



Marc S. Pester
Senior Vice President
Prudential Retirement
200 Wood Avenue South
Iselin NJ 08830

Prudential Retirement Insurance and Annuity Company
280 Trumbull Street, Hartford CT 06103

November 14, 2013

Grant Boyken
California Secure Choice Retirement Savings Program
915 Capitol Mall, Room 110
Sacramento, CA 95814
Attn: Secure Choice RFI#13-01

Dear Grant,

On behalf of Prudential, we are pleased to share our thoughts with the California Secure Choice Retirement Savings Investment Board in designing the newly-created California Secure Choice Retirement Savings Program. As suggested, we provided responses to all questions that we have relevant expertise and experience. Prudential's leadership in delivering income and protection solutions in the defined contribution market qualifies us in addressing California's problem of retirement security for private sector employees.

We understand the statutory goals and objectives for the Program focus on delivering retirement security to each and every participant. We believe this requires a plan structure that incorporates the best practices from defined contribution plan design (e.g., portability of benefits, automatic enrollment and escalation, and default contribution levels and investment options) and best practices from defined benefit plan design (e.g., certainty of retirement income independent of market downturns).

To that end, we have suggested an approach that puts participants on a path to a secure retirement (i.e., Target Date Fund with Guaranteed Minimum Withdrawal Benefit) that best addresses the participant risks. Delivering successful participant outcomes requires an approach that addresses both investment risk (sequencing of return risk) and longevity risk (risk of outliving one's assets), together with driving better participant behaviors (saving, investing and spending). For example, an approach that simply enrolls each 20 year-old participant in a pooled fund with a guaranteed interest credit may serve to eliminate investment risk, but it will fall materially short in generating the needed investment returns to address longevity risk (i.e., putting those participants on a path to a secure retirement).

We welcome the opportunity to share our thoughts in more detail. We will reach-out to you next month to schedule some time for us to visit with you.

Best Regards,

Marc Pester

Bennett Kleinberg

cc: Bennett Kleinberg
Vice President, IIS Innovation
Prudential Retirement

Registered Representative, Prudential Investment Management Services LLC

A Prudential Financial company, Three Gateway Center, 14th floor, Newark, NJ 07102-4077
Tel. 973-802-8624

Response to the Request for Information from:
California Secure Choice Retirement Savings Program

Presented by:

Marc S. Pester*
Senior Vice President
Prudential Retirement
200 Wood Avenue South
Iselin, NJ 08830
marc.pester@prudential.com

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Grant Boyken
California Secure Choice Retirement Savings Program
915 Capitol Mall, Room 110
Sacramento, CA 95814

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PLAN STRUCTURE

- 1) What type of plan structure would you recommend to best meet the statutory goals and objectives for the Program, which include simplicity, ease of administration for employers, preservation of principal and portability of benefits (e.g., a pooled fund with guaranteed interest credited to individual accounts on a regular basis that utilizes a gain and loss reserve? Individually held IRA-type accounts with a variety of funds from which participants could choose? Something else altogether?)**

The statutory goals and objectives for the Program focus on delivering retirement security to each and every participant. This requires a plan structure that incorporates the best practices from defined contribution plan design (e.g., portability of benefits, automatic enrollment and escalation, and default contribution levels and investment options) and best practices from defined benefit plan design (e.g., certainty of retirement income independent of market downturns). Delivering successful participant outcomes requires an approach that both addresses investment risk (sequencing of return risk) and longevity risk (risk of outliving one's assets), and also creates incentives for better participant behaviors (saving, investing and spending). For example, an approach that simply enrolls each 20-year-old participant in a pooled fund with a guaranteed interest credit may serve to eliminate investment risk, but it will fall materially short in generating the needed investment returns to address longevity risk (i.e., putting those participants on a path to a secure retirement).

In order to start participants on a path to a secure retirement, it is essential that the plan design minimizes the number of decisions that the majority of participants need to make. The Program can be structured into three tiers offering participants several ways to invest. Tier 1 can simplify the investment decision-making process for participants through a simplified enrollment approach, which will include using automatic enrollment, specified default contribution levels, and a default investment option. Based on the demographic characteristics of the employee population, the Tier 1 approach is designed to work for the vast majority of participants. Communication and investment education materials should focus on this tier.

