STATE OF WISCONSIN
Department of Employee Trust Funds
Eric O. Stanchfield
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
TTY (608) 267-0676
http://etf.wi.gov

CORRESPONDENCE MEMORANDUM

DATE: May 3, 2007

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Expansion of the Schwab Self-Directed Brokerage Window

In February 2007, Investment Committee members were advised that the Department has had inquires from participants regarding the possible expansion of the self-directed brokerage (SDB) option offered through Charles Schwab. Participants have questioned why the Board limits the SDB to mutual funds only, and have requested that the Board open the SDB option to permit access to exchange traded funds (ETFs) and stocks. Investment Committee members suggested it would be prudent to reconsider the Board-imposed limitations on SDB investment options. This memo reviews the SDB option and discusses possible investment options.

Background

The Board made the decision to include an SDB option in the Wisconsin Deferred Compensation Program (WDC) in 1998. After a Request for Proposal process in 1999, the Schwab Personal Choice Retirement Account (Schwab PCRA) was added to the WDC and opened to participants in early 2000. At the time, the Board decided to limit investment choices available through the SDB option to mutual funds only.

The table below shows current PCRA usage. Of the approximately 44,000 participants in the WDC, less than two percent use the PCRA.

Schwab PCRA Usage As of December 31, 2006	
WDC Participants	WDC Assets
708	$43,458,924

SDB Investment Options

Based on results compiled by the National Association of Government Defined Contribution Administrators in its *2006 Survey of Plans*, of the 36 state level s. 457 plans that responded to the survey, 19 (53%) offer an SDB option. Of these 19, 74% (14 of 19) require the participant to pay to use this feature. Along with the WDC, Florida, Nevada, Pennsylvania and Texas do not charge individual participants who use the SDB option.

Reviewed and approved by David Stella, Deputy Secretary

Signature   Date

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For Great-West Retirement Services (GWRS) administered government plans, Advised Assets Group reports that out of the 61 government plans providing a SDB, 38 permitted participants to purchase everything offered through the SDB, including securities. The other 23 only offer mutual funds.

Schwab PCRA Use
Schwab reports that ten state level s. 457 plans currently use the PCRA as their SDB option. Of the ten, seven are open brokerage and three allow only mutual funds. Of the seven open brokerage plans:

- Six allow trading in all equities (listed, NASDAQ, and over-the-counter (OTC) securities). The OTC securities include penny stocks.
- One plan allows for equity trading only in listed and NASDAQ securities.
- Two allow for option trading (covered calls and protective puts).
- Five allow for trading of publicly traded limited partnerships.
- Four allow for trading of foreign securities.
- All restrict tax exempt fixed income, but allow investment in treasury securities.

Costs for SDB Option Expansion
If the Board chose to expand the PCRA option, there would be no additional costs to the Board from Schwab. Schwab would need an updated trading menu indicating which additional options the Board agreed would be available for purchase through the WDC's SDB option. The Schwab PCRA offered by the WDC provides access to over 2,500 mutual funds, individual domestic and foreign stocks, fixed income investments, publicly traded limited partnerships, ETFs, money market funds and options (covered calls and protective puts).

A PCRA pricing summary from Schwab is attached to this memo. It outlines the current transaction costs borne by participants using the PCRA to purchase equities and other open brokerage investments.

Legal Considerations
It is difficult to assess the potential liability issues that the Board could face if the SDB were opened to permit additional options. When asked recently, Schwab could not identify any liability cases specifically related to SDB option accounts in a s. 457 or s. 401(k) plan. GWRS is aware of two situations where plans allowed non-mutual fund options within their SDB and this did result in losses to the participant that may not have otherwise occurred. There are likely many other plans that have offered a full-menu SDB with no reported problems.

The Employee Retirement Income Security Act (ERISA) requires plan fiduciaries to act prudently and for the exclusive benefit of plan participants. As a s. 457 plan, the WDC does not fall under the regulations and standards imposed by ERISA. However, in practicality, most ERISA standards are followed by the WDC and other s. 457 plans as ERISA requirements are considered standard "best practices" for the retirement industry.

A white paper that was completed for Schwab by Baker & McKenzie in 1998 addressed the concept of SDB accounts from a fiduciary perspective. It concluded that when an SDB option is offered in conjunction with a sensible core lineup, "plan sponsors should not increase their fiduciary liability under ERISA Section 404."[1] Staff believes that the WDC offers a diverse and sensible list of investment options in the WDC core spectrum.

Another white paper by the firm of Pillsbury, Winthrop, Shaw, Pittman in 1999 addressed several potential areas where trustees could be liable under ERISA if they offered an unrestricted SDB investment option to their participants. To avoid a breach of fiduciary duty, this firm recommended no investments should be permitted that:

- "…would cause the plan to hold assets with "indicia of ownership" outside the jurisdiction of the federal district courts of the United States;
- … are not permitted by the plan document or that would jeopardize the plan's tax qualified status;
- …could result in the loss of an amount greater than a participant's account balance;
- … would result in a "prohibited transaction" or that would greatly increase the difficulty of compliance with the "prohibited transaction" rules;
- …[are] illiquid or not permitted for IRAs" (to avoid potential problems with distributions and IRA rollovers).[2]

Based on information provided by Schwab, the WDC's SDB is sufficiently limited to avoid the types of investment options listed above that could increase the Board's fiduciary liability. As noted earlier, the Schwab PCRA provides access to over 2,500 mutual funds, individual domestic and foreign stocks, fixed income investments, publicly traded limited partnerships, ETFs, money market funds and options (covered calls and protective puts). The Schwab PCRA *does not* include access to currencies, precious metals, real estate, collectibles, private placements, futures, commodities, margin account, index and equity options, short sales or Schwab corporate debentures/collateralized debt obligations.

Conclusion
Department staff will be available at the meeting to discuss this memo and the possible expansion of the SDB option.

If the Board were to decide to expand the SDB option to include investment options beyond mutual funds, staff will work with Schwab and GWRS to coordinate a campaign to announce this change to WDC participants.

Attachments

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[1] "What Fiduciaries Need to Know About Self-Directed Brokerage Accounts: A Legal Perspective on the Schwab Personal Choice Retirement Account" Baker and McKenzie. March 1998.
[2] "Self-directed Investment Options in 401(k) Plans: Legal and Fiduciary Issues" Pillsbury, Winthrop, Shaw, Pittman LLP. 1999.