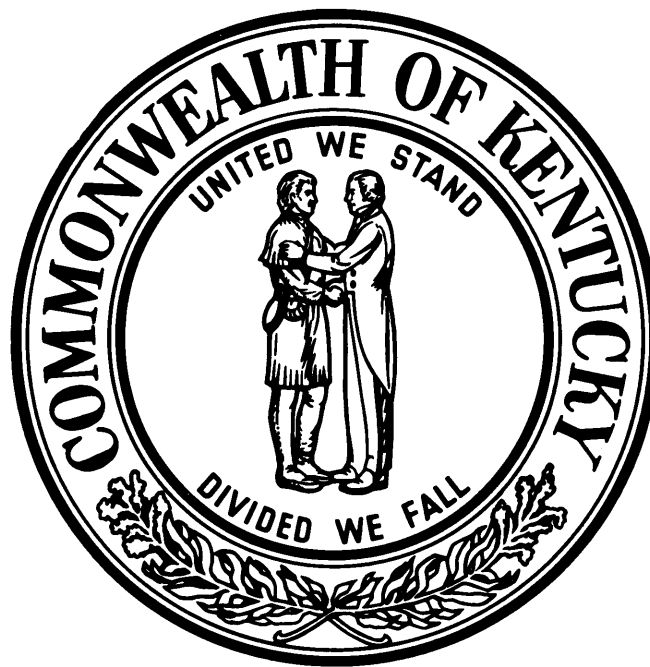


**PROGRAM EVALUATION:  
KENTUCKY PUBLIC EMPLOYEES  
DEFERRED COMPENSATION SYSTEM**



**RESEARCH REPORT NO. 169**

**LEGISLATIVE RESEARCH COMMISSION  
Frankfort, Kentucky**

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# **PROGRAM EVALUATION: KENTUCKY PUBLIC EMPLOYEES DEFERRED COMPENSATION SYSTEM**

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Research Report No. 169

Legislative Research Commission  
Frankfort, Kentucky  
January 1980

This Report was prepared by the Legislative Research Commission and paid for from state funds.



## FOREWORD

The Committee for Program Review and Investigation, at its November, 1978 meeting, heard a request from Representative Harold DeMarcus for a review of the Deferred Compensation System. This study, Program Evaluation: Kentucky Public Employees Deferred Compensation System, is the first study undertaken by the Committee. The written comments of the Deferred Compensation System Board of Trustees are included in the appendices to the report.

We thank the Deferred Compensation System Board of Trustees and their staff for their assistance and cooperation in the course of this study.

Gaynelle Ruth Trevino was the project manager for this study and the principal author of this report. The project staff also included Paul William Squires and Robert Scheffel Wright. Any questions concerning the report may be directed to Mrs. Trevino or to Mr. Wright.

Vic Hellard, Jr.  
Director

The Capitol  
Frankfort, Kentucky  
January 1980



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## SUMMARY OF RECOMMENDATIONS

### Delays in Crediting Participant Accounts:

1. Funds in transit between payroll deduction and investment in participants' accounts should be invested temporarily for the benefit of the Deferred Compensation System and participants.
2. Income from temporary investments should be used to defray administrative expenses of the system.
3. The general fund appropriation should be reduced or eliminated as investment income is received.
4. The Appropriations and Revenue Committee should consider this issue in its budget review proceedings, as well as the related issue of whether general fund appropriations for DCS are appropriate.
5. The Board of Trustees should act to assure that only one bank is utilized in transferring payroll deductions to participant accounts.
6. The General Assembly should consider legislation authorizing the Commonwealth to disburse funds via electronic funds transfer.
7. Payroll deductions from public school employees should be forwarded to the state treasurer as for other employees eligible for participation in the deferred compensation system.
8. The account at Central Bank and Trust Company should be eliminated.
9. Electronic funds transfer should be utilized to transfer funds from school boards to the state treasury (and also to transfer funds from there to the insurance companies).

### Sales Charges:

10. A comparison of plan administration proposals in other states should be made before another agreement for administration is made. Also, contractual arrangements with insurance companies should be compared in the same manner.
11. The Board of Trustees should review the sales charges presently in force to determine whether they serve the best financial interests of participants or whether an alternative structure would be better.
12. The Board of Trustees should seriously consider requesting new bids for the annuity contracts and evaluating all proposed products actuarially to determine which provides the best return to participants.

Statements Are Not Received in a Timely Manner:

13. The Board of Trustees should notify participants individually of changes in plan provisions and participant agreements.
14. The Board of Trustees should continually monitor and periodically review processing time of statements and related computer services and employee performance to insure that statements are produced and delivered in a timely manner.

The Revised DCS Plan Has Not Been Issued:

15. The Board of Trustees should act to assure that the revised plan is provided to participants as soon as possible.

Deferred Compensation System Staff:

16. The Board of Trustees should complete a systems analysis with the Deferred Compensation System, with cooperation of the Bureau of Computer Services.
17. The payroll operation should be included in a central payroll system.
18. Job descriptions, job procedures, the number of employees, and salaries should be reviewed as all recommendations of this review are implemented.
19. The General Assembly should consider legislation requiring that the administrative costs of the DCS be borne by participants rather than paid for by a general fund appropriation.

Legal Questions:

20. The Board of Trustees should maintain a declaratory judgment action without delay, to resolve the question whether investment of deferred compensation monies in common stocks is in conflict with Section 177 of the Kentucky Constitution.
21. The Board of Trustees should review its eligibility policies to assure consistency with statutes.
22. The Board of Trustees should propose legislation to achieve the strict eligibility requirements it desires.

Program Marketing Performance:

23. The Board of Trustees should monitor the program administrator's marketing and promotion activities on a regular basis to assure that all eligible employees have the program explained to them and receive an opportunity to participate.

State Computer System Support:

24. The Board of Trustees should request that the Bureau of Computer Services evaluate services for the DCS as part of the review of employee jobs and procedures.



## INTRODUCTION

The 1974 General Assembly, in Senate Bill 230 (coded as K.R.S. 18.510 to 18.600), authorized deferred compensation for public employes, including persons in the public school system. The Kentucky Public Employes Deferred Compensation System, with the powers and privileges of a corporation, was established to transact all business relating to deferred compensation for public employes of the Commonwealth and public school employes. The system is administered by a Board of Trustees composed of:

1. Commissioner of Insurance, ex-officio;
2. Commissioner of Finance, ex-officio;
3. Commissioner of Personnel, ex-officio; and
4. Two members appointed by the Governor.

The board employs an executive secretary, who is the chief administrative officer of the board. Additionally, the board may:

1. Appoint other employes as necessary and fix their compensation, subject to the approval of the Commissioner of Personnel;
2. Require such employes as deemed proper to execute bonds for the faithful performance of their duties;
3. Establish a system of accounting;
4. Contract for services necessary for the operation and administration of authorized deferred compensation plans, including annual audits; and
5. Take necessary action and make rules and regulations not inconsistent with the enabling statute.

Employes serve at the will and pleasure of the Board of Trustees.

The Attorney General or his designee may act as legal advisor and attorney for the board, and the board may also appoint legal counsel. An annual financial report of receipts, disbursements, assets and liabilities is to be sent to the Governor and the Legislative Research Commission. Board meetings and records are open to the public.

Written agreements between employes and the State of Kentucky provide for deductions from wages to participate in deferred compensation plans, established by the Department of Finance and subject to the approval of the Board of Trustees. Investment options include annuity contracts based on fixed and variable income funds, life insurance and disability income insurance.

State employes elect to participate in the deferred compensation program in addition to any retirement or other benefits. Income deferred (deducted for the program) is still included as regular compensation for the purpose of computing the retirement and pension benefits earned by employes. However, income deferred (deducted) for the program is not subject to income taxes withheld from employes' earnings.

Investments may be only as permitted by the Act and not prohibited by Section 177 of the Kentucky Constitution. Persons or companies offering such investments must be licensed by the State of Kentucky and applicable federal regulatory agencies.

The State Treasurer is the custodian of funds collected and pays to the board, when warrants are issued, amounts to be administered as provided in the Act.

Any city, county or other political subdivision or combination of those entities is authorized to establish a deferred compensation program for its employees. Such deferred compensation plans are not considered in this review, which deals only with the Kentucky Public Employees Deferred Compensation System (DCS).

### Program Review and Investigation Committee Action

At its November 30, 1978, meeting, a request for a review of the Deferred Compensation System was submitted by Representative Harold DeMarcus.

A preliminary review, presented April 6, 1979, addressed the following complaints about the program.

1. Delays occur from the time payroll deductions are made until participants' accounts are credited.
2. Statements have not been received in a timely manner.
3. The sales charges are excessive.
4. The State computer system does not provide sufficient support to the system.
5. Duties of the DCS staff do not justify their salaries.

The Committee voted to have a full review of the Deferred Compensation System after hearing the preliminary report. The Committee also requested that the possible financial impact in a change of insurance company carrier(s) be reviewed.

### DELAYS IN CREDITING PARTICIPANT ACCOUNTS

#### State Employees

The flow of deductions to state employee participant accounts is as follows:

1. Payroll deductions are made.
2. The state treasurer deposits the deductions into a "special deposit trust account" at Farmers Bank and Capital Trust Company.

3. The DCS executive secretary transfers these amounts from the Farmers Bank account to a clearing account at State National Bank.
4. The executive secretary writes checks to Nationwide Insurance Company and Kentucky Central Life Insurance Company from the account at State National Bank.
5. The insurance companies credit individual accounts for contract amounts when checks are received (sooner in some cases).

Exhibit 1 shows that elapsed time from the date that payroll checks are written and deductions are made to the date that amounts deducted are credited to individual accounts varies. These dates on which payroll checks were written were obtained directly from the State Treasury Department. The dates on which funds were transferred to the State National Bank and on which checks were written and mailed to Kentucky Central were provided by DCS staff. Kentucky Central always credited deposits for interest as of the first, regardless whether they were received early or late. Elapsed times from payroll deduction to deposit may vary (1) for individual employees, as pay dates vary from period to period, and (2) from one employee to another, as some are paid earlier than others for a given pay period.

For example, for the pay period ending June 15, 1976, payroll checks were actually written June 29, 1976. Fifteen days later, a check was written to transfer funds from Farmers Bank to State National Bank. Nineteen days after that, checks were written to send funds to the insurance companies. Then, four days later, participant accounts were credited for the deductions. The lag from the time of deduction until accounts were credited was 38 days elapsed. For the pay period ending March 31, 1979, payroll checks were written April 9, 1979; 16 days later a transfer was made to State National Bank; one day later checks were sent to the insurance companies; four days later accounts were credited. From time of deductions to credit of account, 21 days elapsed.

Amounts deducted from employee checks remain in Farmers Bank until the check transferring funds to State National Bank clears and they remain at the State National Bank until the checks to the insurance companies clear. The State Treasurer has an investment arrangement with Farmers Bank for funds on deposit at Farmers Bank, but does not have an investment arrangement with State National Bank. Investment income earned on deferred compensation deductions at Farmers Bank is credited to the general fund (not to DCS or program participants), while no investment income from the funds for any state account is earned at State National Bank. Any funds transferred from State National Bank and received by the insurance companies before the first of the month can be invested for the credit of the insurance companies.

It is important to note the dates that deductions were credited to participant accounts. Note, for example, the pay period ended January 26, 1977. Funds were transferred to Kentucky Central on March 15, 1977, but participant accounts were credited as of March 1 -- fully fourteen days before checks were written to the company. An advance against the premiums due was made by the company on the first of the month so that no interest was lost by the participant for that particular month.

In 68 pay periods, the insurance company received 40 payments before the first of the month and 28 payments after the first of the month. The total

## EXHIBIT 1

FLOW OF DEDUCTIONS TO PARTICIPANTS' ACCOUNTS,  
JUNE 15, 1976 TO MARCH 31, 1979

Pay Period Ended	Date Payroll Checks Written	No. of Days in Farmers Bank		Funds Transferred to State Nat'l. Bank		Days in State National Bank		Checks Mailed to Ky. Central & Nationwide		Number of Days in Transit and at Ky. Central		Credited to Parti- cipants' 2 Accounts
		Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	Total No. of Days	
6/15/76	6/24/76	15		7/9/76	19			7/28/76	4			8/1/76
6/30/76	7/12/76	10		7/22/76	6			7/28/76	4			8/1/76
7/15/76	7/27/76	8		8/ 4/76	23			8/27/76	5			9/1/76
7/31/76	8/11/76	9		8/20/76	7			8/27/76	5			9/1/76
8/15/76	8/25/76	14		9/8/76	22			9/30/76	1			10/1/76
8/31/76	9/10/76	17		9/27/76	3			9/30/76	1			10/1/76
9/15/76	9/28/76	10		10/8/76	20			10/28/76	4			11/1/76
9/30/76	10/11/76	15		10/26/76	2			10/28/76	4			11/1/76
10/15/76	10/26/76	10		11/5/76	25			11/30/76	1			12/1/76
10/31/76	11/10/76	9		11/9/76	11			11/30/76	1			12/1/76
11/15/76	11/19/76	18		12/7/76	22			12/29/76	3			1/1/77
11/30/76	12/7/76	21		12/28/76	1			12/29/76	3			1/1/77
12/15/76	12/20/76	16		1/5/77	26			1/31/77	1			2/1/77
12/31/76	1/13/77	7		1/20/77	11			1/31/77	1			2/1/77
1/15/77	1/26/77	21		2/16/77	27			3/15/77*	-14			3/1/77
1/31/77	2/9/77	14		2/23/77	20			3/15/77*	-14			3/1/77
2/15/77	2/22/77	13		3/ 7/77	36			4/12/77*	-11			4/1/77
2/28/77	3/8/77	17		3/25/77	18			4/12/77*	-11			4/1/77
3/15/77	3/23/77	14		4/ 6/77	33			5/9 /77*	- 8			5/1/77
3/31/77	4/7/77	15		4/22/77	17			5/9 /77*	- 8			5/1/77
4/15/77	4/25/77	16		5/11/77	27			6/7 /77*	- 6			6/1/77
4/30/77	5/9/77	17		5/26/77	12			6/7 /77*	- 6			6/1/77
5/15/77	5/25/77	14		6/8/77	20			6/28/77	3			7/1/77
5/31/77	6/9/77	12		6/21/77	7			6/28/77	3			7/1/77
6/15/77	6/24/77	12		7/6/77	27			8/ 2/77*	- 1			8/1/77
6/30/77	7/11/77	16		7/27/77	6			8/ 2/77*	- 1			8/1/77
7/15/77	7/26/77	15		8/10/77	21			8/31/77	1			9/1/77
7/31/77	8/9/77	14		8/23/77	8			8/31/77	1			9/1/77

EXHIBIT 1

FLOW OF DEDUCTIONS TO PARTICIPANTS' ACCOUNTS  
(Continued)

Pay Period Ended	Date Payroll Checks Written	No. of Days in Farmers Bank Total No. of Days	Funds Transferred to State Nat'l. Bank	Days in State National Bank Total No. of Days	Checks Mailed to Ky. Central & Nationwide	Number of Days in Transit and at Ky. Central Total No. 1 of Days	Credited to Parti- cipants' 2 Accounts
8/15/77	8/24/77	16	9/9/77	20	9/29/77	2	10/1/77
8/31/77	9/9/77	20	9/29/77	0	9/29/77	2	10/1/77
9/15/77	9/26/77	16	10/12/77	21	11/2/77*	- 1	11/1/77
9/30/77	10/10/77	16	10/26/77	7	11/2/77*	- 1	11/1/77
10/15/77	10/26/77	16	11/11/77	20	12/1/77	0	12/1/77
10/31/77	11/8/77	15	11/23/77	8	12/1/77	0	12/1/77
11/15/77	11/22/77	20	12/12/77	17	12/29/77	3	12/1/77
11/30/77	12/7/77	14	12/21/77	8	12/29/77	3	1/1/78
12/15/77	12/20/77	23	1/12/78	29	2/10/78*	- 9	2/1/78
12/31/77	1/11/78	21	2/1/78	9	2/10/78*	- 9	2/1/78
1/15/78	1/30/78	14	2/13/78	24	3/19/78*	- 8	3/1/78
1/31/78	2/10/78	18	2/28/78	9	3/9/78*	- 8	3/1/78
2/15/78	2/27/78	17	3/16/78	19	4/4/78*	- 3	4/1/78
2/28/78	3/9/78	20	3/29/78	6	4/4/78*	- 3	4/1/78
3/15/78	3/23/78	22	4/14/78	12	4/26/78	5	4/1/78
3/31/78	4/10/78	16	4/26/78	0	4/26/78	5	5/1/78
4/15/78	4/24/78	31	5/25/78	1	5/26/78	6	5/1/78
4/30/78	5/9/78	16	5/25/78	1	5/26/78	6	6/1/78
5/15/78	5/25/78	33	6/27/78	13	7/10/78*	6	6/1/78
5/31/78	6/8/78	21	6/27/78	13	7/10/78*	- 9	7/1/78
6/15/78	6/23/78	34	7/27/78	1	7/28/78	- 9	7/1/78
6/30/78	7/11/78	16	7/27/78	1	7/28/78	4	8/1/78
7/15/78	7/27/78	29	8/25/78	18	9/12/78*	4	8/1/78
7/31/78	8/9/78	16	8/25/78	18	9/12/78*	- 11	9/1/78
8/15/78	8/24/78	34	9/27/78	8	10/ 5/78*	- 4	9/1/78
8/31/78	9/12/78	15	9/27/78	8	10/ 5/78*	- 4	10/1/78
9/15/78	9/28/78	28	10/26/78	5	10/ 5/78*	- 4	10/1/78
9/30/78	10/11/78	15	10/26/78	5	10/31/78	1	11/1/78
10/15/78	10/24/78	34	11/27/78	7	12/ 4/78*	1	11/1/78
						- 3	12/1/78

# EXHIBIT 1

## FLOW OF DEDUCTIONS TO PARTICIPANTS' ACCOUNTS

(Continued)

Pay Period Ended	Date Payroll Checks Written	No. of Days in Farmers Bank		Funds Transferred to State Nat'l. Bank	Days in State National Bank		Checks Mailed to Ky. Central & Nationwide	Number of Days in Transit and at Ky. Central		Credited to Participants' Accounts
		Total No. of Days	Total No. of Days		Total No. of Days	Total No. of Days		Total No. of Days	Total No. of Days	
10/31/78	11/9/78	18		11/27/78	7		12/4/78*	- 3		12/1/78
11/15/78	11/2/78	31		12/22/78	13		1/4/79*	- 3		1/1/79
11/30/78	12/6/78	16		12/22/78	13		1/4/79*	- 3		1/1/79
12/15/78	12/20/78	37		1/26/79	4		1/30/79	2		2/1/79
12/31/78	1/12/79	14		1/26/79	4		1/30/79	2		2/1/79
1/15/79	1/25/79	33		2/27/79	0		2/27/79	2		3/1/79
1/31/79	2/8/79	19		2/27/79	0		2/27/79	2		3/1/79
2/15/79	2/26/79	28		3/26/79	1		3/27/79	5		4/1/79
2/28/79	3/8/79	18		3/26/79	1		3/27/79	5		4/1/79
3/15/79	3/23/79	33		4/25/79	1		4/26/79	4		5/1/79
3/31/79	4/19/79	16		4/25/79	1		4/26/79	4		5/1/79

### Sources:

Payroll dates: State Treasurer  
Transfer and mailing dates: Deferred Compensation System  
Dates credited to participant accounts: Kentucky Central Life Insurance Company

1 Negative figures show the number of days an account was credited before a remittance was received.

2 No interest credit was lost for the month. Note that the participant account was credited as of the first of the month.

number of days (not the total number of times) that payments were late exceeded the total number of days that payments were early, so Kentucky Central apparently credited more interest to participant accounts than they might have earned by investing idle funds to their benefit in these lag or float periods.

