and penalties contained in the State DC Plan and State 457 Plan provider contracts and found that the standards agreed upon in the contracts are inconsistent among providers within the same plan and, in some instances, insufficient. For example:

- Hartford's contract includes a service level standard requiring Hartford to process initial participant enrollment forms within five calendar days of receipt, subject to a \$1,000 penalty each time Hartford fails to meet the standard.
- Great-West's State DC Plan and State 457 Plan contracts include a service level standard requiring Great-West to process 95 percent of initial participant enrollment forms within five calendar days of receipt, subject to a one-time annual \$500 penalty if Great-West fails to meet the standard.
- ICMA's contract does not have a service level standard for processing initial enrollment forms.

Additionally, Buck Consultants found that many of the penalty amounts contained in the contracts for both Plans are not sufficient to impact provider behavior. It is

standard industry practice for providers to put a portion of their fees at risk against service failures. For example, if the plan's administrative cost is \$100,000, the provider should be willing to give back 1 percent, or \$1,000, of that fee each time the provider fails to meet an established service level standard. The actual percentage established as the penalty amount should depend on the importance and frequency of the transaction. Alternatively, the penalty should be set at a specific meaningful dollar amount per transaction. By establishing substantive penalties, providers have more of an incentive to ensure they comply with service level standards. Many of the penalty amounts contained in the contracts for the State DC Plan and the State 457 Plan, however, are not substantive enough to act as an incentive for the providers to comply with standards. For example, Great-West must pay an annual \$500 penalty and ICMA must pay an annual \$100 penalty for failing to comply with their respective standards for depositing contributions as directed by the participant within a specified time frame. A penalty of \$100 or \$500 per year, regardless of the number of times the provider fails to meet the standard during the year, is meaningless and insufficient to impact provider behavior. As discussed below, Great-West as the third-party administrator for the State 457 Plan is the only provider to have paid penalties.

## **Monitoring**

Buck Consultants found that the Department is not actively monitoring provider performance, but instead relies on the providers to self-monitor their own performance and inform the Department if penalties should be applied. According to Buck Consultants, typically a plan sponsor periodically reviews transaction reports from the providers, spot-checks transactions, and questions the providers about recent transactions to assess compliance with service level standards. Regardless of whether the transactions have any errors, asking the questions demonstrates to the providers that the plan sponsor is monitoring the provider's performance.

Currently, the Department has each provider send a quarterly self-evaluation of its performance that addresses each goal from the performance standards sections of the contract. The Department, however, does not verify the information reported in these self-evaluations. Rather, staff summarize the self-evaluations and present this information to the Committee annually. None of the bundled investment providers for the State DC Plan has reported that it has failed to meet the service level standards in its contract and thus owes penalties. Great-West, as the third-party administrator for the State 457 Plan, has paid penalties on two occasions for failing to comply with its standards.

The lack of consistent and clear performance standards and adequate penalties, as well as the lack of monitoring, limits the Committee's and the Department's ability to hold providers accountable for complying with the terms of their contracts and for providing quality services to State 457 and State DC Plan

participants. According to Department management, when contracts were being negotiated the Department asked each provider to propose fair service level standards and the penalty amounts that should apply to those standards. The Committee and the Department accepted the providers' proposed standards and penalties without independently evaluating their validity and appropriateness, negotiating appropriate changes, or attempting to make the standards and penalties consistent across providers.

The Committee and the Department should reevaluate service level standards and penalty amounts for the State 457 Plan's third-party administrator and the State DC Plan's bundled investment providers. As part of this evaluation, the Committee and the Department should review contracts from other organizations for similar plans to identify the types of service standards and penalties used for deferred compensation and defined contribution plans. The Committee and the Department should then renegotiate contracts with the providers to ensure the contracts have adequate standards and penalties that are applied consistently across all providers within the same plan. Additionally, the Department should actively monitor provider performance to ensure that established standards are complied with and that the State and participants receive appropriate value for the moneys paid to providers. Options the Committee and the Department should consider include requiring providers to submit transaction reports on a periodic basis for review by Department staff, periodically spot-checking important transactions such as enrollments and contributions where mistakes will result in increased contribution costs or lower returns, and following up with providers on errors identified.

