D. Program Design

1. Overview

   i. Scope and Methodology

   The Scope of Services under the Contract calls for the Program Design element to:

   ✓ Evaluate and recommend the investment options for the Program
   ✓ Devise and recommend an operational model for the Program
   ✓ Recommend plan rules and procedures

   In order to deliver on the requirements of the Program Design elements, the Program Design team in coordination with the Market Analysis and Feasibility Study teams and in collaboration with a broad range of stakeholders:

   ✓ Conducted a thorough analysis of investment options and made recommendations for the investment options best suited for California Secure Choice as described in the Investments section below.
   ✓ Evaluated in depth various potential operational models and made a recommendation for the Operational Model most responsive to program requirements as described in the Operational Model section below.
   ✓ Recommended plan rules and procedures after an extensive evaluation of alternatives as described in the Plan Rules and Procedures section below.

   ii. Timeline
### iii. Key Recommendations

#### Investments

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Default Investment Option At Launch</strong></td>
<td><strong>Dynamic Asset Allocation Target Date Investment Strategy</strong> implemented through Managed Accounts or through Target Date Funds as fallback, pending legal confirmation by K&amp;L Gates that managed accounts are permissible. An income-focused strategy should be favored over an accumulation-focused strategy if such strategies becomes available in the US market prior to launch. Based on participant demand, two to three complementary target risk strategies can be offered as non-default options to be proactively selected by participants provided that adequate advisory tools are offered for them to make an informed choice. <strong>OR</strong> Pooled IRA with Reserve Fund, packaged as a Retirement Savings Bond.</td>
</tr>
<tr>
<td><strong>Additional Investment Offering After launch</strong></td>
<td>Consider a Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB) as a complementary offering in two to three years after launch once there are sufficient account balances in participant accounts.</td>
</tr>
<tr>
<td><strong>Default Payout Method</strong></td>
<td>Most DC plans default to the lump sum method, but the best policy is to orient towards lifetime income. Initially (first 3-5 years), account balances for retirees under the California Secure Choice Plan will be too small to convert into a meaningful income stream. <strong>The Board, therefore, has time to consider options before selecting a default payout method.</strong></td>
</tr>
<tr>
<td><strong>NOTE:</strong> Authorizing legislation should give the Board flexibility to determine default payout.</td>
<td></td>
</tr>
<tr>
<td><strong>Proprietary Funds</strong></td>
<td>Should California Secure Choice implement the Dynamic Asset Allocation Target Date Strategy as the default investment option, we recommend creating proprietary (i.e., custom) California Secure Choice funds as investment vehicles for that option.</td>
</tr>
</tbody>
</table>
Even though commonplace among large DC plans, creating a proprietary fund is somewhat involved and would require that the Secure Choice organization to hire a specialized consultant.

**Operational Model**

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational Model</td>
<td>We recommend the Direct Service Operational Model where a single recordkeeper services employers directly without intermediation by the State of California Employment Development Department (EDD) in order to facilitate a faster launch and more flexibility in Program features.</td>
</tr>
</tbody>
</table>

While the EDD-as-Intermediary Model is less costly over the long-term (approximately 10%), the startup costs are significantly higher (see Financial Feasibility Study) than the Direct Service Operational Model, the launch date is likely to be 2 years later and some features, such as auto-escalation, may not be feasible.

We also recommend that California Secure Choice hire a consultant to develop the RFP requirements for the selection of a recordkeeper, to run the RFP process and to oversee the implementation of the operational model.
### Plan Rules and Procedures

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary Considerations</strong></td>
<td>The following factors are the primary drivers of recommendations for plan rules and procedures:</td>
</tr>
<tr>
<td></td>
<td>✓ Simplicity of administration, compliance and enforcement</td>
</tr>
<tr>
<td></td>
<td>✓ Minimization of the administrative and decision-making burden on employers</td>
</tr>
<tr>
<td></td>
<td>✓ Recordkeeping logistics</td>
</tr>
<tr>
<td></td>
<td>✓ Legal constraints</td>
</tr>
<tr>
<td><strong>Rules and Procedure Topics</strong></td>
<td>Extensive recommendations are made covering the following areas:</td>
</tr>
<tr>
<td></td>
<td>✓ Plan Basics</td>
</tr>
<tr>
<td></td>
<td>✓ Definition of Employer (“ER”)</td>
</tr>
<tr>
<td></td>
<td>✓ Definition of Eligible Employees (“EEs”) / Participants</td>
</tr>
<tr>
<td></td>
<td>✓ Voluntary Participation</td>
</tr>
<tr>
<td></td>
<td>✓ Auto-Enrollment and Payroll Deduction Mechanics</td>
</tr>
<tr>
<td></td>
<td>✓ Social Security Number (“SSN”) / Identity Issues</td>
</tr>
<tr>
<td></td>
<td>✓ Money Out</td>
</tr>
</tbody>
</table>
2. **Investments**

   i. **Overview**

   The Overture team evaluated eight program investment vehicles that represent different approaches to investment and risk. Each option was considered through a broad range of features and characteristics in order to narrow down the options to two or three candidates for the consideration of the Board.

   In the next sections, the investment options under consideration, the evaluation approach and the recommendations will be presented as follows:

   - Retirement Plan Investment Basics
   - Plan Design Considerations
   - Investment Option Selection Process
   - Investment Option Scores
   - Investment Option Recommendations
   - Comparison of Recommended Program Investment Options

   ii. **Retirement Plan Investment Basics**

   a. **Retirement Plan Structure and Cash Flows**

   Retirement is one of the most important events in the life of an individual. Its collective impact is equally important for the well-being of a nation especially as the population ages. Planning for retirement through retirement plans that channel savings into investments is therefore critical for the financial health of individuals and nations.

   *From a structural perspective*, retirement plans fall into two categories: Defined Benefit (“DB”) plans and Defined Contribution (“DC”) plans. The IRS defines them as follows:

   A **Defined Benefit Plan**, also known as a traditional pension plan, promises the participant a specified monthly benefit at retirement. Often, the benefit is based on factors such as the participant’s salary, age and the number of years he or she worked for the employer. The plan may state this promised benefit as an exact dollar amount, such as $100 per month at retirement. Or, more commonly, it may calculate a benefit through a plan formula that considers such factors as salary and service.

   A **Defined Contribution Plan** is a retirement plan in which the employee and/or the employer contribute to the employee’s individual account under the plan. The amount in the account at distribution includes the contributions and investment gains or losses, minus any investment and administrative fees. Generally, the contributions and earnings are not taxed until distribution. The value of the account will change based on contributions and the value and performance of the investments. Examples

of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans and profit-sharing plans.

The California Secure Choice Plan (“SCP”) is designed to be a Defined Contribution plan that holds investments in a Traditional IRA or Roth IRA account.

*From a cash flow perspective*, the “retirement event” is preceded by what is called the Accumulation Phase during which a worker accumulates and invests assets to be withdrawn during the non-working years and is followed by the Payout or Decumulation Phase during which the accumulated assets are drawn upon to fund retirement or other income requirements.

The image below illustrates the two phases for a US worker with a 40-year career.

![Diagram showing Accumulation and Payout phases](image_url)

Such a worker can expect to receive at retirement 37% (or more) of her final pay in US Social Security benefits and, depending on her retirement plan, her contribution rate, investment returns, the prevailing interest rates at retirement and various other factors, an additional income from her retirement plan (shown in the illustration as 22% of final pay).
Retirement income is the ultimate measure of the value of a retirement plan, whether Defined Benefit or Defined Contribution.

DB plans are designed for retirement income. They begin with retirement income targets (i.e., payout phase cash flows) and work out the necessary elements to achieve those targets.

The challenge with DC Plans is that the focus is often on the accumulation phase.
The growing consensus is that DC plan design needs to shift from wealth accumulation (i.e., accumulation phase) to income focus (i.e., payout phase). Even though the California Secure Choice Program is designed as a DC plan, retirement income is a principal consideration used by the Overture team in evaluating the various investment vehicle options.

b. Accumulation Phase

The contributions or savings during the accumulation phase are typically invested in accordance with an Investment Strategy.

Asset Allocation is the implementation of an investment strategy by allocating funds to various asset classes. Asset classes are economic resources sharing similar risk and return characteristics. Traditional asset classes include domestic and international stocks, bonds and cash. For a diversified portfolio, asset allocation is the primary driver of investment risk and returns.

Investment Risk or Uncertainty derives from the possibility of loss. It is often measured as volatility, which is a measure of the variability in the value of an investment. From an investor’s experience perspective, however, it is better represented as the actual loss (in percentage terms).

Asset classes span the risk spectrum:
- Very Low Risk—near cash instruments such as money markets or US T-bills.
- Lower Risk—medium-term investment grade bonds denominated in US dollars such as US Treasury notes.
- Higher Risk—US and international stocks

Investment return is correlated with investment risk. Historically, risky assets such as stocks generate higher returns over time than less risky assets such as government bonds.

The risk-return profile of an investment also varies with the time horizon of the investment. In the long-term (e.g., 20+ years), riskier investments, such as stocks, are expected to generate higher average returns with a smaller chance of trailing behind inflation, and lower-risk investments are expected to yield lower returns with a greater probability of falling behind inflation. In the near term (e.g., 3-5 years), riskier investments may experience significant drops in value; while lower risk investments tend to hold steady.

For retirement savings, long-term outcomes are the most critical, and small differences in returns can be magnified over time. The chart below illustrates how an additional 1% in returns (from 5% to 6%) sustained over a full career of 40 years translates into a nearly 50% higher ending balance. Conversely, a 1% reduction in returns through fees (from 6% to 5%) reduces the ending balance by nearly 30%.
The chart below illustrates how a US $1 in 1926 would have fared throughout the years if it were invested in in different asset classes.

