DRAFT – PENDING BOARD APPROVAL
STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES

OPEN SESSION MINUTES
MEETING # 428

Date: December 7, 2018

Place: Department of Human Resources Development
14th Floor Merit Appeals Board Conference Room
235 South Beretania Street, State Office Tower
Honolulu, HI 96813

Present: Brian Moto, Chairperson
Ryker Wada, Ex-Officio Member
Ken Kitamura, Ex-Officio Member
Roderick Becker, Employee Member
Kalei Rapoza, Employee Member
Kalbert Young, Employee Member
Kenneth Villabrille, Employee Member

Others: Krishna Jayaram, Deputy Attorney General
Christopher Leong, Deputy Attorney General
Cynthia Akiyoshi, DHRD Staff
Craig Chaikin, Segal Marco Advisors
Kevin Malmud, Plan Administrator Staff (Prudential)/Honolulu Office
Jeanne Kanai, Plan Administrator Staff (Prudential)/Honolulu Office
Grace Baracao, Plan Administrator Staff (Prudential)/Honolulu Office
Julie Klassen and Carol Blumenthal, Prudential Retirement
Leila Kagawa, DAGS/ETS
Tara Cook, DAGS/ETS
Doreen Kuroda, DHRD

Call to Order: There being a quorum present, Chairperson Brian Moto called the meeting to order at 9:02 a.m.

Agenda: The agenda for this meeting was filed with the Office of the Lieutenant Governor, as required by Hawaii Revised Statutes section 92-7.

Chairperson Moto welcomed everyone and proceeded with introductions, including Deputy Attorney General Christopher Leong from the Department of Attorney General who is temporarily replacing DAG Jayaram. Introductions continued with the Prudential staff. Guests in attendance from the public included Julie Klassen and Carol Blumenthal from Prudential Retirement; Leila Kagawa and Tara Cook from DAGS/ETS; and Doreen Kuroda from DHRD. No one from the public was present to testify, and there were no attendees via the conference line.

Chairperson Moto proceeded to Agenda Item no. 1.

Agenda Item # 1: Approval of Minutes Nos. 426 for the September 7, 2018 meeting and 427 for the October 22, 2018 meeting

A motion was made by Trustee Young and seconded by Trustee Wada to adopt Minutes Nos. 426 and 427, as prepared. The motion passed unanimously.

Agenda Item # 2: Discussion with Office of Enterprise Technology Services on Payroll Deferral Issues to the Island $avings Plan

Chairperson Moto stated that Ms. Kagawa and Ms. Cook have offered to attend the meeting and briefly explain the causes of the problems and remedies being implemented to address the issues and summarized that a number of payroll issues were brought to the Board's attention at the September 7, 2018 meeting. The Board had expressed concerns that the delays and mistakes in contribution deferrals could have a negative financial impact on Plan participants and needs to be addressed. Both DHRD and Prudential have been experiencing a payroll issue every pay date. The Board prepared a letter to ETS asking for some explanations and solutions so that Plan participants are not negatively harmed. ETS did respond back to the Board with an explanation. Chairperson Moto asked if ETS would briefly explain the causes of the deferrals and contribution problems that occurred and whether ETS has solutions to the problems so that the problems would not occur in the future.

Ms. Kagawa stated that she is the program manager and Ms. Cook is the payroll functional manager. As the payroll functional manager, Ms. Cook is able to correct the problems systematically. Ms. Kagawa presented a diagram of the data flow and mechanics of the timing. It is not only system related but also needs to be coordinated with the departments in terms of when the transactions need to be submitted to the DAGS system.

Ms. Kagawa provided updates and points to explain the flow of the business process:

- Most of the issues relayed in the Board's September 18, 2018 letter that are system-related have been addressed such as the multiple jobs.
- A response has been prepared to the additional questions that ETS received.

There have been technical issues that ETS experienced when the data systems came together.

