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CORRESPONDENCE MEMORANDUM

DATE: July 16, 2013

TO: Wisconsin Deferred Compensation Board Investment Committee

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Self-Directed Brokerage Account Option Review

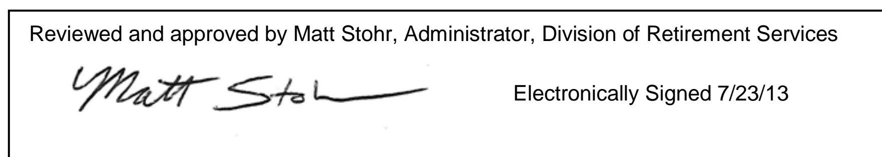
This memo reviews the Self-Directed Brokerage Account (SDBA) and discusses possible options for expanding SDBA investment choices.

A SDBA is an option many defined contribution plans offer to provide participants with additional investment choices. Through an SDBA, participants may select investment options beyond the plan's core investment options.

After review and careful consideration of SDBAs in the late 1990s, the Wisconsin Deferred Compensation Board (Board) voted to include an SDBA option in the Wisconsin Deferred Compensation Program (WDC) and in 1999 released a Request for Proposals for an SDBA provider. Charles Schwab and Co., Inc. was selected and the Schwab Personal Choice Retirement Account (PCRA) was added to the WDC as the SDBA and opened to participants in early 2000.

The Board periodically reviews the investment options and services offered through the WDC, including the PCRA, which was last reviewed in 2007. Through the PCRA, Schwab offers plan sponsors the option to provide participants with access to thousands of mutual funds, individual domestic and foreign equities, fixed income investments, publicly traded limited partnerships, exchange-traded funds, money market funds and options (covered calls and protective puts). When the Board opened the SDBA to WDC participants in 2000, it chose to limit SDBA investment choices to mutual funds only. In 2007 the Board reviewed this decision and decided not to make any changes; the WDC's SDBA continues to offer access to only additional mutual funds not currently found in the WDC's core investment option lineup.

As the table below illustrates, while assets in the PCRA have grown steadily, the actual number of WDC participants using the PCRA has remained fairly constant at less than 800.



Board	Mtg Date	Item #
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Schwab Personal Choice Retirement Account Usage			
As of	WDC Participants	Active PCRA Users	WDC Assets in PCRA
December 31, 2003	40,600	732	$24,491,614
December 31, 2008	49,000	756	$35,861,066
December 31, 2012	52,000	732	$57,206,990

Expansion of SDBA Investment Options
A few WDC participants periodically contact the Department requesting the ability to use the SDBA option to purchase different investments, including exchange traded funds and stocks. Including additional options to the SDBA would certainly please the participants who have requested this in the past and may draw new participants. If the Board were interested in expanding the SDBA investment options, the following investment options are available in the Schwab PCRA and could be added to the list of SDBA investment options permitted by the Board:

Schwab PCRA Investment Options	
Type	**Schwab's comments**
Taxable mutual funds	Most common option permitted and what WDC offers presently.
Tax-Exempt mutual funds	Not recommended unless the plan offers a Roth option. (Without a Roth option, it generally does not make sense to purchase a tax free investment in a tax deferred plan.)
Equities (stocks)	Plan sponsor decision. "Listed and NASDAQ" is common, which includes exchange traded funds and closed-end mutual funds. Could also specifically exclude potentially higher risk over-the-counter securities.
Publically Traded Limited Partnerships	Schwab data suggests that at present, more plans are excluding this option from their PCRA lineup than including it.
Taxable Fixed Income	O.k. Schwab notes that most "open brokerage" PCRAs include this option. Could limit to certificates of deposit only if desired.
Tax-Exempt Fixed Income	Not recommended unless the plan offers a Roth option. (Without a Roth option, it generally does not make sense to purchase a tax free investment in a tax deferred plan.) Could also limit to "Treasuries Only" to include U.S. Treasury Securities (bills, notes and bonds)
Foreign Securities	No overriding consensus on this type, but many plan sponsors using the Schwab PCRA have permitted them in the past. Schwab notes that in recent years, more plan sponsors are choosing "none."
Options (covered calls and protective puts)	Not permitted by many plans.

