COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Date: May 3, 2019

Subject: School Employees' Defined Contribution Plan

To: Public School Employees' Retirement Board

From: Jennifer A. Mills
Deputy Executive Director of Benefits and
Director of Defined Contribution Investments

At the May 23, 2019 Board meeting, I am pleased to present the final terms of the Plan Document and implementation determinations relating to the School Employees' Defined Contribution Plan ("Plan"). The coordination efforts of staff, consultants, Vitech, and Voya Institutional Plan Services, LLC ("Voya") was impressive with each party playing a crucial role in our success. We will walk through the governance structure developed and recommended by staff to implement Act 5 and review key decisions resulting from the process. A summary of the plan provisions will be provided that explains the basic structure of the Plan and the important changes made to the Public School Employees' Retirement System ("System") to accommodate the new classes of service and the Plan.

Summary of Resolutions:

The following resolutions will be presented to the Board at the May 23, 2019 Board meeting relating to the Plan. A more detailed description of the resolutions follows.

1. A resolution adopting the Plan Document of the Plan. A redline of the changes made to the Plan Document since the Board's review in May 2018 is attached as "Attachment A" along with a final version attached as "Attachment B."

2. A resolution approving the Vanguard Treasury Money Market Investor Fund to invest the assets held in the forfeiture account for non-vested employer contributions, the account for stale-dated checks, and the Plan Expense Reimbursement Account (PERA).

3. A resolution authorizing a change in share class for the Calvert Balanced Fund from the I Share Class to the R6 Share Class to reduce the fee to the participant.

Descriptions of Resolutions:

Adopt the Plan Document of the DC Plan

Act 5 of 2017 established the Plan for all school employees hired on or after July 1, 2019. Although Act 5 of 2017 provided the basic structure for the Plan, the Internal Revenue Code ("IRC") and the Public School Employees' Retirement Code ("Retirement Code") require the Board to adopt a plan document containing the written terms and provisions of the Plan under which the participants' rights and benefits are derived.

The Plan was drafted to coexist with the System and to mirror the structure and administration of the System. The System remains the system of record regarding notice, elections, and membership qualification to avoid inconsistencies in recreating the rules in the DC Plan.

In May 2018, the Board approved the submission of the draft Plan Document to the Internal Revenue Service ("IRS") for a determination letter to confirm its tax-qualified status. By letter dated April 3, 2019, the IRS issued a favorable determination letter to the Plan. A copy is attached as Attachment "C."

Accordingly, the final terms of the Plan Document must be adopted by the Board before administration on July 1, 2019. Other than minor improvements in wording and requested changes by the IRS, the relevant content changes are minimal.

Substantive Content Changes to the DC Plan

3.06 Employer Defined Contributions.

The rate of employer defined contributions for a Class T-G participant is greater than the rate for a Class T-H or Class DC participant. Thus, if a participant elects either Class T-H or Class DC, the employer will have made excess employer defined contributions of 0.25% of compensation prior to the class election. Because the dollar amount is relatively low compared to the cost to PSERS of tracking and developing a return process for the excess contributions to the employer, the Plan Document was amended to allow the participant to retain the 0.25% of excess employer contributions in the individual participant investment account.[1]

3.08 Administration of Forfeitures.

The Retirement Code, as written, permits the non-vested employer contributions (e.g., when a member terminates before reaching the three-year threshold for vesting of employer contributions) to be credited to the participant's most recent employer. During

[1] Most of the adjustments were estimated at less than $100.

contract negotiations with Voya in June 2018, PSERS was advised that Voya does not track contributions by employer for other plans and, therefore, included an extra cost in its proposed participant fee. To provide a more manageable and administratively feasible plan provision that will not increase administrative costs by Voya or PSERS, the Plan Document was amended to require the forfeiture of non-vested employer contributions to be applied to administrative expenses rather than to the most recent employer, similar to what happens in a pension forfeiture situation. This amendment is more in line with defined contribution plan forfeiture provisions and will defray the costs to all participants. The amendment will also eliminate the potential windfall to the most recent employer, who may not have contributed on behalf of the participant during the entire employment.

8.01 Distribution Permitted upon Termination of School Service.

Following receipt of a distribution date for a terminated participant, Voya will run a monthly sweep to determine whether such participant's account is equal to or less than $5,000. If the amount is $5,000 or less, then the account will be subject to a mandatory distribution. The purpose of transferring small accounts out of the Plan is to reduce the risk of increased plan costs, fiduciary risks, and other ancillary problems such as "missing" participants and uncashed checks.

The Plan Document was originally drafted to include this common provision for a mandatory distribution but excluded accumulated rollover contributions from the determination of whether a participant's account meets the $5,000 threshold. During implementation efforts with Voya, we were advised that Voya cannot exclude rollovers from the calculation. Because the risk is low in including rollovers in the Plan, the Plan Document was amended to consider the total balance of a terminated participant's individual investment account when determining the $5,000 limit at the time Voya runs the sweep.

Article XVII The Trust.

In addition to the creation of a Plan Document for the plan, the Retirement Code requires the creation of a trust agreement to reflect the administration of the accounts in which the assets of the plan are held. Rather than creating a separate trust document, the terms of a trust agreement were incorporated into the Plan Document.

Vanguard Treasury Money Market Investor Fund

The Vanguard Treasury Money Market Investor Fund ("Vanguard Fund") was selected and recommended due to its low expense ratio and competitive yield relative to its peers. The Vanguard Fund will be used to invest the assets held in the following accounts:

- Forfeiture Account
- Stale Dated Check Account
- Plan Expense Reimbursement Account

Plans generally invest the assets in similar accounts in a capital preservation option, such as a money market fund, due to their stability, low volatility, and liquidity. The Vanguard Fund meets these requirements with a lower expense ratio and higher yield than other similar funds. The Vanguard Fund will be a fund outside the investment menu and will not be available to the participants.

Federated Treasury Obligations Institutional Fund and JP Morgan US Government Money Market Institutional Fund were considered but the fees and yields were not competitive compared to Vanguard's Money Market Fund.

Calvert Balanced Fund—Switch from Class I to Class R6

At the December 2018 Board meeting, the Board selected the Calvert Balanced Fund I for the specialty allocation/socially responsible fund. In February 2019, Calvert Balanced launched a new R6 share class at 64 bps net expense and adjusted the I share class from 62 bps to 68 bps, net expense. We are, therefore, recommending that the Board adopt a resolution switching from the Class I to the Class R6. A summary of the difference in the ratios are provided below.[2]

Calvert Balanced Fund	Class I – 12/31/2018	Class I – 2/1/2019	Class R6 – 2/1/2019
Gross Expense Ratio	0.67%	0.71%	0.67%
Net Expense Ratio	0.62%	0.68%	0.64%

[2] Note that the draft DC Investment Policy delegates authority to the Director, with concurrence from the Investment Office Professional staff and the consultant for the Plan, to review share classes of investment options and adjust classes to reduce fees, when available, to avoid having to seek formal approval from the Board.