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### **Recommendation No. 5:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should ensure the third-party administrator for the State of Colorado 457 Deferred Compensation Plan and the bundled investment providers for the State of Colorado Public Officials' and Employees' Defined Contribution Plan are held accountable for providing quality services to participants by:

- a. Identifying appropriate service level standards and penalties and renegotiating contracts to ensure these standards and penalties are applied consistently across all providers within a plan.
- b. Actively monitoring provider performance to ensure compliance with established standards and applying penalties as appropriate.



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## State Deferred Compensation Committee and Department of Personnel & Administration Response:

- a. Agree. Implementation date: December 2008. The Committee and the Department will work with the providers and its investment provider to review the performance standards, identify the appropriate best practices, and make changes that are consistent among all providers.
- b. Partially agree. Implementation date: December 2008. The Department will implement monitoring procedures to the extent possible with the currently available staffing levels. As mentioned in the Department's response to Recommendation No. 4, the Department does not have sufficient staffing resources to provide adequate administration or day-to-day plan oversight. Therefore, actively monitoring performance standards will require additional staff.

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## Administration Documentation

The third-party administrator for the State 457 Plan and the three bundled investment providers for the State DC Plan perform a variety of administrative services for the Plans. These include processing contributions, changes in contribution amounts, in-service withdrawals while the participant is still employed, and final distributions. It is standard industry practice for plan administrators to provide documentation to the plan sponsor to show how the plan will be administered. This documentation includes:

- **Plan administrative manuals** that identify, at a high level, each of the processes used by the administrator to operate the plan and the roles of various staff responsible for implementing these processes.
- **Plan rules documents** that detail each of the plan's processes according to plan requirements and administrative specifications. The plan rules document provides a more detailed level of the processes described in the plan administrative manual.
- **Process flows** that highlight each administrative process from beginning to end, identifying each step, control event, responsible party, and timing requirement for each process used to operate the plan.

- **Reconciliation reports** that allow the plan sponsor to evaluate whether transactions have been processed accurately and timely. These reports typically include calendars of scheduled transactions, transaction records, and reconciliations.

All of these documents should be contained in one operating manual that details how the provider will operate the plan, specific processes, important controls, and roles and responsibilities of various staff.

Buck Consultants reviewed the administrative documentation provided by the third-party administrator for the State 457 Plan and the three bundled investment providers for the State DC Plan and found that some of the providers do not supply sufficient documentation for the Committee and Department (the plan sponsors) to oversee plan administration. Specifically, Buck Consultants found that none of the providers for either Plan has plan rules documents or process flows and two providers do not have a plan administrative manual. While all of the providers have some reconciliation reports, the number of reports available from Hartford for the State DC Plan and Great-West for both Plans is more limited.

Administrative documentation, such as plan administrative manuals, plan rules documents, process flows, and reconciliation reports, is critical to the Committee's and Department's ability to adequately manage the State 457 and State DC Plans. This information allows for meaningful plan administration, institutionalizes plan knowledge for succession purposes, and helps ensure the quality of plan administration regardless of personnel changes and other factors. The Committee's and Department's contracts do not require the plan administrators to provide this documentation. The Committee and Department should require their third-party administrator and bundled investment providers to maintain and submit sufficient administrative documentation to support the administration of the State 457 and State DC Plans. This may require the Department to amend its contracts with the plan administrators.

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## **Recommendation No. 6:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should require the third-party administrator for the State of Colorado 457 Deferred Compensation Plan and the bundled investment providers for the State of Colorado Public Officials' and Employees' Defined Contribution Plan to maintain and provide adequate documentation consistent with industry standards to support the administration of the Plans, amending contracts as necessary.

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## **State Deferred Compensation Committee and Department of Personnel & Administration Response:**

Partially agree. Implementation date: March 2009.

The Committee and the Department will require the plan administrators to maintain and provide adequate documentation consistent with industry standards to support the administration of the Plans, and will amend the contracts as necessary. As mentioned in the Department's response to Recommendation No. 4, the Department does not have sufficient staffing resources to provide adequate administration or day-to-day plan oversight. Therefore, fully implementing this recommendation through a review of this documentation will require additional staff.