The use of checks instead of electronic transfers causes much delay in the flow of funds to participant accounts. However, opinion of the Attorney General 79-206 (Appendix A) states that "the electronic transfer of funds from the state treasury cannot be legally done under the present statutes. Action of the General Assembly will be necessary to authorize this kind of transfer...."

Staff calculated an estimate of the amount of interest that could have been earned on the amounts deposited at the State National Bank from January, 1976, through June, 1979, had they earned interest at prevailing short-term interest rates. The estimate was prepared by multiplying the actual balances on deposit times the number of days each balance existed, times a daily periodic interest rate derived from the average interest rate paid on new U.S. Treasury bills issued in each month. This rate was used for this estimate because Farmers Bank uses current Treasury bill rates in calculating the rate it pays on state money invested there overnight and over weekends.

The amount of potential interest earnings thus estimated was \$42,710 for the period January, 1976, through June, 1979. This is only an estimate. The true amount depends on the actual investment opportunities available to the bank on specific dates throughout this period.

#### RECOMMENDATIONS:

1. Funds in transit between payroll deduction and investment in participants' accounts should be invested temporarily for the benefit of the Deferred Compensation System and participants.
2. Income from temporary investments should be used to defray administrative expenses of the system. (See also discussion of the propriety of a general fund appropriation for DCS under "Staff Duties and Salaries" below.)
3. The general fund appropriation should be reduced or eliminated as investment income is received.
4. The Appropriations and Revenue Committee, in its budget review proceedings, should consider this issue with the related issue of whether general fund appropriations for DCS are appropriate.
5. The Board of Trustees should act to assure that only one bank is utilized in transferring payroll deductions to participant accounts.
6. The General Assembly should consider legislation authorizing the Commonwealth to disburse funds via electronic funds transfer.

## Public School System Employees

For participants who are in the public school system, steps in the transfer of deductions to participant accounts are as follows:

1. Payroll deductions are made.
2. The school board deposits deductions to a special account at the Central Bank and Trust Company in Lexington.
3. The DCS executive secretary writes checks to the insurance companies on the account at Central Bank and Trust.
4. The insurance companies credit individual accounts when the checks are received.

The account at the Central Bank and Trust Company was established under authority of the Secretary of Finance, State Treasurer and the Board of Trustees of the Deferred Compensation System. The account was established because of school board(s) objections to depositing money in the state treasury that had been withheld from public school system employees' pay.

The enabling statutes for the DCS specify that the group of employees eligible for the system "includes persons in the public school system" and also specify that the "state treasurer shall be the custodian of the funds collected."

### RECOMMENDATIONS:

1. Payroll deductions from public school employees should be forwarded to the state treasurer as for other employees eligible for participation in the deferred compensation system.
2. The account at Central Bank and Trust Company should be eliminated.
3. Electronic funds transfer should be utilized to transfer funds from school boards to the state treasury (and also to transfer funds from there to the insurance companies).

### SALES CHARGES

Annuity plans offered through the deferred compensation system are described briefly below.

1. Fixed Annuity: The fixed annuity account is offered by Kentucky Central Life Insurance Company. Annual interest payments at a guaranteed rate are made; the interest rate is re-set annually for the next year. A sales charge (or load fees) of six percent of each new contribution is assessed.
2. Variable Annuity: The variable annuity is offered by Nationwide Life Insurance Company. Participants may choose that

their contributions be invested in any of four mutual funds. A sales charge of five percent of each monthly contribution is assessed, plus an annual charge of \$8.00 per participant account.

Life insurance and disability income contracts may also be purchased from Kentucky Central.

The Board of Trustees of the Deferred Compensation System surveyed other states to obtain an "Analysis of Deferred Compensation Programs" (Exhibit 2). Teachers Insurance Annuity Association, which has the largest tax sheltered annuity program in the nation, was included for comparative purposes.

Note that sales charges (or "load fees") may vary from "none" to 8%, while administrative charges vary from "none" to \$13.00 yearly. (Of course, asset charges of .59% could be more than \$13.00 yearly.) It is important to compare the surrender value and yield <sup>1</sup> at ten, twenty and thirty year intervals when comparing sales and administrative charges.

The sales charge for Kentucky is higher than those in most states surveyed. As the sales charge is applied only to current or new contributions at the time they are made, while the interest rate applies to prior years' contributions, to interest on prior contributions and to current contributions, at thirty years Kentucky is second in yield.

The most important aspect of these comparisons is the net performance of an investment product over the period of time an average employee participates in a plan. Load charges may be the employee's best financial alternative, under some circumstances, while a no-load product with a lower interest rate will be better under different circumstances.

The comparative example set forth in Table 1 shows the net gain and account value of contributions of \$1,000 per year over different periods of employee participation. Case A shows the earnings and growth in account values of an account earning 8.5 percent per year interest and having a 6.0 percent front-end sales charge (load fee). This is exactly the arrangement under the DCS fixed annuity contract option offered by Kentucky Central Life Insurance Company. Case B shows the same data for an account earning 7.75 percent per year but with no sales charge. This "spread" of 0.75 percent is a reasonable estimate of the amount the carrier would lower the guaranteed interest rate if the sales charge were eliminated. Under these conditions, employees who participate in the program for more than 15 years are better off with the sales charge, while employees who participate for less than 15 years are better off with the no-load, lower-interest alternative. Thus, in the example, an employee who contributed \$1,000 per year for 25 years would have an account value of \$80,840.75 under Case A, but of only \$76,103.50 under Case B. An employee who contributed the same yearly amount for ten years would have more under the no-load conditions -- \$15,034.37 -- than under the higher-interest option with the 6 percent sales charge -- \$14,737.18.

Aside from consideration of ultimate yield on investment, much of the complaint regarding the sales charges associated with the deferred compensation products arises from a presentation made to the Task Force on Deferred Compensation by the Kentucky Employees Retirement System (KERS). While a firm sales charge was not proposed, it was projected that actual administrative and sales costs would not exceed two percent of current contributions. The KERS proposal was accepted by the task force, but a later study by the Department

EXHIBIT 2  
ANALYSIS OF DEFERRED COMPENSATION PROGRAMS

State	Administrator	% Enrolled	Product	Curr. Int. Rate	Sales Chge.	Admin. Charge	-----10 Years----- Surrender Value	Yield %	-----20 Years----- Surrender Value	Yield %	-----30 Years----- Surrender Value	Yield %
Alabama	PEBSO	5.7	Fixed	7.0 %	8.0 %	None	\$ 13,601	6.55	\$ 40,356	9.69	\$ 92,987	13.55
Arizona	PEBSO	8.6	Fixed	8.25%	N/L	\$12 Yr.	15,365	9.75	49,313	13.96	124,318	20.28
California	Multi-Company	6.0	Fixed	8.0 %	3.0 %	\$12 Yr.	14,988	9.07	47,347	13.17	117,207	18.75
California			Fixed	8.33%	N/L	\$12 Yr.	15,435	9.88	49,791	14.19	126,259	20.70
Connecticut	Multi-Company	2.2	Fixed	6.0 %	5.25%	None	13,238	5.89	36,946	8.07	79,402	10.62
Illinois	T. Rowe Price	Unavail.	Fixed	8.05%	None	.59% Ast	15,133	9.33	46,069	12.40	107,192	16.60
Iowa	Multi-Company	4.2	Fixed	Varies	Vary	Varies	Varies	Varies	Varies	Varies	Varies	Varies
Kentucky	PEBSO	4.9	Fixed	8.5 %	6.0 %	None	15,130	9.33	49,340	13.97	126,687	20.79
Maine	Variable Life Ins. Co.	4.2	Fixed	4.0 %	5.0 %	None	11,862	3.39	29,421	4.49	55,412	5.46
Maryland	PEBSO	24.7	Fixed	7.8 %	N/L	\$12 Yr.	14,977	9.05	46,720	12.72	112,989	18.06
Michigan	State-Civil Service	18.8	Fixed	8.91%	None	\$13 Yr.	16,262	11.39	54,442	16.40	144,085	24.53
Minnesota	State-Retire. System	10.3	Fixed	7.0 %	2.0 %	None	14,488	8.16	42,988	10.95	99,052	14.85
Mississippi	Multi-Company	3.4	Fixed	8.0 %	5.0 %	None	14,707	8.56	46,458	12.60	115,005	18.28
Montana	PEBSO	15.4	Fixed	7.8 %	N/L	\$12 Yr.	14,977	9.05	46,720	12.72	113,989	18.06
Montana			S & L	5.25%	None	\$12 Yr.	13,233	5.88	35,307	7.29	72,128	9.06
Montana			Bank	5.0 %	None	\$12 Yr.	13,048	5.54	34,303	6.81	68,923	8.37
Nebraska	Hartford Ins. Co.	4.1	Fixed	7.5 %	3.0 %	\$10 Yr.	14,600	8.36	44,690	11.76	106,708	16.50
No. Carolina	DCCA	8.3	Fixed	Varies	Vary	Varies	Varies	Varies	Varies	Varies	Varies	Varies

EXHIBIT 2 (Continued)

State	Administrator	% Enrolled	Product	Curr. Int. Rate	Sales Chge.	Admin. Charge	----- 10 Years----- Surrender Value	% Yield	----- 20 Years----- Surrender Value	% Yield	----- 30 Years----- Surrender Value	% Yield
Dakota	Multi-Company	3.3	Fixed	Varies	Vary	Varies	Varies		Varies		Varies	
Idaho	Mollmann & Assoc.	3.9	Fixed	7.5 %	3.5%	\$8 Yr.	14,554	8.28	44,551	11.69	106,375	16.4
Idaho	Multi-Company	2.5	Fixed	8.25%	3.0%	None	15,393	9.81	49,403	14.00	124,544	20.3
Idaho			Bank	8.0 %	None	None	15,645	10.26	49,423	14.01	122,346	19.81
Idaho	Multi-Company	1.9	Fixed	Varies	Vary	Varies	Varies		Varies		Varies	
Idaho	State-Retire. System	5.5	Fixed	8.0 %	\$6 Yr	1/2% Asset	15,083	9.24	46,053	12.41	109,647	17.1
Idaho	Teachers Ins. Assoc.	Unavail.	Fixed	7.75%	4.0%	None	14,808	8.74	46,045	12.41	111,939	17.61

ES:

1. Values are based on the gross deferral of \$1,000.00 annually less any sales and administrative charges. Surrender penalties are deducted if applicable.
2. Gross deferral instead of net deferral used in computing yield.
3. All no-loads (N/L) computed on the basis of a 2% surrender penalty which comes off the back end instead of the front end. Administrative charges, usually \$12.00 annually, are also levied against these participant's accounts.
4. Only five states could identify any direct costs to the taxpayers as appropriations made specifically for Deferred Compensation. These were: Connecticut - \$12,000; Kentucky - \$86,400; Mississippi - \$40,000; Nebraska - \$8,100.00; and Oklahoma - \$43,350. Most states include the deferred compensation budget in the general appropriation to the state agency that has administrative oversight of the program (such as Finance, Personnel, Insurance, etc.) or fund the direct costs by charges to the participants. All states also incur indirect costs such as payroll deduction costs, computer services, supplies, etc.
5. Self-administered states are somewhat limited in their marketing as enrollment is done principally by mail. Literature is periodically distributed with paychecks and is available in the personnel sections.

EXHIBIT 2 (Continued)

RANKING BY RATE OF YIELD FOR 10 YEAR'S PARTICIPATION		RANKING BY RATE OF YIELD FOR 20 YEAR'S PARTICIPATION		RANKING BY RATE OF YIELD FOR 30 YEAR'S PARTICIPATION	
STATE	% YIELD	STATE	% YIELD	STATE	% YIELD
1. Michigan	11.39	1. Michigan	16.40	1. Michigan	24.53
2. California	9.88	2. California	14.19	2. Kentucky	20.79
3. Oklahoma	9.81	3. Oklahoma	14.00	3. California	20.70
4. Arizona	9.75	4. Kentucky	13.97	4. Oklahoma	20.33
5. Kentucky	9.33	5. Arizona	13.96	5. Arizona	20.28
6. Illinois	9.33	6. Maryland	12.72	6. Mississippi	18.28
7. Utah	9.24	7. Montana	12.72	7. Maryland	18.06
8. Maryland	9.05	8. Mississippi	12.60	8. Montana	17.62
9. Montana	9.05	9. Utah	12.41	9. TIAA	17.13
10. TIAA	8.74	10. Illinois	12.40	10. Utah	16.60
11. Mississippi	8.56	11. TIAA	12.40	11. Illinois	16.50
12. Nebraska	8.36	12. Nebraska	11.76	12. Nebraska	16.42
13. Ohio	8.28	13. Ohio	11.69	13. Ohio	14.85
14. Minnesota	8.16	14. Minnesota	10.95	14. Minnesota	13.55
15. Alabama	6.55	15. Alabama	9.69	15. Alabama	10.62
16. Connecticut	5.89	16. Connecticut	8.07	16. Connecticut	5.46
17. Maine	3.39	17. Maine	4.49	17. Maine	

TABLE 1

THIRTY-YEAR COMPARISON OF ACCOUNT VALUES AND INTEREST EARNED  
UNDER ALTERNATIVE INTEREST RATE AND SALES CHARGE ASSUMPTIONS

YEAR	CUMULATIVE CONTRIBUTIONS	8.5% Interest, 6% Sales Charge		7.75% Interest, No Sales Charge	
		CUMULATIVE ACCOUNT VALUE	CUMULATIVE INTEREST EARNED	CUMULATIVE ACCOUNT VALUE	CUMULATIVE INTEREST EARNED
1	\$ 1,000	\$ 977.50	\$ 37.50	\$ 1,036.30	\$ 36.30
2	2,000	2,041.40	161.40	2,155.82	155.82
3	3,000	3,199.33	379.34	3,365.25	365.25
4	4,000	4,459.61	699.63	4,671.80	671.80
5	5,000	5,831.26	1,131.31	6,083.27	1,083.27
6	6,000	7,324.15	1,684.24	7,608.09	1,608.09
7	7,000	8,949.00	2,369.13	9,255.37	2,255.37
8	8,000	10,717.46	3,197.63	11,034.95	3,034.95
9	9,000	12,642.26	4,182.45	12,957.46	3,957.46
10	10,000	14,737.18	5,337.39	15,034.37	5,034.37
11	11,000	17,017.27	6,677.49	17,278.07	6,278.07
12	12,000	19,498.89	8,219.13	19,701.99	7,701.99
13	13,000	22,199.87	9,980.13	22,320.57	9,320.57
14	14,000	25,139.60	11,979.87	25,149.46	11,149.46
15	15,000	28,339.17	14,239.46	28,205.54	13,205.54
16	16,000	31,821.55	16,781.86	31,507.07	15,507.07
17	17,000	35,611.75	19,632.07	35,073.76	18,073.76
18	18,000	39,736.96	22,817.30	38,926.89	20,926.89
19	19,000	44,226.80	26,367.16	43,089.48	24,089.48
20	20,000	49,113.51	30,313.88	47,586.38	27,586.38
21	21,000	54,432.15	34,692.54	52,444.44	31,444.44
22	22,000	60,220.91	39,541.31	57,692.67	35,692.67
23	23,000	66,521.25	44,901.77	63,362.40	40,362.40
24	24,000	73,378.00	50,819.09	69,487.06	45,487.06
25	25,000	80,840.75	57,342.49	76,103.50	51,103.50
26	26,000	88,963.13	64,525.52	83,251.25	57,251.25
27	27,000	97,803.44	72,426.13	90,973.00	63,973.00
28	28,000	107,425.30	81,108.19	99,314.94	71,314.94
29	29,000	117,897.40	90,640.56	108,326.80	79,326.80
30	30,000	129,295.30	101,098.70	118,062.50	88,062.50

of Insurance concluded that KERS would not be suitable for administration and sales. KERS never presented a firm proposal in writing to the Department of Insurance. The Board of Trustees considered proposals submitted for the Department of Insurance study and did not choose KERS. PEBSCO was designated by the Board as sales administrator and marketing agent for the investment plans offered through Kentucky Central and Nationwide Life Insurance Companies.

