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CORRESPONDENCE / MEMORANDUM

DATE: October 13, 2014

TO: Deferred Compensation Board

FROM: Shelly Schueller, Deferred Compensation Director

SUBJECT: Administrative Expense Account Investment and Target Balance Policy Update

The Investment Committee and Department of Employee Trust Funds (ETF) staff recommend the Deferred Compensation Board (Board) update the Administrative Expense Account Investment and Target Balance Policy to state that the Board's policy is to maintain a target balance in the administrative expense account of 100% of anticipated annual plan expenses.

The Deferred Compensation Board (Board) has been discussing its fiduciary responsibilities as they relate to the decisions the Board may be asked to make regarding the administrative expense account balance and the use of reimbursements from various Wisconsin Deferred Compensation Program (WDC) investment options.

At the September 11, 2014, Investment Committee meeting, committee members reviewed the attached information on the Board's fiduciary duties and related items. The Investment Committee and Department staff concurred on a minimum expense account target balance of 100% of annual plan expenses. The proposed changes are illustrated on the attached draft Administrative Expense Account Investment and Target Balance Policy statement.

Staff will be at the November 4, 2014, meeting, to discuss this memo and answer any questions on the contents.

Attachments:
1) August 14, 2014 Department memo to the Investment Committee titled "Fiduciary Duties and Allocation of Reimbursements" (without attachments)
2) October 1, 2014 Draft of Administrative Expense Account Investment and Target Balance Policy

Reviewed and approved by Matt Stohr, Administrator, Division of Retirement Services.

Matt Stohr

Electronically Signed 10/20/14

Board	Mtg Date	Item #
DC	11.4.14	10A

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CORRESPONDENCE / MEMORANDUM

DATE: August 14, 2014

TO: Deferred Compensation Board Investment Committee Members

FROM: Shelly Schueller, Deferred Compensation Director
David Nispel/ Dan Hayes, ETF Legal Counsel
Bob Willett, Chief Trust Financial Officer

SUBJECT: Fiduciary Duties and Allocation of Reimbursements

The Deferred Compensation Board (Board) has been discussing fiduciary duties as they relate to the decisions the Board may be asked to make regarding the use of reimbursements from various Wisconsin Deferred Compensation Program (WDC) investment options. Generally speaking, it is in the Board's best interest to follow sound, prudent fiduciary governance processes because these processes protect participants and shield the Board from liability. This memo provides a general refresher of fiduciary duties, discusses questions related to the Board's fiduciary duties regarding allocation of reimbursements and offers recommendations for the committee's consideration.

Fiduciary Duties

The common law of trusts defines the scope of authority and responsibilities of trustees as all powers necessary and appropriate for the carrying out of the trust's purposes, including acting to ensure that a plan receives all funds to which it is entitled so that those funds can be used on behalf of participants and beneficiaries. Fiduciaries are personally liable to make good to the plan any losses from breaching their fiduciary responsibility. Fiduciaries are held to the highest standard of conduct imposed by law.

- The 1996 Small Business Job Protection Act (SBJPA) imposed fiduciary duties including the exclusive benefit rule (loyalty) and prudence requirements on s. 457(b) plans such as the WDC.

- State laws also impose fiduciary duty through the Uniform Trust Act and Uniform Prudent Investor Act. In addition to complying with state Uniform Trust Act and the Uniform Prudent Investor Act, most governmental plans like the WDC use Employee Retirement Income Security Act of 1974 (ERISA) rules as a best practices guide.

<u>Basic fiduciary principles:</u>

- Duty of loyalty (exclusive benefit rule)

Reviewed and approved by Matt Stohr, Administrator, Division of Retirement Services
Matt Stohr
Electronically Signed 8/27/14

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DCIC	9.11.14	2A

- Duty of prudence
- Duty to diversify plan assets
- Duty to monitor funds and providers and make changes when warranted
- Duty to follow terms of plan documents

The duties of loyalty and prudence are of primary importance for the Board as they consider share classes, use of reimbursements and the administrative expense account balance.

Loyalty - The duty of loyalty includes acting in the best interests of plan participants, including ensuring that plan fees and expenses are "reasonable."

Prudence - The duty of prudence focuses on the process followed when making fiduciary decisions. Prudence requires fiduciaries to act with the care, prudence, skill and diligence a knowledgeable person administering a retirement plan would use. Among other things, a sound, prudent process includes regular meetings at which careful, diligent, thorough decision-making processes are followed and documented, and periodically reviewing decisions to ensure they continue to be right for the plan.

