Office of Internal Audit

Third-Party Administrator Contract Compliance Audit: Wisconsin Deferred Compensation Program – Empower

May 9, 2024

Prepared for the Deferred Compensation Board, June 6, 2024, by Shellee Bauknecht

Executive Summary

We have completed a contract compliance audit of the Deferred Compensation Board's (Board's) contract ETJ0061 with Empower for administrative services for the Wisconsin Deferred Compensation Program (WDC). Employee Trust Funds' (ETF's) Division of Benefits Administration (DBA) is responsible for oversight of the contract with Empower for the WDC. As part of ETF's third-party administrator (TPA) oversight, periodic contract compliance audits are conducted to monitor the administration of the programs. ETF's DBA is responsible for ensuring any audit findings are resolved with Empower.

This audit was completed in accordance with the Office of Internal Audit's (OIA) fiscal year 2024-2025 Biennial Audit Plan to evaluate the design and operating effectiveness of internal controls over Empower's compliance with contract ETJ0061 for calendar year (CY) 2023. This audit was insourced to ETF's OIA to provide independent and enhanced assurance over contract compliance while reducing costs.

Our audit focused on eligibility, contribution limits, rollover account segregation, distributions, reporting requirements, equity wash requirements, and fees related to participant accounts, managed accounts, and Empower's administrative fee. Overall, we found Empower was compliant with most of the compliance requirements of its contract with ETF for administrative services for the WDC included in the scope of our audit. Our review resulted in 4 findings with recommendations for Empower and ETF to improve administration of the WDC.

We recommended Empower:

- Implement a process to ensure records can be provided to ETF to allow for timely monitoring and validation of performance standards and implement a report review process to ensure the Quarterly Service Level Agreement Report is accurate.
- Implement procedures and controls to ensure required minimum balances in the core investment options are maintained for participants utilizing the self-directed brokerage option and participant fees are appropriately charged.
- Determine the cause for an override of a transfer from the Stable Value Fund to a competing investment option and implement process to ensure equity wash requirements are adhered to.
- Improve its calculation of over deferral projections to accurately identify participants that are at or near exceeding the maximum contribution limit and provide notification to those participants.

We recommended ETF:

- Require supporting documentation for the Quarterly Service Level Agreement Reports and consider a contract penalty for instances when requests for supporting documentation are not timely or accurately provided; perform regular reviews or sample verifications of performance standards; and amend contract language to clarify the appropriate scale to be used for the Employer Survey performance measure.

- Identify changes that may be warranted to the Plan and Trust, the administrative services contract, program materials, and operational procedures and provide guidance to Empower to ensure required minimum balances of the core investment options are maintained for participants utilizing the SDB option and participant fees are appropriately charged.

We also provided several additional considerations for ETF and Empower to further improve processes related to the administration of the WDC as discussed in the Process Improvements Considerations section of our audit report.

Audit Objective and Scope

The audit objective was to evaluate Empower's compliance with the Board's contract for WDC administrative services. Our audit focused on participant eligibility, contribution limits, rollover account segregation, distributions, reporting requirements, equity wash requirements, and fees related to participant accounts, managed accounts, and Empower's administrative fee. Our review also included adherence to established performance standards, maintenance of participant records, and whether transactions were processed accurately and in compliance with regulatory and contractual requirements. We excluded processes and controls of employers from our review. We also considered procedures performed as part of the financial statement or service organization control audits to avoid duplicative testing.

Our audit period included CY 2023 and was conducted in conformance with International Standards for the Professional Practice of Internal Auditing.

Background

Contract and Key Responsibilities

ETF and the Board have statutory authority for program administration and oversight of the WDC. The Board contracts for administrative services for the WDC through a competitive bid process. The Board's current contract (ETJ0061) with Empower for WDC administrative services is for the period December 1, 2022, through November 30, 2027, with the option to renew for two additional 3-year periods. Empower's annual administrative fee is $2,623,960, which is prorated and collected monthly by Empower.

Staff within ETF's DBA is responsible for monitoring the WDC and the contract with Empower as well as ensuring audit findings are resolved. ETF is responsible for assisting Empower regarding communications to participating state and local government employers and employees, approval of marketing and promotional materials, and operating decisions.