ETF Observations

The majority of SDBA-related requests received from WDC participants focus on the mutual fund only limitation. If the WDC's SDBA option was expanded to include listed and NASDAQ equities (including exchange traded funds but not over-the-counter stocks), it would address many of the requests received from participants to date. Staff does not have any concerns with including taxable fixed income in the SDBA. Lastly, because WDC participants may already contribute to their accounts via the Roth (pre-tax) option, expanding the SDBA to include tax-exempt mutual funds and tax-exempt fixed income would be acceptable.

However, staff does not recommend expanding the SDBA to include over-the-counter equities, publically-traded limited partnerships or foreign securities or options. While these may be appealing and intriguing investment options for some investors, they are not properly suited for a retirement savings plan such as the WDC. Participants seeking to invest in these options may pursue them via non-plan sponsored avenues including brokerage firms and financial planners.

Government Plan Sponsor Use of SDBAs

According to the results compiled by the National Association of Government Defined Contribution Administrators (NAGDCA) in its *2013 Defined Contribution Plan Survey Report*, published March 2013, SDBAs are fairly common offerings by plan sponsors but not used very often by plan participants. Nearly half (49%) of the 136 government defined contribution plan sponsors[1] who responded to the survey offer a SDBA to their participants. Of those offering the SDBA, nearly all reported that less than five percent of their participant use the SDBA. The 2013 survey did not ask about options included in SDBAs, but in 2010, the NAGDCA survey results indicated that just over half (51%) of the forty-six respondents offer select mutual funds only and 49% offer equities, bonds and mutual funds.

Schwab reports that it is currently the SDBA provider for approximately 260 s. 457 plans, of which approximately 29% are mutual fund only options. Most plans using the Schwab platform offer participants the ability to invest in equities, exchange traded funds and fixed income securities.

Staff also queried the WDC's record keeper, Great-West Retirement Services (GWRS), regarding the use of SDBAs by other government plan customers. GWRS reports that 171 government plans administered by GWRS offer SDBAs. Of these, nearly half (85) offer only mutual funds and just over half (91) permit other investments including equities and exchange traded funds.

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[1] NAGDCA membership is open to all government defined contribution plan sponsors and includes s. 457 plans such as the WDC as well as ss. 401(k) and 401(a) plans and s. 403(b) plans. In 2013, 89 s. 457 plans responded to the survey request; the remaining 47 offered one of the other defined contribution plans.

Administration and Fees

If the Board chooses to expand the PCRA option, Schwab would need an updated trading menu from the Board indicating which additional options the Board will make available through the SDBA option. There would be no additional costs to the WDC from Schwab for this expansion and staff would work with GWRS to publicize the expansion to participants.

Although Section 8.01 of the WDC Plan and Trust document permits the Board to charge an additional fee for participants using the SDBA, currently there are no extra administrative fees for those using the SDBA. This places the WDC in the minority of NAGDCA s. 457 plan sponsors; approximately 63% of the fifty-seven plans responding to the 2010 NAGDCA survey charge an additional SDBA fee.

Staff from the Department and Schwab will be available at the August 20, 2013 Investment Committee meeting to discuss the contents of this memo. If the Investment Committee is interested in expanding investment options offered through the SDBA, staff would request that a representative from Schwab attend the next Board meeting to discuss this with the Board.

Attachments: A. "Self Directed Brokerage Windows: Should Your Plan's Window Be Open or Shut?" 2009. Scott McLerran, Ennis Knupp Research.
B. "Is Fiduciary Liability of Self-Directed Brokerage Options Too Great for 401k Plan Sponsors?" Christopher Carosa, *Fiduciary News*. June 11, 2013.

Self-directed brokerage windows (windows) offer defined contribution plan participants flexibility to invest in opportunities not available through the plan's core line-up. Windows allow participants access to a broad array of stock and bond investments, including mutual funds and, in some cases, individual stocks and bonds. Windows can also be designed to exclude certain investments, such as single issuer stocks and bonds, while maintaining their key function of providing participants a broadened range of investment opportunities.

We have long advised our plan sponsor clients with fiduciary responsibility for defined contribution plans to develop their plan's investment structure by focusing on the three goals of 1) low cost, 2) broad diversification, and 3) simplicity. We firmly believe an investment structure designed by focusing on these goals provides the greatest number of participants with the highest likelihood of success, defined as accumulating meaningful assets to help support a secure retirement.