Reimbursements Questions

As part of commitment to uphold its fiduciary responsibilities to WDC participants, there are three primary questions the Board should carefully consider:

1. ***Must the Board take the WDC's operating account balance down to zero each year?*** The answer appears to be unclear at the present time. In *Revenue Sharing Best Practices: An Excellent Time to Revisit Your Revenue Sharing Policies and Procedures* (GWRS Focus on 457 Newsletter August 31, 2011 copy attached), Question 9 on page 7 asks, "Why Can't We "Hold Over" Excess Revenue for Another Year?" Great-West's answer in the newsletter indicates that because there is no provision to do so, holding revenue for a future year's expenses is not acceptable. Great-West further states that based on forfeiture account guidance, best practice is to allocate excess amounts to participant accounts annually. Finally, the Great-West newsletter points out that waiting several years to do this could be a liability for the Board because participants who close out their accounts before the allocation is completed may not receive the excess revenue which they are owed. If this were to occur, Great-West has suggested that participants could "properly allege that they did not benefit because the allocation occurred after they" closed their account.

   However, Great-West's position on this seems to be somewhat of an outlier. In response to a query posed in July 2014, to the government members of the National Association of Government Defined Contribution Administrators (NAGDCA), 19 of 21 (90%) responding plans indicated that they carryover an account balance each year. The carryover amount varied between two and eighteen months-worth of a plan's anticipated expenses. It does not seem prudent nor a best practice to take the Board's administrative expense account to zero each year.

Staff does not recommend changing this policy, but does propose updating the Board's Administrative Expense Account Investment and Target Balance Policy to specifically declare that the Board will maintain a balance in its account in order to satisfy the plan's anticipated expenses.

2. ***Must the Board evaluate share class options with respect to cost, reimbursements, etc?*** Yes. In March 2013, the US Court of Appeals for the 9th Circuit affirmed in *Tibble v. Edison International* that the plan fiduciaries of Edison's s. 401(k) plan breached their fiduciary duties because they didn't examine share class alternatives, specifically whether they should offer institutional share classes where available.

   On behalf of the Board, the Department has monitored share class options available to the WDC. Institutional share classes have been offered when available. Institutional share classes typically do not provide reimbursements and frequently have lower expense ratios, which can result in savings for investors. In February 2012, the Board moved the WDC to the institutional share class of the American Funds EuroPacific Fund. In June 2014, the Board voted to move to the institutional share class for the T. Rowe Price Mid-Cap Growth Fund, which will also result in lower costs for WDC participants investing in this fund.

   In the spring of 2014 Fidelity opened ContraFund institutional share class "K" to plans such as the WDC that can meet Fidelity's minimum investment requirements. The institutional share class does not provide a reimbursement. However, staff did not recommend that the Board change ContraFund share classes. That is because the Department's analysis showed that the slightly lower cost of the new "K" share class does not translate to enough savings for WDC participants, when compared to the overall loss of the Fidelity reimbursement. Changing ContraFund share classes would negatively affect participant administrative fees, perhaps requiring an immediate increase of approximately fifty percent (50%).

   Staff does not recommend changing share classes unless it is fiscally prudent and in the best interests of WDC participants.

3. ***How should reimbursements be allocated?*** A review of best practices followed by s. 401(k) plans and a recent NAGDCA query of s. 457 plan sponsors indicates that it would be appropriate for the Board to allocate the reimbursements back to the participants in the fund that generated the revenue.

   Responses to a query posed to NAGDCA in July 2014 revealed that 16 of 21 responding plans (76%) received reimbursements. Seven operate similar to the WDC and simply use the reimbursements for general plan expenses. Many utilize the reimbursements for overall plan expenses, and distribute any surplus revenue after expenses to their participants. A few have offered "fee holidays" which suspend participant administrative fee collection for a period of time, and at least two use the reimbursements to purchase additional shares of the option providing the reimbursement for benefit of the participants in that fund.

Unless reimbursements are returned to the participants whose balances created the reimbursement, the Board's current use of reimbursements may be viewed as inherently inequitable; some participants' investment choices (those that provide a reimbursement) are subsidizing the expenses of other participants in the plan. 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 their account balance in each of the plan's funds. The WDC's administrator has indicated that they could rebate participants on a monthly basis, and that there would not be an additional charge to the WDC for this service.