Source: Morningstar Ibbotson
The table below illustrates the long-term average returns and highest annual losses (labeled “Lowest Annual Return”) of various asset classes from 1926 to 2014.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Inflation</th>
<th>Near Cash (T-Bills)</th>
<th>100% Bonds</th>
<th>50% Stocks 50% Bonds</th>
<th>100% Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compound Average Annual Return</td>
<td>2.9%</td>
<td>3.5%</td>
<td>5.7%</td>
<td>8.5%</td>
<td>10.1%</td>
</tr>
<tr>
<td>Premium Over Inflation</td>
<td></td>
<td>0.6%</td>
<td>2.8%</td>
<td>5.6%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Lowest Annual Return</td>
<td>-10.3%</td>
<td>0.0%</td>
<td>-14.9%</td>
<td>-24.3%</td>
<td>-43.3%</td>
</tr>
<tr>
<td>% Negative Years</td>
<td>11.2%</td>
<td>2.2%</td>
<td>25.8%</td>
<td>21.3%</td>
<td>27.0%</td>
</tr>
<tr>
<td>Highest Annual Return</td>
<td>18.2%</td>
<td>14.7%</td>
<td>40.4%</td>
<td>34.6%</td>
<td>54.0%</td>
</tr>
<tr>
<td>% Positive Years</td>
<td>88.8%</td>
<td>97.8%</td>
<td>74.2%</td>
<td>78.7%</td>
<td>73.0%</td>
</tr>
</tbody>
</table>

Source: Morningstar Ibbotson

The charts and tables below compare the short-term and long-term outcomes based on various asset allocations and illustrate why long-term outcomes are the most critical for retirement savings. For example, the “Worst Case” scenario of the higher risk asset allocation (i.e., 70% Stocks + 30% Bonds) is better than or even with the “Best Case” scenarios for the lower risk asset allocations.

SB1234 currently caps allocations to stocks at 50%. Based on the foregoing, we recommend that the cap should be removed and that investment policy decisions be delegated to the Board.
c. **Payout Phase**

The payments in the payout phase can be structured as:

- ✔ A lump sum distribution
- ✔ An income stream
  - o Group annuity product with an insurance company
  - o Structured withdrawal program (SWP)
  - o In-plan collective payout option
- ✔ A combination of the above methods

An annuity is an insurance company contract that provides a series of payments to the participant in exchange for a payment (premium) or series of payments. Life annuities provide guaranteed retirement income for the remainder of one’s life in exchange for a lump sum payment.

Annuities can also be used during the accumulation phase to guarantee returns on contributions (considered as investment options below). Promised payments can be fixed or variable.

“Annuity” is also a generic term that includes the income stream from a traditional pension.

Private annuities are more expensive than traditional pension annuities because the former generally offer lower rates of return/interest and include profits and marketing costs.

The income stream/annuity product space is in rapid development. Initially (first 3-5 years), account balances for retirees under the California Secure Choice Plan will be too small to convert into a meaningful income stream.

The Board, therefore, has time to consider options before selecting a default payout method. Authorizing legislation should give the Board flexibility to determine the default payout.

iii. **Plan Design Considerations**

**Retirement Income** in a defined contribution plan such as California Secure Choice is a function of **Contributions** and **Asset Allocation** (e.g., mix of stocks/bonds).

**The Key Sponsor Decisions** in Any Auto-Enrollment Plan, including California Secure Choice are:

1. **The Default Contribution Level** and auto-escalation policy
2. **The Investment Policy**: setting the asset allocation by risk profile(s). It is important to recognize that sponsor responsibility for investment policy applies to both off-the-shelf products and custom/proprietary funds.
(3) **The Default Payout Method** at retirement (lump sum, systematic withdrawal, annuity, or combo). Most DC plans default to the lump sum method, but the best policy is to orient towards lifetime income. Initially (first 3-5 years), account balances for retirees under the California Secure Choice Plan will be too small to convert into a meaningful income stream. The Board, therefore, has time to consider options before selecting a default payout method. Authorizing legislation should give the Board flexibility to determine default payout.

iv. **Investment Option Selection Process**

a. **Approach**

The approach for the evaluation of the various program investment options (investment product or investment vehicle are also used interchangeably) was to score each option along two dimensions

1. **Product Score**: this reflects the intrinsic relative value of the investment option
2. **Implementation Risk Score**: this reflects the risks of implementing the investment option within the context of the California Secure Choice Program.

An Evaluation Committee consisting of five members representing various partners of the Overture consortium produced the scores for the various investment options using criteria that were defined with feedback from the Board.

The Product Score is based on the following criteria

1. **Benefit and Cost Criteria**
   a. Income Replacement
   b. Lifetime Income
   c. Product Risks
   d. Fund Accessibility
   e. Embedded Costs

2. **Administrative Criteria**
   a. Ease and Efficiency of Administration
   b. Financial Transparency
   c. Ease of Communication

The **Income Replacement** concept refers to the level of income needed in retirement to maintain the same standard of living before retirement. The Income Replacement Ratio — retirement income expressed as a percentage of pre-retirement income—has become a standard metric for assessing the adequacy of retirement income. There is no consensus on how high the income replacement ratio must be to maintain the same standard of living during retirement as before retirement. Various studies have suggested that middle class households
should target income replacement ratios between 65% and 85%; while lower-income households typically need higher replacement ratios than middle-income households because they spend a larger proportion of their incomes on necessities. 21 For an average person who worked a full career and retired at 65 years of age in 2015, US Social Security benefits replaced about 40 percent of past earnings. 22 Therefore, in order to provide a meaningful complement to Social Security for those who have no other retirement savings, California Secure Choice should target income replacement ratios in excess of 20% over a full career.

**Lifetime Income** relates to longevity risk (i.e., the significant statistical probability that individuals will live longer in retirement than they expect) and the lack of understanding about the appropriate rate at which retirement income can be withdrawn. One of the shortfalls of many retirement plan designs is that more focus is placed on the accumulation phase since the distribution phase is many years away. The use of an income stream/annuity during the payout phases addresses this risk. This criterion assesses the suitability and compatibility of the investment option with an annuitization approach at retirement.

**Product Risks** refers to product-specific risks or features that can increase or mitigate risk to retirement income. These include the exposure to interest rate risk at retirement in the case of annuitization (low interest rates at retirement often translate into low annuity income), embedded investment guarantees and potential conflicts of interest (e.g., principal-agent issues and free rider problem).

**Fund Accessibility** relates to participants’ ability to access pre-retirement funds. Limiting fund accessibility is important because early access can undermine the purpose of saving for retirement. At the same time, placing strict restrictions on withdrawing pre-retirement funds may impact the Program’s participation rates. Since the IRA structure allows withdrawal subject to a penalty 23, any additional limitations would have to be placed at the product level. The ideal investment option should allow for the application of restrictions at the discretion of the Board. 24

**Embedded Costs** refers to costs, often hidden, that are charged by the investment product provider within the product and therefore appear to the investor as diminished investment returns. We have seen earlier how even a 1% fee sustained over a career can lower the retirement benefits substantially. One of the problematic elements of the investment process is


23 The penalties and their application differ between Roth IRA and Traditional IRA. In some instances no penalties apply. See http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics---Tax-on-Early-Distributions

24 K&L Gates, counsel to the Board, is inquiring with the Department of Labor whether product-level restrictions are permissible.
the lack of cost transparency of some investment products. The Overture team has striven in its evaluation of the various investment options to deconstruct the underlying cost elements.

**Ease and Efficiency of Administration** - The ideal retirement program should be simple with a low administrative burden and low management costs. The program should minimize the administrative burden on both employers and the State. The impact of each investment option on the California Secure Choice Program’s administrative efficiency is evaluated as part of the scoring exercise.

**Financial Transparency** - The ideal investment option should be transparent with full disclosure of all fees and embedded costs. In many DC plans, hidden fees can eat away an appreciable portion of returns. Even with full fee disclosure, trading costs are often vague and have been estimated, by one study, to cost an additional 0.66% for the median equity mutual fund in 401(k) plans and 1.99% at the fifth quintile.²⁵

**Ease of Communication** - Participants should clearly understand the nature of their investment option, its benefits and its risks. The ideal investment option should be easy to describe and communicate.

For every investment option, each Product Score criterion was independently scored by Evaluation Committee members on a scale of 1 (Worst) to 5 (Best). The scores for each criterion were averaged across members to produce an Average Criterion Score for every investment option.

The Product Score for each investment option was calculated as the weighted average of the Average Criterion Scores for that investment option using the weights in the table below.

---

### Product Design Team Weightings

**BENEFITS (70%)**

- Income Replacement (50%)
- Lifetime Benefit (10%)
- Risks (15%)
  - Interest Risk Rate at Retirement (25%)
  - Guarantee (25%)
  - Non-Fee Conflicts (50%)
- Fund Inaccessibility (15%)
- Plan Cost/ Sustainability (10%)

**ADMINISTRATION (30%)**

- Ease & Efficiency of Administration (33.33%)
  - At Secure Choice Level (50%)
  - At Record Keeper Level (50%)
- Financial Transparency (33.33%)
- Ease of Communication (33.33%)

---

The Implementation Risk Score is based on the following criteria:

1. Potential for Errors
2. Scalability
3. Structural Complexity

**Potential for Errors** refers to the likelihood of errors that can affect participant investments and/or benefits (e.g., a mis-entered birthdate can adversely affect the choice of target date fund if such funds are the default investment option).