Our extensive consulting experience in the defined contribution market has found that many plan sponsors have determined that windows are an important supplement to their plan's investment structure by allowing participants access to an even broader range of investments. We believe that offering a window that provides this additional diversification may add value to plans as a complement to a thoughtfully developed core investment structure. However, we recommend that the window be designed to exclude participant access to single issuer stocks or bonds, with the exception of government issues. We further encourage plan sponsors to provide ongoing participant communication as a consistent

reminder of the advantages offered by the carefully monitored and cost effective core line-up. Low cost and simplicity, in addition to diversification, are equally important goals.

Plan sponsors either currently offering a window or evaluating if adding a window to their plan is right for their participants are encouraged to consider the following four key points in their evaluation:

1) Determine that offering a window is a valuable plan design benefit; this is a separate decision from the fiduciary duty to monitor as a plan investment.

2) Believe the plan design benefit is not negated by the potentially higher costs, including: account maintenance fees, transaction costs, generally higher expense ratios for retail mutual funds, and mutual funds that may charge front- or back-end loads.

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3) Provide for detection and prevention of any prohibited transactions, for example, trading options and futures, selling short, or using margin accounts.

4) Perform a reasonable level of periodic monitoring to remain informed on plan participant use; this task falls under the important fiduciary duty to monitor plan investments.

Background and Historical Perspective

Plan sponsors have traditionally targeted windows for use by specific participant sub- groups within the plan. For example, plan sponsors of professional organizations (examples include financial, legal, and engineering) have historically been the most visible users of windows. These sponsors often determine that their highly educated participants are also likely skilled investors and may benefit from the increased flexibility a window provides. Some sponsors are targeting specific subsets of participants believed to be skilled investors, such as management, when offering a window. A few sponsors simply are responding to the demands of a small, but often very vocal, number of participants who believe strongly that they are skilled investors and require the flexibility a window provides to execute their investment strategies.

Plan sponsors that offer a window typically believe it offers these investment savvy plan participants:

- Flexibility to execute more complicated investment strategies.
- Ability to take advantage of specific market conditions; including the ability to be more aggressive in strong markets or more defensive in difficult markets.
- Ability to concentrate investments in compelling areas or completely avoid certain areas determined to be too risky or currently out of favor.

Peer Utilization. The percentage of plans offering a window has increased over the past ten years. The Profit Sharing/401(k) Council of America (PSCA) 52nd Annual Survey reflecting 2008 plan year data (PSCA Survey 2008) found that 23.8% of surveyed plans offered a window compared to 19.1% for the 2001 plan year. Historical research indicates about 5% of plans offered a window in 1997. The PSCA Survey 2008 included 908 plans covering 7.4 million participants and over $600 billion in plan assets. Vanguard, a significant defined contribution service provider, reported that 9% of its client plans offered a window for the 2008 plan year. A survey of our defined contribution plan sponsor clients in late 2009 found that about 27% include a window in their plan.

Participant Utilization. In contrast, participant utilization as measured by total assets invested in a window has remained relatively low. The PSCA Survey 2008 reported that 2.5% of total plan assets (including those plans without windows) were invested in a window, compared to 0.3% of total plan assets for the 2001 plan year. Our clients with a window had an average asset allocation of a about 3.5%.

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Merits and Drawbacks

Consultants, plan sponsors, and defined contribution plan researchers continue to debate the advantages and disadvantages of a window. Windows have become increasingly common over the past ten years, and the practical experience over their history provides some evidence regarding their merits and drawbacks.

We highlight some of the key merits and drawbacks consistent with an earlier research paper released in 2004 on the same topic:

Merits

Self-directed brokerage windows offer the following key merits:

Strong appeal to certain plan participants. Certain plan participants, as previously described, believe they are skilled investors and require the investment breadth and flexibility a window offers to execute their investment strategies. These participants may be particularly attracted to the ability to create strategies with a more concentrated investment focus; believing they have the ability to outperform the more broadly diversified funds offered in the core line-up.

Maximum diversification and customization. The financial markets of the past ten have years have been extremely volatile and unpredictable. Windows offer participants the ability to customize their portfolios to take advantage of market opportunities. A host of scenarios could be envisioned where a window may offer some advantages. For example, plan participants concerned about inflation could purchase Treasury Inflation Protected Securities (TIPS) or inflation sensitive commodity or real return funds. Plan participants worried about corporate fixed income credit issues could invest in individual Treasury or government issues or similarly focused mutual funds. Sector specific and concentrated equity funds, for example technology or alternative energy, could be accessed. Certificates of deposit (CDs) backed by FDIC insurance may be available.