While most participants are expected to participate in the Tier 1 approach, best practices should allow flexibility for those individuals looking for more active participation. Tier 2 focuses on participants who want investment education to assist them in developing a customized investment mix. Finally, Tier 3 would appeal to those participants looking for a complete do-it-yourself solution. To minimize investment confusion, participants will not be provided additional information about Tier 2 and 3 unless and until they request it. The tiers operate cumulatively, meaning Tier 2 includes all options in Tier 1, and Tier 3 includes all options in both Tier 1 and Tier 2.

The plan structure should be designed to promote a long-term investment horizon. This type of design encourages participant rollovers of other tax-favored retirement assets into the plan, and minimizes leakage out of the plan. Education and communication materials will drive awareness and clarity about investment options and transactional activities, including the value of keeping assets in the plan upon separation from the employer.

These tiers are described in more detail below:

Tier 1

Tier 1 is designed for unsophisticated investors who prefer a one-step approach to creating a diversified investment portfolio with the ease and convenience of professionally managed funds. Tier 1 is also designed for defaulted participants who fail to make an affirmative investment decision. One can think of this as the “Do it for me” tier.

Tier 1 would default participants who did not make an election into a ready-mixed portfolio: target date funds with a guaranteed lifetime income benefit.

The target date funds are constructed with a glide path that begins to allocate investments to guaranteed income approximately 10 years prior to the expected retirement date. We expect this option to garner most of the assets, and to appeal to employees across the demographic spectrum.

In 2010, seven in ten 401(k) plans offered target-date funds (TDFs), and more than a third (36 percent) of 401(k) participants invested in TDFs.¹ It is estimated that 80% of defined contribution assets will be held in target date funds by 2020.²

As part of a best-in-class target date fund structure that puts participants on an appropriate investment path, these target date funds incorporate an in-plan guaranteed lifetime income component to produce better outcomes (i.e., addressing both market and longevity risk, as well as driving better participant behaviors). Tier 1 participants will have many of the important benefits customarily afforded to a defined benefit plan annuitant:

- Protection against investment and longevity risk
- Security of receiving guaranteed income they cannot outlive

Target date funds with a guaranteed lifetime income benefit deliver an outcome akin to pooling in a defined benefit plan. In a defined benefit plan, pooling is critical to the plan's ability to deliver benefits. Defined benefit plans efficiently pool longevity and investment risk across large numbers of participants. Longevity risk is pooled, because participants who only live a few years after retiring "subsidize" the participants who live for decades. With a guaranteed lifetime income benefit, participants who remain, after the underlying fund in which they invested is depleted, receive the most income. Defined benefit plans pool investment risk: plan participants who retire after periods of very strong investment performance do not receive a larger pension. These market gains are absorbed by the plan to support payouts to future participants, some of whom may retire after periods of weak market performance. With a guaranteed lifetime income benefit, the level of income is similarly less sensitive to periods of exceptional market performance.

This Tier 1 approach is effective because it will require a lower level of savings on a per-participant basis than that of a traditional defined contribution plan that does not incorporate the same level of retirement income to a group of employees. To validate this point, a recent study³ found that the cost to deliver the same level of retirement income to a group of employees is 46% lower in a defined benefit plan than it is in a defined contribution plan. The lack of risk pooling in a non-guaranteed defined contribution plan is a key reason for this. Defined benefit plan sponsors are able to fund their plans based on the average life expectancy of their participant populations, because the average life expectancy of a large number of participants can be reliably predicted. In contrast, an individual defined contribution participant cannot reliably predict how long he or she will live. As a result, financial experts recommend that individuals fund their retirements assuming that they will live to age 95.

Moreover, defined contribution participants without the presence of a retirement income guarantee can "safely" withdraw only a small portion of their savings each year in retirement. Defined contribution participants without income protection need to be sure that their defined contribution savings will last through any ups and downs in the financial markets, and for as long as they live. As a result, studies recommend that individuals withdraw no more than 4% from their retirement accounts in their first year of retirement, and adjust that amount by inflation every year thereafter.