Empower's key responsibilities include: day-to-day recordkeeping, technical assistance, customer services, marketing and promotional materials, proper retention of records, participant account activity and valuation, monitoring contribution limits, processing rollovers and maintaining separate rollover accounts, timely investments of contributions and transfer requests, enforcing equity wash requirements, processing of domestic relations orders (DROs) to divide accounts, timely processing of distributions including approvals of unforeseeable financial emergency hardship applications and participant notification of required minimum distributions, providing required reporting to ETF and participants, meeting performance standards in the Quarterly Service Level Agreement Report, and implementing goals specified in the annual Strategic Partnership Plan.

Program Information

The WDC is a supplemental retirement savings plan that receives and invests employee payroll deferrals and reinvests investment earnings. The WDC was created by Wisconsin Laws of 1981 Chapter 187 and established in 1982 for state employees. It has been available to local employers since 1985. The WDC is available to all active state and university employees. Active local government and school district employees may also be eligible if their employer has elected to offer this optional benefit program. The WDC is governed by Section 457 of the Internal Revenue Code (IRC), Wisconsin Statutes §40.80, 40.81, & 40.82 and Wisconsin Administrative Code ETF Chapter 70.

Contributions

Participants may contribute 100% of taxable income to their accounts, up to a federal maximum that is adjusted annually. The CY 2023 regular contribution limit was $22,500. Participants over age 50 were eligible to contribute an additional $7,500 annually, a total annual limit of $30,000. Participants within three years of normal retirement age[1] in CY 2023 who under-contributed in prior years were also eligible for a special catch-up contribution of an additional $22,500 annually, total annual limit of $45,000[2].

Participants are responsible for monitoring contributions to ensure annual limits are not exceeded. As required by contract, Empower performs a review after the end of the third quarter to identify participants that are projected to exceed the annual limits. These participants are sent a communication to inform them of the potential over deferral. Empower also performs this review at the close of the calendar year and resolves any accounts that contributed over the annual limit in accordance with Internal Revenue regulations.

Other retirement account savings account balances, including those invested in 401(k), 403(b), 457(b), and IRAs[3], may be rolled into a participant's WDC account. Empower is required to maintain separate accounts for rollovers except for transfers from different Section 457 plans offered by eligible employers.

[1] Normal retirement age is 65 unless otherwise specified by an employer or unless categorized as a protective employee.
[2] Per federal rules, participants may not contribute to both the age 50+ catch-up option and the special catch-up option in the same calendar year, even if eligible to use both options.
[3] A prior employer-sponsored Roth account may be transferred into a WDC Roth 457(b) account. However, per Internal Revenue Service (IRS) regulations, a participant cannot transfer Roth IRAs into a WDC Roth account.

Investments

The Board selects the investment options offered by the WDC and regularly reviews the performance of the investment options offered to determine if they continue to meet established performance benchmarks. Options that are determined to be no longer acceptable may be removed from the WDC and new options may be added at any time. Participants may select various core investment options, including target retirement date portfolios, mutual funds options, commingled trust options, a stable value fund, and an FDIC-insured bank option. A self-directed brokerage (SDB) option is also available for participants desiring to invest in mutual funds that are not part of the core WDC investment options.

Empower is to prohibit direct transfers between the WDC's Stable Value Fund and competing investment options to adhere to equity wash requirements, as stated in its contract with the Board. Additionally, after a participant makes a transfer from the Stable Value Fund to a non-competing investment option, Empower is to prohibit all transfers from that non-competing investment option into a competing investment option for 90 days.

Fees

Per contract terms, the annual administrative fee paid to Empower is $2,623,960. The administrative fee is prorated and collected by Empower monthly as documented and reported in the Unallocated Plan Account.

Participant fees provide the primary source of funding for WDC administration and are reported in the Unallocated Plan Account. State funds are not used for the administration of the WDC. A monthly participant fee is deducted from participant accounts to cover the cost of administering the WDC. See Table 1 for monthly participant fees for CY 2023.