Little evidence of inappropriate participant use. Plan sponsors, as fiduciaries required to act in the best interests of plan participants, can look to current and historical participant usage data suggesting there is little evidence of inappropriate window use by participants. This provides some support to the observation that participants confident in their investment skills are the predominant users of windows. The typical plan participants are not migrating in significant numbers to windows. This observation is consistent with large amounts of research regarding plan participant behaviors that find participants simply do not often make significant transfers with their plan assets.

Drawbacks

In contrast, windows have some drawbacks:

Potential higher costs. There are several types of potential higher costs incurred by plan participants using a window that are not incurred when investing in the core line-up, including: 1) annual account maintenance fee, 2) fees for certain mutual fund transactions, including front- or back-end loads, and 3) higher expense ratios for many mutual funds; in many cases plan participants are investing in retail share classes rather than the institutional share class often available in the core line-up. These additional costs in aggregate can be significant. The key question becomes: for the typical window user do the advantages offered by access to a broader selection of investments offset the potential higher costs?

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Participant risk due to lack of diversification. Each option in the core line-up is monitored for participant suitability, which includes a sufficient level of broad diversification. A participant invested in only one option in the core line-up will not be insulated from a loss in a severe market drop; however, the imbedded diversification will provide some reasonable protection. Participants in the window are able to create more concentrated positions that may expose them to more substantial losses. We recommend that the window exclude single issuer stocks or bonds, except for government issues, to prevent participants from exposing their portfolios to possible catastrophic losses. We believe a quick review of a sample of companies that were considered by many to be bellwether issues but were bankrupted in the market meltdown from 2007 to early 2009 (for example; GM, Lehman Brothers, AIG, Chrysler, and Washington Mutual) provides ample support for not allowing window users the ability to invest in single issuer stocks or bonds.

Challenge of fiduciary oversight. Plan sponsors have the fiduciary duty to prudently select and monitor investment choices. Plan sponsors can take some comfort as windows continue to build an ever lengthening and apparently successful track record. Plan sponsors cannot monitor all possible investments available in the window. However, we recommend, at least annually, some type of review of participant window use to help fulfill the important fiduciary roll of monitoring plan investments. The defined contribution service provider can provide information on participant window usage for the plan sponsor to review.

Recommendation to Plan Sponsors Offering or Reviewing a Window

We recommend plan sponsors offering or reviewing a window for their plan consider four key points in their evaluation. For plan sponsors already offering a window in their plan, we recommend revisiting these four key points on a periodic basis.

Determine that there is plan design benefit to offering a window. Review your participant demographics and identify the sub-group you believe will benefit from a window. Evaluate whether or not a window fits within your plan's overall goals and investment structure.

Consider the potential higher costs. As described in the merits and drawbacks section, plan participants investing through a window can incur several types of potential higher costs. At some level, the plan sponsor should be informed regarding these additional costs and formulate an affirmative position that the advantages offered by a window are believed to offset their potential higher costs.

Provide for detection and prevention of prohibited transactions. Certain types of transactions or investments, such as buying on margin or selling short, are prohibited. The plan sponsor must work with their defined contribution service provider to monitor and prevent prohibited activities.

Perform some level of ongoing review. Plan sponsors are not required to monitor the extensive list of investments available in a window. However, there is a fiduciary requirement to monitor plan investments. We recommend plan sponsors periodically review participant window usage, for example: number of participants utilizing, account balances, participants with single investment portfolios, and trends in these statistics. The plan's defined contribution service provider can assist by providing participant statistics and comparisons. While there is no explicit regulatory measure to satisfy this component, we recommend plan sponsors review, at least annually, how their plan participants are utilizing the window that the plan sponsor has made available.

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Limited Mutual Fund Window

We advise plan sponsor clients to avoid including a "limited mutual fund" variation of a window. In this type of window arrangement a large number of mutual funds would be offered to participants, but not the entire mutual fund universe. This limited window requires some type of determination regarding which mutual funds to include and, therefore, may imply the plan sponsor, as fiduciary, is monitoring these mutual funds and has determined their suitability for participant investment.