The initial agreement between the Board of Trustees and PEBSCO (Appendix D) expired October 8, 1979, and a new, more detailed agreement between the Board and PEBSCO was adopted at that time.

The Board of Trustees of the Kentucky Employees Retirement System considered the question whether they would choose to administer the deferred compensation program. They officially declared that they were not in a position to consider administering the system nor to make any proposal to do so.

#### RECOMMENDATIONS:

1. A comparison of plan administration proposals in other states should be made before another agreement for administration is made. Also, contractual arrangements with insurance companies should be compared in the same manner. There is no assurance that what other states are doing represents a wiser course, but some data can be obtained from comparison.
2. The Board of Trustees should review the sales charges presently in force to determine whether they serve the best financial interests of participants or whether an alternative structure would be better.
3. The Board of Trustees should seriously consider requesting new bids for the annuity contracts and evaluating all proposed products actuarially to determine which provides the best return to participants.

#### POSSIBLE FINANCIAL IMPACT OF A CHANGE OF INSURANCE CARRIER

For participants, there should be no significant financial impact in a change of insurance carrier in a deferred compensation system. It is possible that a carrier holding previous contributions could lower the interest rate paid thereon to the guaranteed minimum rate, which is typically less than the current rate paid. In such an event, though, the Board of Trustees (not the participants themselves) could transfer such funds to another carrier. When changes were made in other states, these were the results.

1. Investments already made remained with the original carrier. Should investments be taken from the original carriers, the state has an obligation to participants for the amount of the original investment even though with another carrier.
2. New investments are made, from a certain date, with another carrier, with the express consent and agreement of participants.

There could be an adverse financial impact for an insurance carrier which had not recovered start-up costs by the time a change of carrier was effected. There should be no adverse financial impact on the plan administrator, assuming that agency agreements were favorable for operations to start and continue.

#### TIMING OF STATEMENTS

The Public Employees Deferred Compensation Plan (Appendix B) specified that "all interest, dividends, charges for premiums, benefits payable under policies or annuities, and capital or market changes applicable to each employee's deferred account shall be reflected in each quarterly report..." (emphasis added). Moreover, the agreement signed by each participant in the plan designated that quarterly statements would be rendered.

As the Deferred Compensation System was put into operation, the following problems with quarterly statements arose.

1. About 60 to 90 days were necessary to process information.
2. Interest was shown at year-end only on fixed annuity accounts.

As a result of these and of other problems which had not been previously recognized or anticipated in reconciling deductions made through the great number of payrolls in the state, the quarterly statements were confusing and incomplete. The Board of Trustees changed to annual statements, but did not notify participants individually of the change. A publication entitled "Commonwealth of Kentucky, Deferred Compensation Report, Fall 1977," contained an announcement that the quarterly statement had been discontinued and that only annual statements would be provided.

Account statements for 1978 were issued within the time limit specified in the agreement between the Board of Trustees and PEBSCO, the program administrator. Statements show the status of accounts through October 31 of any calendar year; only those deductions made through October 31 are shown on the statement. This feature continues to cause some confusion among participants who are accustomed to financial statements for a normal calendar year (January 1 - December 31) instead of other fiscal year periods -- e.g., November 1 - October 31.

#### RECOMMENDATIONS:

1. The Board of Trustees should notify participants individually of changes in plan provisions and participant agreements.
2. The Board of Trustees should continually monitor and periodically review processing time of statements and related computer services and employee performance to insure that statements are produced and delivered in a timely manner.

## REVISED DCS PLAN HAS NOT BEEN ISSUED

Changes in the Internal Revenue Code affecting deferred compensation plans for public employes were officially promulgated in October, 1978, and became effective on January 1, 1979. (A summary of these changes is included here as Appendix C.) These changes do affect Kentucky's deferred compensation plan. Because of these changes, a revised plan must be issued to participants.

### FINDING:

The new plan has not yet been issued to participants.

This is another instance of the Board's failure to notify participants of changes in the program. In addition to the general recommendation stated at the end of the previous section, we also make the following specific recommendation.

### RECOMMENDATION:

The Board of Trustees should act to assure that the revised plan is provided to participants as soon as possible.

## DCS STAFF DUTIES AND SALARIES

Present staff members at the deferred compensation system and their monthly salaries are listed below.

Executive Secretary	\$2,074.00
Administrative Secretary	998.00
Account Clerk	643.00

This staff handles approximately 6,800 individual accounts, answers participants' inquiries, transmits funds within the system and transmits to the plan administrator the detail of deductions from more than 300 payrolls in the state.

This function includes issuing federal tax forms (1099 forms) issuing and authorizing checks to participants, and filing necessary tax forms and reports with the Internal Revenue Service. Most of this mass of detail work is handled manually. Projections indicate that the number of participants will increase. The Board must thus prepare for an increased workload.

An equity problem surrounds the issue of whether the Commonwealth should support the Deferred Compensation System via general fund appropriations. Specifically, it can be argued that the administrative costs of a fringe benefit which at present serves a minority of state employes (roughly 6,100 out of over 36,000 eligible) should be borne by those whom it benefits rather than by

the taxpayers, and that the state's support in establishing, organizing and providing trustee oversight to the program is sufficient. Further, it may be inconsistent for the state to support this fringe benefit with a general fund appropriation while it does not do so for the Kentucky Employees Retirement System. Withdrawal of general fund support would not mean the end of the program, nor would it mean that the Board of Trustees would be without staff: the costs could be borne by the participants if the Board of Trustees so chose. At the present contribution levels of approximately \$6,000,000 per year, the Board's administrative costs of approximately \$90,000 per year represents about 1.5 percent of new contributions annually. Obviously, the change in question would reduce the return to participants: the Board would have to balance its need for executive staff with its concerns for maximum yield to participants.

#### RECOMMENDATIONS:

1. The Board of Trustees should complete a systems analysis within the Deferred Compensation System, with cooperation of the Bureau of Computer Services.
2. The payroll operation should be included in a central payroll system.
3. Job descriptions, job procedures, the number of employees and salaries should be reviewed.
4. The General Assembly should consider legislation requiring that the administrative costs of the DCS be borne by participants rather than paid for by a general fund appropriation. (See also discussion of interim investments above.)

#### LEGAL QUESTIONS

Several important legal questions arose in our investigation and in the committee's deliberations on the statutory structure and authority of the Deferred Compensation System. The main questions were: (1) whether deferred compensation monies -- i.e., amounts deducted from participants' salaries -- could be invested in the common stock of corporations or in mutual funds, whether backed by stocks or bonds, and (2) whether the Kentucky Employees Retirement System (KERS) could provide the services now provided by the Kentucky Public Employees Deferred Compensation System (DCS). To resolve these questions, a formal opinion of the Attorney General (OAG 79-414, Appendix E) was obtained.

#### Investments in Stocks and Mutual Funds

Section 177 of the Kentucky Constitution provides that:

The credit of the Commonwealth shall not be given, pledged or loaned to any individual, company, corporation or association, municipality, or political subdivision of the state; nor shall the

Commonwealth become an owner or stockholder in, nor make donation to, any company, association or corporation...

In two previous opinions, OAG 73-695 and 73-808, the Attorney General advised that there was a possibility that stock investments might be in conflict with Section 177 of the Kentucky Constitution, and recommended that a declaratory judgment action should be maintained to resolve the issue. This was not done.

However, the Attorney General provides an affirmative opinion, based on further consideration of case law, that deferred compensation monies may legally be invested in the common stock of a corporation or in mutual funds. This opinion is based primarily on the principles that

the monies of the PEDCS do not come directly from tax funds, but are voluntarily assigned to it from employees of the Commonwealth, and there is no diversion of tax revenues from normal government channels by such investments.

Further, the Court of Appeals has held that "becoming a 'member' of a mutual company does not make the insured a 'stockholder' within the meaning of Section 177 of the Kentucky Constitution." This is applied to the specific conclusion that deferred compensation monies may be invested in mutual funds.

#### RECOMMENDATION:

The Board of Trustees should maintain a declaratory judgment action without delay, to resolve the question whether investment of deferred compensation monies in common stocks is in conflict with Section 177.

#### Administration of the Deferred Compensation Program by the Kentucky Employees Retirement System

As discussed elsewhere in this report, one source of complaints and confusion over the level of sales charges was a presentation made by the previous general manager of KERS to the Deferred Compensation Task Force, in which it was estimated that KERS could administer a deferred compensation program for charges approximately equal to two percent of new contributions. The Committee for Program Review and Investigation asked whether it would be possible for KERS to administer the deferred compensation program.

The opinion of the Attorney General addressed this question:

KERS could not offer a deferred compensation plan without massive statutory change in its composition or without (statutorily) offering a separate fund which would meet federal requirements for consideration as a deferred compensation system.

If proper statutory changes were enacted, though, KERS could offer what is now offered by the Deferred Compensation System. The Board of Trustees of the Kentucky Employees Retirement System considered the question whether they would choose to do so. They officially declared that they were not in a position to consider administering the system nor to make any proposal to do so.

## Definition of Employee

The Board of Trustees implemented in practice a rule defining "employee" (for purposes of eligibility) more narrowly than in KRS 18.510. Specifically, the board has adopted a definition very similar to that used by the Kentucky Employees Retirement System.

We requested the opinion of the Attorney General on this matter. His response is given here in full.

We do not believe the board of PEDCS can, by regulation, reduce the term 'employee' inconsistently with the definition of the term in the statute. Otherwise, the regulation would have the effect of amending the statute. An administrative agency has only those powers granted to it by the statute creating it.

Providing the clarification does not, in effect, amend the statutory definition, such clarification may be authorized where it merely interprets and actually clarifies a statutory definition.

## RECOMMENDATIONS:

1. The Board of Trustees should review its eligibility policies to assure consistency with statutes.
2. The Board of Trustees should propose legislation to achieve the strict eligibility requirements it desires.

## ROLE OF THE PROGRAM ADMINISTRATION COMPANY

The program administration company (or program administrator) is the Public Employees Benefit Services Corporation of Kentucky (PEBSCO-Kentucky), a wholly owned subsidiary of the Public Employees Benefit Services Corporation (PEBSCO), a Delaware corporation having its main offices at Oklahoma City, Oklahoma. PEBSCO-Kentucky is, by written agreement with the Board of Trustees, the exclusive program coordinator (administrator) of the program. PEBSCO-Kentucky is paid according to separate agency agreements (contracts) with Kentucky Central Life Insurance Company and Nationwide Insurance Company. (Participants pay sales charges to the insurance companies, which in turn pay commissions to PEBSCO-Kentucky.)

The program administration agreement requires that PEBSCO-Kentucky provide seven basic services to the deferred compensation program.

1. Assist the Board of Trustees in preparing the Deferred Compensation Plan and its attendant agreements, together with appropriate requests for rulings, so that all documents meet the requirements of Kentucky law, the Internal Revenue Code, Securities Exchange Commission regulations and U. S. Department of Health, Education and Welfare regulations.

2. Assist the Board of Trustees in preparing bid specifications for insurance and annuity contracts and assist the Board in reviewing bids received.
3. Review from time to time and provide pertinent information to the Board concerning the performance of insurance and annuity contracts.
4. Consult with and advise the Board of Trustees and appropriate staff of the Department of Finance and Department of Personnel in developing computer software systems and other management systems.
5. Provide reports to all participants, as well as appropriate summaries to the Board of Trustees which detail the deferred amounts collected and the values and coverages obtained and remaining.
6. Interview personally all eligible employees and explain the advantages of the system (that is, promote and market the products offered by the Deferred Compensation System).
7. Recommend procedures to install and maintain a comprehensive method of audits and controls to assure the system's fiscal integrity.

The Deferred Compensation System was duly established and appropriate favorable rulings obtained by PEBSCO's and PEBSCO-Kentucky's assistance. PEBSCO-Kentucky assisted in preparing bid specifications, but the task of reviewing bids received was assumed and performed by the Kentucky Department of Insurance. Issues concerning data processing assistance and account statements are addressed elsewhere in this report. Issues concerning periodic review of products and development of system audits and controls were not addressed by this study.<sup>2</sup> PEBSCO-Kentucky's performance in promoting and marketing the plan is addressed below.

Program review staff did visit the PEBSCO offices in Oklahoma City. They observed an operation of substantial size which seemed to be well-organized and smoothly running. PEBSCO personnel seemed to be quite knowledgeable concerning their operations and their client accounts.

A survey of a randomly selected sample of state employees was made to evaluate the quality of PEBSCO-Kentucky's marketing and promotion activities. The sample consisted of approximately one percent of all permanent full-time and permanent part-time state employees, excluding seasonal, temporary, emergency and federally funded, time-limited employees. (This selection coincides with the eligibility policy adopted by the Board of Trustees.) Four hundred twenty-seven survey forms were mailed, of which 170 usable responses were returned.<sup>3</sup> Public school system employees were not surveyed because very few are enrolled. The survey questionnaire was used to answer the following questions regarding PEBSCO-Kentucky's plan marketing and promotion and performance.

1. Has PEBSCO-Kentucky explained the Deferred Compensation System to a significant percentage (all) of state employees?

2. Has PEBSCO-Kentucky explained the DCS to all eligible employees, including those outside the Frankfort area?
3. Has PEBSCO-Kentucky explained all of the available DCS investment and insurance options to potential participants?
4. Of employees who have had the plan explained to them was it explained to them by the program administrator or by another party?

A copy of the survey form is included here as Exhibit 3.

Not all respondents answered all questions. Several respondents answered that they had or had not had the DCS program explained to them but did not answer the questions whether they had received explanations of the specific options. For example, 170 persons answered that they had or had not had the DCS explained to them -- 73 had; 97 had not -- but only 157 responded to the question whether the fixed annuity option had been explained to them. Responses are summarized in Table 2. The N beside each question indicates the number of respondents answering the given question.

Of 167 respondents, 89 (52 percent) had heard of the Public Employees Deferred Compensation System. Sixty (35 percent) had heard of PEBSCO. Twenty-nine respondents (17 percent) participate in the DCS program. Of these, 16 participate in the fixed annuity option, 1 in the variable annuity option, 5 in the life insurance option, and 2 in the disability income insurance option; 5 indicated that they did not know in which option they were enrolled.<sup>4</sup>

Seventy-three respondents (42 percent) have had the program explained to them; 97 have not. Of those who have had the DCS explained to them, 39 were contacted by PEBSCO (or Davenport-Dillard, the predecessor corporation of PEBSCO) representatives, 10 learned of the program through Department of Personnel staff or publications, 7 from an insurance company,<sup>5</sup> and 7 either from others (e.g., co-workers) or they could not recall who contacted them.

Of the 73 who had the program explained to them, 61 had the fixed annuity explained, 56 received an explanation of the variable annuity, 66 received an explanation of the life insurance option, and 53 received an explanation of the disability income insurance option.

Because of the low response rate to the questionnaire, a firm conclusion regarding the question whether high-salaried personnel received explanations of DCS more often than low-salaried employees is not possible. However, casual observation indicates that a higher proportion of high-salaried than of low-salaried employees have received explanations of the program.

Geographically, three counties were more heavily represented among respondents than others: Franklin County yielded 74 respondents, Jefferson County 14 and Warren County 10. The other 44 counties from which responses were received yielded a total of 70 responses. Far more respondents in the three most represented counties had heard of DCS than in the other forty-four counties: 63 percent vs. 40 percent. More respondents in the three counties had heard of PEBSCO: 41 percent vs. 30 percent. Slightly more respondents in the three counties are participants in the deferred compensation program: 19 percent vs. 16 percent.

EXHIBIT 3

DEFERRED COMPENSATION SYSTEM STUDY SURVEY FORM


Dear State Employee:

The Committee for Program Review and Investigation is studying the Kentucky Public Employees Deferred Compensation System (DCS) including the functions of the program administration company, PEBSCO.

Please help us in this study by completing the following questionnaire. Your response will be of great value to us in completing a report for the Committee.

Individual names will not be included in the report.

Thank you very much for your help.



Gaynelle R. Trevino  
Senior Program Analyst  
Legislative Research Commission  
502-564-8100, Ext. 566

1. Your Name \_\_\_\_\_
2. Your Job Title \_\_\_\_\_
3. County where your work station (or main work station) is located \_\_\_\_\_
4. How long have you been an employee of the Commonwealth? \_\_\_\_\_ Years
5. If your employment has not been continuous, please show how long your current period of employment has been \_\_\_\_\_ Years
6. Have you heard of the Public Employees Deferred Compensation System (DCS)? \_\_\_\_ Yes \_\_\_\_ No
7. Have you heard of the Public Employees Benefit Services Corporation (PEBSCO)? \_\_\_\_ Yes \_\_\_\_ No
8. Are you enrolled / a participant in the DCS? \_\_\_\_ Yes \_\_\_\_ No

*If your answer to question 8 is YES, please answer question 9. If your answer to question 8 is NO, please skip to question 10.*

9. There are four investment plans available through the DCS. Please indicate with an "X" which of the four you participate in:  

Fixed Annuity	_____
Variable Annuity	_____
Life Insurance	_____
Disability Income Insurance	_____
Do Not Know	_____
10. Has the Deferred Compensation System been explained to you? \_\_\_\_ Yes \_\_\_\_ No

11. There are four plans available in the DCS. Please check whether each has been explained to you.

	Has Been Explained To Me	Has Not Been Explained To Me
Fixed Annuity	_____	_____
Variable Annuity	_____	_____
Life Insurance	_____	_____
Disability Income Insurance	_____	_____

IF YOU HAVE NOT BEEN CONTACTED TO HAVE THE DCS PROGRAM EXPLAINED TO YOU, you do not need to answer the remaining questions (12 through 14). Please skip to question 15.