Table 1. 2023 WDC Participant Administrative Fees

Participant Account Balance	Monthly Participant Fee	Annual Participant Fee
$0 to $5,000	$0.00	$0.00
$5,001 to $25,000	$1.25	$15.00
$25,001 to $50,000	$3.00	$36.00
$50,001 to $100,000	$6.50	$78.00
$100,001 to $150,000	$8.25	$99.00
$150,001 to $250,000	$11.75	$141.00
Over $250,000	$17.25	$207.00

The WDC also offers investment advisory services which are provided through Empower Advisory Group, LLC. The services include Online Advice, which is free to participants, and My Total Retirement. Participation in My Total Retirement is voluntary, and participants may opt in or out at any time. Participants who choose to have their WDC account managed through My Total Retirement are charged an annual managed account fee based on a percentage of their account balance, as shown in the table below, which is assessed to the participant's account quarterly.

Table 2. WDC Managed Account Fees

Participant Account Balance	Annual Managed Account Fee
Up to $100,000	0.45%
Next $150,000	0.35%
Next $150,000	0.25%
Greater than $400,000	0.15%

Distributions

Participants can withdraw funds from their WDC account upon retirement, termination from employment, experiencing an unforeseeable financial emergency[4], reaching at least age 59½, or upon death for beneficiaries. Required minimum distributions (RMDs) from the WDC are required at a certain age. The mandatory withdrawal age changed from 72 to 73 beginning in CY 2023 as a result of the SECURE Act 2.0.

Required Reporting

Empower is required to submit certain reports containing required data elements by specific dates as outlined in the contract. These required reports include the Quarterly Service Level Agreement Reports (or performance standards reporting), Investment Performance and Expense Ratio Review, Unallocated Plan Account Reconciliation, Plan Summary, Service Organization Control reports, Quarterly and Annual Plan Reviews, and the Strategic Partnership Plan. Certain other reports are required to be delivered to ETF as needed or upon request, such as the complaints resolution log. Required reports are used to assess WDC activity, for ETF financial reporting, and for monitoring Empower's contract performance. ETF evaluates and assesses penalties for failed performance standards reported on the Quarterly Service Level Agreement Report.

Results and Recommendations

Positive Results

Overall, we found Empower was compliant with most of the requirements of its contract with the Board for administrative services for the WDC included in the scope of our audit. We found participants and employers in the WDC were eligible and distributions were appropriately made. The appropriate annual administrative fee stated in the contract was collected by Empower. Reports required by the contract were timely and required data elements were included. We found reported performance standards met the required benchmarks and no penalties were warranted for CY 2023.

[4] An unforeseeable financial emergency is an "immediate severe financial hardship" to the participant or beneficiary resulting from: An illness or accident affecting the participant or the participant's spouse or dependent; loss of property due to casualty; the imminent foreclosure of a primary residence; the need to pay medical expenses; and the need to pay for funeral expenses of a spouse or dependent.

Our review resulted in 4 findings with recommendations and several additional considerations for Empower and ETF to ensure contract compliance and proper administration of the WDC.

Findings, Recommendations and Management Responses

1. Quarterly Service Level Agreement Reporting

Finding

Supporting documentation was not provided for each quarter for 12 of 17 the performance standards reported by Empower in the Quarterly Service Level Agreement Report. Empower indicated that certain performance standards do not have reporting or support available or that Empower would not provide the support as part of the audit.

In addition, the Call Abandon Rate and Customer Care Center Availability performance standards for one quarter did not recalculate to the value reported based on supporting documentation, however, the performance standards were still met.

Lastly, we found the Employer Satisfaction performance standard metric stated in the contract was not applied, a 4-point scale was applied instead of a 10-point scale as described in the contract. The contract language was not updated to reflect the intended metric to be used for the employer surveys.

Risk/Effect

Without supporting documentation, ETF cannot validate the performance measures reported and adequately evaluate Empower's contract performance. Misreported performance standards could result in missed performance standards and penalties.

Recommendation

We recommend Empower:

a) implement a process to ensure records can be provided to ETF to allow for timely monitoring and validation of performance standards; and
b) implement a report review process to ensure the Quarterly Service Level Agreement Report is accurate.