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## **Final Distribution Forms**

With both the State DC Plan and the State 457 Plan, participants can receive distributions from the Plans when employment ends with the State (or other participating employer for the State 457 Plan), including throughout retirement. Distributions from both Plans are taxed at the time of withdrawal, and participants making withdrawals from the State DC Plan must pay an additional 10 percent penalty tax for early withdrawal if they do not meet minimum age requirements (i.e., age 59 1/2) or other exemptions under the Internal Revenue Code. According to State DC Plan documents, participants can choose from several different forms of distribution, including one lump sum payment of the entire balance, partial lump sum distributions, installment payments, and annuity purchases. In an annuity purchase, the lump sum value of the participant's account is used to purchase an annuity that will pay uniform benefits for the remainder of the participant's or the participant's spouse's lifetime. For the State 457 Plan, participants can also choose between one lump sum payment, installment payments, or annuity purchases. To select their form of distribution, participants must complete the final distribution election form provided by either the participant's bundled investment provider (Great-West, Hartford, or ICMA) under the State DC Plan or the third-party administrator (Great-West) for the State 457 Plan. The bundled investment providers and the third-party administrator use the final distribution election form to process distributions.

Buck Consultants reviewed the final distribution election forms for all of the providers under both Plans and found that the forms are incomplete because they do not include a list of all distribution options available under the respective plans. Specifically, Buck Consultants found that the forms for the State DC Plan

do not include installment payments and annuity purchase as distribution options. For the State 457 Plan, Buck Consultants found that the form does not include annuity purchase as a distribution option.

Final distribution election forms should accurately reflect plan provisions and include a complete list of all distribution options so that participants are aware of the options available under each Plan. Many participants may not be aware of all options and thus may not follow up with the provider or third-party administrator if their option of choice is not listed on the form. This may result in participants' choosing an option that does not best meet their financial needs. The Committee and the Department should work with the bundled investment providers and third-party administrator to ensure final distribution election forms accurately reflect the full range of distribution options available under each plan.

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### **Recommendation No. 7:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should work with the bundled investment providers for the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the third-party administrator for the State of Colorado 457 Deferred Compensation Plan to ensure final distribution election forms accurately reflect all distribution options available under the plans.

### **State Deferred Compensation Committee and Department of Personnel & Administration Response:**

Agree. Implementation date: December 2008.

The Committee and the Department will work with the providers to ensure the final distribution election forms are updated.

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## **Code Limits**

The Internal Revenue Code of 1986 (Code) limits the total amount of participant and employer contributions that can be allocated to a participant's account and that can be considered when calculating contributions for any plan year for defined contribution accounts. For Calendar Year 2008 these limits are as follows:

- Section 415(c) of the Code limits the total amount of participant and employer contributions that can be allocated to a participant's account in any plan year to the lesser of \$46,000 or 100 percent of eligible income.
- Section 401(a)(17) of the Code sets the maximum amount of annual participant compensation that may be considered when determining benefits under defined contribution plans at \$230,000. This means that participants and employers may make contributions based on all eligible pay (as defined in the Plan document) up to \$230,000. No more contributions are allowed once a participant reaches \$230,000.

The Department, as the plan sponsor for the State DC Plan, is responsible for monitoring contribution and compensation levels for participating state employees.

Buck Consultants reviewed the administration of the State DC Plan and found that the Department does not have processes in place to ensure that the Plan is complying with Code limits. Based on Buck Consultants' assessment of state employee salaries and State DC Plan contribution amounts, it is unlikely that participants have violated either limit. However, if the State DC Plan were to violate these limits and not correct them in a timely manner, the Internal Revenue Service (IRS) would require the Plan to correct the issues by using the IRS Employee Plan Correction Resolution System, which dictates how compliance failures should be corrected. Depending on the severity of a failure, the Department may be able to correct the violation on its own. If the issue is more serious, a corrective filing with the IRS would be required. If the IRS were to audit the Plan before issues were self-identified and corrected, the IRS would determine how the issues should be corrected, and the Plan could be subject to penalties. Similar issues related to the Department's reconciliation of contribution amounts for the State 457 Plan were previously raised in the Fiscal Year 2007 Financial Audit of the Plan.