**Scalability** refers to benefits that can accrue from higher volumes. Some investment options may become more attractive as assets grow in the Program.

**Structural Complexity** refers to the financial, legal and operational complexity of an investment option. The higher the overall complexity of an investment option, the higher the implementation risk which can manifest in execution delays, cost overruns and unforeseen difficulties.

For every investment option, each Implementation Risk criterion was independently scored by Evaluation Committee members on a scale of 1 (Low Risk) to 5 (High Risk). The scores for each criterion were averaged across members to produce an Average Criterion Score for every investment option.

The Implementation Score for each investment option was calculated as the equally-weighted average of the Average Criterion Scores for that investment option.

b. **Program Investment Options**

The Overture team evaluated eight program investment options that represent different approaches to investment and risk:

- ✔ Asset Allocation Strategies (individuals bear investment risk)
- ✔ Pooled IRA with Reserve Fund (pooled investment risk)
- ✔ Bank Deposit (FDIC insured)
- ✔ Annuities (private insurance contracts with guaranteed benefits)

The options are representative of a broad range of market options from “plain vanilla” investments to products with stronger income focus and/or guarantee.

Each option was considered through a broad range of features and characteristics including benefits, costs and several dimensions of risk, administrative and operational implications.
The investment options considered were the following:

(1) **Target Risk Funds**: A target risk fund aims to expose its investors to a specified level of investment risk. Target risk funds typically label themselves as "conservative", "moderate risk" or "aggressive" in terms of their risk exposure. The investment strategy is typically implemented as an asset allocation such that higher exposures to stocks correspond to higher levels of risk.

(2) **Dynamic Asset Allocation (DAA)/Target Date Funds (TDFs) with Accumulation Focus**: Target date funds are funds that implement a dynamic asset allocation strategy where the level of risk assumed declines as the fund approaches a particular retirement date. The vast majority of TDFs are accumulation-focused. This means that the level of investment risk ("asset volatility") is reduced over time by shifting allocations to lower risk/volatility asset classes such as bonds.

(3) **Dynamic Asset Allocation (DAA)/Target Date Funds with Retirement Income Focus also known as Target Date Retirement Income Funds (TDIRFs)**: TDIRFs are a new crop of target date fund that implements a dynamic asset allocation strategy where the level of "risk to retirement income" is reduced as the fund approaches a particular retirement date.

(4) **Pooled IRA with Reserve Fund**: This investment option will be described in greater detail in the next section. It consists of a California public authority that receives participant contributions and manages them in a single investment pool. The authority issue shares to participant IRA accounts with values equal to their contribution and declares periodic distributions (interest credits) based on the performance of the investment pool. The purpose of the structure is to smooth participant investment returns over time by creating a reserve that is used when the pool investment returns are negative and that is built up when the pool investment returns exceed certain thresholds. The structure creates no legal liability to the State because participant shares are only redeemable against assets belonging to the authority.

(5) **Bank Deposit**: This refers to an FDIC-insured Bank Deposit or Certificate of Deposit (CD).

(6) **Deferred Fixed Annuity**: A deferred annuity is an annuity contract that delays payment of an income stream until the investor elects to receive such income (e.g., at the time of retirement). A deferred fixed annuity is a deferred annuity that guarantees an interest rate on contributions and accumulates up to the payout time (e.g., retirement).

(7) **Variable Annuity with Guaranteed Minimum Accumulation Benefit (GMAB)**: A variable annuity (VA) is an insurance contract that allows the participant to invest contributions in a selection of investments during the accumulation phase and then pays the retiree an income stream that is determined
by the performance of the investments chosen during the accumulation phase. A VA with GMAB guarantees that the participant’s account value will be at least equal to a certain minimum percentage (usually 100%) of the amount invested after a specified number of years (typically 7-10 years) regardless of actual investment performance. GMABs typically place constraints on the asset allocations allowed.

(8) **Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB):** A VA with GMWB guarantees that a certain minimum percentage (e.g., 5%) of the amount invested can be withdrawn annually during retirement regardless of the actual investment performance. If underlying investments perform well, a participant may be able to withdraw higher levels than the minimum.
The table below compares the eight investment options

<table>
<thead>
<tr>
<th>Investment Option</th>
<th>Investment Risk</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Risk Funds</td>
<td>No Guarantee. Participant bears risk.</td>
<td>Widely available.</td>
<td>Within an auto-enrollment framework, defaulting to a TRF may be too risky for participants approaching retirement or conversely not sufficiently aggressive for young participants.</td>
</tr>
<tr>
<td>DAA TDFs with Accumulation Focus</td>
<td>No Guarantee. Participant bears risk.</td>
<td>Widely available.</td>
<td>Traditional automated glidepath may be rigid.</td>
</tr>
<tr>
<td>DAA TDFs with Income Focus (TDIFs)</td>
<td>No Guarantee. Participant bears risk.</td>
<td>Income orientation. Reduced interest rate risk for annuitization at retirement. More dynamic strategy in changing markets.</td>
<td>Products currently under development in US and may be available prior to CA Secure Choice launch.</td>
</tr>
<tr>
<td>VA with GMAB</td>
<td>Insurance Guarantee.</td>
<td>Principal protection while allowing participants to invest in higher risk/higher return asset classes like equities. Higher returns than bank deposit.</td>
<td>High cost of guarantee during accumulation. Does not protect retirement income from interest rate risk at time of annuitization.</td>
</tr>
<tr>
<td>VA with GMWB</td>
<td>Insurance Guarantee.</td>
<td>Allows participants to invest in higher risk/higher return asset classes like equities while maintaining a retirement income floor.</td>
<td>Not available for participants with more than 10 years to retirement. High cost of guarantee. No guaranteed COLA.</td>
</tr>
</tbody>
</table>
c. **Modeling the Investment Options**

As part of the scoring process, each investment option was modeled to estimate its expected income replacement ratio profile using a model developed specifically for that purpose. The description of the model can be found in the next section entitled “Methodology and Assumptions for the Calculation of Income Replacement Rates.”

The following assumptions were used across all investment options:

1. Participant entry age at 25
2. 5% contribution rate with no escalation on an initial salary of $30,000
3. Participant retirement age at 67
4. Group annuity purchased at retirement with a 2% COLA and 15-year period certain

In addition, the following product-specific assumptions were used:

1. Target Risk Fund: assumed a fixed 70% equity and 30% bond asset allocation.
2. Dynamic Asset Allocation/Target Date Fund with Accumulation Focus: assumed a 90/50 glidepath (explained in next section)
4. Pooled IRA with Reserve Fund: assumed a fixed 70% equity and 30% bond asset allocation and used the crediting rules described in the next section.
5. Variable Annuity with Guaranteed Minimum Accumulation Benefit (GMAB): assumed a 60% equity and 40% bond asset allocation with a 100% minimum accumulation benefit.
   - This type of annuity is only available starting 10 years prior to retirement. Before age 55 we assume contributions go to a typical TDF with accumulation focus.
   - At age 55, the balance is moved over to the variable annuity with GMWB and subsequent contributions also go into the variable annuity.
   - The basic guarantee is that for every $100 contributed into the variable annuity, the insurance company guarantees a minimum lifetime retirement income (with no COLA) of $5 (i.e., 5% income guarantee) – even if the account value goes to zero.
   - Contributions are invested following a 60% Stocks and 40% bonds asset allocation.
   - The insurance company charges an annual fee of 1% of assets (on top of investment fees) for the guarantees.
   - If net investment results are favorable, the guarantee can be “stepped up” – both prior to and after retirement.
   - If death occurs before the account value is zero, death benefits are payable.
d. Methodology and Assumptions for the Calculation of Income Replacement Rates

Retirement account balances are influenced by a number of variables whose values cannot be predicted with certainty. These variables include investment returns, inflation, wage growth, and annuity purchase rates. Yet each of these factors affects the value of assets in an individual’s account and the amount of lifetime income that can be provided at retirement.

In order to model this uncertainty we use a Monte Carlo simulation method. Monte Carlo simulations require that each input variable, such as investment returns, be assigned a probability distribution – defined primarily by a mean expected value assumption and a standard deviation, or volatility, assumption to reflect the uncertainty of the outcome. For each simulation, we randomly select input values from the distribution of possible values for that variable and produce results based on those values. The simulation process creates a full range of multi-year scenarios for all of the key variables that might affect the development of an individual’s account balance. The statistical distribution of the results under all of these scenarios provides important information on the probability of an individual meeting his or her goals or falling short (“shortfall risk”).

We use the following assumptions in our Monte Carlo simulations:

**Price Inflation**
To simulate results for price inflation, we assume a median long-term inflation rate (CPI-U) of 2.5%. Although our inflation simulations produce a distribution that is skewed (i.e. non-normal), the observed standard deviation for annual results is 1.6%.

**Wage Inflation**
Wage inflation is simulated to reflect price inflation, plus an average real wage growth of 0.5% per year. The resulting distribution has a mean value of 3.0%, with a standard deviation of 1.3%.

**Ten-Year Treasury Note**
Our simulated results for the yield on 10-year Treasury notes were generated using a mean value of 4.25%, which is equal to the expected price inflation plus a real yield of 1.75%. The observed standard deviation is 1.0%, which is consistent with historical experience.

**Investment Returns**
We use three types of inputs to model asset class returns: estimates of expected mean returns, volatility (standard deviation), and correlation among asset classes. The most crucial inputs are the estimates of expected return.