Tier 1 participants also will benefit from better behaviors. According to DALBAR (the Boston-based research group that has analyzed behavior over two decades), the psychological factors of behavioral finance help explain why investors often make buy and sell decisions that contradict the best investment practices. To deepen our understanding of better behaviors, Prudential completed two proprietary research studies in 2012.⁴

1 ICI Research Perspective: 401(k) Plan Asset Allocation, Account Balances and Loan Activity in 2010

2 LIMRA, November 2012

3 "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Plans", Almeida and Forna, 2008

4 Prudential Retirement, "Better Participant Outcomes through In-plan Guaranteed Retirement Income," 2012.

The first study surveyed participants in Prudential Retirement administered plans with and without Prudential's in-plan retirement income option.

The second study examined participant outcomes based on their investment in an in-plan guaranteed retirement income option. This study examined more than 20,000 full-service defined contribution participants aged 50 and over, and focused on how market volatility affected the behavior of those who did and did not invest in a Prudential Retirement in-plan guaranteed retirement income option.

Prudential's research showed that participants were more likely to "stay the course" when in-plan guaranteed retirement income options are part of their retirement plan. More than half of those polled said that investing in an in-plan guaranteed income option made them more prone to weather market volatility, and two of the three said investing in an in-plan guaranteed retirement income option made them more confident in general about their retirement security. Furthermore, our research found that plan participants with in-plan guaranteed retirement income options were more inclined to stay invested during market turmoil, were better diversified and contributed more than participants without guaranteed retirement income.

Driving better savings behavior...

- Providing an in-plan guaranteed retirement income option correlates with participants contributing more—38% more—than average 401(k) plan participants contribute
- 67% of participants said investing in an in-plan guaranteed retirement income option made them more confident in general about their retirement security.

Driving better investing behavior...

- Nearly three out of four of those polled said guaranteed income would make them more likely to "stay the course."
- During the down market from 1Q 2008-2Q 2009, plan participants invested in in-plan guaranteed retirement income were 2.5 times more likely to stay invested in equities than participants without an in-plan guaranteed retirement income option.
- Investors in IncomeFlex (a Prudential sponsored in-plan guaranteed minimum withdrawal benefit) feel comfortable investing more aggressively (60% risky assets) than if they had to worry about the downside market risk right before and after retirement (sequencing of return risk). Without an income guarantee, participants would have the responsibility of developing and implementing over time their own more conservative asset allocations.

Driving better spending behavior...

- IncomeFlex allows participants to exceed a 4% "safe withdrawal strategy" by providing certainty that their defined contribution savings will last through any ups and downs in the financial markets, and for as long as they live.
- Even with a "safe withdrawal rate" of 4%, nearly half of participants will either run out of money or need to reduce their spending in retirement.⁵

This is achieved by having a process and investment contract that allow the provider to smooth market volatility through spreading gains and losses over the duration of the portfolio.

Tier 2

The vast majority of participants would be expected to affirmatively elect through a simplified enrollment process or automatically default into Tier 1. Selecting Tier 2 is an active choice. The second tier would focus on giving participants who want to more actively participate in choosing their investment options that choice.

⁵ A "safe" investment option is one that contains certain safeguards and protections that are not present in other investments. No inference should be drawn that a "safe" investment option is free of risk.

This is ideal for the participant who wants investment education to assist in developing a customized investment mix. One can think of this as the “Do it with help” tier. Participants can select from investment options covering all of the core asset classes, growth and value funds, large-cap, mid-cap, and small-cap funds, and domestic and international equity. Fixed income is also included. Nontraditional asset classes such as real estate, commodities, and TIPS round out the customized investment mix.