IF YOU HAVE BEEN CONTACTED TO HAVE THE DCS PROGRAM EXPLAINED TO YOU, please answer questions 12 through 15.

12. By whom were you contacted? (Please check all that apply.)

Department of Personnel Staff \_\_\_\_\_  
Representatives or Salespersons of PEBSCO \_\_\_\_\_  
(or Davenport-Dillard of Kentucky) \_\_\_\_\_  
Insurance Company \_\_\_\_\_  
Other \_\_\_\_\_

13. Did you ask for the program to be explained to you? \_\_\_\_\_ Yes \_\_\_\_\_ No

14. Was the program explained to you in a group presentation or an individual presentation?  
\_\_\_\_\_ Group \_\_\_\_\_ Individual

15. This space for your comments:

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TABLE 2  
SUMMARY OF DEFERRED COMPENSATION  
SYSTEM SURVEY RESPONSES

	<u>YES</u>		<u>NO</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
1. Have you heard of the Public Employees Deferred Compensation System? (N = 167)	89	53%	78	47%
2. Have you heard of PEBSCO? (N = 162)	60	37%	102	63%
3. Are you enrolled in the DCS? (N = 166)	29	17%	137	83%
4. Have you had the DCS program explained to you? (N = 170)	73	43%	97	57%

Source: Committee for Program Review and Investigation survey of  
randomly selected eligible employees, 1979.

Because of the relatively low response rate, it is difficult to draw firm statistical conclusions whether these differences are significant. However, it appears that PEBSCO-Kentucky may have devoted more effort to contacting state employees in areas where they are concentrated geographically (Franklin, Jefferson and Warren Counties) than in other areas. The program administration agreement between the Board of Trustees and PEBSCO-Kentucky does provide that PEBSCO-Kentucky shall market, promote and explain the DCS program to all eligible state employees.

#### RECOMMENDATION:

The Board of Trustees should monitor the program administrator's marketing and promotion activities on a regular basis to assure that all eligible employees have the program explained to them and receive an opportunity to participate.

#### STATE COMPUTER SERVICES

The Personal Services Contract Review Subcommittee questioned a computer services contract which the DCS board had with PEBSCO. The contract provided for payroll collection and reconciliation services which had not been anticipated at the time the system had been established and the administrative agreement had been made between the Board of Trustees and PEBSCO. The Bureau of Computer Services had estimated that development of a package would cost about \$50,000, and that annual operating expenditures of about \$15,000 should be expected for a system developed internally. As a result of the subcommittee's consideration, the contract was reduced from \$50,000 and a \$3.00 charge for each participant, to \$21,600 and a \$3.00 charge for each participant. The contract expired June 30, 1979.

The Bureau of Computer Services provides no services to the DCS. This is evidenced by the manual processing of detailed data from a computer-payroll deduction run to another computer for statement purposes.

#### RECOMMENDATION:

The Board of Trustees should request that the Bureau of Computer Services evaluate services for the DCS as a part of the review of employe jobs and procedures.



## FOOTNOTES

1. It is not immediately apparent what this yield figure represents. It is not a compound annual interest rate earned by the funds.
2. PEBSO has advised the Board of Trustees to have audits conducted and has helped to obtain the carriers' agreement to pay for an audit.
3. Other survey forms were returned but were unusable because employees had left state employment or did not answer questions for other reasons, and because of inconsistent answers.
4. Several respondents indicated that they were enrolled but did not respond as to which option(s) they had chosen.
5. These responses are most likely erroneous. To the best of our knowledge, neither carrier ever sent representatives to present the plan to state employees. Further, in our best judgment, these respondents have probably confused PEBSO or Davenport-Dillard employees with insurance company representatives.





APPENDIX A

COMMONWEALTH OF KENTUCKY  
OFFICE OF THE ATTORNEY GENERAL  
FRANKFORT

ROBERT F. STEPHENS  
ATTORNEY GENERAL

March 8, 1979

CHARLES W. RUNYAN  
ASSISTANT DEPUTY ATTORNEY GENERAL

Mrs. Frances Jones Mills  
State Treasurer  
Capitol Annex  
Frankfort, Kentucky 40601

**OAG 79 206**

Dear Mrs. Mills:

The Treasury Department is considering the possibility of conducting a pilot program for the direct deposit of funds into the bank accounts of certain persons who receive benefit payments from the state of Kentucky. We assume you mean retired state employees. The transfer of funds will be effected electronically from the state depository bank to the payee's designated institution. In this type of transfer no check will be issued by the state treasurer. By the electronic transfer the recipient's institutional deposit account will receive a credit to the recipient's account reflecting the precise amount of money value being so electronically transferred.

You request an official opinion of this office concerning the state treasurer's authority to pay out funds in this manner.

Clearly a warrant document has to be prepared by the department pursuant to KRS 41.110, 41.120 and 41.130. KRS 41.120 states that all claims against the state shall be paid by the treasurer on the warrants of the Department of Finance. KRS 41.130 specifies the data to be included in the warrant document.

Mrs. Frances Jones Mills  
Page 2.

Once the warrant documents are prepared by Finance and submitted to the state treasurer, KRS 41.150 requires the treasurer to accept the warrant documents "and issue his [or her] check on a state depository bank in payment therefor. . ." (Emphasis added). KRS 41.150(2) requires the treasurer to maintain a "check register" that shall show "all checks issued", name of payee, etc. (Emphasis added).

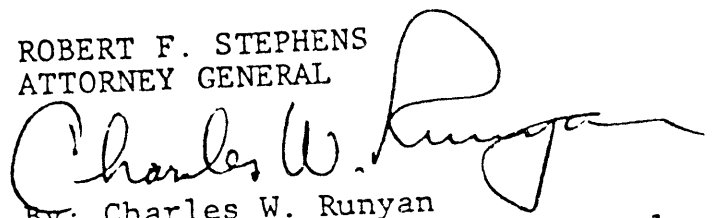
KRS 41.160 provides in part that "no money shall be paid out of the treasury except by the check of the treasurer upon a state depository." (Emphasis added). See *Gibony v. Commonwealth, Ky.*, 91 S.W. 732 (1906) 733, holding that the mailing of the check of the treasurer upon a designated state depository constituted payment to him of the amount specified therein. Note KRS 337.070, which requires all employers who employ 10 or more and who pay by check, making deductions from salaries, to specifically state the amount for which the deductions are made and the general purpose of the deductions.

The payment of salaries underwent through the years an evolution from cash to the paycheck. Now there is a national interest in the latest step in this evolutionary process of the monetary system, i.e., banking paychecks electronically. However, it is our opinion that the electronic transfer of funds from the state treasury cannot be legally done under the present statutes. Action of the General Assembly will be necessary to authorize this kind of transfer.

Under the explicit language of KRS 41.160, the check is presently the exclusive device for transferring money out of the state treasury. An ordinary "check" is an unconditional promise to pay a sum certain, taking the form of a written document or negotiable instrument. See *Pikeville Nat. Bank & Trust Co. v. Shirley*, 281 Ky. 150, 135 S.W.2d 426 (1940) 431; and KRS 355.3-104.

Sincerely,

ROBERT F. STEPHENS  
ATTORNEY GENERAL



By: Charles W. Runyan  
Assistant Deputy Attorney General

CWR:sb

APPENDIX B  
STATE OF KENTUCKY

PUBLIC EMPLOYEES DEFERRED COMPENSATION PLAN

THE STATE OF KENTUCKY ("EMPLOYER"), hereby establishes the Kentucky Public Employees Deferred Compensation Plan, (hereinafter called "The Plan"). The Plan consists of the provisions set forth in this document, and is applicable to each employee who adopts the Plan. The Plan is effective as to each such employee upon the date he signs the Participation Agreement referred to herein.

ARTICLE I

Definitions

1.01. A definition of words and terms used in this Plan is attached, entitled Exhibit "A", and by this reference is made a part of the Plan.

ARTICLE II

Election to Defer Unearned Compensation

2.01. Each EMPLOYEE shall have the option to participate under the Plan by signing and filing a Participation Agreement within thirty days after first being offered by personal interview an opportunity to participate in the Plan. By such signing the EMPLOYEE consents to the EMPLOYER deferring the amount specified in the Participation Agreement from the EMPLOYEE'S gross compensation for each month commencing after 30 days from the date of his signing and filing a Participation Agreement with the Trustees. The dollar amount deferred ("deferred amount") must equal at least \$10.00 per month, and shall be retained by the EMPLOYER.

2.02. (a) The election of the EMPLOYEE to participate under this Plan, the amount of compensation he elects to have deferred and his investment specification are irrevocable. However, the EMPLOYEE may terminate his election to participate and may amend the amount of compensation to be deferred or his investment specification, by signing and filing with the Trustees a written termination or amendment, on a form approved by the Trustees. Any such termination or amendment shall be effective prospectively only, from and after the next following January 1. Such termination or amendment must be made and filed with the Trustees on or before the preceding November 30, and may be made only once in any calendar year.

(b) Notwithstanding the provisions of Paragraph 2.02(a), upon approval by the Trustees of an EMPLOYEE'S application for withdrawal on account of financial hardship as defined in Paragraph 5.02, the EMPLOYEE may revoke his election to participate or may amend the amount of compensation to be deferred.

2.03. Any person who becomes an EMPLOYEE after the announcement that the Plan is open for participation shall have the option, within thirty days after first being offered by personal interview an opportunity to participate in the Plan, to effect an initial election to participate under this Plan for each month commencing after 30 days from the date of his signing and filing a Participation Agreement with the Trustees. Any such EMPLOYEE who does not file such an initial election or any EMPLOYEE who elects to participate after filing a termination pursuant to Paragraph 2.02 hereof, may subsequently participate under this Plan for each month commencing on or after the first day in a Plan year (January 1) only by signing and filing with the Trustees a Participation Agreement on or before November 30 of the preceding year. However, should an EMPLOYEE elect to participate after a termination, the rights, benefits, and deferred amounts accruing prior to such termination will not be merged in any way with the EMPLOYEE'S rights, benefits, and deferred amounts accruing after such election to participate, but such EMPLOYEE will be given a new account number upon such election for deferred amounts subsequently accruing.

### ARTICLE III

#### Investment, Amount and Report

3.01. The EMPLOYER shall remit the deferred amount after the end of each month to the Trustees of the Plan in accordance with the terms of the revocable Trust Indenture created simultaneously with and as part of this Plan for the purpose of facilitating the administration, investment and maintenance of accounts of record of all participating EMPLOYEES.

3.02. All contracts and other evidences of the investment or other application of all assets under this Plan shall be owned by and registered in the name of Trust, on behalf of the EMPLOYER. However, the Trustees shall provide for a separate account ("deferred account") as to each EMPLOYEE that reflects the monies deferred, any investment or other application of the monies and all consequences of the investment or other application thereof.

3.03. The EMPLOYEE'S deferred account shall be credited monthly with the amount deferred from the preceding month. A report of the total credit amount in the EMPLOYEE'S deferred account shall be furnished to the EMPLOYEE not less frequently than sixty (60) days after the end of each quarter of a calendar year.

3.04. All interest, dividends, charges for premiums, benefits payable under policies of insurance or annuities, and capital or market changes applicable to each EMPLOYEE'S deferred account shall be reflected in each quarterly report. Credits to the EMPLOYEE'S

account shall be subject to the EMPLOYEE'S then effective investment specification. All reports to the EMPLOYEE shall be based on the net fair market value of the assets of the deferred account as of the quarterly valuation date as if the deferred amount had been invested according to the investment specification.

3.05. All assets of this Plan, including all deferred amounts, shall be the property solely of the EMPLOYER and shall be subject to all the claims of creditors of the EMPLOYER, cognizable at law or in equity, without protection or preference. For convenience, and to facilitate an orderly administration of the Plan, individual deferred accounts for all EMPLOYEES will be provided for by the TRUSTEES showing the EMPLOYEE'S name and other identifying nomenclature together with appropriate debit and credit balances but all assets of the Plan shall be the exclusive property of the EMPLOYER.

3.06. The rights of the EMPLOYEE created by this Plan shall be that of a general creditor of the EMPLOYER only and in an amount equal to the fair market value of the deferred account maintained with respect to the EMPLOYEE, determined as if the deferred amounts had been invested pursuant to the EMPLOYEE'S investment specification. The EMPLOYEE acknowledges that his rights are no greater than those of a general creditor of the EMPLOYER and that in any suit for an accounting, to impose a constructive Trust, or to recover any sum under this Plan, shall be adjudged solely on the basis that the extent of the EMPLOYEE'S rights are limited to those of a general creditor of the EMPLOYER. The EMPLOYER acknowledges that the Trustees of the Plan are the agents of the EMPLOYER and the EMPLOYER is the creator and beneficiary of the revocable Trust created to facilitate the orderly administration of this Plan.

#### ARTICLE IV

##### Investment of Deferred Amounts and Credit Balance

4.01. The deferred amount shall be delivered or credited by the EMPLOYER to the Trustees who shall hold such amount to be paid to the EMPLOYEE pursuant to Article V, as if such amounts were invested in such investments as are deemed appropriate by the Trustees, including but not limited to insurance or annuity contracts, and which have been specified by the EMPLOYEE in the Participation Agreement which he signs and files with the Trustees in accordance with Paragraph 2.02 hereof.

4.02. All such investment options must be offered by such persons, companies, or entities authorized and duly licensed by the State of Kentucky and applicable federal regulatory agencies to offer such insurance or investment programs.

4.03. The EMPLOYEE'S investment specification shall only require the EMPLOYER to use such specification as an index for

determining the benefits to be paid pursuant to Article V. The EMPLOYER shall be under no obligation to invest the deferred amount in the manner specified.

## ARTICLE V

### Benefits

5.01. The EMPLOYEE is entitled to have paid to him the benefits created by his participating in this Deferred Compensation Plan, in accordance with the provisions of this Article. The benefits payable to the EMPLOYEE will be the equivalent of the total benefits that would have been created had the deferred amounts been invested as specified by the EMPLOYEE taking into consideration losses and gains where applicable.

(a) Normal Retirement. Upon the EMPLOYEE attaining normal retirement age, he may retire and receive the benefits provided under this Plan. Such benefits shall be paid in accordance with the payment options 1, 2, 3, 4 or 5 as selected by the EMPLOYEE pursuant to Paragraph 5.01(i) of this Plan. Any credits remaining in the deferred account of an EMPLOYEE receiving benefits under this paragraph who dies, shall be paid in accordance with paragraph 5.01 (f) hereof.

(b) Early Retirement. The EMPLOYEE may select early retirement in accordance with the Retirement Laws of Kentucky. Such benefits shall be paid in accordance with the payment options selected by the EMPLOYEE pursuant to Paragraph 5.01 (a) and (i) of this Plan. Any credits remaining in the deferred account of an EMPLOYEE receiving benefits under this paragraph who dies, shall be paid in accordance with Paragraph 5.01 (f) hereof.

(c) Late Retirement. If the EMPLOYEE continues his employment with the EMPLOYER after attaining normal retirement age, all benefits payable under this Plan will be deferred whether or not the EMPLOYEE continues to defer additional sums under this Plan, until the EMPLOYEE retires. At such time such benefits shall be paid in accordance with the payment options selected by the EMPLOYEE pursuant to Paragraph 5.01 (a) and (i) of this Plan. Any credits remaining in the deferred account of an EMPLOYEE receiving benefits under this paragraph who dies, shall be paid in accordance with Paragraph 5.01 (f) hereof.

(d) Disability. If prior to retiring, the EMPLOYEE becomes disabled as defined by the provisions of any applicable insurance or annuity contract, which may be purchased by the EMPLOYER to discharge its obligation under this Plan, or in the absence of such provisions as defined herein, the Trustees shall:

(1) Maintain any insurance or annuity contracts in force under the provisions for premium waiver, if such

provision has been included in the contracts and pay the benefits provided (other than any benefits to be paid as if life insurance contracts or disability income insurance contracts had been purchased) in accordance with payment option 1 as selected by the EMPLOYEE pursuant to paragraph 5.01(i) of this Plan.

(2) Exercise the nonforfeiture provisions of any insurance or annuity contract if no waiver of premium provision has been included, and pay any benefits provided and all other credits if any in the EMPLOYEE'S deferred account in accordance with payment option 1 as selected by the EMPLOYEE pursuant to Paragraph 5.01(i) of this Plan.

(3) If the EMPLOYEE has specified that amounts be paid as if such amounts were invested in disability income insurance contracts, pay (in equal payments during the disability of the employee) such benefits as would be provided if such amounts had been so invested.

(e) Termination of Employment. If the EMPLOYEE terminates his employment with the EMPLOYER (without being disabled or retiring) the benefits, except benefits payable pursuant to a life insurance or disability income insurance specification, shall be paid in accordance with payment option 1 or 2 as selected by the EMPLOYEE pursuant to Paragraph 5.01(i) of this Plan. Upon such termination of employment, benefits payable pursuant to any life insurance or disability income insurance specification are to be paid in a lump sum in cash or in kind as selected by the EMPLOYEE at the time of his election to participate in this Plan.

(f) Death

(1) Before Benefits are Paid for Retirement, Disability or Termination of Service.

If the EMPLOYEE dies while employed with the EMPLOYER and before retirement and without disability or termination of service benefits being paid to him under this Plan, except for benefits payable pursuant to any life insurance or disability income insurance specification, the benefits otherwise payable under this Plan shall be paid to his designated beneficiary pursuant to payment option 1, 2, 3, or 4 as selected by the EMPLOYEE pursuant to Paragraph 5.01(i) of this Plan.

(2) After Benefits are Being Paid for Retirement, Disability or Termination of Service.

If the EMPLOYEE dies while benefits are being paid to him under this Plan pursuant to payment option 1 or 4 and before such benefits have been exhausted, then the remaining benefits payable, other than benefits payable pursuant to any life insurance or disability income insurance specification, shall be paid to the EMPLOYEE'S designated beneficiary in accordance with Paragraph 5.01(f) (5).

(3) Plan Completion Benefits.