We recommend ETF:

a) require supporting documentation to be submitted with the Quarterly Service Level Agreement Reports or as requested and consider a contract penalty for instances when requests for supporting documentation are not timely or accurately provided to ensure additional accountability over contract performance;
b) perform regular reviews or sample verifications of performance standards; and

c) amend the contract language to clarify the appropriate scale to be used for the Employer Survey performance measure.

Significance: Medium

<u>Empower Response</u>

Empower acknowledges this finding and will work with ETF staff to review options to determine what is feasible and appropriate to validate and support that the Quarterly Service Level Agreement Reports are accurate.

Empower is open to amending the contract to remove the specific scale of the Employer Satisfaction Survey or specify a scale other than 10 points.

Responsible Staff:

- Emily Lockwood, Managing State Director, Empower
- Kathy Castle, Lead Client Service Manager, Empower

Completion Dates: January 2, 2025

<u>ETF Management Response</u>

ETF acknowledges the findings of this audit. ETF relies on Empower to report accurate data on the performance standards and to have backup documentation supporting the reports when requested. Regarding the specific recommendations in this report:

1) ETF will review existing contract performance standards and available documentation with Empower, with a goal of adjusting standards as appropriate and feasible. This may involve seeking a contract amendment that includes:
    - A provision requiring that Empower submit supporting documentation upon ETF's request, and/or
    - the potential addition of a contract penalty for instances when requests for supporting documentation are not timely or accurately fulfilled.
2) ETF will review options to enhance its oversight of performance standards, likely including periodic sampling to verify accuracy. The goal of this review will be to add processes that ensure contract performance standard accountability.
3) ETF will clarify the appropriate scale to be used for the Employer Survey performance measure and propose a contract amendment if appropriate.

Responsible Staff:

- Shelly Schueller, Deferred Compensation Director, DBA, ETF

Completion Dates: January 2, 2025

2. SDB Option - Required Minimum Balances and Participant Fees

Finding

The WDC Plan and Trust requires that participants utilizing the SDB option maintain a minimum of $500 in the core investment options. If at any time a participant's core investment options fall below $250, the Plan and Trust requires notification to the participant. The balance of the participant's core investment options may be restored to the $500 required minimum in accordance with the Plan and Trust. Participant fees are collected from a participant's balance in the core investment options.

We found participant fees for 9 of 25 observations in our sample were charged a partial participant fee, which was equal to the balance remaining of the participant's core investment options, or no participant fee because all of the participant's balance was with the SDB option and a minimum required balance of the core investment options was not maintained. Had the required minimum balance been maintained for these participants, we estimate $962.15 of participant fees should have been collected.

Risk/Effect

Participant fees will not be appropriately collected for participants utilizing the SDB option whose core investment options required minimum balance is not maintained.

Recommendation

We recommend ETF identify changes that may be warranted to the Plan and Trust, the administrative services contract, program materials, and operational procedures and provide guidance to Empower to ensure required minimum balances of the core investment options are maintained for participants utilizing the SDB option and participant fees are appropriately charged.

We recommend Empower implement procedures and controls to ensure required minimum balances in the core investment options are maintained for participants utilizing the SDB option and participant fees are appropriately charged.

Significance: Medium

Empower Response

Empower acknowledges this finding. Empower will review internal procedures and work with ETF to determine whether a process can be developed for ensuring participants keep a balance of at least $500 in their core account. Empower will also review communications to determine if additional language is needed in any materials. Empower will expect to discuss a possible contract amendment and updated plan document.

Responsible Staff:

- Emily Lockwood, Managing State Director, Empower
- Kathy Castle, Lead Client Service Manager, Empower

Completion Dates: December 31, 2024

ETF Management Response

ETF acknowledges this audit finding. ETF relies on Empower to accurately calculate and collect participant administrative fees, including those from the roughly 1,000 participants using the SDB. Regarding the specific recommendations for this finding, ETF will:

1) draft proposed language for the Board's approval related to necessary changes to the Plan and Trust,
2) collaborate with Empower on a potential administrative services contract amendment to clarify operational requirements related to administration of the SDB option,
3) pursue necessary changes to WDC participant materials,
4) provide guidance to Empower to ensure participants using the SDB option understand the minimum balance that must be maintained within their core WDC investment options and consequences of falling below the minimum; and
5) verify that participants using the SDB option are charged correct participant fees.

