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CORRESPONDENCE / MEMORANDUM

DATE: May 15, 2014

TO: Deferred Compensation Board

FROM: Robert C. Willett, CPA, Chief Trust Financial Officer
Shelly Schueller, Deferred Compensation Director

SUBJECT: Plan Expenses, Income, Administrative Fees and Reimbursements

Staff recommends the Deferred Compensation Board (Board) continue to use investment option reimbursements, for the benefit of all Wisconsin Deferred Compensation program (WDC) participants, until changing to lower-cost share classes is fiscally feasible and investment option reimbursements are reviewed as part of the annual participant fee analysis.

This memo provides an overview of plan expenses, sources of income and a discussion concerning investment option reimbursements. As plan fiduciaries, the Board acts solely in the interest of plan participants and their beneficiaries and should make decisions with the care, skill, prudence and diligence of a prudent person. Among other responsibilities, being a fiduciary includes paying reasonable plan expenses, defraying expenses where possible and documenting the process used to make fiduciary decisions.

At the Board's March 2014 meeting, the Board noted that the share classes used by the WDC for some investment options provide the Board with income in the form of reimbursements. These reimbursements are used to pay for plan expenses and thus help keep participant administrative fees low. It is important the Board understands and carefully evaluates its choices regarding the use of investment option reimbursements.

Expenses

The Wisconsin Deferred Compensation Program (WDC) incurs such annual expenses as administrative services (record keeping and outreach), domestic relations order division fees, financial statements audits, Department staff costs, and contract compliance audits. These expenses must be paid by the plan and its participants because the WDC does not receive funding from the state or participating employers.

Reviewed and approved by Robert J. Conlin, Secretary

Electronically Signed 5.21.14

Board	Mtg Date	Item #
DC	6.3.14	9B

Income

See the discussion in the participant fee analysis memo (Ref. DC | 6.3.14 | 8A). Income to pay for the WDC's expenses comes from three sources:

- administrative fees paid by the approximately 53,000 participants in the plan;
- any gains (income) on the Board's administrative account balance; and
- reimbursements received from investment options that offer share classes providing administrative fee payments or plan expense reimbursements to plan sponsors.

Investment option reimbursements received by the Board are deposited in the Board's administrative account, from which administrative expenses are paid. The Board seeks to keep a reserve balance equal to approximately half of the plan expenses. Using investment option reimbursements to fund administrative expenses helps keep WDC participant fees low. Participants with less than $5,001 in the plan do not pay an administrative fee. Fees are capped at $66 per year for those with account balances greater than $100,001.

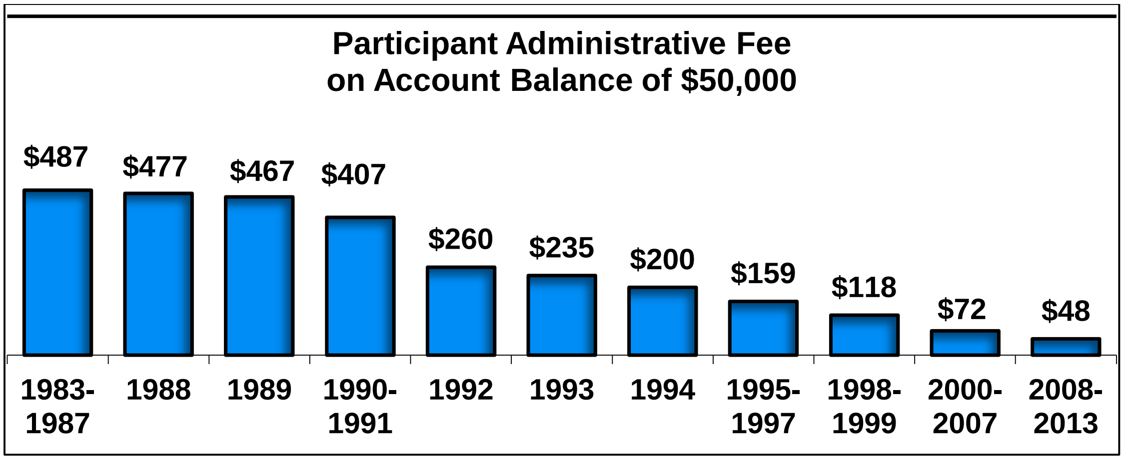
Three mutual fund investment options offered by the WDC provide a reimbursement to the Board. In addition, two of the "fixed" investment options pay a reimbursement proportional to their share of marketing expenses, based on assets in that option as of the close of the calendar year.

Table 1: WDC Investment Options Providing Reimbursements

WDC Investment Option	Participants as of 12/31/13	Expense Ratio	Reimb.	3 Year Average Annual Reimbursement to Board Account	Lower Cost Avail?	If Yes, Lower Cost Exp. Ratio
FDIC	3,400	---	---	$580	No	---
Federated US Gov't Securities: 2-5 Years	5,602	0.85	0.20	$70,415	No	---
Fidelity Contrafund	20,819	0.74	0.25	$1,015,290	*Yes*	0.63
Stable Value Fund	19,639	---	---	$3,521	No	---
T. Rowe Price MidCap Growth	20,008	0.80	0.15	$405,242	*Yes*	0.62

Participant Administrative Fees and Reimbursements

When the WDC started in the early 1980s, participant administrative fees were set quite high in order to cover plan expenses. The Board chose to utilize some investment option share classes that offered a reimbursement to the plan. These reimbursements were, and still are, used to offset participant administrative fees. The reimbursements the Board receives as a result of some participants' investment choices subsidize the cost for other participants who do not use those investment options. As WDC assets rose, so did reimbursements. The rise in plan assets and subsequent reimbursements helped enable the Board to lower participant administrative fees, as shown below.