Upon the death of the EMPLOYEE, benefits payable pursuant to any life insurance specification shall be paid to the EMPLOYEE'S designated beneficiary pursuant to the payment option elected in accordance with Paragraph 5.01(f)(1), except that any monthly family income benefit payments which are payable until the year the EMPLOYEE would have attained 65 years of age are to be delivered or credited by the EMPLOYER to the Trustees who shall hold such amount to be paid to the designated beneficiary as if such amount were invested in those investment specifications, other than life insurance, selected by the EMPLOYEE pursuant to Paragraph 4.01. Where such amounts are to be so delivered or credited, all benefits payable (other than any lump sum payment pursuant to any life insurance specification) are to begin when payments of benefits would have begun if the EMPLOYEE were not deceased and were to retire upon attaining 65 years of age.

(4) Family Income Benefit.

Upon the death of the EMPLOYEE, benefits payable pursuant to any life insurance specification shall be paid to the EMPLOYEE'S designated beneficiary pursuant to the payment option designated in accordance with Paragraph 5.01(f)(1) plus any monthly family income benefit payments to the designated beneficiary for the term of 10, 15, or 20 years from the year such life insurance specification is effected as specified in the Participation Agreement which the EMPLOYEE signs and files at the time of his election to participate in the Plan.

(5) Designated Beneficiary.

The EMPLOYEE has the right to name and file with the Trustees of the Plan, a written beneficiary or change of beneficiary form, designating the person or persons who shall receive the benefits payable under this Plan in the event of the EMPLOYEE'S death. The form for this purpose shall be provided by the Trustees. It is not binding on the Trustees or the EMPLOYER until it is signed, filed with the Trustees by the EMPLOYEE, and accepted by the Trustees. If the EMPLOYEE dies without having a beneficiary form completed and on file, the payments shall be made to the properly appointed fiduciary of the EMPLOYEE'S probate estate. However, if a fiduciary has not been appointed and qualified within 30 days after the death, the payment may be made first, to a surviving spouse, second, to a surviving child or children, and third, to a surviving parent or parents. The EMPLOYEE accepts and acknowledges that he has the burden for executing and filing, with the Trustees, a proper beneficiary designation form.

(g) Commencement of Payment. The payment of benefits shall begin as soon as possible but in no event later than the first day of the month next following forty-five (45) days after the occurrence of the event that gives rise to the beginning of the payment of benefits.

(h) Short Term or Lump Sum Settlement. Notwithstanding anything in this Article to the contrary, if at any time the amounts held under this Plan in the account maintained for the EMPLOYEE, or his beneficiary, total to a credit of \$5,000.00 or less and for any reason the EMPLOYEE has ceased to be an EMPLOYEE of the EMPLOYER, the Trustees are authorized to deviate from the restrictions imposed by the paragraphs in this Article and effect a lump sum settlement.

(i) Options. The following options are available for selection by the EMPLOYEE. If, at the time of his election to participate in the Plan, the EMPLOYEE fails to select a payment option with regard to any investment specification for any event which causes payment of benefits to begin, he shall be deemed to have elected to have the benefits payable upon occurrence of such event as if he had elected the 10% payout available in payment option 1.

#### A. Payment Options

As provided in Paragraphs 5.01(a)-(f), the EMPLOYEE may elect with regard to each investment specification, the following options from the Plan:

Option 1. -- Payment of an equal percentage of the the deferred account each year. Payment of fixed amounts until exhaustion of the EMPLOYEE'S deferred account. Payments made each year will be equal to 10%, 15% or 20% of the credit balance of the EMPLOYEE'S deferred account at the time payments commence as elected by the EMPLOYEE.

Option 2. -- Lump sum payment. The total benefits payable in one cash payment.

Option 3. -- Life annuity -- An annuity payable during the lifetime of the EMPLOYEE or his beneficiary if this option is selected under Paragraph 5.01(f).

Option 4. -- Life annuity with period certain guaranteed. An annuity payable during the lifetime of the EMPLOYEE, or his beneficiary if this option is selected under Paragraph 5.01(f), with the guarantee that if at his death payments have not been made for the guaranteed period as elected, payments will continue to the beneficiary. The guaranteed period to be elected must be either 10, 15 or 20 years.

Option 5. -- Joint and Survivor annuity -- An annuity payable during the lifetime of the EMPLOYEE and the EMPLOYEE'S designated beneficiary.

#### B. Method of Payment Options

If the EMPLOYEE has elected a payment option requiring installment payments, the EMPLOYEE may also elect to have such payments made either monthly, quarterly, semi-annually or annually.

### C. Payment Upon Termination of Employment

The EMPLOYEE may elect, in the event of termination pursuant to Paragraph 5.01(e), to have payment of benefits begin at the time of termination or deferred until the EMPLOYEE reaches normal retirement age.

5.02. Notwithstanding any other provisions herein, for "financial hardship," an EMPLOYEE may apply to the Trustees to withdraw from the Plan prior to retirement or any other termination of his employment with the EMPLOYER. If the application for withdrawal is approved by the Trustees, the withdrawal shall be effected as of the first day of the month next following such approval being given. The amount paid would be limited strictly to that amount necessary to meet the emergency situation. Any remaining benefits would be paid upon retirement, termination of employment, disability or death in accordance with Paragraph 5.01. "Financial hardship" shall be limited to real emergencies which are beyond the EMPLOYEE'S control and which would cause the EMPLOYEE great hardship if early withdrawal were not permitted. For example "financial hardship" could include the following: impending personal bankruptcy; unexpected and unreimbursed major expenses resulting from illness or accident of the EMPLOYEE or any dependent thereof; major property loss or any other type of unexpected or unreimbursed personal expense of a major nature that would not normally be budgetable. Foreseeable personal expenditures normally budgetable, such as a down payment for a home, the purchase of an automobile, college or other schooling expenses, etc., will not constitute a "financial hardship." The decision of the Trustees concerning "financial hardship" shall be final as to all EMPLOYEES.

## ARTICLE VI

### Administration of Plan

6.01. The EMPLOYER may at any time amend, modify or terminate this Plan with or without the consent of the EMPLOYEE (or any beneficiary thereof). However:

(a) All amendments shall become effective on the first day of the month following the giving of not less than forty-five days prior notice of the amendment. Notice shall be deemed given when the the amendment is posted in the office of the Trustees. To the extent it is possible to do so, the Trustees shall mail a copy of all amendments that become effective during the quarter to the EMPLOYEE with his quarterly report. No amendments shall deprive the EMPLOYEE of any of the benefits to which he is entitled under this Plan with respect to deferred credits accrued to his account prior to the effective date of the amendments; and

(b) If the Plan is curtailed, terminated, or the acceptance of additional deferred amounts suspended permanently, the Trustees shall nonetheless be responsible for the supervision and the payment of benefits in accordance with Article V hereof.

6.02. Any companies that may issue the policies, contracts or other investment media used by the EMPLOYER or specified by the EMPLOYEE are not parties to the Plan and such companies shall have no responsibility or accountability to the EMPLOYEE or his beneficiary with regard to the operation of this Plan.

6.03 The entering into this Agreement by the EMPLOYER and the EMPLOYEE shall not be construed to give a contract of employment to the EMPLOYEE or to alter or amend an existing employment contract of the EMPLOYEE, if in fact one exists, nor shall the entering into this Plan be construed as affording to the EMPLOYEE any representation or guarantee regarding his continued employment.

6.04 The EMPLOYER and the Trustees do not and cannot represent or guarantee that any particular Federal or State income, payroll, personal property or other tax consequence or result will occur because of the EMPLOYEE'S participation in this Plan. The EMPLOYER will at the outset file this Plan with the Internal Revenue Service for the purpose of obtaining a ruling regarding the tax consequences of the Plan. The EMPLOYEE may consider the ruling but in the final analysis should consult with his own representative regarding all questions of any Federal or State income, payroll, personal property or other tax consequences to him arising from his adoption or participation in this Plan.

6.05. Whenever used herein, the masculine gender includes the feminine and the singular includes the plural unless the provisions of the contract specifically require a differing construction.

6.06. The law of the State of Kentucky shall apply in determining the construction and validity of this Plan and all rights and obligations under it.

6.07. Except as otherwise required by law, the rights of the EMPLOYEE (including any compensation deferred or benefits paid) under this Plan shall not be subject to the rights of creditors of the EMPLOYEE or any beneficiary, and shall be exempt from execution, attachment, garnishment, prior assignment, transfer by operation of law in the event of bankruptcy or insolvency, or any other judicial relief or order for creditors or other third persons.

6.08. This Plan alone, and the Participation Agreement executed pursuant to it, and any subsequently adopted amendment thereof, shall constitute the total agreement or contract between the EMPLOYER and the EMPLOYEE regarding the Plan. No oral statement regarding the Plan may be relied upon by the EMPLOYEE.

6.09. This Agreement and any properly adopted amendment, shall be binding on the parties hereto and their respective heirs, administrators, trustees, successors and assigns and on all designated beneficiaries of the EMPLOYEE.

## ARTICLE VII

### Notice to ALL EMPLOYEES to Read These Provisions Providing Broad Powers and Absolute Safeguards to the EMPLOYER

7.01. The EMPLOYER, or its authorized agents, the Trustees, are authorized to decide or to resolve any questions of fact regarding the EMPLOYEE or his deferred account needed or necessary to decide the EMPLOYEE'S rights under this Plan and such decision is final and binding on the EMPLOYEE and any beneficiary thereof.

7.02. The EMPLOYER, or its authorized agents, the Trustees, are authorized to construe the Plan and to resolve by its decision any ambiguity in the Plan providing that all such decisions are applied thereafter uniformly to all other participants in the Plan until the Plan is subsequently amended or unless the facts and circumstances applicable to another EMPLOYEE are substantially different.

7.03. The EMPLOYEE specifically understands and acknowledges that to the extent of any investment loss or other loss arising from the use of the EMPLOYEE'S investment specification as an index for measuring the benefits to be paid under this Plan, that the EMPLOYEE'S deferred account will be charged with the loss and that such loss will reduce the benefits payable to the EMPLOYEE under this Plan. The EMPLOYEE accepts this and all other investment risk of loss which is inherent in this Plan.

7.04. The EMPLOYEE specifically agrees not to seek recovery against the EMPLOYER, the Trustees or any other EMPLOYEE, contractee or agent of the EMPLOYER, or as against any other person having an administration or investment position relative to the Plan, for any loss, if any, sustained by the EMPLOYEE or his beneficiary, for the non-performance of their duties, negligence, or any other misconduct of the above named persons, except that this paragraph shall not excuse fraud or a wrongful taking by any person.

7.05. The EMPLOYER or its agents including the Trustees, if in doubt concerning the correctness of their action in making a payment of a benefit, may suspend the payment until satisfied as to the correctness of the payment or the person to receive the payment, or to allow the filing in any State court of competent jurisdiction, a suit in such form as they deem appropriate, including an interpleader action, for a legal determination of the benefits to be paid and the persons to receive them. The EMPLOYER shall comply with the final orders of the Court in any such suit, subject to its right to seek appellate review, and the EMPLOYEE, for himself and his beneficiary, consents to be similarly bound thereby insofar as it affects the benefits payable under this Plan or the method or manner of payment.

7.06. The EMPLOYER, or its agents, is hereby held harmless from all court costs and all claims for attorneys' fees arising from any action brought by the EMPLOYEE or any beneficiary thereof under this Agreement or to enforce his rights under this Plan, including any amendments hereof.

7.07. Neither the EMPLOYEE nor his beneficiary nor any other designee shall have any right to commute, sell, assign, encumber, hypothecate, transfer or otherwise convey the right to receive any payments hereunder which payments and right thereto are expressly declared to be nonassignable and nontransferable; and, any such assignment or transfer shall not be recognized by the EMPLOYER, and if made by the EMPLOYEE in writing shall be deemed to constitute a termination by the EMPLOYEE pursuant to Paragraph 5.01 (e) herein.

IN WITNESS WHEREOF, the undersigned have executed  
this Plan this \_\_\_\_\_ day of \_\_\_\_\_, 1974.

STATE OF KENTUCKY

(SEAL)

ATTEST:

\_\_\_\_\_  
Chairman

\_\_\_\_\_  
Vice Chairman

\_\_\_\_\_  
TRUSTEES:

\_\_\_\_\_  
Commissioner, Executive Dept. for  
Finance and Administration

\_\_\_\_\_  
Commissioner of Insurance

\_\_\_\_\_  
Commissioner of Personnel

## EXHIBIT "A"

### DEFINITIONS

The following terms shall, for purposes of this Plan have the meanings set forth in this Exhibit.

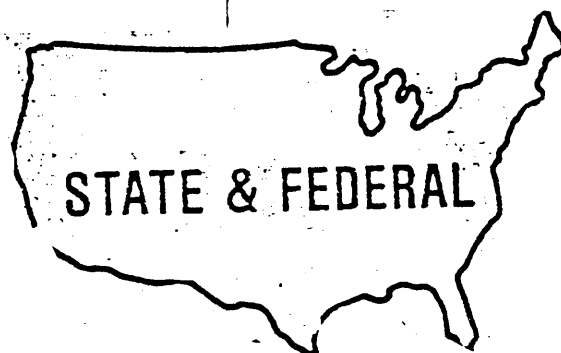
1. EMPLOYER means, the State of Kentucky.
2. EMPLOYEE means, a person holding an office or position of employment in the state government of Kentucky and agencies thereof, including persons in the public school system. "EMPLOYEE" shall not include emergency, temporary, seasonal, or probationary appointments within the state government of Kentucky, nor shall the term "EMPLOYEE" include part-time or temporary employees within the state institutions of higher learning and each public school system, which institutions and school systems shall apply their own policy or definitions in determining the scope of the terms "part-time" or "temporary." In no event shall employees who execute contracts for services be determined as "part-time" or "temporary" by such institutions or school systems.
3. COMPENSATION means all payments made to an EMPLOYEE by the EMPLOYER as remuneration for services rendered. It does not include reimbursement for expenses or the EMPLOYEE'S contribution to Social Security, any State Retirement System, or health insurance.
4. PLAN YEAR means, the calendar year in which the Plan becomes effective, and each succeeding calendar year during the existence of this Plan.
5. RETIREMENT DATE means the last day of the month in which the EMPLOYEE retires pursuant to the Retirement Laws of Kentucky.
6. NORMAL RETIREMENT AGE means the age at which the EMPLOYEE is entitled to retire with full benefits under the Retirement Laws of Kentucky by virtue of age, length of service, or both.
7. EARLY RETIREMENT AGE means the age at which the EMPLOYEE is entitled to retire with partial benefits under the Retirement Laws of Kentucky, by virtue of age, length of service, or both.
8. BENEFICIARY means the person properly designated by a participant to receive the participant's benefits created by this Plan.
9. TRUSTEES means the Board of Trustees of the Kentucky Public Employees Deferred Compensation Plan or members of the Administrative Council as provided for in the Trust Indenture establishing the Trust.
10. ASSET means any owned physical object or right having monetary value.

11. DISABILITY means the inability of the EMPLOYEE to engage in substantially all of the duties of his regular occupation, except that after continuous disability has existed to the EMPLOYEE'S 65th birthday, or for 24 months, if longer, then during the continuance of disability, Disability means the inability of the EMPLOYEE to engage in any gainful occupation in which he may reasonably be expected to perform because of education, training or experience, with due regard for vocation and economic status immediately prior to commencement of disability.

APPENDIX C

SUMMARY OF 1978 CHANGES IN INTERNAL REVENUE CODE  
AFFECTING DEFERRED COMPENSATION PLANS  
OF STATE AND LOCAL GOVERNMENTS

AMERICAN  
JURISPRUDENCE  
2d



FEDERAL TAXATION  
A COMPLETE ANALYSIS  
OF  
THE 1978 REVENUE ACT

¶ 866. Deferred compensation plans of state and local governments, and of rural electric cooperatives

In the past IRS has issued favorable private letter rulings with respect to unfunded deferred compensation plans under which employees of state and local governments were permitted to elect to defer a portion of salary that would otherwise be payable. The rulings allowed deferral of tax on deferred amounts.

Earlier this year, IRS issued proposed regs that would immediately tax compensation that could be deferred at the employee's individual election. (TC ¶ H-3511; TG ¶ 3172; FT ¶ 3172)

The Act blocks this IRS attempt to deny deferred compensation treatment in the case of option-type deferred compensation plans of state and local governments covering employees, or both employees and independent contractors performing personal services. The Act also gives the same advantage to option-type deferred compensation plans of tax-exempt rural electric cooperatives.

The new rules set forth certain tests that must be met but these rules do not apply until after '81 except that ceilings on the deferrable amounts apply after '78.

Liberal rule applies to taxable years beginning before '82. All option-type plans to which the new law applies (whether currently in existence or not) have until Jan. 1, '82 to satisfy the plan requirements for classification as an eligible state deferred compensation plan. But the ceiling limits that are imposed by the new provision apply for all taxable years beginning after '78. (H Rept p 58)

Thus, in the case of any taxable year beginning after '78 and before '82, the following transition rules apply.

(1) *Deferral.* Any amount of compensation deferred under a plan of a state providing for a deferral of compensation (other than plans listed below), and any income attributable to amounts so deferred, is includible in gross income only for the taxable year in which the deferred compensation is paid or otherwise made available to the participant or other beneficiary. ('78 Act § 131(c)(2)(A)(i))

These transition rules do not apply to qualified pension, etc., plans; that portion of any plan which consists of a transfer of property in connection with the performance of services; or that portion of any plan which consists of a nonexempt employee benefit trust.