A stable value option is also included in this tier. Stable value offers returns comparable to intermediate-term bonds but with low volatility associated with money market funds. Stable value provides book-value (principal plus accumulated interest) withdrawal guarantees (subject to certain contractual restrictions), which are known as benefit responsiveness. Stable value options provide investors with low return volatility. This is achieved by having an interest crediting rate mechanism in the investment contract that allows the provider to smooth market volatility through spreading gains and losses over the duration of the portfolio. The underlying investment portfolio of stable value options is typically composed of high quality, short/intermediate-term corporate and government bonds, mortgage-backed securities, and asset-backed securities⁶.

Babbel and Herce showed that over the period of January 1989 through December 2009, Stable Value products generated an average annual return of 6.1%, outpacing both intermediate-term bond funds (5.6%), and money market funds (3.9%).

As of 3Q 2013, the crediting rate for the average stable value investment was 2.08%, while the average money market fund was still yielding virtually 0% (0.01%).⁷ Research conducted by Dr. Babbel also has shown that portfolios using stable value as their conservative core can track the efficient frontier more closely than those that use money market funds.⁸

To support a stable value option within the plan, it is necessary to create the conditions for a long-term participant investment horizon. Participants' investments in stable value-options must be expected to remain for a long time horizon in order to support a competitive rate and product. To compose a best-in-class institutional stable value solution, appropriate guardrails must be contemplated in the plan. One such guardrail is an equity wash provision. An equity wash provision requires any transfers a participant makes from the stable value investment option to a “competing” option to first be directed to any other investment option not designated as a competing option for a period of time (usually 90 days). A competing option is defined as an investment option offered to participants that have principal preservation as a primary objective (such as a money-market option or short-term bond option) or other characteristics similar to stable value. Additionally, self-directed brokerage or mutual fund windows may be deemed competing if a competing option is made available through the window.

The purpose of equity wash provisions is to minimize the opportunities for arbitrage between the competing options and the stable value option during periods of rising interest rates. This minimizes the chance that fund managers, to meet redemption requests, might have to liquidate some of their bond holdings at the very time their market value has been depressed. Equity wash provisions also protect long-term investors in stable value, whose subsequent returns could be harmed by forced liquidation sales.

Tier 3

Tier 3 offers a self-directed brokerage window that allows participants access to a broad universe of investment choices for sophisticated investors who desire full flexibility to choose the investments that suit their time horizon and investment style. This tier would include a minimum account balance and a fee for the brokerage account.

⁶ Money-market funds are diversified, and permit redemptions at net asset value on any day the fund is open. Stable value allows withdrawals at book value for benefit-responsive withdrawals. Past performance is not indicative of future results.

⁷ SVIA Quarterly Characteristics Survey

⁸ Stable value products and money market funds are not completely free of risk, but do represent the closest proxy for a risk-free investment option available in most retirement plans

INVESTMENT OPTIONS

2) What investments would you recommend to best meet the goals and objectives of the Program, both in terms of the types of funds and underlying assets, and the style of management (i.e., active vs. passive)?