The Department's and the Committee's contracts with the three bundled investment providers state that the providers are responsible for monitoring contribution amounts to ensure compliance with Section 415 limits and compensation amounts to ensure compliance with Section 401 limits. However, the Department does not give the providers the participant salary information necessary to perform this monitoring, nor has the Department performed reviews to ensure the providers are monitoring contribution amounts. In addition, the Department has not performed any monitoring itself. Since the Department is the plan sponsor and has access to salary information, the Committee and the Department should work with the investment providers to implement mechanisms for monitoring State DC Plan participant contribution and compensation amounts to ensure the Plan does not violate Code limits. There are only a small number of participants that could potentially be at risk of violating Code limits because there

are a limited number of state employees with salaries exceeding \$230,000. Therefore, the Department should review annual participant contributions for prior years for employees at the higher end of the state wage scale and refund any contributions exceeding the limits. Going forward, the Department should monitor contribution amounts during the Plan year and cease contributions once the limits are reached.

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### **Recommendation No. 8:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should work with the bundled investment providers to implement mechanisms for monitoring State of Colorado Public Officials' and Employees' Defined Contribution Plan participant contribution and compensation amounts on a regular basis to ensure these amounts comply with Internal Revenue Code limits. The Department should also review contributions for prior years and address any instances in which limits were violated.

### **State Deferred Compensation Committee and Department of Personnel & Administration Response:**

Partially agree. Implementation date: March 2009.

The Committee and the Department will work with the providers to monitor participant contribution and compensation amounts to ensure compliance with IRS requirements. While part of this monitoring will be performed by the providers, some additional workload will be required of the Department. As mentioned in the Department's response to Recommendation No. 4, the Department does not have sufficient staffing resources to provide adequate administration or day-to-day plan oversight. Therefore, the Department will implement monitoring procedures to the extent possible with the currently available staffing levels.

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## **Conflict of Interest Policies**

As discussed previously, the Committee has fiduciary responsibility for the State DC and State 457 Plans. The Committee is staffed by a Plan Manager, who is an employee of the Department. The Plan Manager is responsible for providing administrative and technical support to the Committee with respect to both Plans. The nine Committee members and the Plan Manager must adhere to the *State of Colorado Deferred Compensation Committee Governance Manual (Governance*

*Manual*), which sets forth rules of conduct and ethical standards for the Committee members and the Plan Manager. The Committee is entrusted with making policy decisions for the State DC and State 457 Plans. Therefore, it is important that Committee members disclose real or perceived conflicts that could affect their decision-making ability and avoid situations that could lead to real or perceived conflicts of interest.

We reviewed the *Governance Manual* and found that the conduct and ethical standards included in the *Governance Manual* do not provide specific guidance for Committee members regarding how they should identify and handle real or perceived conflicts of interest. Rather, the standards only state that Committee members shall avoid engagement in any activity that creates a conflict of interest. Further, the standards do not provide descriptions of activities that are or could be considered a conflict of interest. We also found that the Committee and the Department do not specifically cover the code of conduct and relevant policies in the orientation provided to new Committee members and do not provide refreshers on the policies to Committee members on a routine basis. In addition, the Committee does not require the Committee members and Plan Manager to annually sign a statement that discloses real or potential conflicts of interest and documents their understanding of the code of conduct.

By comparison, the Public Employees' Retirement Association's (PERA's) policies on Board of Trustees' conduct provide specific requirements and guidance for trustees. For example, PERA's policies require that:

- PERA trustees annually disclose to the Colorado Secretary of State any financial or personal interests that may create an actual or potential conflict of interest by completing and signing a conflict of interest questionnaire; further, trustees must update the disclosures as new conflicts occur.
- PERA trustees are prohibited from receiving any monetary payment from any person, agent, firm, corporation, or association with which PERA does or seeks to do business that would influence or appear to influence the conduct of their duties.
- PERA trustees are personally liable for any loss resulting from a violation of the code of conduct.

Further, the PERA trustee policies include a description of activities that would be considered a conflict of interest.

To ensure that Committee members act consistently and appropriately in addressing real or perceived conflicts, the Committee should strengthen the conflict of interest policies in the *Governance Manual* by including guidance on

what constitutes a conflict of interest and examples of activities that could be considered a conflict. The Committee should also consider including language requiring members to recuse themselves from discussions and votes where a conflict of interest exists. The Committee and the Department should also take steps to ensure that the code of conduct and relevant policies are covered in the orientation provided to new Committee members, periodic refreshers are provided to the entire Committee on a routine basis, and Committee members and the Plan Manager annually sign a statement that discloses real or potential conflicts of interest and documents their understanding of the code of conduct. The Committee should consider using the PERA Board's conduct policies as a guide.