- The process of how vacation payouts are authorized and approved has not changed and authorizations remain at the departmental level.
- In the general flow of the process, there are four areas in the process:
  - There is the Prudential role which consists of the submission of the change through an electronic file to set-up the deductions.
  - There is the department HR role where employees complete the retirement paperwork, prepare and submit the G-2 form, complete the transaction in the system and notifies the payroll office of the termination and of the vacation payout deferral. Authorizations remain the same as before but are now being done in the new system;
  - There is the department fiscal team which reviews the payout, ensures the funds are available and confirms the deferral for the payroll team.
  - There is the agency payroll office where they verify the information and process in the payroll system. An additional verification step has been added where they now have the capability to see the deduction in the system that Prudential has provided.

- There is an electronic approval process; HR payroll job data that comes in and the departments entering in on the online PCS and all works together in one system.
- There have been challenges in having the two operational systems.
- Some of the issues were because of dual employment and employees may have been active in both systems. Some errors were because when the Prudential file is sent, but the Payroll did not come in to transact with the vacation payout. These two pieces are critical and need to be timed to come together.
- One component is that HR needs to look at the files to confirm the vacation credits and has sometimes caused delays in getting the confirmation to payroll.
- Departments now have more visibility to see the payout deductions.
- Notification comes from the department and DAGS then picks up the transaction. Whether it is a deferral or payout, it is determined before it gets to DAGS. They are the processor role which ensures that the taxes are appropriately assessed and is systematically programmed provided it is coded appropriately. There were some instances where the payout was issued as a check instead of the deferral to the Plan and some employees then chose to keep the checks.
- The transactions on the deferrals must be authorized by the employee and the departments and then is sent to the payroll staff to process in the system.
- ETS is the Program Management Office (PMO) which oversees and is implementing the new system. The PMO works with the stakeholders and

does make recommendations and must work together with the operational units for policy matters and any business process modifications. As the PMO, they do not have the directive authority to implement the changes but must work with the agencies to effect those changes. The PMO has recommended to DAGS that necessary coordination is required with DHRD and other HR jurisdictions to communicate with all HR and payroll offices and provide clarification and/or updates.

Ms. Kagawa reviewed the individual questions presented to ETS and presented its responses.

- The processors mentioned in their response letter refers to the jurisdiction/departmental payroll staff. Because ETS shares the data, there needs to be coordination with their human resources to understand what drives payroll for their employees who are retiring. The systems are now coming together and sometimes the coding has not been in agreement because the systems have been separate for so many years. There is now one data point to collect certain HR fields that drives the payroll.
- DAGS/HawaiiPay does have procedures in place to verify that the amount of the vacation deferral is processed accurately.
- Off-cycle processing means processing in-between regular payroll cycles. Corrections are done during off-cycle processing, including vacation pay deferrals. Off-cycle processing are recorded and released on the regular on-cycle payroll dates. Disbursements will be carried forward with the next regular on-cycle process and may include payroll adjustments. The option of ACH off-cycle checks may have costs so they will need to look at this option and consult with Budget & Finance.
- In response to the situation involving a contribution change that was delayed, the payroll system is effective date driven and there are two types of paid employees. There are lagged employees who are paid five days after the pay period ends and the payroll is processed before the pay period ends. There are "after-the-fact" or ATF employees whose pay is delayed. When the pay period closes, then two weeks later they are paid on the following pay cycle. When the file is received, HR is driving whether the employee is lagged or ATF, and this drives when the deductions are set up for the effective date. If HR has a change on the effective date, this could impact when a deduction is effective for an employee. Leave without pay situations could change a lagged employee to an ATF status. In the case referred to, there was a delay in setting up the change. DAGS processed the file after the cutoff and the reason was due to a system operator not running the file on time. ETS does not anticipate this situation to reoccur because all employees will be on one system beginning in January 2019. The process does heavily rely on HR internal process to give the information on time.
- The largest volume of employees to move to the new payroll system is Group 3. This group includes multi-employment appointments. As the HR and

payroll data are coming together, ETS is examining and testing the logic to ensure deductions are not doubling up and there are safeguards and control measures in place. ETS noted that the responsibility will be with individual departments/jurisdictions to process HR and payroll transactions correctly to allow for the deductions to be processed accurately. Ms. Cook explained that there are two pieces - the HR data needs to be in the system and accurate, and the Prudential file needs to come in and set up the deductions. The payroll person needs to come in and payout the vacation leave. Once that is done, the DAGS system will handle and look at the paychecks from multiple jobs to determine which paycheck to make the deferral. An employee could be paid three different jobs at one time, so the system will coordinate which paycheck the vacation payout and deferral will hit.