**U.S. Fixed Income**
We assume an expected return for US bonds in any single year of 4.8%. With an assumed standard deviation of 5.0% (reflective of historical experience), the expected long-term compound return for bonds becomes 4.5%. (The effects of year-to-year volatility will always produce a lower long-term compound return expectation, as compared with the single-year expectation.) The expected real return of 2.0% over inflation is in line with historical results.
The full range of long-term compound bond returns that are used in the simulation model is shown in the following table listing the distribution of returns by percentile:

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>4.5%</td>
</tr>
<tr>
<td>95%</td>
<td>5.2%</td>
</tr>
<tr>
<td>75%</td>
<td>4.8%</td>
</tr>
<tr>
<td>50%</td>
<td>4.5%</td>
</tr>
<tr>
<td>25%</td>
<td>4.2%</td>
</tr>
<tr>
<td>5%</td>
<td>3.9%</td>
</tr>
</tbody>
</table>

**Equities (Mix of US and non-US)**

We assume an expected return for stocks in any single year of 9.9%. With an assumed standard deviation of 19.5% (reflective of historical experience), the expected long-term compound return for equities becomes 7.9%. (The effects of year-to-year volatility will always produce a lower long-term compound return expectation, as compared with the single-year expectation.) The spread between the expected equity return and the expected bond return is 3.4%, which is reflective of the long-term historical “equity risk premium.” Equity returns are modeled so that they have an average correlation with bond returns of 4.5%. The full range of long-term compound equity returns that are used in the simulation model is shown in the following table listing the distribution of returns by percentile:

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>7.9%</td>
</tr>
<tr>
<td>95%</td>
<td>13.8%</td>
</tr>
<tr>
<td>75%</td>
<td>10.2%</td>
</tr>
<tr>
<td>50%</td>
<td>7.8%</td>
</tr>
<tr>
<td>25%</td>
<td>5.5%</td>
</tr>
<tr>
<td>5%</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

**Annuitization**

To convert the account balance at retirement into a lifetime income requires that the balance be divided by an annuity factor (i.e. we assume that the retiree is electing an annuity payout option). We model the annuity factors based on the interest yield simulated at the point of retirement. The model is intended to approximate a market-priced annuity sold under a group annuity contract. The assumed interest rate used for pricing is set at the simulated yield on the 10-year Treasury bond, plus 50 basis points. We also include a 5% load in the price to cover insurance company fees, profits and contingency reserves. The annuity that we use is a single life annuity with a fixed 2% COLA and a 15-year certain period (which essentially guarantees a return at death equal to the original annuity cost less benefits paid up to the date of death). For mortality we assume a unisex blend of 50% male / 50% female experience and use mortality rates that reflect expected improvements over the next 35 years (RP 2014 mortality table rates for blue collar workers with projection from table MP 2014).
### e. Investment Option Evaluation

The table below lists the Product Score and Implementation Risk Score for each investment option.

<table>
<thead>
<tr>
<th>Investment Option</th>
<th>Product Score</th>
<th>Implementation Risk Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Risk Funds</td>
<td>4.11</td>
<td>1.13</td>
</tr>
<tr>
<td>DAA TDFs with Accumulation</td>
<td>3.86</td>
<td>1.67</td>
</tr>
<tr>
<td>DAA TDIFs</td>
<td>4.05</td>
<td>1.67</td>
</tr>
<tr>
<td>Pooled IRA with Reserve Fund</td>
<td>3.93</td>
<td>2.33</td>
</tr>
<tr>
<td>Bank Deposit</td>
<td>2.76</td>
<td>1.00</td>
</tr>
<tr>
<td>Deferred Fixed Annuity</td>
<td>2.52</td>
<td>2.87</td>
</tr>
<tr>
<td>VA with GMAB</td>
<td>2.58</td>
<td>3.13</td>
</tr>
<tr>
<td>VA with GMWB</td>
<td>2.98</td>
<td>3.13</td>
</tr>
</tbody>
</table>

The lowest possible score is 1 and the highest possible score is 5. A higher Product Score means “better,” but a higher Implementation Risk Score means “riskier” or “worse.”

The chart below displays the Product Score for each investment option on the y-axis and the Implementation Risk Score on the x-axis.

![Chart showing product score vs. implementation risk](image)

Note that the non-guaranteed asset allocation options are relatively close to each other at the top left (i.e., Higher Product Score/Lower Implementation Risk) and the insurance-guaranteed products are at the bottom right (i.e., Lower Product Score/Higher Implementation Risk). This does not eliminate the insurance guaranteed options from consideration because from a behavioral perspective such guarantee may encourage higher contributions rates and potentially higher income replacements (more likely under Option 8-VA with GMWB).

Besides the behavioral aspect described above, other considerations for evaluating investment options include:
(1) **Implementability at Launch**
- Target Date Income Funds and Strategies are currently under development in the US and may be available prior to the California Secure Choice launch. If available before launch, target date income strategies are readily implementable using the Managed Account approach recommended in the next section.
- Variable Annuities with GMWB are available for participants with 10 years or less to retirement. The eligible participant universe in the first 3 to 5 years after the launch of California Secure Choice is unlikely to have sufficient balances at retirement to afford meaningful income replacement from annuitization. Our recommendation is to consider offering Variable Annuities with GMWB 3 to 5 years after launch.

(2) **Suitability under Auto-Enrollment**
- Target Risk Funds: Defaulting participants to a particular Target Risk Fund is complicated due to suitability issues. If all participants are defaulted to a Medium to Low Risk TRF, then younger participants are likely to experience low lifetime returns and therefore low income replacement rates. On the other hand, if all participants are defaulted to an Aggressive TRF, then participants nearing retirement may be exposed to excessive risks. TRFs are best used as non-default options available for participants with a sufficient level of financial literacy.

The table on the next page encapsulates the key considerations for selecting and recommending the various investment options.
<table>
<thead>
<tr>
<th>Asset Allocation</th>
<th>Equity Path</th>
<th>Median</th>
<th>5th %-tile</th>
<th>Costs and Benefits</th>
<th>Errors, Scalability, Structural Complexity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Risk Fund</td>
<td>70%</td>
<td>24.7%</td>
<td>13.5%</td>
<td>Hi</td>
<td>High</td>
</tr>
<tr>
<td>Dyn AA/Target Date Fund (Accumulation)</td>
<td>90% to 50%</td>
<td>24.2%</td>
<td>13.4%</td>
<td>Hi</td>
<td>High</td>
</tr>
<tr>
<td>Dyn AA/Target Date Fund (Income)</td>
<td>98% to 48%</td>
<td>24.4%</td>
<td>14.0%</td>
<td>Lo</td>
<td>Low</td>
</tr>
<tr>
<td>Reserve Fund (2058 Cohort)</td>
<td>70%</td>
<td>22.4%</td>
<td>12.3%</td>
<td>Hi</td>
<td>High</td>
</tr>
<tr>
<td>Reserve Fund (2078 Cohort)</td>
<td>70%</td>
<td>29.7%</td>
<td>15.4%</td>
<td>Hi</td>
<td>High</td>
</tr>
<tr>
<td>Bank Deposit</td>
<td>10%</td>
<td>10.0%</td>
<td>8.3%</td>
<td>Lo</td>
<td>Low</td>
</tr>
<tr>
<td>Deferred Fixed Annuity</td>
<td>13.4%</td>
<td>10.0%</td>
<td>12.3%</td>
<td>Lo</td>
<td>Low</td>
</tr>
<tr>
<td>Variable Annuity with GMAB</td>
<td>19.0%</td>
<td>12.3%</td>
<td>12.7%</td>
<td>Med</td>
<td>Medium</td>
</tr>
<tr>
<td>Variable Annuity with GMWB</td>
<td>22.0%</td>
<td>12.7%</td>
<td>Lo</td>
<td>Med</td>
<td>Medium</td>
</tr>
</tbody>
</table>

**Income Replacement Rate**

- **GUARANTEED**
- **NOT GUARANTEED**

**Recommendation**

- Not as Default
- Yes as Default
- Yes
- No
- Delayed
v. Investment Option Recommendations

a. Default Investment Option Recommendations

Based on the considerations described in the previous section (i.e., Product Score, Implementation Risk Score, Implementability at Launch and Suitability under Auto-Enrollment), the top two recommendations for the default investment option for California Secure Choice at launch are:

- **Dynamic Asset Allocation Target Date Investment Strategy** implemented through Managed Accounts or through Target Date Funds as fallback, pending legal confirmation by K&L Gates that managed accounts are permissible. An income-focused strategy should be favored over an accumulation-focused strategy if such strategies becomes available in the US market prior to launch. Based on participant demand, two to three complementary target risk strategies can be offered as non-default options to be proactively selected by participants provided that adequate advisory tools are offered for them to make an informed choice.

  OR

- **Pooled IRA with Reserve Fund** packaged as a Retirement Savings Bond.

We also recommend considering a Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB) as a complementary offering in two to three years after launch once there are sufficient account balances in participant accounts.

The chart below summarizes our investment option recommendations.
b. **Dynamic Asset Allocation Target Date Strategy**

The target date investment strategy is based on the theory that young workers have time on their side and can invest heavily in riskier, higher-return assets while near-retirees do not have that luxury.

Target Date investment strategy is designed to maximize returns and manage volatility near retirement by dynamically adjusting the asset allocation along a declining risk trajectory as the target retirement date approaches.

The key design issue for this strategy is the implementation of the risk trajectory as an asset allocation glidepath and whether the trajectory continues “to or through” retirement. The two charts below illustrate a “Typical” glidepath that starts with a 90% allocation to stocks and progressively declines to 50% as the fund approached the retirement date and a “Lower Risk” glidepath that starts at 75% and ends at 35%.