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### **Recommendation No. 9:**

The State Deferred Compensation Committee (Committee) should strengthen safeguards for preventing conflicts of interest by:

- a. Including guidance in the conflict of interest policies in the code of conduct on what constitutes a conflict of interest and holding members liable for violations of the conflict of interest policy.
- b. Considering including language in the code of conduct requiring members to recuse themselves from discussions and votes where a conflict of interest exists.
- c. Working with the Department of Personnel & Administration to include the updated code of conduct recommended in part "a" above in the orientation materials provided to new Committee members and offering refreshers to current Committee members on a routine basis.
- d. Requiring Committee members and the Plan Manager to annually complete and sign a statement disclosing real and potential conflicts of interest and documenting their understanding of the code of conduct.

### **State Deferred Compensation Committee Response:**

Agree. Implementation date: March 2009.

Given the interpretation of Amendment 41, the Committee will direct legal counsel to review its current conflict of interest policies for potential changes and recommend changes. The Committee shall ensure that new Committee members receive any additional training necessary and require annual recertification of these guidelines.

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## Plan Summaries

The purpose of a plan summary is to provide, in easy to understand layman's terms, a description of a plan and its features to help potential participants decide whether a plan is right for them. For employees to make appropriate choices, they must understand the plans and their options. Generally, plan summaries describe the eligibility requirements, service crediting rules, contribution provisions, investment options, vesting requirements, and the timing and forms of benefit payments. It is important that the information contained in a plan summary be consistent with the plan document, which is the controlling and legal operational description of the plan. The Department has prepared or coordinated the preparation of plan summaries for both the State DC Plan and the State 457 Plan.

Buck Consultants reviewed the plan summaries for the State DC and State 457 Plans and found that overall, both summaries are generally easy to understand. However, the summaries contain a number of provisions that do not accurately reflect the plan documents filed with the Internal Revenue Service and certain rules related to the respective Plans. Examples of issues identified with both plans include:

### State DC Plan

- The summary states that employees contribute 8 percent of their monthly salary to the Plan and the State contributes 10.15 percent. However, according to the plan document, state troopers contribute 10 percent of their monthly salary and the State contributes 12.85 percent for troopers.
- The summary states that the bundled investment providers will select the default investment fund if a participant fails to select a fund. However, according to the plan document, the State Deferred Compensation Committee selects the default fund.
- The summary states that participants can elect a joint and survivor annuity with a spousal beneficiary. However, the plan document does not limit the beneficiary to the participant's spouse.
- The summary states that participants cannot roll over a total distribution of less than \$200 or a partial distribution less of than \$500 to an eligible retirement plan. However, the plan document does not include these restrictions on rollovers.

**State 457 Plan**

- The summary states that participants can roll over amounts from other plans, including a traditional IRA, into the State 457 Plan. However, according to the plan document, participants can only roll over amounts from another state 457 plan.
- The summary does not describe the forms of payment available to retirees under the Plan. The plan document only allows lump sum distributions, periodic installments, or the purchase of an annuity contract.

Although neither the State DC Plan nor the State 457 Plan is required to provide summaries, it is best practice to do so. However, for the summaries to be effective, it is important that the information contained in the summaries accurately reflect the provisions of the Plans. If participants are not accurately informed of their benefits and rights under the Plans, they may not make appropriate choices and could bring legal action against the State, which could increase costs associated with the Plans. The Committee and the Department should revise the summaries for both the State DC Plan and the State 457 Plan to ensure they accurately reflect the provisions of the Plans. The Committee and the Department should also update the summaries whenever changes in the Plans occur.

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**Recommendation No. 10:**

The State Deferred Compensation Committee and the Department of Personnel & Administration should revise the summaries for the State of Colorado Public Officials' and Employees' Defined Contribution Plan and the State of Colorado 457 Deferred Compensation Plan to ensure they accurately reflect the provisions of their respective plans. The Committee and the Department should also ensure the summaries are updated for any future changes in the Plans.

**State Deferred Compensation Committee and  
Department of Personnel & Administration  
Response:**

Agree. Implementation date: March 2009.

The Committee and the Department will direct the vendors to update the plan summaries to accurately reflect the provisions of their respective plans. Prospectively, the Committee and the Department will ensure that changes to the Plans are reflected in updated plan summaries.