Tier 1

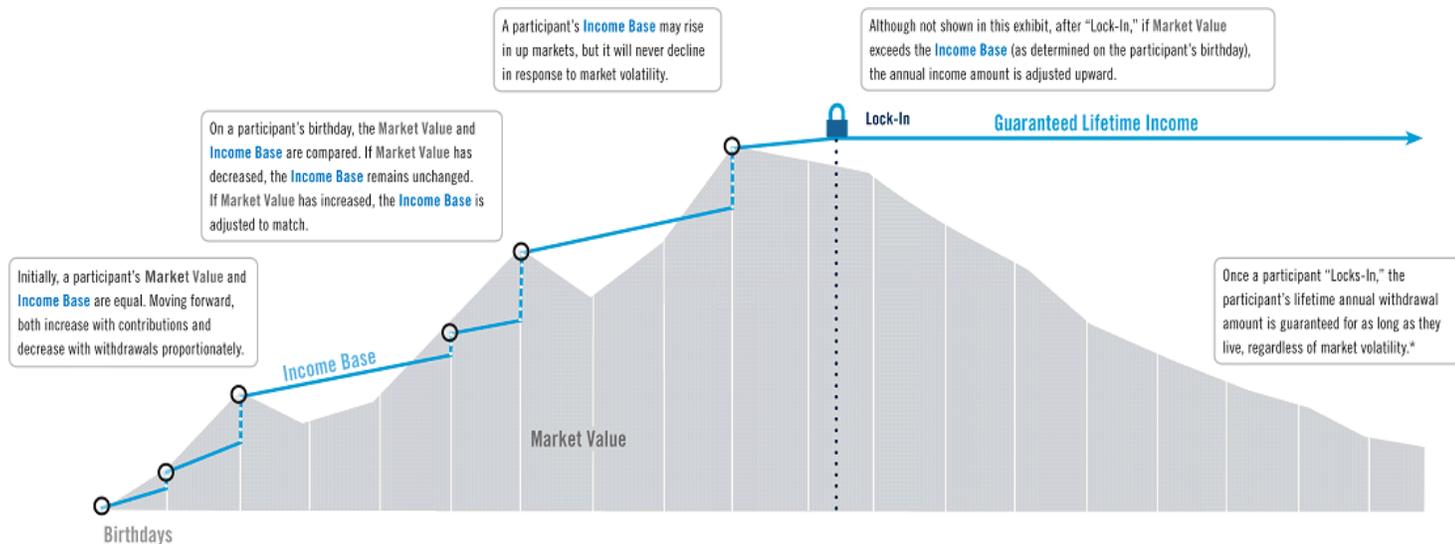
The target-date funds would include both passive index components and active strategies. Use of passive and active equity strategies provides diversification and helps provide optimization and balance in a cost-efficient manner. A combination of passive and active strategies may provide incremental alpha over pure index alternatives by utilizing nontraditional components and quantitative strategies. The target-date funds include equity exposure across market capitalizations and geography, which helps provide access to a broader opportunity set. Also fixed-income asset classes help provide stability, which is particularly important as the target date approaches. Finally, nontraditional asset classes offer the potential for increased returns with low correlation to stocks and bonds, as well as the potential to hedge inflation. We believe portfolios diversified across asset classes and investment styles provide the best opportunity for superior risk-adjusted performance over the longer term. Additionally, we believe that no single investment manager can consistently produce those superior returns across multiple asset and style classes.

Valuable as they may be, target-date funds alone do not completely address retirement investors' main concerns: securing guaranteed retirement income and protecting that income from market volatility.

This presents a potential opportunity to combine the diversification features of target-date funds with the stability of in-plan guaranteed retirement income options. This solution would offer participants a liquid, guaranteed-income option that protects retirement income from market downturns and offers the potential to capture market gains. It helps solve for longevity risk and the sequencing of market return, while participants are assured that they will not outlive their retirement income.

A guaranteed lifetime withdrawal benefit (GLWB), a type of in-plan guaranteed retirement income option, is the optimal guarantee to be paired with a target-date fund. GLWBs provide guaranteed income for life. Additionally, they have several other important features. They allow participants to retain control of their assets, protect participants' income through market downturns, and offer participants the ability to capture potential market gains. Participants may cancel the guarantee at any time. Finally, GLWBs allow participants to cover their spouses. GLWBs are specially designed to work within a target-date structure, as the guarantee is activated 10 years prior to the maturity date of the target-date fund.

The below exhibit shows how a GLWB can help participants accumulate assets and convert those assets into guaranteed income.⁹



GLWB benefits, by providing flexibility and control, can help overcome participants’ hesitancy to utilize a lifetime income option.

In a 2008 white paper titled “What’s Behind the Lack of Interest in Annuitization”, Prudential looked at a number of consumer perceptions behind participants’ anti-annuitization behavior. Many of the key perceptions can be alleviated through the use of a GLWB as the in-plan guaranteed retirement income option. For example, retirees feel that they will lose control of their money if they annuitize, while a GLWB allows participants to retain control. Retirees want continued access to their funds. Also, retirees feel that interest rates have been too low to lock-in a benefit stream for life. This concern is alleviated through the use of a GLWB, which offers participants the ability to capture potential market gains. Finally, retirees feel that immediate annuities won’t keep up with inflation. In summary, although there is academic research that would suggest that immediate fixed annuities provide a high level of value, only a GLWB provides the flexibility and control necessary to help participants make the decisions needed to create a better outcome.