Responsible Staff:

- Shelly Schueller, Deferred Compensation Director, DBA, ETF

Completion Dates: January 2, 2025

3. Equity Wash Requirements

Finding

As stated in the contract, Empower is to prohibit direct transfers between the Stable Value Fund and competing investment options. Additionally, after a participant makes a transfer from the Stable Value Fund to a non-competing investment option, Empower is to prohibit all transfers from that non-competing investment option into a competing investment option for 90 days.

We identified one transfer that was processed from the Stable Value Fund to the FDIC Bank Option, a competing investment option, for $100,000. Empower indicated that the system control preventing this transfer was overridden.

Risk/Effect

Equity wash requirements are intended to minimize arbitrage, which negatively impacts those participants who choose to remain in the Stable Value Fund. Equity wash requirements protect Stable Value Fund returns over the long term.

Recommendation

We recommend Empower determine the cause for the override of the transfer from the Stable Value Fund to a competing investment option and implement a process to ensure equity wash requirements are adhered to.

Significance: Low to Medium

Empower Response

Empower acknowledges this audit finding. The override of the transfer was due to a manual oversight. The manager who approved the override is no longer with Empower. The call center representative who entered the override has been provided coaching and training. The participant account is being corrected and the participant will be notified in writing once the correction is complete.

Responsible Staff:

- Kathy Castle, Lead Client Service Manager, Empower

Completion Dates: June 30, 2024

ETF Management Response

ETF acknowledges this audit finding. ETF relies on Empower to correctly implement the Stable Value Fund equity wash provision for the WDC. Failure to do so could jeopardize the plan's ability to offer this investment option. ETF requested and Empower has shared information regarding the root cause of this situation. The actions described in the Empower response indicate the firm has taken steps that should prevent potential future override events.

4. Contribution Limit Review

Finding

As stated in the contract, Empower is to determine if any participants are at or near exceeding the maximum contribution limit, contact the participant to the extent practical, and assist the participant to remedy.

We reviewed 25 participants in Empower's analysis of participants projected to exceed contributions limits after the end of the third quarter to determine whether a notification of the projected over deferral was provided to the participant and if any over deferrals after year-end were appropriately resolved.

We calculated 3 participants were projected to exceed the required contribution limits by $4,428.08 cumulatively but were not provided an over deferral notification letter. Empower appropriately resolved these over deferrals after year-end.

Risk/Effect

Participants projected to exceed contributions limits may not be appropriately notified to prevent the over deferral before year-end. These over deferrals are then required to be corrected consistent with Internal Revenue regulations.

Recommendation

We recommend Empower improve its calculation of over deferral projections to accurately identify participants that are at or near exceeding the maximum contribution limit and provide notification to those participants.

Significance: Low to Medium

Empower Response

Empower acknowledges this finding and will revisit our internal procedures to determine where improvements and efficiencies can be made to this process.

Responsible Staff:

- Emily Lockwood, Managing State Director, Empower

Completion Dates: September 30, 2024

ETF Management Response

ETF accepts this audit finding. There is a contract provision requiring Empower to ensure that contributions do not exceed the annual limit because many participants do not keep track of their deferrals and the federal contribution limits. When an over deferral occurs, it can cause a great deal of frustration and has potential tax implications for the participant. These can lead to a poor customer experience. Over deferrals also create additional work related to calculating and issuing refunds for Empower.

ETF has requested that Empower review their over deferral procedures to determine if any adjustments can be made to ensure that all participants who might be at risk of over deferring receive notification.