Conclusions

We have long advised our plan sponsor clients with fiduciary responsibility for defined contribution plans to develop their plan's investment structure by focusing on the three goals of 1) low cost, 2) broad diversification, and 3) simplicity. We firmly believe an investment structure designed by emphasizing these goals provides the greatest number of participants with the highest likelihood of success, defined as accumulating meaningful assets to help support a secure retirement.

We recommend that plan sponsors currently offering a window and plan sponsors evaluating if offering a window is right for their plan participants consider the value- added proposition and appropriate monitoring and detection practices. We believe most clients will find that a self- directed brokerage window, excluding access to single issuer stocks or bonds other than government issues, adds value to their plan as a complement to a thoughtfully developed core investment structure.

We also recommend that plan sponsors offering a window provide ongoing plan participant communications as a consistent reminder of the advantages offered by the carefully monitored, broadly diversified, and cost effective core line-up.

Scott McLerran, CFA October 2009

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Is the Fiduciary Liability of Self-Directed Brokerage Options Too Great for 401k Plan Sponsors?

By Christopher Carosa, CTFA | June 11, 2013

Holmes Osborne, principal of Osborne Global Investors, Inc. in Santa Monica, California, is about to meet with a heavy equipment company that wants a self-directed plan. As he typically finds, the desire for a self-directed plan stems from one of the executives wanting to buy individual stocks. "I'm completely for self-directed plans," says Osborne, who plans to recommend a self-directed platform from a major mutual fund company that features low-fee funds. He adds, "When you take all fees, including my 25 basis points, some participants will be in at under 40 basis points. This is pretty reasonable." Osborne feels comfortable with his recommendation. "As for self-directed," he says, "I don't see that being a liability for plan sponsor. There are trillions of dollars in online trading accounts. This is the same thing."

Or is it?

According to Brooks Herman, Head of Data and Research at BrightScope, Inc. in San Diego, California, "brokerage windows on 401k plans really give investors unlimited (and ultimately the ability to select some very risky assets) investment choice. It appears to be a feature that is increasing over time." Herman looked at the number of 401k plans that filed their Form 5500 with a service code indicating that they offer a self-directed brokerage option and fund the number has nearly doubled from 2006 to 2011 (the most recent year available to the public. While there were nearly 52,000 401k plans offering a self-directed brokerage option in 2011, there were only 519 403(b) plans doing the same. But don't let that small number dissuade you. "403(b) plans just started becoming ERISA compliant in 2009," says Herman, who points out "there are far fewer 403(b) plans than 401k plans." Still from 2009 to 2011, the number of 403(b) plans offering a brokerage window increased more than 35%.

It's clear Osborne is not alone in his enthusiasm for self-directed options. More plans are offering the self-directed options, but are employees taking the bait? Dan Cassidy leads P-Solve Cassidy – a consulting firm focused on enterprise risk management of retirement plans located in Waltham, Massachusetts. He says self-directed brokerage accounts are "still not a very common option in plans." Cassidy has seen, even when offered, participation in these options is very low ("about 1%").

Others attest to the rarity of these options. Gabriel Potter, Senior Researcher, Westminster Consulting, Rochester, New York, says, "Self-direction options are the exception, not the rule, for most 401k plans." Susan Conrad, vice president of Plancorp Retirement Plan Advisors in St. Louis, Missouri says, "About 20% of our prospects offer self-directed brokerage accounts as investment alternatives." But, she warns, even this number "might be above average because we have a high concentration of medical practices.

In my experience, physicians and engineers offer self-directed brokerage accounts more than other employers."

Potter says the types of employees that generally use self-directed options are "highly engaged employees" like "highly compensated individuals and those working with a separate investment adviser." He describes the typical characteristics of plans that offer self-directed brokerage options in this way: "Plans with self-directed options can come from very large companies with thousands of employees looking to maximize their options to wide variety of participant needs. Conversely, they can also come from very small companies looking to provide maximum flexibility without the burden of selecting investment options. (For instance, some small companies can forgo the 401(k) structure entirely in favor of a Simple IRA retirement option, leaving plan participants completely responsible for retirement investment decisions.)"

Most feel the push towards self-direction comes from only a few employees. Cassidy says, "the most common reason we see plans add it is to appease a small vocal group – usually an executive or two – who have an outside financial advisor who does not like the options in the plan, and wants to do something else with the executive's account."