Where financially feasible, the Board has taken steps to convert from retail share classes with reimbursements to institutional share classes with lower costs. In 2012, the Board moved the EuroPacific Growth fund from the R5 to R6 share class. This move not only eliminated a reimbursement to the Board, but also resulted in savings to individual participants investing in the EuroPacific Growth fund – and it was achieved without requiring an increase in overall participant administrative fees. Moving to the institutional share class of the T. Rowe Price MidCap Growth fund can also be achieved without requiring an increase in participant administrative fees, as noted in the participant fee analysis memo (Ref. DC | 6.3.14 | 8).

Recently, the focus in the 401(k) industry (and consequently in the 457 industry) has centered on transparency regarding fees and providing more equity for plan participants. Some experts[1] now suggest that plans are treating their participants inequitably unless reimbursements are returned to the participants whose balances created the reimbursement. Returning the reimbursements to the participants whose balances created the reimbursement ensures that all participants are paying a similar proportion of the plan's administrative costs based on the account balance in each of the plan's funds.

There is no clear federal guidance for plan sponsors on the best use of reimbursements. Plan sponsor options for use of reimbursement funds include:

1. Retaining reimbursements and using them to pay plan expenses;

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[1] For example, Fred Reish's article: "The Equitable Allocation of Revenue Sharing to Participants" (Online at http://www.napa-net.org/wp-content/uploads/The-Equitable-Allocation-of-Rev-Sharing.pdf)

2. Retaining reimbursements for paying plan expenses, but also offsetting participant fees with a “holiday” that suspends fees until the plan again needs to raise revenue to pay expenses;
3. Using reimbursements to purchase additional shares of the option generating the reimbursement for the participants in that fund; and
4. Distributing reimbursements periodically to participants, either per capita (per participant) or in proportion to their account balances (pro rata). Allocations are usually done after a balance reaches a certain amount or on a specific date. Pro rata allocation can be further refined to be based on participant balances in the funds that generate the reimbursements.

Responses to an unscientific query posed to the National Association of Government Defined Contribution Plan Administrators (NAGDCA) revealed no consistent application of reimbursements among responding plan sponsors. Some administrators utilize the reimbursements for overall plan expenses. Others distribute excess or surplus revenue from reimbursements to participants in the form of partial or total refunds or rebates. A few have offered “fee holidays” that suspend participant administrative fee collection for a period of time, and at least one administrator uses the reimbursements to purchase additional shares of the option providing the reimbursement for benefit of the participants in that fund.

Discussion Points

1. *Does the Board want to continue moving to the lowest-cost share class where feasible?* Staff recommends the Board continue to monitor investment option share classes and change to lower cost share classes when fiscally feasible.

2. *Would moving to the lower-cost share class available for Fidelity Contrafund affect participant administrative fees?* Yes. As discussed in the participant fee analysis memo (Ref. DC **|** 6.3.14 **|** 8), and the share class review memo (Ref. DC **|** 6.3.14 **|** 9A), if the Board were to move the WDC to the Fidelity ContraFund institutional share class (which does not offer reimbursements), then plan expenses would exceed plan income within three years. To make up the difference, it is likely that participant fees would have to be increased, perhaps by as much as 51%. Therefore, staff does not recommend changing the Fidelity Contrafund share class at this time.

3. *If the Board maintains offering share classes that offer reimbursements, how should reimbursements be allocated?* This question merits careful consideration, as the Board needs to weigh the interests of all WDC participants when deciding what to do with reimbursements. Investment option reimbursements could be allocated back to the participants in the fund that generated the revenue. This would eliminate equity concerns, as participants would no longer receive reimbursement “subsidies” from other participants. However, allocating the reimbursements to just the participants in the fund providing the reimbursement would eliminate a large source of income for the Board’s administrative expense account, and the Board would still need to cover plan expenses. Changing the allocation formula from its present across-the-board use would make it highly likely that an increase in participant administrative fees would be needed. Therefore, staff does not recommend changing the reimbursement allocation at this time.

Practically and administratively, the WDC will face challenges if reimbursement usage is changed. The low administrative fees participants now enjoy are dependent on the reimbursements, especially the reimbursements received from Fidelity Contrafund. Eliminating the reimbursements by changing to lower-cost institutional share classes, or directing rebates to participants invested in reimbursement-generating options will deplete the Board's administrative expense account quickly and require a large increase in participant administrative fees which is unlikely to be popular with participants.

Recommendation
Based on information available at this time, staff recommends the Board continue to use investment option reimbursements for the benefit of all WDC participants until changing to lower cost share classes is fiscally feasible. In addition, to ensure participants are offered the most suitable share classes available for the WDC's investment options, staff believes it would be prudent to include a regular review of investment option reimbursements as part of the annual participant fee analysis.

Staff will be available at the Board meeting to discuss this memo and answer any questions.