- The cause of what caused deductions to be made to two retirement plans may have been due to where there were wrong designations on the record and now the data is coming together. ETS is working with the HR departments to make sure the corrections are made.
- The payroll files that come in only will show the contribution changes. On the system it will look at if the employee is ATF or lagged and when the effective date of deduction will hit.
- In the case where an employee retired and is rehired as an 89-day hire and had both a PTS Plan deduction and a deferred compensation plan contribution deduction, the system did not look at the FICA retirement codes to cancel out the regular Plan deductions even if the employee is not eligible for regular Plan deductions. And, Prudential does not send a cancellation of Plan contributions until the next calendar year. Ms. Cook explained that there is no customization right now programmed in the system to change designations. The payroll staff can see the deductions and designations and payroll staff can then cancel a payroll deduction if needed.

Chairperson Moto requested ETS assistance in accommodating meeting requests from DHRD on tax calculations which have a bearing on the deferred compensation amounts, and from Prudential on operational inquiries. ETS responded that the meetings requests can be accommodated. There were no other questions from the Board.

Agenda Item # 3: Overview of Funds Currently on the Watch List by Segal Marco Advisors: Wellington Research Value Fund

Mr. Chaikin provided a brief market commentary on the Third Quarter 2018 and additional updates to current period:

- Through the end of September 2018, the S&P was up 10.5% year-to-date. The month of October, the S&P was down, and up 2% in November for a year-to-date return of 5.1%.

- The market has seen increased volatility in December and there have been concerns on trade issues. Although the market has been volatile, the economic fundamentals have been in an okay position.
- The yield on the 2-year Treasury exceed the yield on the 5-year Treasury. It means that investors were being compensated more for investing in the 2-years versus 5-years. The yield on 10-year Treasury rates are above short-term rates, so this may be a short-term instance and may not indicate a recession.
- Wellington Research Value Fund was placed on the watch list at the September 7, 2018 Board meeting.
- Wellington is a large cap value manager and a bottom-up investment manager. They look at a company's fundamentals to see whether it will be included in the portfolio. They like companies that have a strong balance sheet, good cash flow, and look for undervalued names out of favor.
- The year-to-date as of September 30, 2018 for Wellington fund places performance slightly ahead of the benchmark. Through November 30, 2018, performance was down but relative to the benchmark the performance was up.
- The biggest source of Wellington's fund underperformance has come in the last two months where they have had continued stock selection challenges in the consumer staples, healthcare and information technology sectors.
- Segal will continue to monitor since the fund has been on the watch list only for the past two months.

Chairperson Moto proceeded to Agenda item #4 and stated that this item is related to procurement and will be discussed in Executive Session.

<u>Agenda Item # 4:</u> <u>Review of Draft Contract for RFP No. DCP-17-1, Request for Proposals for a Target Date Fund Investment Option</u>

A motion was made by Trustee Rapoza and seconded by Trustee Young to move into Executive Session at 10:17 a.m. to confer with the Plan's legal counsel and to deliberate or make a decision upon a matter that requires the consideration of information that must be kept confidential pursuant to a state or federal law, pursuant to HRS §§ 92-5(a)(8), 103D-105, and 103D-303. The motion passed unanimously.

EXECUTIVE SESSION

All guests were excused except for Segal Marco Advisors.

<u>Meeting Reconvened</u>: **A motion was made by Trustee Young and seconded by Trustee Wada to move out of Executive Session at 10:26 a.m. The motion passed unanimously.**

All guests rejoined the meeting.

Chairperson Moto provided a brief summary saying that the Board reviewed the drafted contract agreement and plans to enter into a contract with The Vanguard Group to provide their Vanguard Institutional Target Retirement series which will replace the current LifeCycle portfolio funds.

A motion was made by Trustee Young and seconded by Trustee Kitamura to approve the drafted contract agreement and enter into a contract with The Vanguard Group. The motion passed unanimously.