(2) *Ceiling.* Except for the "catch up" provision, discussed below, the maximum amount of the compensation of any one individual that may be excluded from gross income under (1) above (and under the new law) for

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compensation deferred. This amount is then compared to the includible compensation for the taxable year to determine if the limitations on deferral have been satisfied for the taxable year. (H Rept p 58)

For most employee participants in the typical deferred compensation arrangement maintained by states or local governments, the compensation to be received for a typical year is fixed by statute or contract and the employee enters into a salary reduction agreement with the employer that will specify how much is to be deferred. In a typical arrangement, the 33⅓% of includible compensation limitation equals 25% of the salary that would be received except for the salary reduction agreement. For example, an employee who is scheduled to receive \$12,000 during a taxable year could enter into a salary reduction agreement and elect to defer \$3,000 (25% of gross compensation of \$12,000 and 33⅓% of includible compensation of \$9,000). (S Rept p 67)

In the case of an independent contractor who agrees to perform services during a taxable year in return for some compensation payable currently and additional compensation payable in a later year, a different rule applies. In this situation, as of the close of the taxable year, the present value of the right to receive the future payment or payments must be determined and compared to the includible compensation for the taxable year to decide whether the limitations on deferral have been satisfied. (H Rept p 58)

For example, a consultant may agree to provide services to a state for one year in return for current payment of \$25,000 plus payments of \$5,000 per year for an additional five years with the deferred payments to begin after a period of ten years. It is clear that includible compensation is \$25,000. The present value of the right to receive the additional \$5,000 a year for 5 years must also be fixed in order to determine whether the percentage limitation has been met. (S Rept p 67)

If future payments are subject to a substantial risk of forfeiture, they are not valued until there is no longer a substantial risk of forfeiture. At the close of the first taxable year in which the future payments are no longer subject to a substantial risk of forfeiture, the present value of these future payments is compared to the includible compensation for that taxable year to decide whether the deferral limitations have been met. (H Rept p 58)

(3) *Catch-up provision.* The plan may provide that, for one or more of the participant's last three taxable years ending before he attains normal retirement age under the plan, the ceiling on the amount deferrable is the lesser of (a) \$15,000, or (b) the sum of:

- (A) the plan ceiling established for the taxable year, *plus*
- (B) So much of the plan ceiling established for taxable years before the taxable year as has not heretofore been used. (Code Sec. 457(b)(3))

If no normal retirement age is specified by the plan, the catch-up

provision may be applied for the participant's last three taxable years ending before either the later of age 65 or the normal retirement age specified in any other retirement plan maintained by the sponsoring entity. (H Rept p 54)

The underutilized deferral limitation for a taxable year is the difference between the compensation actually includible in income for that year and the compensation that would have been includible in income if the maximum deferral limitation had been utilized. For example, an individual with a salary of \$20,000 who did not elect to defer any compensation has an underutilized deferral limitation of \$5,000 (\$20,000 — \$15,000 (includible compensation if the 33⅓% deferral limitation had been utilized)). In calculating the underutilized deferral limitation, the participant must use the actual plan limitations if they are less than the limitations provided by the Code. (H Rept p 54)

❖ *Illustration:* A 62-year old participant in a plan with a normal retirement age of 65 is scheduled to receive a salary of \$20,000 during the next taxable year. The prior years deferral limitations have been underutilized by at least \$10,000. The participant can elect to defer \$15,000 of next year's compensation. The regular limitation is \$5,000 ( $\$20,000 - \$5,000 = \$15,000 \div 3 = \$5,000$ ). The catch-up amount is \$10,000 ( $\$15,000 - \$5,000$ ).

(4) *Deferral agreement must be made before beginning of calendar month of deferral.* Compensation may be deferred for any calendar month only if an agreement providing for deferral has been entered into before the beginning of that calendar month of deferral. (Code Sec. 457(b)(4))

(5) *When benefits could be made available to participants or other beneficiaries.* The plan must not provide that amounts payable under the plan will be made available to participants or other beneficiaries earlier than when the participant is separated from service with the state or is faced with an unforeseeable emergency, determined in the manner prescribed by Treasury regs. (Code Sec. 457(b)(5))

Treasury regs will prescribe what constitutes "separation from service" for an independent contractor. (S Rept p 68)

An unforeseeable emergency does not include the purchase of a residence or the need for funds to send children to college. Also, the plan may permit the withdrawal of only the amount of funds reasonably needed to satisfy the emergency needs. (H Rept p 55)

(6) *Amounts deferred, etc., must remain the sponsor's assets subject to claims of general creditors.* The plan must provide that the following must

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TC References are to the Tax Coordinator  
 TG References are to the Tax Guide  
 FT References are to Am Jur 2d, Federal Taxation

remain solely the property and rights of the state (without being restricted to the provision of benefits under the plan) subject only to the claims of the state's general creditors until made available to the participant or other beneficiary:

- (a) all amounts of compensation deferred under the plan,
- (b) all property and rights to property (including rights as a beneficiary of life insurance protection) purchased with amounts of compensation deferred under the plan, and
- (c) all income attributable to these amounts, property or rights. (Code Sec. 457(b)(6); H Rept p 55) Gain from the disposition of property is treated as income attributable to the property. (Code Sec. 457(d)(8))

Thus, while the plan participants may select among any optional methods provided under the plan for investing amounts of deferred compensation, they cannot have any secured interest in the assets purchased with their deferred compensation. Moreover, the assets may not be segregated for the participants' benefit in any manner that would put the assets beyond the reach of the general creditors of the sponsoring entity. (H Rept p 55)

*Effect of failure to meet any of the six requirements.* A plan that is administered in a manner which is inconsistent with any of the six requirements above is treated as not meeting that requirement as of the first plan year beginning more than 180 days after the date of notification by IRS of the inconsistency unless the state corrects the inconsistency before the first day of the plan year beginning more than 180 days after the date of IRS notification. (Code Sec. 457(b))

*Individuals who are participants in more than one plan.* The maximum amount of compensation of any one individual which may be deferred for any taxable year cannot exceed \$7,500 as modified by the catch-up provision. (Code Sec. 457(c)(1))

The \$7,500 limitation (as well as the percentage limitation) applies at the individual level as well as at the plan level. Thus, if an individual participates in more than one eligible plan (whether or not maintained by the same sponsoring entity) he must designate how the \$7,500 limitation will be allocated among the various eligible plans in which he participates. If the \$7,500 limit is exceeded all excess amounts deferred for the taxable year will be includible currently in income. (H Rept p 56)

While excess deferrals under an eligible state deferred compensation plan are generally includible in income in the year of deferral, earnings credited on the deferred amounts are not subject to current taxation as long as the participant has no interest in the assets of the state or local government sponsoring the plan which is more secure than that of general creditors. Where the participant has no interest which is more secure than that of general creditors, earnings on excess deferred amounts under the plan are

not taxable to the participant until paid or otherwise made available. When paid or otherwise made available, the earnings on the excess deferred amounts will be taxed under the annuity rules. (H Rept p 57)

**Coordination with tax-sheltered (Sec. 403(b)) annuities.** An individual may participate in an eligible state deferred compensation plan and also have amounts contributed by an employer for the purchase of a tax-sheltered annuity or mutual funds held in a custodial account with part or all of these contributions being excludable under Code Sec. 403(b). (TC ¶ H-9500 *et seq.*; TG ¶ 5204; FT ¶ 5204) In this event, the contributions excludable under Code Sec. 403(b) would reduce both the \$7,500 and the 33⅓% of includible compensation limitations. (Code Sec. 457(c)(2); H Rept p 56)

¶ **Illustration:** A public school official with a contract salary of \$30,000 in her first year of service with the school system could be eligible to participate in both an eligible state deferred compensation plan and a tax-sheltered (Code Sec. 403(b)) annuity plan sponsored by her employer. Contributions to both plans are to come from salary reductions.

The public school official elects to participate in the tax-sheltered annuity plan to the maximum extent possible while also participating in the eligible state deferred compensation plan. She can elect to defer \$4,500 under Code Sec. 403(b) and \$3,000 under the eligible state deferred compensation plan.

The applicable limitations are computed as follows:

(1) Code Sec. 403(b) exclusion for the tax-sheltered annuity— $20\% \times \$22,500$  (includible compensation after reduction of contract salary for salary reductions deferred under both plans)  $\times 1$  (one year of service) = \$4,500. (There is no reduction under Code Sec. 403(b)(2)(A)(ii) for amounts contributed in prior years by the employer and excludable by the employee, since this is assumed to be the first year of service with the school system.)

(2) Code Sec. 457(b)(2) limitation (limitation on deferral under an eligible State deferred compensation plan) is \$3,000, which is the lesser of—

(a) \$7,500, or

(b)  $33\frac{1}{3}\% \times \$27,000$  (includible compensation after reduction of contract salary by deferral under the eligible State deferred compensation plan but before reduction for the exclusion under sec. 403(b)) = \$9,000.

(c) Lesser of \$7,500 or \$9,000 = \$7,500.

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(d) \$7,500, as determined under (c), reduced by the exclusion of \$4,500 under Code Sec. 403(b) = \$3,000.

For purposes of determining the exclusion allowance under Code Sec. 403(b), any amount deferred in a prior taxable year of the employee under an eligible state deferred compensation plan (without regard to the sponsoring entity) is treated as an amount contributed by the employer for annuity contracts and excluded by the employee, if the taxable year of deferral counts as a year of service in the computation of the exclusion under Code Sec. 403(b). (H Rept pp 56-57)

♥ *Illustration:* Assume that in year 2, the public school official in the *RIA illustration* (above) still had a contract salary of \$30,000 and elected to defer the maximum amount possible under a tax-sheltered annuity while not taking advantage of the deferral under an eligible state deferred compensation plan. The exclusion allowance under Code Sec. 403(b) would be \$3,214.28, computed as follows:

(a)  $20\% \times \$26,785.72$  (includible compensation) = \$5,357.14

(b)  $\times 2$  years of service = \$10,714.28

(c) less \$7,500 (\$4,500 excluded under Code Sec. 403(b) in the prior taxable year and \$3,000 deferred under an eligible State deferred compensation plan in the prior taxable year) (d) maximum exclusion allowance = \$3,214.28 (assuming no deferral under the eligible state deferred compensation plan in year 2).

Participants in an ineligible state deferred compensation plan. The rules discussed below apply only to an ineligible state deferred compensation plan that provides an option to defer compensation. These rules don't apply to a state's regular retirement plan (whether or not the plan is a qualified retirement plan) which does not provide an option to defer compensation. These rules would not apply to qualified plans; that portion of any plan which consists of a transfer of property in connection with the performance of services; or that portion of any plan which consists of a nonexempt employee benefit trust. (Code Sec. 457(e)(2); H Rept p 57)

If an option type state deferred compensation plan fails to meet the requirements of an "eligible" plan, all compensation deferred under the plan is includible in the gross income of the participant (or beneficiary) for the first taxable year in which there was no substantial risk of forfeiture of the rights to the compensation. (Code Sec. 457(e)(1)(A); H Rept p 57) The rights of a person are subject to a substantial risk of forfeiture if that person's rights to the compensation were conditioned on the future performance of services by any individual. (Code Sec. 457(e)(3)(B))

The tax treatment of any amount made available under the plan is determined under the rules relating to annuities, etc., in Code Sec. 72. (Code Sec. 457(e)(1)(B))

For purposes of applying the rules discussed above, the term "plan" includes any agreement or arrangement. (Code Sec. 457(e)(3)(A))

The Act "will not result in double taxation of income in the event that a plan becomes ineligible. For example, if an amount is set aside by the employer for an employee under a plan, and the amount set aside is taxed to the employee under section 83, the employee would not be taxed on that amount again if the plan becomes ineligible. Similarly, if an employee is taxed on compensation under an ineligible plan and an amount is subsequently set aside by the employer for the employee under the plan, the amount set aside would not be taxed again under section 83."

While amounts deferred under an ineligible state deferred compensation plan are generally includible in income in the year of deferral, earnings credited on the deferred amounts are not subject to current taxation as long as the participant has no interest in the assets of the state or local government sponsoring the plan which is more secure than that of general creditors. Where the participant has no interest which is more secure than that of general creditors, earnings on amounts deferred under the plan are not taxable to the participant until paid or otherwise made available. When paid or otherwise made available the earnings on the deferred amounts will be taxed under the annuity rules. (H Rept p 57)

□ Effective: Tax years beginning after '78. (§ 131(c)(1))

### Other employee plans

#### ¶ 870. Nondiscrimination rules imposed on medical reimbursement plans after '79

An important fringe benefit for employees (especially those who are high-salaried) is for the employer to agree to pay part or all of the uninsured medical expenses of the employee, his spouse and dependents. These payments are deductible by the employer and are specifically excluded from the employee's gross income if the amounts are received by the employee under accident and health insurance or under an accident and health plan and are paid by the employer (or attributable to employer contributions) to reimburse the employee for his medical expenses and those of his family. This income exclusion is an exception to the general rule which taxes employer-funded sickness and accident payments received by an employee. (TC ¶ H-1925 *et seq.*; TG ¶ 3244; FT ¶ 3244)

Under current law a reimbursement arrangement can qualify as a medical reimbursement plan even though it discriminates in favor of employees who are highly compensated or who are officers or shareholders as long as there

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APPENDIX D

PROGRAM ADMINISTRATION AGREEMENT BETWEEN  
PEBSCO OF KENTUCKY (FORMERLY DAVENPORT-DILLARD OF KENTUCKY)  
AND THE D.C.S. BOARD OF TRUSTEES, AS AMENDED

AGREEMENT

THIS AGREEMENT, made and entered into this 8<sup>th</sup> day of October, 1974, by and between the Board of Trustees of the Kentucky Public Employees Deferred Compensation System (hereinafter referred to as the "Board of Trustees") and Davenport-Dillard of Kentucky, Inc., a Kentucky Corporation, 215 St. Clair Street, Frankfort, Kentucky, (hereinafter referred to as "D-D").

WITNESSETH THAT:

WHEREAS, D-D is a Kentucky Corporation which specializes exclusively in the creation, installation, administration and supervision of Deferred Compensation Programs for states, cities, counties and their employees; and,

WHEREAS, the State of Kentucky has authorized a deferred compensation program with the passage of Senate Bill 230 and the creation of the Kentucky Public Employees Deferred Compensation System (hereinafter referred to as the "System") to be administered under the supervision of the Board of Trustees; and,

WHEREAS, the Board of Trustees under a resolution dated Oct. 8, 1974 has adopted the terms of this Agreement; and,

WHEREAS, The Board of Trustees deems it desirable to authorize and appoint D-D to perform certain functions as hereinafter provided;

NOW, THEREFORE, it is hereby mutually agreed between the parties hereto as follows:

1) The Board of Trustees hereby appoints D-D as the Exclusive Program Coordinator for the System effective as the date of this Agreement and continuing for a term of five years. This contract shall be renewable for an additional five years unless written notice of termination is given to D-D at least six months prior to the expiration of the original term. Provided, however, that this Agreement may, upon 30 days advance written notice, be terminated by the Board of Trustees for malfeasance, nonfeasance, misfeasance, or gross neglect should D-D fail or unreasonably refuse, on request of the Board of Trustees, to substantially perform the services required to be rendered hereunder by D-D.

2) In its capacity as Exclusive Program Coordinator, D-D shall have the right and be required to conduct the enrollment of all employees who elect to participate in the System. The right of enrollment shall include the right of D-D or its assignees to act as the agent of record on the purchase of all insurance and/or annuity contracts and to appoint its designee to act as the broker/dealer to execute all securities transactions, dealing with the assets held by the Kentucky Public Employees Deferred Compensation Trust Fund (hereinafter referred to as "Fund"), and in such capacity D-D, its assignees or designee, shall receive all commissions and expense allowances.

due and payable by any of the insurance and/or investments companies with whom such assets are invested (or paid to for insurance and/or annuity premium considerations) in amounts normally paid within the industry by insurance and/or investment companies as a marketing allowance for the sale of such insurance and/or annuity contracts to include expenses for promotional materials, and as provided for under the terms of the plans and programs instituted by the Board of Trustees. Except however, any amendments to the plans and programs as instituted by the Board of Trustees as they affect the terms of D-D's agency or broker/dealer arrangements with such insurance and/or investment companies may only apply to assets derived from employees compensation yet to be deferred.

Should the Board of Trustees elect at any time to place assets held by the Fund in investments other than those offered by any insurance and/or investment companies where D-D, its assignees or designee, receive compensation as above provided, then D-D and the Board of Trustees may mutually agree at that time upon appropriate charges to be levied against such assets as compensation to D-D for its services.

D-D shall pay all of its expenses associated with its performance of the terms of this Agreement. In no event shall the Board of Trustees be liable to D-D for any compensation or consideration. Any compensation or consideration payable to D-D as provided herein shall be paid by the insurance and/or investment companies as above provided, and/or a custodian bank, if required by the Board of Trustees.

3) D-D hereby agrees to utilize its best efforts and to provide appropriate personnel to include D-D's private legal counsel, where necessary:

- A. To assist the Board of Trustees in the preparation of a Deferred Compensation Plan and its attendant agreements together with appropriate requests for rulings so that all such documents meet the requirements, in the opinion of the Attorney General of the State of Kentucky, of Senate Bill 230, the Internal Revenue Service, the Securities and Exchange Commission, the U.S. Department of Health, Education and Welfare, and Kentucky's Statutes and Constitution - especially Sections 177 and 179;
- B. To assist the Board of Trustees in the preparation of bid specifications for the insurance and/or annuity contracts to be provided by insurance and/or investment companies for the System, and to assist the Board of Trustees in their review of all responses received from invitations to bid such specifications, all such assistance being as is determined necessary by the Board of Trustees from time to time.
- C. To review from time to time and to provide pertinent information to the Board of Trustees concerning the performance of any insurance and/or annuity contracts selected by the Board of Trustees and utilized by the System, and to make suggestions concerning

possible improvements to such insurance and/or annuity contracts, as such improvements or alternatives become available on the marketplace and feasible to implement.

D. To meet with the Board of Trustees and the appropriate personnel within the Executive Department for Finance and Administration and the Department of Personnel to advise and assist them, the insurance and/or investment companies, and a custodian bank, if required by the Board of Trustees, in the development and maintenance of computer software systems and other management systems necessary for the administration of the System.