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## Statutory Compliance

As discussed previously, the purpose of defined contribution and deferred compensation plans is to allow participants to save a portion of their income on a tax-deferred basis. To qualify for tax-deferred accumulations, plans must comply with federal requirements. The State DC Plan was created and is operated in a way to satisfy the qualification requirements of Section 401(a) and other related provisions of the Internal Revenue Code of 1986 (Code), to the extent they apply to governmental plans. The State 457 Plan was created and is operated in a way to satisfy the requirements of Section 457 of the Code. The Code recommends that defined contribution and deferred compensation plans prepare and submit to the Internal Revenue Service (IRS) for approval a “plan document” that presents the legal and operational provisions of the plan in a single cohesive document to enable the persons responsible for the plans to appropriately administer them. Additionally, both plans must comply with applicable provisions of state statutes.

Buck Consultants compared the State DC Plan and State 457 Plan documents with current federal and state laws to determine whether the documents are up to date and whether the Plans are in compliance with both. Buck Consultants identified several areas for both Plans where plan documents need to be updated to comply with federal and state laws. These areas are discussed below.

### State DC Plan

Buck Consultants compared the State DC Plan document with the Code to assess compliance with the qualification requirements of Section 401(a), certain related sections of the Code, and applicable regulations. Buck Consultants found that, in general, the State DC Plan document accurately reflects most Code qualification requirements. However, Buck Consultants identified several areas where the Plan document needs to be updated to ensure compliance with Section 415 of the Code. Section 415 limits the amount of employee and employer contributions that can be allocated to a participant’s account in any plan year. The amounts that count toward the limit are referred to in the Code as “annual additions.” Prior to 2007, IRS regulations allowed defined contribution plans to allocate annual addition amounts in excess of Section 415 limits to suspense accounts, where the additions remain until the excess can be transferred to a participant’s account. As of 2007, however, the regulations no longer allow the use of suspense accounts. Buck Consultants found that the State DC Plan document does not clearly define the contribution amounts that count as annual additions, and the Plan document continues to include language allowing the Plan to use suspense accounts to correct excess annual additions. Additionally, the Plan document continues to include language on combined limits for contributions that was repealed effective December 31, 1999.

In addition, Buck Consultants found that the State DC Plan document includes provisions under Section 401(a) of the Code related to distributions and the commencement of distributions that are not applicable to governmental plans. Although these Code provisions do not apply to the State DC Plan, the Plan must comply with them because they are included in the Plan document. Finally, the State DC Plan document has not been updated to include new rollover provisions adopted in the federal Pension Protection Act of 2006 (PPA).

Buck Consultants also compared the State DC Plan document with state statutes to assess compliance and identified two areas where the Plan document should be revised. First, Buck Consultants found that the Plan document does not clearly define the responsibilities of the State Deferred Compensation Committee, as the trustee and plan administrator of the State DC Plan, compared with the responsibilities of the bundled providers. Statute [Section 24-52-203, C.R.S.] provides that the Committee has the authority to administer the State DC Plan, including the authority to limit the number of funds offered by each bundled investment provider. Although the Plan document states that the Committee will establish the funds, the document also states that the bundled providers shall be delegated duties of the Committee necessary to comply with contractual obligations. One of the providers' duties under the contracts is to select the investment funds offered by the Plan. As a result, the Plan document is not clear as to the Committee's responsibilities compared with the bundled providers'. Second, Buck Consultants found that the Plan document states that University of Colorado employees are allowed to participate in the State DC Plan. However, statute [Section 24-52-202(5), C.R.S.] specifically excludes any state college, university, or institution under the control of the Board of Regents of the University of Colorado from the definition of "eligible employee."