<u>Agenda Item # 5:</u> <u>Overview by Segal Marco Advisors on the Proposed Transition from the Current LifeCycle Portfolios to the New Target Date Retirement Series, including but not limited to:</u>

a. Discussion on the Mapping of the Custom LifeCycle Portfolios to the New Target Date Retirement Series, as recommended by Segal Marco Advisors, and Potential Action Thereon

b. Discussion on the Qualified Default Investment Alternative and Action on Potential Changes Thereon

Mr. Chaikin explained the Qualified Default Investment Alternative, or QDIA:

- QDIA is a term used by ERISA.
- There is no QDIA in the Plan but best practice is being used. Since the Plan is an elective option there is not typically a lot of non-elections by participants. However, if there is no election made by a participant, the monies need to be parked somewhere.
- Currently, if a participant has not made an election, the monies are mapped to an age-appropriate LifeCycle portfolio fund, based on a retirement age of 65 years. If there is no birth date on file for the participant, then the default fund is the LifeCycle Income Fund.
- In the ERISA world, if a participant has not made a choice of investment elections, the Plan Sponsor can make an investment decision for participants.
- There are four types of QDIAs:
    - Capital Preservation Fund, like the Stable Value Fund, is considered a QDIA for the first 120 days of participation;
    - Target Date Fund
    - Managed Accounts/managed portfolios; and
    - Balanced Fund.
- The trend has been towards the Target Date Fund or managed portfolios.

- The three options that would satisfy the QDIA regulations are the Target Date Fund, Managed Accounts or Balanced Fund:
  - All three options are diversified amongst stocks and bonds and have a glidepath with a managed risk allocation, versus the participant making an investment allocation.
  - The new Target Date Funds will have the Vanguard funds as the underlying funds. Under Morningstar and GoalMaker, the underlying funds will continue to be the Plan's core investment options.
  - The key component of the Target Date Fund is time horizon which is how participants are invested within the Target Date Funds. For the new Target Date Funds, the participant will pay the stated expense ratio which will be 9 basis points for Vanguard.
  - The GoalMaker (a Managed portfolio) utilizes the core line-up, and the participant pays the weighted average expense ratio of the investment options. If using Morningstar (a Managed account), the weighted average is what is in the portfolio plus the management fee.

Mr. Chaikin remarked that he would not recommend the Morningstar Managed account because of the additional fee, or the GoalMaker as the option would be specific to Prudential and would be a problem if Prudential is no longer the record keeper. Although GoalMaker tool is easy for participants to understand, it requires an additional step in that participants need to set a risk tolerance which is a major factor for GoalMaker. As a QDIA, the Board would then need to decide and set a risk tolerance. The recommendation would be the Target Date Funds as the QDIA as it easy for participants to understand and has a ticker symbol that can be tracked and where participants can get information on their own. The con for Target Date Funds is time horizon which is the primary factor that influences the default decision, and it is a one size fits all.

A motion was made by Trustee Young and seconded by Trustee Wada to adopt the Target Date Funds as the default mechanism for the Plan, as recommended by Segal Marco Advisors. The motion passed unanimously.

Mr. Chaikin stated that there is a disconnect in the line-up with respect to the mapping of the new Target Date Funds. Currently, the LifeCycle portfolios are in 10-year increments. The new Vanguard Target Date Funds are in 5-year increments. There are also some participants who may have multiple investment options which includes an allocation to a LifeCycle portfolio. He is suggesting moving the participant's assets that are invested in the current LifeCycle portfolio to an age appropriate Target Date Fund. It would be a one-time mapping at the time of the transition, so if participants would like to be invested in different Target Date Fund the participant would need to go in and make the change once the new funds are available.

The Board raised concerns that mapping to an age appropriate fund may not be what the participants elected. Trustee Becker commented that participants may have deliberately elected the LifeCycle portfolio to be more conservative or more aggressive. Ms. Klassen remarked that mapping to the age appropriate fund may be a fair amount of clean-up of participants' portfolios in the areas where the elected fund may not be age appropriate. If it is like-to-like mapping, there would not be the clean-up of the multiple use of Target Date funds. Generally, if a Target Date fund is selected then the person would be in one Target Date fund. So, the question is whether the mapping should be to move to the assets to the same fund as what the participant expressly elected. There is some presumption that the participant made a cognitive decision to be invested in that fund.