A target date strategy can be implemented either as a series of **Target Date Funds (TDFs)** or as **Managed Accounts**.

**Target Date Funds (TDFs)**

A TDF is a mutual fund that automatically implements the target date investment strategy.

The Investment Manager of each TDF makes the investment decisions for the fund according to the investment policy for that fund.

TDFs are widely used default investment options in 401k plans and are typically offered as series of 5-year retirement date intervals (e.g., “Target 2040” or “Target 2045”). Participants are defaulted to the TDF that corresponds to their expected retirement age based on their date of birth (validated by Recordkeeper).
A TDF offering could include a large number of TDFs to cover all age groups and various risk profiles (e.g., conservative, moderate and aggressive versions of TDF 2030), but this is more costly and is better addressed using the Managed Account approach described below.

**Mutual Funds vs Managed Accounts**

A **Mutual Fund** is a *Pooled Investment Vehicle (PIV)*. A PIV is an investment vehicle made up of a pool of funds collected from many investors for the purpose of investing in stocks, bonds, money market instruments and other securities. The mutual fund is managed by an investment manager/firm.

A **Managed Account** (aka Individually Managed Account or Separately Managed Account) is an investment account (e.g., IRA) owned by the participant but managed by a professional investment management firm. Managed accounts differ from pooled investment vehicles like mutual funds in that each portfolio is specific to each participant.
Recommended Managed Account Structure

Managed accounts can be used to build customized asset allocation strategies using a few investment building blocks (e.g., stock fund, bond fund, money market fund).

![Diagram showing Stock Fund, Bond Fund, and Near Cash]

This allows for greater economies of scale, as well as flexibility, at the program level and participant level.

For each account, the Investment Manager, aided by software, allocates contributions across building blocks and re-balances the portfolio according to the strategy selected for that account.

The Board sets the default strategy and the range of choices for participants.

We recommend an initial low risk strategy for the first three years after enrollment followed by a target date investment strategy based on the participant’s date of birth (validated by recordkeeper), with participant choice to dial risk up or down or switch to a static low-risk/moderate/aggressive strategy. We further favor the income approach over the accumulation approach should it become available prior to launch.
The illustration below shows how participants can intuitively dial risk up or down in a managed account.

![Illustration showing risk dial for managed accounts]

Participants would not be allowed to pursue a “do it yourself” strategy under managed accounts by picking and choosing their own investment mix.

**Proprietary Funds**

In the managed account/TDF option, the Board can choose off-the-shelf products from the market or create proprietary funds.

“Proprietary” here means that the funds are created for California Secure Choice by the California Secure Choice organization with support from the investment advisor, administrator, custodian, etc.

Given the likely scale of the Program, there are significant cost and fee-related advantages to creating proprietary funds. Proprietary funds will afford the Program

- An enhanced ability to drive down investment management costs.
- A greater flexibility on plan revenue structure (asset-based fees vs. fixed dollar account maintenance fees). This allows the Program to keep expense ratios reasonable for all participants and not unduly burden startup savers.
- The ability to place liquidity restrictions or lockups at the product level.

Should California Secure Choice implement the Dynamic Asset Allocation Target Date Strategy as the default investment option, we recommend creating proprietary California Secure Choice funds as investment vehicles for that option. Even though commonplace
among large DC plans, creating a proprietary fund is somewhat involved and would require that the California Secure Choice organization hire a specialized consultant.

c. **Pooled IRA with Reserve Fund**

**SB1234 Plan Design Intent**

SB 1234 attempts to replicate the collective risk-sharing aspect of cash balance plans in the DC context with no employer or state-backed guarantee. Private insurance products that are similar to cash balance plans exist but offer low returns.

We designed and modeled the **Pooled IRA with Reserve Fund** investment option as one way to implement collective risk pooling and return smoothing based on the Collective 401(k) concept from the Center for American Progress, developed by study team actuary Rowland Davis.

**Federal Regulatory Constraints**

Structuring the Reserve Fund as envisaged in SB 1234 has two challenges:

(1) IRAs are typically invested in Pooled Investment Vehicles (PIVs) in the form of a mutual fund, which may require federal registration under the Investment Company Act of 1940.

(2) A mutual fund cannot maintain a reserve because net assets on the balance sheet of the PIV are owned by the shareholders/participants.

**The Workaround**

A special purpose legal entity such as a statewide public authority (“California Secure Choice Authority” or “CASCA”) is established to receive on its balance sheet all the contributions of participants, or an existing public authority is designated for this purpose.

CASCA issues securities to each participant with a par value equal to their contribution at the time of contribution:

- These securities behave like shares in a money market mutual fund but are structured as variable interest bonds to benefit from federal registration exemptions.
- The bonds are redeemable at par value (i.e., face value).
- The bonds would constitute the only investment in participant Secure Choice IRA accounts.
- The Reserve Fund consists of assets in excess of the value of bonds held by participants.
CASCA invests the assets on its balance sheet with oversight and direction by the Board, advice from investment consultants and implementation by one or more investment managers.

The Plan policy, described below, is designed so that liabilities never exceed assets. The structure creates no legal liability to the State because participant shares are only redeemable against assets belonging to the authority.

**Plan Policy**

The Plan Investment Policy would be to manage assets on the CASCA balance sheet as a single pooled investment in accordance with an investment policy and investment guidelines approved by the Board. We used a 70% equities and 30% bonds asset allocation for modeling purposes. Assuming no seed capital, we recommend a more conservative investment policy (e.g., 20% Equities and 80% Bonds) for the first 3 years of the program.

The Plan Crediting Policy is the policy for declaring periodic interest distributions on the CASCA bonds (which should by default be automatically reinvested) based on CASCA investment returns and reserve policy. The crediting rules that were used for modeling are based on the 3-year Smoothed Return, the size of Reserves and a collar with 0% Floor and 10% Cap and are applied as follows:
Crediting Policy Illustration

The chart below shows the 1990-2004 hypothetical CASCA fund returns and participant returns based on the investment and crediting policies described above under two scenarios: (i) Startup Plan where there are no reserves at the beginning of the period and a conservative investment policy is applied over the first 3 years and (ii) Mature Plan where reserves stand at 40% of liabilities at the beginning of the period.

Because the late 1990s bull market would have allowed the Pooled IRA program to build up healthy reserves, participants would have been buffered against loss in the 2001/2002 market collapse, whether as a startup plan or as a mature plan. The Mature Plan would have offered excess returns above the collar during most years.

The chart below shows the 2000-2014 hypothetical CASCA fund returns and participant returns based on the investment and crediting policies described above under two scenarios: (i) Startup Plan where there are no reserves at the beginning of the period and a conservative investment policy is applied over the first 3 years and (ii) Mature Plan where reserves stand at 40% of liabilities at the beginning of the period.
The Startup Plan would have had smoothed returns during most of the 2000s, but reduced account balances during the 2008 financial crisis. The Mature Plan with a healthy starting reserve of 40% of liabilities would have protected participants from any loss in 2008 and offered surplus interest during recovery. The Startup Plan shows higher participant returns during the early 2000s because of unusually high bond returns and the conservative initial asset allocation.

**Basic Trade Offs of Pooled IRA with Reserve Fund**

**Pros:**
- ✓ A properly designed Reserve Fund can facilitate inter-generational risk smoothing and can produce a tighter range of results with less downside risk in the long-term.
- ✓ The investment process is less complex, compared to the Dynamic Asset Allocation Target Date Strategy, as it involves the management of one portfolio (albeit with additional analysis needed for an appropriate investment strategy).
- ✓ Recordkeeping is also simpler because there is only one security owned by participants: the Secure Choice Bond.

**Cons:**
- ✓ In the early years some of the available returns will be diverted towards establishing the desired reserve level and will not flow into credits to participants.
- ✓ Legal complexity (related to the special purpose entity and the issuance of bonds) and operational complexity (related to managing the entity with its staff).

**vi. Comparison of Recommended Program Investment Options**
Comparison of Recommended Program Investment Vehicles

Overall Features

<table>
<thead>
<tr>
<th></th>
<th>Option 1: Dynamic Asset Allocation Auto IRA (DC)</th>
<th>Option 2: Pooled IRA (Reserve Fund)</th>
<th>Traditional Pension (DB) for comparison purposes only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Replacement Range 5th Percentile to Median¹</td>
<td>13% - 23%</td>
<td>2058 Cohort: 12% - 22%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>2078 Cohort: 15% - 30%</td>
<td>Function of Career Income</td>
</tr>
<tr>
<td>Who Bears Investment Risk</td>
<td>Participant</td>
<td>Participants Collectively</td>
<td>Sponsor</td>
</tr>
<tr>
<td>Sponsor Liability</td>
<td>No Guarantees by Sponsor</td>
<td>No Guarantees by Sponsor</td>
<td>Explicit Obligation to Fund Shortfalls</td>
</tr>
<tr>
<td>Fiduciary Responsibility²</td>
<td>Normal Especially on Product &amp; Default Selection³</td>
<td>Elevated Fiduciary Responsibility Especially on Crediting Policy Unless Board Has No Discretion⁴</td>
<td>Normal</td>
</tr>
<tr>
<td>Ease of Implementation</td>
<td>High (no proprietary product) Moderate (proprietary product)</td>
<td>Moderate Additional legal and actuarial services required, but recordkeeping will be simple</td>
<td>N/A</td>
</tr>
<tr>
<td>Flexibility in Benefit Design</td>
<td>Limited Can add available investment &amp; insurance products; less flexibility on customization of private insurance guarantees</td>
<td>Leaves Door Open to Private Investment Guarantee &amp; In-Plan Annuity</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Notes

1- Nth Percentile means N% probability that result would be X% or lower. For example, there is a 5% probability that the income replacement rate for the Auto-IRA option would be 13% or less. Conversely, this also means that there is a 95% probability of the income replacement rate exceeding 13%. Median means 50th percentile.