Process Improvement Considerations and Other Items to Note

We provided the following process improvement suggestions for ETF and Empower's consideration to improve the efficiency and effectiveness of administration of the WDC:

1) ETF consider imposing penalties associated with failed performance standards each quarter, rather than only if the performance standard is missed for two consecutive quarters, to promote timely corrective action to meet future performance standards.
2) ETF consider reviewing performance standards with Empower to determine whether certain performance standards add value to the program to be reported at plan-level versus globally and whether Empower can accommodate this.
3) ETF work with Empower to correct a participant's Social Security Number that we identified as incorrect for the WDC based on ETF data.
4) Empower determine the cause for managed account fees that are not charged a prorated fee at the time of full withdrawal and implement process to ensure managed account fees are appropriately collected. We found 4 of 25 managed account fees, for a total of $496.79, were not collected by Empower at the time of a full withdrawal. Empower indicated that this was a known intermittent administrative issue that is currently under review. These fees are collected by Empower and do not impact the funds used to administer the WDC.

Audit Methodology

The OIA conducted this audit by performing the following testing procedures:

- *Eligible participants* – We compared all participants to Wisconsin Retirement System (WRS) data to target potential ineligible participants. We compared 2,231 participants not found in the WRS data to an eligible employer list from Empower and selected 25 for further review.
- *Contribution limits* – We reviewed Empower's analysis of participants projected to exceed regular, 50+ catch-up, and special catch-up contributions limits after the 3rd quarter and those that exceeded these contribution limits after year-end. For 25 participants, we recalculated deferral projections, determined whether a notification of the projected over deferral was provided to the participant, and determined whether over deferrals after year-end were appropriately resolved.
- *Rollover account segregation* – We sampled 25 of 756 participant with rollovers in CY 2023 and verified that separate accounts were maintained for the rollover.
- *Unforeseeable Emergency Hardship Withdrawals* – We selected 25 of 85 hardship applications approved in CY 2023 to verify the hardship was supported by documentation and contributions were suspended for the hardship period.
- *DROs* – We selected 10 of 51 DROs processed in CY 2023 and reviewed for supporting documentation. We also reconciled DROs documented in the quarterly Detailed DRO Report to DROs reported in the Quarterly Plan Review.

- *RMDs* – SECURE Act 2.0 changed the RMD age from 72 in CY 2022 to 73 in CY 2023. Participants who turned 73 in CY 2023 also turned 72 in CY 2022 and were already subject to RMD. Therefore, the population size for participants requiring an RMD for CY 2023 was significantly reduced. We reviewed for RMD notices for all 8 participants age 73 or older who terminated in CY 2023 and reviewed whether the RMD was taken. We reviewed the RMD notice for the beneficiary of one participant that was actively employed, 73 or older, and passed away in CY 2023.
- *59.5+ In-service distributions* – For 59.5+ in-service distributions, we verified the participant was at least 59.5 years of age based on participant data for all 499 distributions identified for CY 2023.
- *Participant fees* – We recalculated participant fees for all participants for each month of CY 2023. We selected 25 of 203 participant fees that did not meet expectations for further review.
- *Managed account fees* – We recalculated managed account fees for all participants for each quarter of CY 2023. We selected 25 of 7,073 managed account fees that did not meet expectations for further review which included participants who withdrew funds prior to the quarter end and were assessed a prorated fee.
- *Required reporting* – We reviewed reports required by the contract for overall reasonableness and timeliness, including whether the reports contained the required data elements. We performed additional testing of the following reports:
  - *Quarterly Service Level Agreement Report* – We reviewed the reporting methodology applied and verified the accuracy of all performance standards reported based on supporting documentation provided for each quarter of CY 2023. We determined whether penalties for failed performance standards were appropriately imposed or waived.
  - *Investment Performance and Expense Ratio Review* – We reviewed the total returns and expense ratios for 10 investments and 2 benchmarks for the 4th quarter report to publicly available information.
  - *Unallocated Plan Account* – We tested that administrative fees collected by Empower were for the contracted amount and participant fees collected traced to WDC activity for the cumulative 4th quarter report of CY 2023.
  - *Complaints Log* – We reviewed that complaints for CY 2023 were acknowledged and resolved timely based on the data reported in the log.
- *Equity wash requirement* – We reviewed all CY 2023 transfers from the Stable Value Fund directly to a competing fund with no other funds involved in the transfer and identified one for further review. We sampled 25 of 3,516 transfers in which other funds were involved in a transfer to determine if the equity wash requirement was met including for 90 days after the transfer date.