The Board discussed and commented on the different approaches:

- Trustee Young reiterated that the QDIA would come into effect when the existing Plan offerings are terminated, and short of any actions by the participant, the monies would go into a QDIA arrangement versus the new Target Date Fund offerings replacing the existing offerings.

- Trustee Rapoza stated that the reasons for a participant who is in the current LifeCycle fund are unknown. If there are differences in the portfolio earnings, the Board would not be held responsible under the QDIA safe harbor. To minimize any issues, the communication should be clear and timely enough to inform participants that they would be moved over to an age-appropriate fund, and thereafter they would be responsible for going back in to manually make any desired changes.

- Trustee Becker noted that if the market drastically goes down there would be a lot of participants who may be upset as they may have been intentionally invested more conservatively than the fund they would be mapped into despite the volume of communication that goes out to participants.

- Trustee Young remarked that it is hoped the greater majority of participants purposefully and cognitively made the decision on the LifeCycle portfolio they elected. He noted that the Board should have a philosophy and reason for the mapping to the appropriate age and having the default retirement age at age 65 years. On the premise that the participant has made an informed decision of which target date fund to invest in, he stated that the Board should have a philosophy on moving the participant to a different age appropriate fund based on 65 years instead of what the participant chose to be invested in.

  Ms. Klassen stated that to give context around what the behavior has been, the data as of August 2018, there were 3,265 investors in the LifeCycle portfolio funds, and of that number 719 are in one LifeCycle fund. That difference of the number invested in more than one LifeCycle fund does not appear to be a cognitive decision.

- Trustee Becker qualified that those participants could have selected two LifeCycle funds because their age is in-between, and they split between the funds to try and average out the age. He believes that if participants are invested in this Plan they are at a sophisticated level to make the decisions that they made. Mr. Chaikin stated that moving to the 5-year increments would address this scenario.

- Trustee Wada concurred with the like-to-like mapping of the funds and have the communications point out that the best practice is to have one Target Date fund. It would be better than putting participants in funds that they have not chosen. Trustee Kitamura stated that from a risk perspective the like-to-like mapping is safer as it represents how participants enrolled and their thought process at that time, along with increased outreach and education.

Ms. Klassen confirmed that Prudential can do multiple communications to ensure the greater majority of participants are made aware of the fund changes and confirmed that Prudential can do either the like-to-like mapping of the funds or to the age appropriate fund.

A motion was made by Trustee Rapoza and seconded by Trustee Wada to transition the participants' assets using the like-to-like method where participants are mapped from their current LifeCycle Funds that they are invested in to the equivalent or a "like" Target Date Fund in the new Vanguard Target Retirement series, and request that Prudential engage in additional educational activities. The motion passed unanimously.

Trustee Young asked whether Prudential has looked into the issue raised by a participant on difficulties that appeared when attempting to log-in to re-register on the upgraded Prudential website. He stated that he had an error message appear when attempting to re-register and was locked out of his account. He asked if an update could be provided at the next meeting.

Agenda
Item # 6: Staff Administrative Report

Ms. Akiyoshi presented a prepared list to highlight some of the Board's initiatives and projects that were undertaken throughout the year and reviewed the list of major activities which were in partnership with the Investment Consultant, Segal Marco Advisors and with the TPA, Prudential Retirement.

Agenda
Item # 7: Other Business/Announcements

a. Presentation of Resolution to Outgoing Trustee

Chairperson Moto relayed a farewell to Trustee Villabrille who is retiring at the end of this year. He read and presented a Resolution to Trustee Villabrille that was signed by the Board members to acknowledge the outstanding service he provided to this Board.

Trustee Villabrille gave closing remarks on his tenure with this Board.

There was no other business. Chairperson Moto thanked everyone for attending today's meeting and adjourned the meeting at 11:26 a.m.

Taken and recorded by:

Cynthia Akiyoshi
Board Staff

Reviewed and approved by:

Brian T. Moto
Chairperson