1) The administrative functions of the System (and the Board of Trustees) are understood to primarily encompass the following:

- a) To collect all deferred amounts from employees and remit such amounts and other appropriate information each pay period to a custodian bank, or to the insurance and/or investment companies in the event a custodian bank is not required by the Board of Trustees; and,
- b) To receive all change and claim requests from the employee participants, to determine the appropriateness of such change or claim requests, and to forward instructions and documentations concerning such change or claim requests to a custodian bank or to the applicable insurance and/or investment companies.

2) The administrative functions of a custodian bank, if required by the Board of Trustees, and/or the insurance and/or investment companies as may be ultimately selected by the Board to provide the insurance and/or annuity contracts under the System are understood to primarily encompass the following:

- a) To receive all deferred amounts from the System and to distribute and credit such amounts to the appropriate insurance and/or annuity contracts as selected by the employees under their "investment elections" provided for by the terms of the State of Kentucky Deferred Compensation Plan Agreement; and,
- b) To receive all change and claim requests together with appropriate instructions from the System, to effect such changes to the insurance and/or annuity contracts purchased, and to process and remit all distributions of benefits directly to the participants in accordance with such instructions and as provided by the terms of the

arrangements between the Board of Trustees, and each insurance and/or investment companies, and a custodian bank, if required by the Board of Trustees; and,

- c) To provide the necessary information as to deferred amounts received, values and coverages obtained, and benefits paid, in the form required by D-D, so that D-D may compile such information and prepare reports to be provided all participants reflecting the information applicable to all insurance and/or annuity contracts purchased by each participant as required by the State of Kentucky Public Employees Deferred Compensation Plan Agreement.
- E) To provide reports, as required by the Board of Trustees, to all participants, together with appropriate summaries to the Board of Trustees, detailing the deferred amounts collected, and the values and coverages obtained and remaining, for a charge of \$1.00 per participant per report, subject to a cost of living escalator as may be mutually agreed to by the parties hereto. Such charges shall be paid by the insurance and/or investment companies providing the insurance and/or annuity contracts for which the reports are made, and by a custodian bank, if required by the Board of Trustees. The Board of Trustees shall at all times have the right to determine the frequency of such reports.
- F) To personally interview all eligible employees and explain the advantages of their participation in the System provided that D-D may:
  - 1) Obtain access to names of all state employees to include their work location and immediate supervisor; and,
  - 2) Distribute promotional material to all state employees by the stuffing of payroll envelopes, wherever possible; and,
  - 3) Arrange with immediate supervisors a convenient time and place wherein D-D may:
    - a) Make presentations to groups of approximately 20 employees on state premises during working hours; and,
    - b) Make individual presentations to those employees who so request at the conclusion of the group presentation.

G) To recommend procedures which will aid the Kentucky State Auditor, or other appropriate personnel, to install and maintain a comprehensive method of audits and controls to insure the System's fiscal integrity for the protection of the participants, the State, the Board of Trustees, and the involved elected or appointed officials.

4) D-D hereby warrants and agrees that all information concerning the System and participants thereunder is the sole property of the System (and the Board of Trustees), that such information shall be kept confidential, and that such information shall not be used by D-D, or transmitted to any other person (s) or entities by D-D for any purposes whatsoever other than as provided in this Agreement, the Kentucky Public Employees Deferred Compensation Plan Agreement, or subsequent resolutions or instructions of the Board of Trustees.

D-D warrants that it and its representatives shall not utilize any of such information to offer or attempt to offer any programs other than the programs specifically approved by the Board of Trustees to any employee or employees of the State of Kentucky.

5) This contract constitutes the whole agreement between the parties hereto and there are no other agreements between the parties.

6) This Agreement shall be construed in accordance with the laws of the State of Kentucky.

In witness hereof witnessed the signatures of the parties this 8<sup>th</sup> day of October, 1974.

DAVENPORT-DILLARD OF KENTUCKY, INC.

By: John Daniel Davenport  
President

ATTEST:

Walter H. Hume  
Secretary-Treasurer

APPROVED FOR FORM AND LEGALITY  
OFFICE OF THE ATTORNEY GENERAL  
FRANKFORT, KENTUCKY  
BY: W. M. McFigure

BOARD OF TRUSTEES OF THE KENTUCKY PUBLIC  
EMPLOYEES DEFERRED COMPENSATION SYSTEM

Strawn W. Taylor  
Chairman  
Russell A. Johnson  
Vice Chairman  
James O. King  
Commissioner, Exec. Dept. for Fin. & Adm.  
Cecil L. Miller  
Commissioner of Personnel  
Harold B. McElroy  
Commissioner of Insurance

A G R E E M E N T

THIS AGREEMENT, made and entered into this 8<sup>th</sup> day of March, 1979, by and between the BOARD OF TRUSTEES of the KENTUCKY PUBLIC EMPLOYEES DEFERRED COMPENSATION SYSTEM (hereafter referred to as the "Board of Trustees") and PUBLIC EMPLOYEES BENEFIT SERVICES CORPORATION (hereinafter referred to as "PEBSCO"), successor to Davenport-Dillard of Kentucky, Inc., a Kentucky Corporation, 215 St. Clair Street, Frankfort, Kentucky.

WITNESSETH THAT:

WHEREAS, the Board of Trustees and PEBSCO have entered into a contract on October 8, 1974 which requires that the aforesaid contract shall be automatically continued for an additional five year period after the expiration of the original contract period of five years, unless the Board of Trustees shall give at least six months notice of termination prior to expiration of the aforesaid contract and both parties desiring to delete the necessity of giving six months advance notice of termination,

NOW THEREFORE, it is mutually agreed between the parties that so much of the aforesaid contract which requires six months advance notice of termination shall be deleted from the aforesaid contract and amended to read that the Board of

Trustees may notify PEBSCO of its desire to renew or not to renew said contract at any time up to the last date of the present contract which is October 7, 1979.

And the parties further agree that should the Board of Trustees not give any notice on or prior to October 8, 1979, the aforesaid contract shall not be renewed, and the contract shall automatically expire on October 8, 1979.

In witness hereof witnesseth this amendment to the contract entered between the Board of Trustees and Davenport-Dillard of Kentucky, Inc. (on October 8, 1974), this 8<sup>th</sup> day of March, 1979.

PUBLIC EMPLOYEES BENEFIT SERVICES  
CORPORATION, Successor to  
DAVENPORT-DILLARD OF KENTUCKY, INC.

By: John Louis Cawson  
President

ATTEST:

Charles B. Wilkinson

APPROVED FOR FORM AND  
LEGALITY, OFFICE OF THE  
ATTORNEY GENERAL, FRANK-  
FORT, KENTUCKY.

Martin Sager  
Assistant Attorney General

BOARD OF TRUSTEES OF THE KENTUCKY PUBLIC  
EMPLOYEES DEFERRED COMPENSATION SYSTEM

Steven W. Taylor  
Chairman

John D. Hill  
Vice Chairman

Tom Graham, proxy for Sec.  
Commissioner, Department for Finance

Arthur J. Stolley  
Commissioner of Personnel

Jim M. Hill  
Commissioner of Insurance



APPENDIX E

COMMONWEALTH OF KENTUCKY  
OFFICE OF THE ATTORNEY GENERAL  
FRANKFORT

ROBERT F. STEPHENS  
ATTORNEY GENERAL

July 19, 1979

**OAG 79 414**

Mr. Scheffel Wright  
Assistant Director for Program Review  
Legislative Research Commission  
State Capitol  
Frankfort, Kentucky 40601

Dear Mr. Wright:

You seek the answer to several questions raised by the Committee for Program Review and Investigation concerning the Public Employees Deferred Compensation System (PEDCS) and its related administrative company, the Public Employees Benefit Services Corporation (PEBSCO).

You ask:

"1. Under state law, can deferred compensation monies be invested in the common stock of a corporation?"

Kentucky Constitution, Section 177 provides:

"The credit of the Commonwealth shall not be given, pledged or loaned to any individual, company, corporation or association, municipality, or political subdivision of the state; nor shall the Commonwealth become an owner or stockholder in, nor make donation to, any company, association or corporation; nor shall the Commonwealth construct a railroad or other highway."

In two previous opinions, OAG 73-695 and 73-808, this very issue was raised, and this office advised that there was

Scheffel Wright  
July 19, 1979  
Page -2-

a possibility that investment in the stocks of a company by PEDCS might be in conflict with Section 177 of the Kentucky Constitution and that a declaratory judgment action should be maintained to resolve the issue. Apparently, this was not done. So, the issue is still to be resolved.

In *City of Louisville Municipal Housing Com'n v. Public Housing Administration, Ky.*, 261 S.W.2d 268 (1953), the question was raised as to whether the City of Louisville Housing Commission may insure its housing projects in a mutual fire insurance company. It was contended there that the Housing Commission is a state agency, that a mutual fire insurance company is a private corporation and that such a mutual insurance is owned by and shall be operated in the interest of its members and that by so purchasing mutual insurance, the agency was in violation of Sections 177 and 179 of the Kentucky Constitution [Section 179 forbids local subdivisions from investing in private companies in the same manner that Section 177 forbids the state from so investing.]

The Court considered the history and purpose of Sections 177 and 179 of the Kentucky Constitution and quoted from *Hogan v. Kentucky Children's Home Society*, 119 Ky. 235, 83 S.W. 605, 607, 67 LRA 815, to wit:

" . . . . There was a time when the state was allowed to subscribe, and did subscribe, to the capital stock of various quasi public improvement companies, and loaned or gave its credits to such. It was to prevent a repetition of that practice by the state that the section was enacted." It is apparent that section 179 was enacted in order to place upon local governmental units the same general restrictions imposed upon the Commonwealth itself by section 177. The purpose behind both sections was to prevent local and state tax revenues from being diverted from normal governmental channels. The purpose will not be thwarted by the proposed action of the Housing Commission. None of the revenue of the Housing Commission is derived from local or state funds, and it has no authority to assess, levy or collect taxes in any form.

In order for this Court to hold that sections 177 and 179 prohibit the Housing Commission from insuring its properties in a mutual fire insurance company, we would have to read into those sections words which are not there. This we are not authorized to do." [Emphasis supplied]

This opinion was reaffirmed in Louisville Board of Insurance Agents v. Jefferson County Board of Education, Ky., 309 S.W.2d 40 (1958).

Applying the rationale in those decisions to the facts here, the monies of the PEDCS do not come directly from tax funds, but are voluntarily assigned to it from employees of the Commonwealth, and there is no diversion of tax revenues from normal governmental channels by such investments. Like the governmental entities in the two aforesaid cases, the PEDCS has no authority to assess, levy or collect taxes in any form.

Thus, the answer to question #1 is "yes".

"2. Can deferred compensation monies be invested in mutual funds, whether backed by stocks or bonds?"

The aforesaid opinions specifically deal with mutual funds, and the Court in Louisville Board of Insurance Agents v. Jefferson Board of Education, supra, stated at page 41:

"Another valid reason why membership in a mutual insurance company does not render the insured a stockholder of the company is because the policy merely fixes the legal status of the parties during the life of the policy. In no manner is there the same character of interests which a stockholder has in a stock insurance company. The privilege to vote, conferred by the policies in question, is merely incidental to acquiring the insurance protection being sought."

Scheffel Wright  
July 19, 1979  
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In short, the court held that becoming a "member" of a mutual company does not make the insured a "stockholder" within the meaning of Section 177 of the Kentucky Constitution.

So, for two reasons, the answer to question #2 is "yes".

"3. Could the Kentucky Employees Retirement System offer a deferred compensation plan to eligible employees?"

While the KERS could offer a plan, it could not be a deferred compensation plan under the Internal Revenue Code. The basis upon which taxes are deferred and not paid when the employee is paid his salary is that the money so deferred is paid directly to the PEDCS. The funds thus deferred are not the funds of the employee but that of the system. He only has a right to receive subsequent benefits under certain circumstances. The very fact that the monies at the time they are deferred are those of the system (the Commonwealth) makes them non-taxable at that time.

On the other hand, the funds of the KERS are those of the employee at the moment they are withheld for him (KRS 61.570; 61.692). Where the participation by an employee in PEDCS is voluntary, the participation of an employee in the KERS (except those who chose not to participate when his department first came into the KERS) is compulsory. The fact that the monies compulsorily deducted from the employee's pay in KERS is his from the moment of deduction makes such compulsory deductions constitutional.

Therefore, KERS could not offer a deferred compensation plan without a massive statutory change in its composition or without (statutorily) offering a separate fund which would meet federal requirements for consideration as a deferred compensation system.

"4. Could the Kentucky Employees Retirement System administer and offer a deferred compensation plan to employees wherein the amounts deferred (the employee's contributions) were invested in common stocks?"

This question has been answered in #3 and the answer is "no". KERS can invest in common stocks (and does so, KRS 61.650)

Scheffel Wright  
July 19, 1979  
Page -5-

but it would not be a deferred compensation plan.

"5. Could K.E.R.S. offer a plan wherein amounts deferred were invested in mutual funds?"

Based upon the answer to #3, the answer is "no".

"6. Could K.E.R.S. offer a plan wherein amounts deferred were invested in corporate bonds?"

Based upon the answer to #3, the answer is "no".

"7. Can the Deferred Compensation System offer deferred compensation plans directly to eligible employees wherein the amounts deferred by employees were invested in common stocks, mutual funds and corporate bonds?"

Based upon the answer to #'s 1 and 2, the answer is a qualified "yes". But in order to utilize such a method successfully, the PEDCS would need to market the product and would need to sell the product to the employees. This might require sanctioning of the sales material by the Securities Exchange Commission and registration with the Securities Dealers Association. The Department of Insurance would need to license those individuals selling the product as licensed insurance agents. So, while technically the PEDCS could provide the service directly, it could only do so after careful approval, registration and licensing of the persons involved by the various governmental agencies who have jurisdiction of such persons and subject matter.

"8. Could the Kentucky Employees Retirement System establish and offer annuity plans or contracts to participants directly, without the involvement of insurance companies?"

KERS could not offer a deferred compensation system without massive statutory changes, and with such changes it would face the same problem PEDCS would face in a direct marketing method.

Scheffel Wright  
July 19, 1979  
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"9. Can the Deferred Compensation System establish and offer annuity plans or contracts directly to employees?"

This question is governed by the answer to #7.

"10. If the answers to the foregoing questions concerning the Kentucky Employees Retirement System are no while the answers to analogous questions regarding the Deferred Compensation System are yes, may we generally conclude that the K.E.R.S. could assume the functions allowed to the Deferred Compensation System if appropriate statutory transfers of authority were made?"

If proper statutory changes were made, KERS could offer what is now offered by PEDCS.

"11. Kentucky Revised Statutes, Section 18.510 defines 'employee'. Section 18.540 (7) (f) allows the Deferred Compensation System Board of Trustees to make all rules and regulations not inconsistent with the provisions of KRS 18.510 to 18.600. Can the Board, using its rule-making authority, adopt a narrower definition of 'employee' than set forth in Section 18.510? Specifically, could the Board adopt the same definition of 'employee' as that used by the K.E.R.S.?"

We do not believe the board of PEDCS can, by regulation, reduce the term "employee" inconsistently with the definition of the term in the statute. Otherwise, the regulation would have the effect of amending the statute. An administrative agency has only those powers granted to it by the statute creating it.

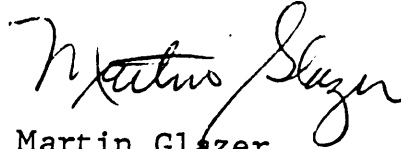
"12. Can the Board by rule clarify the status of groups where it is ambiguous under Section 18.510?"

Scheffel Wright  
July 19, 1979  
Page -7-

Providing the clarification does not, in effect, amend the statutory definition, such clarification may be authorized where it merely interprets and actually clarifies a statutory definition.

Very truly yours,

ROBERT F. STEPHENS  
ATTORNEY GENERAL

A handwritten signature in cursive script, appearing to read "Martin Glazer".

Martin Glazer  
Assistant Attorney General

MG/ba

**KENTUCKY PUBLIC EMPLOYEES  
DEFERRED COMPENSATION SYSTEM  
DEPARTMENT OF FINANCE  
FRANKFORT, KENTUCKY 40601**



Strawn Taylor, Chairman  
John D. Witt

~~James B. McCarty~~ Donald Rhody  
Addie D. Stokley  
~~Raymond~~ Gordon Duke

APPENDIX F

**David W. Edwards**  
**Executive Secretary**  
**Phone 502-584-7710**

December 3, 1979

Honorable Buddy Adams, Chairman  
Committee for Program Review  
and Investigation  
Legislative Research Commission  
Room 9, Capitol Annex Building  
Frankfort, Kentucky 40601

Dear Mr. Adams:

The Board of Trustees of the Kentucky Public Employees Deferred Compensation System wishes to acknowledge the Program Analysis prepared by your staff for the Committee for Program Review and Investigation.

We wish to compliment the subject, quality and integrity of both the final report as well as the program investigation in the development process.

While we naturally feel that many of the recommendations and concerns were already being addressed by the Board, we nonetheless acknowledge that virtually all of these issues are legitimate and require corrective action.

Indeed, at present, we view the issues identified in the report as either resolved or in the process of being resolved. And, that this state of affairs has been hastened by your Committee's program review, evaluation, and recommendations.

We believe that the more substantive issues, especially those involving our cash management transit system, are in good shape. However, legislation authorizing the electronic transfer of funds would substantially shorten the cash flow process from the participant to the carriers. We are awaiting final draft of new Internal Revenue Service regulations concerning our plan and might have a need for certain legislative changes as a result thereof. If so, we would like to work with your committee on incorporating the possible changes resulting from new Federal regulations as well as any other changes which would be beneficial.

With this letter we are providing you with a specific response to each recommendation explaining:

- (1) the basis of our original action on the issue;
- (2) the basis and result of our corrective action;
- (3) the basis for no action.