2- A fiduciary duty is a legal duty to act solely in another party's interests. Parties owing this duty are called fiduciaries. The individuals to whom they owe a duty are called principals.

3- The selection of investment products and, in particular, the default investments place a duty of care on the individual members of the board and program officials entrusted with making the selection.

4- Members of the Reserve Fund board are likely to be deemed fiduciaries. As such they may not profit from their relationship with their principals (i.e., Secure Choice Participants) unless they have the principals' express informed consent. They also have a duty to avoid any conflicts of interest between themselves and their principals. A fiduciary duty is the strictest duty of care recognized by the US legal system. If the Board has discretion in setting the crediting rate of the Reserve Fund, then the utmost care has to be taken in avoiding conflicts of interest or favoring one group of participants over another. This burden can be mitigated if the crediting policy is strictly enshrined in legislation with little discretion left for the board.
## Comparison of Recommended Program Investment Vehicles

### Participant Experience

<table>
<thead>
<tr>
<th>Option 1 Managed Accounts</th>
<th>Option 1 Target Date Funds</th>
<th>Option 2 Pooled IRA with Reserve Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Replacement</td>
<td>13% - 23%</td>
<td>13% - 23%</td>
</tr>
<tr>
<td><strong>5th Percentile to Median Range</strong> <em>(5% contribution rate; 42-year career)</em></td>
<td></td>
<td>2058 Cohort: 12% - 22% 2078 Cohort: 15% - 30%</td>
</tr>
<tr>
<td>Ease of Understanding</td>
<td>Moderate</td>
<td>Easy</td>
</tr>
<tr>
<td>Participant sees allocation across several funds</td>
<td>TDFs are intuitive</td>
<td>Easy-Moderate Savings bond concept is intuitive, but crediting policy may not be</td>
</tr>
<tr>
<td>Ability to Adjust Risk Profile</td>
<td>Easy</td>
<td>Easy-Moderate</td>
</tr>
<tr>
<td>Account interface can be designed to make this intuitive</td>
<td>Participants choose from among several different target dates</td>
<td>N/A No participant choice</td>
</tr>
<tr>
<td><strong>RISK/REWARD</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volatility in Account Balance</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>(Low first 3 years)</td>
<td></td>
<td>Low-Moderate (Low first 3 years of operation)</td>
</tr>
<tr>
<td>Chance of Windfall</td>
<td>~20%</td>
<td>~20%</td>
</tr>
<tr>
<td>(benefit 33% higher than expected after full career)</td>
<td></td>
<td>2058 Cohort: ~20% Mature Program: ~25%</td>
</tr>
<tr>
<td>Chance of Large Loss Near Retirement</td>
<td>Significant</td>
<td>Significant</td>
</tr>
<tr>
<td>(&gt;20% drop in balance)</td>
<td>(Insurance can mitigate, but will reduce benefits)</td>
<td>(Insurance can mitigate, but will reduce benefits)</td>
</tr>
</tbody>
</table>
## Comparison of Recommended Program Investment Options

### Investment-Related Responsibilities of Board & Consultants

<table>
<thead>
<tr>
<th></th>
<th>Option 1 Managed Accounts</th>
<th>Option 1 Target Date Funds</th>
<th>Option 2 Pooled IRA with Reserve Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board: Overall Investment Policy</strong></td>
<td>Determine asset allocation for investment lineup; adjust when prudent</td>
<td>Determine appropriate asset allocation for single portfolio; adjust when prudent</td>
<td>Determine prudent policies for reserve fund accumulation and interest crediting</td>
</tr>
<tr>
<td><strong>Board: Account Crediting</strong></td>
<td>--</td>
<td>--</td>
<td>Credit accounts in strict accordance with established policies</td>
</tr>
<tr>
<td><strong>Investment Consultants</strong></td>
<td>Advise on investment/asset allocation policy, product creation/selection &amp; vendor selection; supervise investment managers in tandem with staff</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Actuaries</strong></td>
<td>Minimal - project average balances, plan demographics, retirement income</td>
<td>Moderate – help determine asset allocation policy, project system assets; help determine appropriate crediting policy</td>
<td></td>
</tr>
<tr>
<td><strong>Legal</strong></td>
<td>Oversee product creation</td>
<td>Draft authorizing legislation and provide legal advice to set up special purpose bond vehicle through which reserve fund can be implemented</td>
<td></td>
</tr>
<tr>
<td><strong>Investment Managers</strong></td>
<td>Day-to-day management of portfolio(s) in accordance with investment policy established and approved by Board</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
3. **Operational Model**

   i. **Overview**

Administering the California Secure Choice Program represents the single largest cost item and can be the primary determinant of its financial feasibility.

Recordkeeping is the central operational function of a retirement plan and as such represents the largest administrative cost component. The recordkeeper is responsible for managing the day-to-day operations of the plan including the maintenance of individual accounts and keeping track of transactions and assets at the individual participant account level. A recordkeeper is also responsible for enrolling participants, tracking participant contribution rates and investment selections, providing account statements, maintaining the plan website and providing general support to participants and plan sponsors/employers.

With a low average wage, a 5% contribution rate and a roll-out phased over 4 years, the recordkeeper will be challenged to manage start-up costs and transaction volumes with very low account balances in the early years.

Our core task is to solve for a fully loaded program cost that does not exceed 100 bps (at steady state) while minimizing the employer burden and maintaining a reasonable participant experience.

In devising the operational model, we have strived to:

   (1) Balance the employer burden against operational costs against the participant experience.
   (2) Incorporate the key drivers of scale to the extent possible.
The table below illustrates some of those drivers of scale we have considered.

<table>
<thead>
<tr>
<th>Minimize Variation</th>
<th>Data The Fewer the Data Sources, the Better</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The fewer choices or “if/then” statements we build into the plan, the less complexity, the lower the cost–simplicity is our friend.</td>
<td>• Priority 1: limit employer interaction with recordkeeper by channeling data transmission through the State of California or optimize recordkeeper interaction with employers through payroll providers, a standard electronic interface or a streamlined web portal.</td>
</tr>
<tr>
<td>• Processing volumes should be spread evenly over the period (e.g. no month-end, quarter-end spikes).</td>
<td>• Priority 2: minimize data from employee to the recordkeeper via paper or phone.</td>
</tr>
<tr>
<td></td>
<td>• Investment data, trading data, etc. would follow industry protocols and interfaces.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Customer Experience</th>
<th>Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The fewer the person-to-person interactions, the less costly the model as 70% of a recordkeeper’s cost is personnel.</td>
<td>• Strong integration and straight-through processing.</td>
</tr>
<tr>
<td>• Operational Model should be designed to drive customers to electronic channels first, with personal interaction prioritized for life events.</td>
<td>• Strong front-end customer interaction capabilities via web, mobile apps, SMS, etc.</td>
</tr>
</tbody>
</table>
| • Key Attributes:  
  o Clear, easy to understand web experience  
  o Minimize paper--everything delivered electronically to the extent permissible. | • Consider traditional recordkeeping solutions as well as some of the new technology solutions coming to market. |

**ii. Potential Operational Models**

We have designed two potential operational models:

(1) **California Employment Department (EDD) as Intermediary** between Employers and the Recordkeeper, and
(2) Direct Servicing of Employers by the Recordkeeper

In both models:

- The relationship is direct between the recordkeeper and employees (participants) for most account-level issues.
- EDD runs employer education outreach/campaign and possibly performs compliance and audit functions.

The chart below illustrates the main functions and flows of the EDD-as-Intermediary Model.

**Pros of the EDD-as-Intermediary Model**

- Employers are already comfortable with EDD. There is no need to establish a relationship with a third party.
- Continuity for employers and retention of historical program data between vendor changes.

**Cons of the EDD-as-Intermediary Model**

- Time lag on enrollments and deposits.
- Employers responsible for tracking employee opt-outs and contribution elections with no centralized audit trail and record of employee elections.
- Inability to implement features that require employee data across employers (e.g., auto-escalation).
- Substantial fixed start-up costs (new software) and development timeline (4-5 years, minimum 3 years).
The chart below illustrates the main functions and flows of the Direct Service Model.

**Pros of the Direct Service Model**
- Smoother auto-enrollment & payment remission process with less time lag (direct feedback loop between employers and the recordkeeper)
- Greater transparency for opt-out tracking and other employee elections
- Faster time to market (at least 2 years but possibly 4 years difference) compared to the EDD-as-Intermediary implementation

**Cons of the Direct Service Model**
- Nearly 300,000 employers would need to set up a direct relationship with the recordkeeper.
- Discontinuity of employer experience and risk of historical data loss in case of vendor change.
iii. **Optimized Operational Model Workflows**

The next two pages contain detailed diagrams that encapsulate the functions and workflows between the different parties for each of the two potential operational models.
In this model, EDD takes on key operational functions.