Recommendations

Staff recommends the Investment Committee recommend the following to the Board:

1. Updating the Board's Administrative Expense Account Investment and Target Balance Policy to affirm the Board's position that maintaining a target balance in the administrative expense account to satisfy the plan's anticipated expenses is desirable (draft attached);

2. Changing share classes to offer share classes that do not provide reimbursements, when fiscally prudent and a more inexpensive (e.g., institutional) share class is available; and

3. Allocating reimbursements back to the participants in the fund that generated the revenue, as long as a minimum balance is maintained in the Board's administrative account. This proposal could be presented at the next Board meeting, along with projections on when this might be accomplished with the least disruption to the existing participant administrative fee structure.

Staff will be at the September 11, 2014, meeting, to discuss this memo and answer any questions on the contents.

Attachments:

a) Revenue Sharing Best Practices: An Excellent Time to Revisit Your Revenue Sharing Policies and Procedures" (GWRS Focus on 457 Newsletter August 31, 2011)
b) Administrative Expense Account Investment and Target Balance Policy with proposed revisions

Administrative Expense Account
Investment and Target Balance Policy
Adopted: May 1996
Last Revised: ~~November 1999~~October 1, 2014 draft for consideration at Nov. 2014 Board mtg.

The Deferred Compensation Board's Administrative Expense Account will be invested in the Stable Value Fund. The Board's Target Balance Policy is that the administrative account from which Wisconsin Deferred Compensation Program (WDC) expenses are paid will attempt to maintain a prudent level of financial resources, which is an account reserve balance that equals approximately ~~45% to 50%~~100% of estimated annual plan expenses. This amount may be adjusted as needed.

Excess Administrative Account Reserve Balance *(adopted xxx):* The balance in this account will be monitored and a report presented to the Board no less than annually, in conjunction with a participant administrative fee review. In the event that the Board's administrative expense reserve exceeds the target balance, participants investing in options generating reimbursements may be partially rebated according to the Board's Investment Option Selection and Reimbursement Policy.

Investment of Board's Administrative Expense Account *(adopted May 1999)*: The Board's administrative expense account shall be invested in the WDC's Stable Value Fund. This move was authorized after the Board recognized that higher returns could be achieved through the Stable Value Fund while still safeguarding the principal. Prior to 1999, the administrative account was invested in the WDC's FDIC option.

Target Balance Policy Background: The Board's goal is to continue to minimize individual participants' annual fee levels while taking into consideration the potential for market downturns that negatively impact asset-based participant fee revenues. ~~Forty-five to fifty percent~~ 100% of annual plan expenses was selected as the appropriate expense account target balance because analysis showed that this would help maintain ~~stabilize~~ stable participant administrative fees while maintaining enough in the Board's administrative expense account to pay for WDC-associated expenses.

The target balance is intended to provide financial stability and flexibility to:

- Maintain services and achieve goals during unanticipated or extended economic downturns resulting in revenue shortfalls
- Avoid unplanned increases in participant administrative fees
- Fund new initiatives and services
- Respond to unexpected opportunities

The WDC is a self-funded program; no state tax revenues may be used to support it. All revenues used to pay plan expenses are generated from participant administrative fees, some investment option reimbursements (for recordkeeping and marketing) and any gains on the Board's administrative expense account.

Historical Background: From 1992 through 1995, the Board used a combination of an annual $10 administrative service fee plus an asset-based participant fee to pay for all WDC-related expenses. From 1995 through 1999, the WDC imposed a straight asset-based administrative fee on participants. This asset-based fee fluctuated, depending on what was required to pay WDC expenses. It also required a very conservative approach by ETF staff when making revenue and expense projections in order to protect against raising participant administrative fees should there be a long- or short-term market downturn. As a result, for several years the revenues generated by the participant administrative fee exceeded annual estimated expenses and the balance in the Board's administrative expense account grew significantly beyond the Board's established rate stabilization reserve level.

In 1998~~-99,~~ the Board began examining the idea of moving the participant administrative fee from an asset-based fee to a flat fee. This proposal was made because it was becoming obvious to staff that using an asset-based participant fee posed potential problems. With many WDC participants investing in equity mutual funds, a potential market down-turn (short- or long-term) could greatly decrease total WDC assets and thus monthly revenues. The volatility associated with the asset-based fee also made it difficult to project revenues: as the markets and WDC assets fluctuate, so would the amount of revenue generated. At ~~their~~ its meeting in November of 1999, the Board approved moving to a flat participant administrative fee beginning in February 2000, which significantly reduced this volatility.