Tier 2

For the second tier, the “Do it with help” tier, our approach would consist of institutional investment options across a range of core and non-traditional asset classes giving participants the ability to more actively choose their investment lineup with the opportunity to receive investor education. This could include a fully integrated, managed accounts solution, or a model portfolio solution in the form of investment education. This option includes education in the form of a personalized retirement strategy, and ongoing tools to help participants meet their retirement goals. The personalized retirement strategy consists of suggestions for:

- Retirement goal and retirement income projections
- Savings rate
- Portfolio asset mix based on the participant’s situation
- Professional investment selection
- Guaranteed income for life

⁹ For Illustrative Purposes Only

Alternatively, the participant can be provided with asset allocation suggestions in the form of a model portfolio and the choice to implement the recommendations or not.

Tier 2 also includes a stable value option. Stable value options provide retirement plan participants with protections that are generally not available as part of most other investment choices within retirement plans. These products typically combine an investment in fixed income securities with a guarantee that participants will receive their entire principal and accumulated interest when they redeem their investments (subject to certain contractual restrictions). The source of interest is a crediting rate promised to participants (typically subject to a floor of 0%, meaning that principal will never be invaded). The crediting rate is typically reset at pre-determined intervals, such as monthly or quarterly. In contrast, comparable retirement investment options, such as fixed-income mutual funds or money-market funds, do not provide such guarantees.

A stable value multi-provider wrap structure may be an optimal solution for the plan. In this structure, a stable value manager is responsible for the management and oversight of a stable value fund. The stable value manager engages multiple wrap providers – such as insurers, banks, or other financial products companies – to extend coverage to designated portions of the stable value fund by entering into investment contracts, or “wrap contracts.” The wrap providers guarantee the return of participants’ principal and accumulated interest, a minimum interest crediting rate and benefit responsiveness.

Tier 3

The third tier provides participants more investment choice and greater control over the types of investments in their retirement accounts. Examples would include:

- Equity securities traded on U.S. exchanges
- Thousands of mutual funds, including sector funds and exchange-traded funds (ETFs)
- Fixed-income securities

3) If you recommend more than one investment option, what would you recommend as the “default,” or automatic, option that would be chosen for participants who do not make an affirmative decision?

Yes, participants who did not choose an election would be defaulted into target-date funds with a guaranteed income benefit. The rationale for this default election is described more fully in the answer to question #1.

4) Would you recommend including any insured interest or insured income products? Why or why not? What are the advantages and disadvantages of these products in terms of performance, risks, cost and transparency?

Yes, we would suggest consideration of a guaranteed lifetime withdrawal benefit as part of our Tier 1 solution, and a stable value option as part of the Tier 2 solution.

To see more clearly the advantages and disadvantages of alternative insured interest or insured income products, it is helpful to compare these products based on their expected level of income, their flexibility to withdraw more than expected if the need were to arise, their ability to provide longevity protection, and the upside potential of the investment.

	EXPECTED LEVEL OF INCOME/RETURN	FLEXIBILITY	UPSIDE MARKET POTENTIAL	DOWNSIDE PROTECTION	LONGEVITY PROTECTION	PREDICTABLE INCOME STREAM
IMMEDIATE INCOME ANNUITIES	Highest	None	None	Yes	Yes	Yes
MONEY MARKET	Very Low	Yes	Minimal	Yes	No	No
INTERMEDIATE TERM FIXED INCOME	Medium	Yes	Some	No	No	No
STABLE VALUE	Medium	Yes	Some	Yes	No	No
TARGET DATE FUNDS WITH GLWB	High	Yes	Significant	Yes	Yes	Yes

Better outcomes in retirement involve more than using investments that provide a stable and low-risk rate of return. To address unforeseen income needs in retirement, consideration needs to be made of investments in which the participant retains full flexibility and control over the account balance. Prudential’s research showed that participants were more likely to “stay the course” when in-plan guaranteed retirement income options were introduced, driving better savings behavior, investing behavior, and spending behavior.