**Employer**
- EE Enrollment
- Individual Opt-Out
- Deferral maintenance/Management
- Payroll deductions

**Employee**
- Life event processing requests (distribution processing)
- Beneficiary Elections
- General queries (balances, prices)
- Distributions/payouts proceeds
- Contribution limit management.
- Excess contribution returns
- Account statements

**Recordkeeper**
- Participant data feeds
- Aggregated participant contribution files
- Inquiries and problem resolution (Case Management)
- Administrative performance reporting/evaluation

**EDD**
- E R Eligibility & Enrollment
- Feeds participant data & dollars
- Problem resolution
- Periodic excess contribution refunds/rejects
- E R Opt-Out
- Audit/Control
- Marketing and Communication Strategy

**SCRIB**
- Investment Manager selection & contract negotiation
- Performance reporting/evaluation

**Investment Management**
- Data required for EE statements
- Investment pricing
- Trading
- Problem resolution

Width of line denotes volume and complexity of interaction.
Direct Servicing by Recordkeeper: Detailed Model

In this model, Recordkeeper takes on all operational functions directly with employers.

- Employer
  - Communicates to EE about Enrollment
  - Payroll deductions
  - On-boarding of individuals
  - Problem resolution
  - Audit/Control/Governance
  - Marketing and Communication Strategy

- Employee
  - EE Enrollment
  - Deferral maintenance/Management
  - Individual Opt-Out
  - Life event requests
  - Beneficiary management
  - General queries (balances, prices)
  - Distributions/payouts
  - Contribution limit management
  - Excess contribution returns
  - Account statements

- Recordkeeper
  - Data required for EE statements
  - Investment pricing
  - Trading
  - Problem resolution

- EDD
  - E Eligibility & Enrollment
  - Feeds or web loaded files – individual demographic and financial data
  - Contribution funding
  - Employee inquiries and problem resolution
  - Feedback report (i.e. report of deferral changes made with provider)
  - EER opt-out
  - Communicates Individual Opt-Out and Deferral Management Decisions to ER

- SCRIB
  - Inquiries & Problem resolution
  - Administrative performance reporting / evaluation
  - List of ERs and EEs participating

- Investment Management
  - Data required for EE statements
  - Investment pricing
  - Trading
  - Problem resolution

Width of line denotes volume and complexity of interaction.
iv. **Optimized Operational Model Features**

The next two pages contain tables with detailed features for each of the two potential operational models.
### Operational Model Features

<table>
<thead>
<tr>
<th>Feature</th>
<th>Model with EDD-as-Intermediary</th>
<th>Model with Direct Servicing from Recordkeeper</th>
<th>Preferred Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>ER Eligibility Determination</td>
<td>ER Determined w/EDD auditing</td>
<td>ER Determined w/State Agency auditing</td>
<td>ER Determined w/EDD auditing</td>
</tr>
<tr>
<td>ER Enrollment</td>
<td>EDD Managed</td>
<td>Recordkeeper Managed</td>
<td>Recordkeeper Managed</td>
</tr>
<tr>
<td>EE Enrollment</td>
<td>ER Managed</td>
<td>ER Managed Set up on RK system &amp; communicates to EE</td>
<td>ER Managed Set up on RK system &amp; communicates to EE</td>
</tr>
<tr>
<td>Opt Out (Employer)</td>
<td>EDD Managed</td>
<td>Recordkeeper Managed</td>
<td>Recordkeeper Managed</td>
</tr>
<tr>
<td>Opt Out (Individual)</td>
<td>ER Managed w/EDD auditing</td>
<td>Recordkeeper Managed</td>
<td>Recordkeeper Managed</td>
</tr>
<tr>
<td>Minimum Contribution Rate</td>
<td>None subject to Recordkeeper/ Custodian limitations</td>
<td>None subject to Recordkeeper/ Custodian limitations</td>
<td>None subject to Recordkeeper/ Custodian limitations</td>
</tr>
<tr>
<td>Deferral Maintenance/ Management</td>
<td>EDD aggregation of all ER files – 1 Recordkeeper feed</td>
<td>Individual ER Files/Feeds and/or Payroll Providers Fees to Recordkeeper</td>
<td>Individual ER Files/Feeds and/or Payroll Providers Fees to Recordkeeper</td>
</tr>
<tr>
<td>Contribution File Management</td>
<td>EDD Feed w/Web reporting and funding</td>
<td>Recordkeeper works with Payroll Providers and ERs</td>
<td>Recordkeeper works with Payroll Providers and ERs</td>
</tr>
<tr>
<td>Contribution File Processing Issue/Reject Management</td>
<td>Recordkeeper Managed</td>
<td>Recordkeeper Managed</td>
<td>Recordkeeper Managed</td>
</tr>
<tr>
<td>Contribution Limit Monitoring and Management (In Plan)</td>
<td>Individual Managed</td>
<td>Individual Managed</td>
<td>Individual Managed</td>
</tr>
<tr>
<td>Contribution Limit Monitoring and Management (Across Plans)</td>
<td>Recordkeeper rejects excess back to Individual via Check</td>
<td>Recordkeeper rejects excess back to Individual via Check</td>
<td>Recordkeeper rejects excess back to Individual via Check</td>
</tr>
</tbody>
</table>
## Operational Model Features (Continued)

<table>
<thead>
<tr>
<th>Feature</th>
<th>Model with EDD-as-Intermediary</th>
<th>Model with Direct Servicing from Recordkeeper</th>
<th>Preferred Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Account Inquiry (i.e. Balances)</td>
<td>Individual self-service via Recordkeeper Web</td>
<td>Individual self-service via Recordkeeper Web</td>
<td>Individual self-service via Recordkeeper Web</td>
</tr>
<tr>
<td>General Account Maintenance (limited – Beneficiaries…)</td>
<td>Individual self-service via Recordkeeper Web</td>
<td>Individual self-service via Recordkeeper Web</td>
<td>Individual self-service via Recordkeeper Web</td>
</tr>
<tr>
<td>Case Management</td>
<td>Direct workflow access - submission to exchange with - recordkeeper via single source (i.e. state only)</td>
<td>Recordkeeper fields issue/problem queries from all individuals and/or employers</td>
<td>Recordkeeper fields issue/problem queries from all individuals and/or employers</td>
</tr>
<tr>
<td>Education and Communication Materials</td>
<td>Secure Choice works with EDD and Recordkeeper to provide Marketing and Communication Content Displayed in Recordkeeper Website. Secure Choice and EDD Collaborates on Employer Outreach and Training</td>
<td>Secure Choice works with EDD and Recordkeeper to provide Marketing and Communication Content Displayed in Recordkeeper Website. Secure Choice and EDD Collaborates on Employer Outreach and Training</td>
<td>Secure Choice works with EDD and Recordkeeper to provide Marketing and Communication Content Displayed in Recordkeeper Website. Secure Choice and EDD Collaborates on Employer Outreach and Training</td>
</tr>
<tr>
<td>Account Statements</td>
<td>Default Mail One Year-End Statement, monthly statements available on Recordkeeper website. Employee can opt out of receiving Year-End Statement by mail</td>
<td>Default Mail One Year-End Statement, monthly statements available on Recordkeeper website. Employee can opt out of receiving Year-End Statement by mail</td>
<td>Default Mail One Year-End Statement, monthly statements available on Recordkeeper website. Employee can opt out of receiving Year-End Statement by mail</td>
</tr>
<tr>
<td>Distribution Services (Retirement eligible population)</td>
<td>Recordkeeper web-based self-service capability</td>
<td>Recordkeeper web-based self-service capability</td>
<td>Recordkeeper web-based self-service capability</td>
</tr>
<tr>
<td>Missing Participants</td>
<td>State manages through own databases</td>
<td>Recordkeeper manages through third Party Vendors</td>
<td>Recordkeeper manages through third Party Vendors</td>
</tr>
<tr>
<td>Tax Reporting – i.e. Annual Contributions form 5498, Distributions form 1099R etc.</td>
<td>Mail to AOR unless Employee Opt into Secure Web-based Recordkeeper “Drop Box” – Login required</td>
<td>Mail to AOR unless Employee Opt into Secure Web-based Recordkeeper “Drop Box” – Login required</td>
<td>Mail to AOR unless Employee Opt into Secure Web-based Recordkeeper “Drop Box” – Login required</td>
</tr>
</tbody>
</table>
v. Operational Model Recommendation

While the EDD-as-Intermediary Operational Model is less costly over the long-term (approximately 10%), the startup costs are significantly higher (see Financial Feasibility Study) than the Direct Service Operational Model, the launch date is likely to be 2 years later and some features such as auto-escalation may not be feasible.

We, therefore, recommend the Direct Service Operational Model. Furthermore, we recommend that California Secure Choice hire a consultant to develop the RFP requirements for the selection of a recordkeeper, to run the RFP process and to oversee the implementation of the operational model.
4. **Plan Rules and Procedures**

   i. **Overview**

   Plan rules and procedures are the fundamental guidelines for the operation of a retirement plan and are a critical component for the success of the California Secure Choice Program.

   The development of the plan rules and procedures was performed by a dedicated committee with participation from the various members of the Overture consortium. The committee collaborated closely with California Secure Choice legal counsel, K&L Gates, and sought input from stakeholders, payroll providers, recordkeepers and other related parties.