Herman says, "The verdict is still out on whether a plan sponsor is fulfilling their fiduciary duty with a brokerage window: it gives them cover because the plan is not limited to two dozen pre-selected assets, but opens them up to exposure if their participants are buying" highly leveraged ETFs, for example.

Indeed, the lure of the "ultimate" choice may be enough to entrap employees and even 401k plan sponsors. Conrad says, "Plan Sponsors often think they are offering participants a benefit by allowing them to invest in any security they choose. The results however, are often destructive for inexperienced investors." She explains, "Participants purchasing individual stocks significantly increase their risk as compared to broadly diversified mutual funds and self-directed brokerage accounts fees are generally higher. Retirement plans often leverage the entire plan balance to qualify for lower cost mutual funds. Investments acquired through self-directed brokerage accounts are purchased at retail which can be significantly more expensive. Higher fees and increased risk can position participants for unfavorable results."

"Ideally, a 401k retirement committee or investment committee must vet the options and monitor them on an ongoing basis to satisfy their fiduciary requirements," says Potter. The dangers of self-directed brokerage accounts mean "unsophisticated individual investors working outside of the vetted options can easily select imprudent investments," he says.

It's not as though 401k plan sponsors had no liability, though. "Prior to 408(b)(2), plan sponsors assumed there were no fiduciary concerns," says Ary Rosenbaum, Managing Attorney, The Rosenbaum Law Firm P.C. He suggests this might not have been totally true because "if you read ERISA 404(c), plan sponsors still could have been on the hook for liability because the information that plan sponsors typically provided to participants selecting these windows were slim to none."

Once July 2012 occurred, it got much worse for plan sponsors. Fred Reish tells *FiduciaryNews.com*, "Last year, in guidance about participant disclosures, the DOL said that plan fiduciaries must prudently select the providers of participant brokerage accounts, that is, the broker-dealers. As with the selection

of any provider, that would include evaluating the costs and services. That guidance came as a bit of a shock to the private sector, since many – maybe most – plan sponsors had believed that was the participants' responsibility. As the DOL position becomes better known, some plan sponsors may be reluctant to include brokerage accounts in their plans. The guidance was in DOL Field Assistance Bulletin (FAB) 2012-02R."

Besides the need for 401k plan sponsors to be prudent in selecting the providers of the brokerage account and stating that a brokerage account is not an investment alternative, Rosenbaum says plan sponsors who opt for the self-directed brokerage window must disclose the following to plan participants:

- "Information on how the window works, such as how and to whom to give investment instructions, account balance requirements, if any, restrictions or limits on trading, how the window differs from the plan's Default Investment Alternative, and who to contact with questions.
- "An explanation of fees and expenses that may be charged individually in connection with the window including start up fees, on-going fees, and any fees or commissions charged in connection with the purchase and sale of a security, including front-end and back-end loads.
- "A quarterly recap of the fees that that were charged and the services to which they relate."

Rosenbaum has never been a fan of the brokerage windows. "I believe participants do better with investing in the plan's core fund lineup than if they use a brokerage account," he says. "In addition, plan sponsors who offer it sometimes don't offer it to all employees, which might violate the IRS' rule on benefits, rights, and features discrimination rule. Finally, I don't think the issue of liability is settled and I'm afraid it will be tested in court. The issue of whether plan sponsors need to monitor the investments in these brokerage accounts won't go away."

Conrad is even more forthright. She says, "We encourage plan sponsors to reduce their fiduciary liability by removing the self-directed brokerage accounts as an investment vehicle. Investors that so choose can buy individual stocks and bonds in their personal accounts. Retirement plans should be designed from a fiduciary perspective."

We'll leave you to ponder this sage advice of Harlan Platt, PhD, Economist and Professor of Finance at Northeastern's D-Amore-McKim School of Business in Boston: "The tendency for nonprofessional investors is to get into the market at the top and sellout at the bottom. Obviously this is counterintuitive or nonproductive. On the other hand, most professionals are merely momentum followers. This seems to put the 401(k) investor into a precarious position. I think most 401(k) investors would be better served by putting their funds into a large investment house and having the money invested in one of their balanced, (i.e., equities and fixed income), funds." To some, this sounds strikingly similar to the "one portfolio" option, the choice of many fiduciary advisers.