Honorable Buddy Adams  
Page No. 2  
December 3, 1979

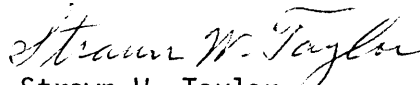
In addition, we are enclosing for your review a copy of a recent Certified Audit, prepared for the Board by Coopers and Lybrand. You will notice it provides a total reconstruction of income, disbursements, assets, liabilities, and audit controls and management recommendations regarding the fiscal integrity of the system. This audit was made at no cost to the Commonwealth as it was paid for by the insurance companies. We believe that it is significant to point out that our new contract with the program administrator provides for annual certified audits, as well as computer services, at no cost to the Commonwealth.

The Board is gratified to report that Coopers and Lybrand found the books and records, systems and programs, to be virtually free of error. You will note they made seven recommendations which have already been acted upon by the Board.

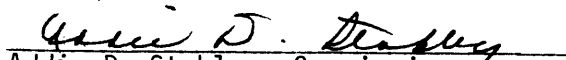
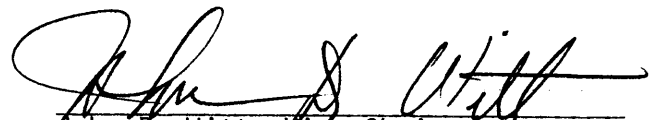

Your interest and support in this important employe program is appreciated, and we want to assure you that the Board will continue to be responsive to your committee.

In addition, we invite you and your staff to attend any of our Board meetings and seek your continued support for this important program.

Very truly yours,



Strawn W. Taylor  
Chairman  
Board of Trustees

  
Addie D. Stokley, Commissioner  
Department of Personnel and Trustee  
John D. Witt, Vice-Chairman  
Board of Trustees  
Donald N. Rhody, Commissioner  
Department of Insurance and Trustee  
for Gordon Duke, Secretary  
Department of Finance and Trustee

SWT:sj

Enclosures (3)

- (1) Response by Deferred Compensation Board of Trustees
- (2) Audit Report (Financial Statements and Management Report)  
by Coopers and Lybrand
- (3) Draft of Deferred Compensation Plan

THE KENTUCKY PUBLIC EMPLOYEES DEFERRED COMPENSATION SYSTEM BOARD OF TRUSTEES  
RESPONSE TO COMMITTEE FOR PROGRAM REVIEW AND INVESTIGATION PROGRAM ANALYSIS

- RECOMMENDATION 1. Funds in transit between payroll deduction and investment in participants' accounts should be invested temporarily for the benefit of the Deferred Compensation System and/or participants.
- RECOMMENDATION 2. Income from temporary investments should be used to defray administrative expenses of the system.
- RECOMMENDATION 3. The general fund appropriation should be reduced or eliminated as investment income is received.
- RECOMMENDATION 4. The Appropriations and Revenue Committee should consider this issue with the related issue of whether general fund appropriations for DCS are appropriate in its budget review proceedings.

RESPONSE:                   Recommendations 1., 2., 3., and 4. are so interrelated that they should be considered jointly rather than individually. The insurance companies are in the process of making the systems changes that are necessary in order to accept semi-monthly deposits and credit earnings on them from the date of receipt. The Trustees have been negotiating with those companies to accept semi-monthly deposits since October 27, 1978, but because of previous contractual agreements, these changes cannot be implemented until June, 1980. This will speed up the deposits by about 15 days for the deferrals withheld at the end of the month for employees paid on a semi-monthly basis and also for all deferrals for employees paid on a monthly basis. For approximately 66% of the deposits this will decrease the time from date of deposit by the State Treasurer into the Special Deposit Trust Fund until date of remittance to the carriers

RESPONSE: from that fund by almost 50%. The remaining 34% of the deferrals withheld at the middle of the month will be remitted to the carriers near the end of that month. Under this remittance system the normal time from deposit by the State Treasurer until deposit by the carriers will be about 15 days for all deferrals.

The Office of Policy and Management, Department of Finance, has advised that earnings by the Special Deposit Trust Fund cannot be allocated to the Board of Trustees for its own use but must accrue to the General Fund. Since the Board receives its appropriations from the General Fund the earnings on the float are, in effect, indirectly funding a portion of the Board's budget.

The State Treasurer is currently earning some \$20,000.00 annually in interest on undeposited deferrals. As the program grows and expands it is anticipated that these earnings will increase in the future and the program may eventually become self-sustaining.

It would therefore seem prudent that, since little or no additional overall revenue would actually accrue to the Commonwealth if the deferrals were invested on a short-term basis specifically for the benefit of the Board, it should continue to receive all of its operating revenue from the General Fund. The carriers could not allocate such earnings to the individual participant's accounts.

RECOMMENDATION 5. The Board of Trustees should act to assure that only one bank is utilized in transferring payroll deductions to participant accounts.

RESPONSE:                   Beginning in September, 1979, the participant deferrals have been disbursed directly to the carriers from the Special Deposit Trust Fund by the State Treasurer.

RECOMMENDATION 6. The General Assembly should consider legislation authorizing the Commonwealth to disburse funds via electronic funds transfer.

RESPONSE:                   The Board has lamented for years over its inability to effectuate a more rapid transfer of funds for the benefit of the participants. The Board would certainly welcome the use of this medium and would support legislation authorizing its use.

RECOMMENDATION 7. Payroll deductions from public school employees should be forwarded to the state treasurer as for other employees eligible for participation in the deferred compensation system.

RECOMMENDATION 8. The account at Central Bank and Trust Company should be eliminated.

RESPONSE: Recommendations 7. and 8. should also be considered jointly. As cited in your report the establishment of this account was authorized by the Secretary of Finance and the State Treasurer. While the Kentucky Statutes provided that the State Treasurer is the custodian it did not contemplate that the state would set up the administrative systems necessary to collect the deferrals. At the time we began to implement the school districts into the overall State system the Trustees and the program administrator, as well as the carriers, investigated the feasibility of centralizing the payroll transmittals from the school districts back through the System's office. This would have required a substantial expansion of the System's manpower requirements to handle more than 180 payroll systems, most of which are not computerized. The Trustees therefore decided that it was in the best interest of the State, and less expensive, to have these deferrals handled by a custodian bank and still believe that this was the proper decision. This decision will be reviewed if necessitated by future changes. If, at anytime in the future, the Board feels that the current system is not delivering the benefits to the State and the participants, the Board will certainly review, conduct an analysis, and make any changes necessary to insure the

RESPONSE: integrity of the plan. This Board has control over the bank account through the Executive Secretary.

The State Treasurer delegated custodial authority for the public school funds to the Central Bank by virtue of authorizing the account for that purpose. Benefits accruing to the Commonwealth are that no administrative costs are incurred by the Board, the State Treasurer, and the Department of Finance in processing these checks.

Even though we realize that a small amount of income accrues to the Central Bank on approximately \$35,000.00 that it handles each month, it is more than offset by the cost of one full-time person employed by the Central Bank to handle these funds.

RECOMMENDATION 9. Electronic funds transfer should be utilized to transfer funds from school boards to the state treasury (and also to transfer funds from there to the insurance companies).

RESPONSE:                   We offer the same response as in Recommendation 6.  
The Board would certainly welcome the use of this medium  
and would support legislation authorizing its use.

RECOMMENDATION 10. A comparison of plan administration proposals in other states should be made before another agreement for administration is made. Also, contractual arrangements with insurance companies should be compared in the same manner.

RESPONSE:

As a result of a long-term concern on the part of the Board, in March, 1979, the Board conducted a survey which included, among other things, the various methods of administration utilized in other states. In addition, those states utilizing the services of PEBSCO were asked to evaluate the performance of PEBSCO. Arrangements with investment carriers were also included in the survey. Responses were received from more than 20 states, some of whom had not yet implemented their program. The results indicated that the Kentucky program is one of the best in the nation. Bids to administer the Kentucky program were requested by advertisements in the Wall Street Journal, the Courier Journal, and the Lexington Herald. Two responses were received and the candidate administrators made presentations to the Board. Letters of declination were received from the Kentucky Retirement System and Aetna Life Insurance Company, each of whom made presentations in 1973. After careful deliberation PEBSCO was reappointed as the program administrator.

RECOMMENDATION 11. The Board of Trustees should review the sales charges presently in force to determine whether they serve the best financial interests to participants or whether an alternative structure would be better.

RESPONSE: The Board has stayed continually abreast of what has been done in other states. Part of our survey referred to in Response 10 included questions concerning the level of charges and benefits in other states. This survey was incorporated into your report and it documents that frequently "no load" products cost the participants more in benefits.

The level of sales and administrative charges was included in the aforementioned survey. A report on this survey was made at a Board meeting on August 1, 1979, at which time it was concluded that the program had been operational for a sufficient length of time to warrant a renegotiation of the sales charge. This was done and a new contract was negotiated whereby the sales charge on the fixed annuity was reduced from 6% to 5% effective January 1, 1980, with a further reduction to 4.5% when the fund assets reach \$45,000,000.00. Subject to the approval of the Securities and Exchange Commission the sales charge on the variable annuity will be eliminated and the annual administrative charge will be increased from \$8.00 to \$12.00 effective January 1, 1980.

RECOMMENDATION 12. The Board of Trustees should seriously consider requesting new bids for the annuity contract and evaluating all proposed products actuarially to determine which provides the best return to participants.

RESPONSE:

The Board wishes to convey the fact that proposals for bids for all products were sent to the largest 100 and all domestic insurance companies at the inception of the program. Data concerning investment products was obtained from the survey conducted by the Board in March, 1979, and is included in your report. That survey does not reflect the new reduction in charges which is shown in our response to Recommendation 11.

Due to the attractiveness of the Kentucky program several states have sought advice from Kentucky and have attempted to model their programs after the Kentucky program.

The following message was received by Chairman Strawn Taylor from the Assembly of Governmental Employees, a national federation of independent state and local associations representing 700,000 public employes, regarding Kentucky's contribution to the field of public employe deferred compensation programs:

"As you know the United States Congress has passed legislation codifying Public Employe Deferred Compensation. Assembly of Governmental Employes has been active in the legislative effort. Outstanding Deferred Compensation Programs such as the Kentucky Program were instrumental in helping us to convince key people in the Congress to support our legislative efforts. We commend Kentucky for an outstanding program. The broad spread of employe participation through income levels shows

RESPONSE:           good plan management and assisted greatly in convincing Congress that public plans do not need arbitrary enrollment quotas as was mandated to private Deferred Compensation Programs. Thank you."

James F. Marshall, Executive Director, Assembly of Governmental Employees, Suite 611, 1730 R. I. Avenue, N.W.,  
Washington, D.C. 20036

RECOMMENDATION 13. The Board of Trustees should notify participants individually of changes in plan provisions and participant agreements.

RESPONSE:

A new plan document, as revised, is currently in the process of being printed. A copy of the new plan document will be sent to each participant by PEBSCO, the program administrator, as soon as they become available. A draft copy of this document is attached.

The Board was apprised several months prior to the final passage of the revised tax plan by IRS which affects deferred compensation programs. Upon being advised that Congress had enacted new legislation the Board then started revising its plan which was submitted to legal counsel in Washington to obtain a legal opinion. The Board was advised by that counsel that it is their opinion that the Kentucky plan is in conformity with the requirements of the Kentucky Law and Section 457 of the Internal Revenue Code.

Future revisions will be made in the plan as deemed appropriate by the Board and as required by new legislation, state or federal, and promptly distributed to the participants.

RECOMMENDATION 14. The Board of Trustees should continually monitor and periodically review processing time of statements and related computer services and employee performance to insure that statements are produced and delivered in a timely manner.

RESPONSE: The Trustees have and will continue to monitor and review the processing time of valuation statements and related computer services and employee performance. Much needed improvements have already been effected in this area. The valuation statements for the reporting year of 1978 were issued on March 1, 1979, sixty days after the end of the year. This is within the time frame set forth in the plan document.

RECOMMENDATION 15. The Board of Trustees should act to assure that the revised plan is provided to participants as soon as possible.

RESPONSE: Please refer to our response to Recommendation 13 for our response to this Recommendation.

RECOMMENDATION 16. The Board of Trustees should complete a systems analysis with the Deferred Compensation System, with cooperation of the Bureau of Computer Services.

RESPONSE: A systems analysis was performed by the Bureau of Computer Services in October, 1975. It was concluded that the computer services could be purchased for about the same charges that the Bureau of Computer Services would make. If the computer service was furnished by the state additional initial costs would be incurred in the amount of about \$50,000.00 to develop the computer programs and the employment of one additional person in the Board's office plus an unspecified amount of time by personnel in the Bureau of Computer Services to perform the input and systems operations. The purchasing of these services rather than having them performed by the Bureau of Computer Services resulted in less costs to the taxpayers. Beginning July 1, 1979, these services are being furnished at no cost to the taxpayers and no additional charge is being levied against the participants for these services. As there is now no cost to the Board for computer services the need for systems analysis does not exist.

RECOMMENDATION 17. The payroll operation should be included in a central payroll system.

RESPONSE:                    There already exists in the Finance Department regulations which provide them with the authority to modify state government's payroll procedures. Currently, the Departments of Personnel and Finance are undertaking a study of state government's various payroll systems, with the purpose of designing a uniform payroll system. Cost estimates of implementing the study will also be obtained. This study does not include a consideration of the payroll systems used by the State's school systems.

RECOMMENDATION 18. Job descriptions, job procedures, the number of employees, and salaries should be reviewed as all recommendations of this review are implemented.

RESPONSE:                   The Board will review these areas and take the appropriate action.

RECOMMENDATION 19. The General Assembly should consider legislation requiring that the administrative costs of the DCS be borne by participants rather than paid for by a general fund appropriation.

RESPONSE:

The Deferred Compensation program is somewhat similar to the U. S. Savings Bond, Credit Union, health and life insurance, and other payroll deduction programs. As such, the state provides the mechanism for an employee's contribution to be deducted from the paycheck on a regular basis. This cost appears to be entirely justifiable since the availability of the Deferred Compensation program is construed as an employee benefit, and all other costs attributed to individual program participation are borne by the individual. Further, it is important to note that the program itself contributes some \$20,000 per year to the general fund from interest on undeposited deferrals. This amount, in part, offsets some of the cost of operating the Deferred Compensation System and the Board sees a growth in its contribution to the General Fund in the near future.

Accordingly, inasmuch as the program is viewed, among others, as an employee benefit, as a program whose participants already absorb much of the administrative cost, and as a program which contributes to the reduction of its own administrative costs, it is the recommendation of this Board that further costs not be shifted to the participants at this time. It is the Board's considered opinion that such a move could have an adverse effect on enrollment and participation and thus the well-being of the entire program.

RESPONSE:

This Deferred Compensation Program, as provided now by Federal law, is designed to let states be competitive with private industry in Kentucky such as I.B.M., General Electric, and Ford, who offer the employees stock purchase and tax-sheltered thrift plans, giving them the same benefits as we now offer. In private industry the companies not only pay the cost of the administration, they match funds in addition to their regular retirement plan.

RECOMMENDATION 20. The Board of Trustees should forthwith maintain a declaratory judgement action to resolve the question whether investment of deferred compensation monies in common stocks is in conflict with Section 177 of the Kentucky Constitution.

RESPONSE:

The Board has accepted the opinion in OAG 79-414 from the Attorney General that there is no conflict with Section 177 of the Kentucky Constitution.

The Board feels that if your Committee does not agree with the Attorney General's opinion that this falls within your purview if you are still desirous of seeking a declaratory judgement.

RECOMMENDATION 21. The Board of Trustees should review its eligibility policies to assure consistency with statutes.

RESPONSE: At a Board meeting held on April 25, 1979, the Trustees clarified the definition of the term "Employee" in its eligibility policies to read as follows:

"Employee" means a person holding an office, position, or employment in state government and agencies thereof and also includes persons in the public school systems.

This is precisely the language contained in KRS 18.510(1).

RECOMMENDATION 22. The Board of Trustees should propose legislation to achieve the strict eligibility requirements they desire.

RESPONSE:

The Board believes that the current legislation adequately achieves the eligibility requirements necessary, in conjunction with the suitability requirements imposed by the regulations of the Securities and Exchange Commission (see response to Recommendation 21).

RECOMMENDATION 23. The Board of Trustees should monitor the program administrator's marketing and promotion activities on a regular basis to assure that all eligible employees have the program explained to them and achieve an opportunity to participate.

RESPONSE:                   The Board recognizes that many problems have been encountered in presenting the program to all eligible employees and that sales promotion efforts by PEBSCO need to be strengthened. Many agencies, including the individual school systems, have resisted the efforts of PEBSCO to present this program, as required by statute, to those eligible employees. The Board and PEBSCO are working on a program which will insure that we get the support of all department heads to make certain that the benefits and services of this program are delivered to all eligible employees of the State of Kentucky. At a future Board meeting PEBSCO will make its recommendations regarding this support program. We welcome any assistance and support that will ease this burden on the Board and PEBSCO.

At the Board meeting held on August 29, 1979, PEBSCO was appointed to serve as program administrator for an additional five years and was required to set forth in writing to the Board a time schedule of increasing their current sales force to assure the Board that all eligible employees will be called upon.

The Board has asked PEBSCO to report, on a periodic basis, to the Secretary of the Board the number of employees attending enrollment meetings and where these meetings are held.

RECOMMENDATION 24. The Board of Trustees should request that the Bureau of Computer Services evaluate services for the DCS as part of the review of employee jobs and procedures.

RESPONSE:

As stated in the response to Recommendation 16. these services were evaluated in 1975 prior to the implementation of the program. The purchasing of these services rather than having them performed by the Bureau of Computer Services resulted in less costs to the taxpayers. Beginning July 1, 1979, these services are being furnished at no cost to the taxpayers and no additional charge is being levied against the participants for these services.