### **State 457 Plan**

As with the State DC Plan, Buck Consultants compared the State 457 Plan document with Code requirements to assess compliance. Section 457 of the Code and the related regulations contain a number of technical requirements that a 457 plan must satisfy. Buck Consultants found that most of these requirements are appropriately reflected in the State 457 Plan document. However, Buck Consultants identified three areas where the Plan document should be updated to ensure compliance with the Code and to clarify Plan provisions. First, the State 457 Plan document does not state that when transferring funds from the State 457 to another 457 plan, the full amount removed from the State 457 Plan must be transferred to the other plan, nor does it state that amounts rolled into the State 457 Plan from another eligible retirement plan must be accounted for separately, as required by the Code and related regulations. Second, the State 457 Plan document includes provisions related to distributions and the commencement of distributions that are not applicable to governmental plans. As with the State DC Plan, including these provisions in the Plan document means that the Plan must

comply with them. Third, the State 457 Plan document could be amended to clarify provisions related to contributions made to multiple 457 plans, and language could be added to expand certain provisions related to excess contributions, catch-up contributions, and the definition of compensation used to apply Section 415 limits. Although these changes are not required under the Code, they would help clarify these provisions and improve administration of the Plan.

Buck Consultants also compared the State 457 Plan document with state statutes to assess compliance and identified one area where the Plan document should be revised. In addition to state employees, statute [Section 24-52-101(4), C.R.S.] permits employees of any city and county, county, city, town, or other political subdivision of the State to participate in the State 457 Plan. The State 457 Plan document currently indicates that 12 school districts have adopted the State 457 Plan, but it does not list any other participating employers. According to the Department of Personnel & Administration, there are actually 16 school districts participating in the plan as well as the South Metro Water Supply Authority. The State 457 Plan document, which should be updated when an employer is added, should be amended to list all participating employers.

If the State DC and State 457 Plan documents are not consistent with federal and state law, it is likely that the Plans will not be administered in accordance with applicable requirements. In this event, the IRS could take corrective actions against the State. With respect to the State DC Plan, corrective actions could include requiring that the State make additional contributions or adjust benefits and file a correction program application with the IRS, which could result in penalties. In egregious cases, the IRS could disqualify the Plan and participants would be immediately taxed on all amounts held on their behalf in the Plan. With respect to the State 457 Plan, corrective actions are not available. In the event the IRS determines at any time that the State 457 Plan is not compliant, the IRS can disqualify the Plan, and participants would be immediately taxed on all amounts held on their behalf in the Plan. If either Plan fails to qualify for tax-deferred status, this would impose an unnecessary financial burden on participants and defeat the primary purpose of both Plans, which is to help employees prepare for a secure retirement.

The State Deferred Compensation Committee should review the State DC and State 457 Plan documents and determine where changes are needed to ensure that both comply with federal and state laws. The Committee should also assess whether plan documents contain unnecessary provisions that could be deleted to reduce administrative restrictions on the plans. Based on this review, the Committee should adopt plan amendments, as necessary. Once plan amendments are made, the Committee should file a determination letter application with the IRS for the State DC Plan. Sponsors of qualified plans, such as the State DC Plan, can apply to the IRS for determination letters indicating that their plans meet

the qualification requirements under Section 401(a) of the Code. Obtaining an IRS determination letter helps ensure that the IRS agrees that a plan document accurately reflects all applicable provisions of the Code at the time the letter is requested. According to the IRS schedule, the Committee should file the application for a determination letter by January 31, 2009. The Committee should also request a Private Letter Ruling from the IRS for the State 457 Plan. A Private Letter Ruling is similar to the determination letter for defined contribution plans. The Private Letter Ruling is a request for the IRS to determine whether the State 457 Plan satisfies federal Code requirements. The Committee last received a Private Letter Ruling for the State 457 Plan in September 2005.

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### **Recommendation No. 11:**

The State Deferred Compensation Committee should ensure the State of Colorado Public Officials' and Employees' Defined Contribution Plan (State DC Plan) and the State of Colorado 457 Deferred Compensation Plan (State 457 Plan) comply with federal and state laws by comparing plan documents for both plans to applicable federal and state laws to identify required provisions that are not in the plans and to identify provisions in the plan documents that are not required by law, amending documents as necessary.

Once amendments are adopted, the Committee should file a determination letter application with the Internal Revenue Service (IRS) for the State DC Plan in accordance with the timeframes established by the IRS and request a Private Letter Ruling from the IRS for the State 457 Plan in a timely manner.

### **State Deferred Compensation Committee Response:**

Agree. Implementation Date: March 2009.

The plan documents may be amended to reflect applicable state and federal laws. The Committee will restate the plan documents and request a determination letter by January 31, 2009 for the State DC Plan and a Private Letter Ruling for the State 457 Plan as recommended by the audit, although not required by the IRS.

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