   There were four driving factors in making our recommendations:

   (1) Simplicity of administration, compliance and enforcement
   (2) Minimization of the administrative and decision-making burden on employers
   (3) Recordkeeping logistics
   (4) Legal constraints

   ii. **Recommendations**

   The Plan Rules and Procedures fall into seven distinct areas:

   ✓ Plan Basics
   ✓ Definition of Employer (“ER”)
   ✓ Definition of Eligible Employees (“EEs”) / Participants
   ✓ Voluntary Participation
   ✓ Auto-Enrollment and Payroll Deduction Mechanics
   ✓ Social Security Number (“SSN”) / Identity Issues
   ✓ Money Out

   The seven sections below constitute our recommendations for the California Secure Choice Plan Rules and Procedures.
## Plan Basics

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan Year</td>
<td>January 1-December 31&lt;br&gt;ERs determine eligibility and begin notifying EEs during 4th quarter prior to each plan year.</td>
</tr>
<tr>
<td><strong>NOTE:</strong></td>
<td>This is distinct from qualified plan year</td>
</tr>
<tr>
<td>IRA Type</td>
<td>Default: Roth IRA&lt;br&gt;☑ Up to $5,500 after-tax annual contribution (or $6,500 if age 50+)&lt;br&gt;☑ Tax-free retirement withdrawals&lt;br&gt;☑ MAGI limit $184,000 married/$117,000 single</td>
</tr>
<tr>
<td></td>
<td>Individual has choice to switch to Traditional IRA with Recordkeeper flag.</td>
</tr>
<tr>
<td><strong>NOTE:</strong></td>
<td>Roth IRA does not require participant to file income tax deduction, unlike Traditional IRA.</td>
</tr>
<tr>
<td>Default Contribution</td>
<td>5%&lt;br&gt;EE can elect percentage or fixed dollar amount per paycheck with no minimum.</td>
</tr>
<tr>
<td>Auto-Escalation</td>
<td>Implement at Board’s discretion beginning 2nd year of program, in 1% increments up 10%.&lt;br&gt;EEs who elect contribution other than default rate prompted to opt into future auto-escalation.</td>
</tr>
<tr>
<td><strong>NOTE:</strong></td>
<td>This will only be implemented if operational model allows this process to be coordinated by Recordkeeper.</td>
</tr>
</tbody>
</table>
### Definition of Employer

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Plan Sponsorship Exemption</strong></td>
<td>At least 1 California EE (i.e., EE who is subject to Unemployment Insurance coverage in California and whose pay is thus reportable to the EDD) must be eligible for qualified employer-sponsored plan in order for firm to be exempt from mandate.</td>
</tr>
<tr>
<td><strong>NOTE:</strong> Statutory language should be included giving Board discretion to adjust eligibility rules for ERs that do not offer meaningful coverage to most of their EEs.</td>
<td></td>
</tr>
<tr>
<td><strong>Firm vs. Establishment</strong></td>
<td>ER eligibility determined at firm level.</td>
</tr>
<tr>
<td><strong>Firm Size (5+ EEs)</strong></td>
<td>Annual determination based on simple look-back rule. We recommend the following criteria: average of monthly employee headcounts reported on EDD Form DE-9 for the 3rd quarter (ending 9/30) is 5.0 or higher. This data is standardized across states, and using it as part of the EE eligibility standard can help avoid duplicate payroll deductions. The fall quarter is less subject to seasonal hiring spikes than summer and winter.</td>
</tr>
<tr>
<td></td>
<td>Include only California EEs (as defined in Eligible Employees in “Definition of Eligible Employees” below) count in calculation. Statute should give Board authority to determine eligibility regulations.</td>
</tr>
<tr>
<td><strong>Eligible Firms that Downsize to Less than 5 EEs</strong></td>
<td>Continue auto-enrollment/payroll deduction through remainder of calendar year. The following year, ER may choose to keep contributing for EEs already enrolled but may not auto-enroll per draft DOL guidelines.</td>
</tr>
<tr>
<td><strong>NOTE:</strong> Request from DOL ability to grandfather ERs once they enter plan, in order to avoid creating two classes of EEs.</td>
<td></td>
</tr>
<tr>
<td><strong>Employment Intermediaries (PEOs, Temp Agencies, etc.)</strong></td>
<td>Party that controls payroll (e.g. temp agency) is responsible for compliance.</td>
</tr>
</tbody>
</table>
### Definition of Eligible Employees / Participants

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees</td>
<td>Eligible for auto-enrollment: All EEs who are (i) EEs as defined by IRS (receive W-2) and (ii) whose pay is subject to California Unemployment Insurance taxes. No exemption for part-time, short-term and seasonal employees. Recommended minimum age: 18 Alternatives: 19 or 20 (no higher, given employment/earnings patterns)</td>
</tr>
<tr>
<td>Owners</td>
<td>Owners eligible to participate if business falls under mandate. This includes LLC/LP partners if they have compensation eligible for IRA contributions under IRS rules.</td>
</tr>
</tbody>
</table>

### Voluntary Participation

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employers Not Covered by Mandate</td>
<td>Allow these ERs to offer Secure Choice IRA. Under the current draft of DOL guidelines for state auto-IRAs, ERs not covered by mandate cannot auto-enroll EEs. Thus such employers could only offer voluntary enrollment to EEs. Strong Recordkeeper control would be required to prevent ER missteps in enrollment. However, if final DOL regulations permit, employers should be allowed to auto-enroll EEs.</td>
</tr>
<tr>
<td>Self-Employed/Independent Contractors</td>
<td>Once the core program is running smoothly, Board should consider allowing individuals to enroll through paperless process and automatic ACH debits.</td>
</tr>
<tr>
<td>Voluntary Employer Contributions</td>
<td>Not allowed for auto-IRA program under draft DOL guidelines and current IRS rules. However, California policymakers should consider whether the Board should have discretion to establish a Multiple Employer Plan (MEP) in the future to receive voluntary employer match to EE contributions.</td>
</tr>
</tbody>
</table>
# Auto-Enrollment and Payroll Deduction Mechanisms

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Active vs. Passive</strong></td>
<td><strong>Passive auto-enrollment:</strong> ER or Recordkeeper—depending on service model—notifies EE of auto-enrollment; EE has 30 days to opt out before Recordkeeper instructs ER to start payroll deduction. <strong>This is only feasible in the Direct Service Model.</strong> In the EDD-as-Intermediary model, ERs would either have to be responsible for implementing the 30 day opt out process, which can be onerous, or else start payroll deduction immediately, in which case the Program would incur increased costs for issuing refunds to EEs opting out. Remove signature requirement for enrollment purposes; keep EE signature as proof of receipt of program info. Again, this is only advisable if the Recordkeeper directly manages the opt-out process.</td>
</tr>
<tr>
<td><strong>EEs Who Change their Mind</strong></td>
<td><strong>Safe harbor period of 6 months</strong> after initial notification to terminate payroll deduction and receive refund of account balance with no transaction fee. This policy may have to be adjusted based on further determinations regarding Recordkeeper costs and Program fee structure. <strong>NOTE:</strong> IRA rules provide tax penalty free withdrawal of contributions made each tax year (through April 15 of following year)</td>
</tr>
<tr>
<td><strong>Waiting Period</strong></td>
<td><strong>None; immediate auto-enrollment.</strong> However, Auto-enrollment/opt-out mechanics entail minimum 30-day delay before payroll deduction.</td>
</tr>
<tr>
<td><strong>IRA Contribution Limits</strong></td>
<td><strong>Individual is responsible</strong> for tracking limit in relation to income. Recordkeeper flags when contributions approach standard limits; issues refund of excess.</td>
</tr>
<tr>
<td><strong>Income Limits on IRA Eligibility</strong></td>
<td><strong>Individual is responsible for tracking eligibility.</strong> If ineligible based on income (small fraction of EEs): - Elect Traditional IRA (may not be pre-tax if spouse contributes to 401(k)-type plan, depending on income) or - Request refund of contributions/terminate payroll deduction.</td>
</tr>
</tbody>
</table>
# Social Security Number / Identity Issues

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer Role in Social Security Number (SSN) Validation</td>
<td>Normal employment eligibility verification process. <strong>NOTE:</strong> Include requirement for Recordkeeper to accept this as part of the RFP to select Recordkeeper.</td>
</tr>
<tr>
<td>Recordkeeper &amp; EE Roles</td>
<td>Recordkeeper performs electronic validation of identity of new enrollees; contacts EE (not ER) regarding invalid Social Security Number (SSN). Under the Direct Service model, no account is created, and payroll deduction for that EE does not commence until issue is resolved. EE responsible for taking action to resolve issue -- correct SSN/name, provide TIN, or opt out--within 45 day period. If no resolution or EE opts out, Recordkeeper takes no further action. Under the EDD-as-Intermediary model, there may be a need for refunds if payroll deduction commences before the Recordkeeper has an opportunity to process SSN issues.</td>
</tr>
</tbody>
</table>
### Money Out

<table>
<thead>
<tr>
<th>Topic</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Early Withdrawals</strong></td>
<td>Draft DOL guidelines prohibit restrictions or penalties; we recommend requesting ability to impose requirement to self-certify hardship.</td>
</tr>
<tr>
<td></td>
<td><strong>NOTE:</strong> Awaiting legal feedback on permissibility of product/fund-level restrictions.</td>
</tr>
<tr>
<td><strong>Loans</strong></td>
<td>Not permitted under IRA rules.</td>
</tr>
<tr>
<td><strong>Rollovers</strong></td>
<td>Regular IRA rules per DOL guidelines – no restrictions.</td>
</tr>
<tr>
<td><strong>Default Payout at Retirement</strong></td>
<td>Board should consider partial group annuity default payout as program matures and account balances build to levels sufficient for annuitization.</td>
</tr>
<tr>
<td></td>
<td><strong>NOTE:</strong> Policy will be contingent on default investment product (e.g., Target Date Fund vs Pooled IRA/Reserve Fund vs Target Date Fund with built-in income insurance).</td>
</tr>
<tr>
<td><strong>Lost Accounts</strong></td>
<td><strong>Escheat to State.</strong> Board to determine criteria for considering an account lost (balance, number of years inactive).</td>
</tr>
<tr>
<td></td>
<td><strong>NOTE:</strong> Small, inactive accounts add to program cost.</td>
</tr>
</tbody>
</table>