As part of our study in 2011¹⁰, more than half of those polled said that investing in an in-plan guaranteed retirement income option made them more prone to weather market volatility, and two out of three said investing in an in-plan guaranteed retirement income option made them more confident in general about their retirement security.⁷

When in-plan guaranteed retirement income options are available:

- Participant satisfaction increases
- Participant confidence increases
- Participant outcomes improve due to better long-term investing behaviors

Our research found that plan participants with in-plan guaranteed retirement income options were more inclined to stay invested during market turmoil, were better diversified and contributed more than participants without guaranteed retirement income.

A GLWB adds to the benefits of an in-plan retirement income option, providing the benefits of liquidity and flexibility. The participant could choose to protect all or a portion of the account balances. Regardless of the amount withdrawn, there are no surrender charges¹¹, even if the withdrawal is larger than the guaranteed amount. Withdrawals can start at age 55, if a participant decides to retire early. Finally, a spouse can be protected through additional income if the spousal benefit is elected, or the remaining market value can be passed on to beneficiaries. GLWB benefits, by providing flexibility and control, can help overcome participants’ hesitancy to utilize a lifetime income option. A stable value option is recommended as part of the Tier 2 solution. Stable value offers returns comparable to intermediate-term bonds but with the low volatility associated with money market funds, all supported by book-value (principal plus accumulated earnings) withdrawal guarantees. Stable Value options provide investors with low return volatility.

¹⁰ Prudential Retirement Plan Participant Survey, 2012; and 2Q/2011 Book of Business, “State of Retirement,” Prudential Retirement, as of 2Q 2011

¹¹ Withdrawals of more than the guaranteed amount will proportionately reduce future guaranteed withdrawal amounts.

Babbel and Herce showed that over the period of January 1989 through December 2009, Stable Value products generated an average annual return of 6.1%, outpacing both intermediate-term bond funds (5.6%), and money market funds (3.9%).¹²

5) Would you recommend the Program provide a lifelong stream of guaranteed income? If so, how would you convert retirement savings into a lifelong retirement income stream, and what investment product would you recommend to accomplish this objective?

Yes. To protect against market and longevity risks and provide better participant outcomes, we would suggest a guaranteed minimum withdrawal benefit feature as part of the plan design structure.

GLWB benefits, by providing flexibility and control, can help overcome participants' hesitancy to utilize a lifetime income option. In a 2008 white paper "What's Behind the Lack of Interest in Annuitization," Prudential looked at a number of consumer perceptions behind participants' anti-annuitization behavior. Many of the key perceptions can be alleviated through the use of a GLWB as the in-plan guaranteed retirement income option. For example, retirees feel that they will lose control of their money if they annuitize, while a GLWB allows participants to retain control. Retirees want continued access to their funds. Also, retirees feel that interest rates have been too low to lock in a benefit stream for life. This concern is alleviated through the use of a GLWB, which offers participants the ability to capture potential market gains. Finally, retirees feel that immediate annuities won't keep up with inflation.

Brown and Warshawsky examined why individuals don't annuitize in their paper "Longevity Insured Retirement Distributions from Pension Plans: Market and Regulatory Issues." Among many reasons was the lack of inflation protection in commercially available annuities. A GLWB offers upside investment potential as a way to keep pace with inflation over time. Health uncertainty and the irreversibility of annuitization was another key driver. The liquidity available in a GLWB allows for withdrawals in excess of the guaranteed amount to handle unforeseen expenses.

In addition to protection against market and longevity risks, and providing flexibility and control, benefits are also portable. If the plan chooses to change its recordkeeper, the benefits can move to the new recordkeeper. This offers an additional advantage when compared to a traditional income annuity. Finally, the fees for the benefit are transparently disclosed. The "fee" for a traditional income annuity is imbedded in the income provided to the participant, and is therefore less transparent.

6) Would your recommendations require changes to the investment policy parameters in SB 1234? If so, what modifications to the statute would you recommended, and why?

We suggest two changes to the investment policy parameters in SB 1234. These recommendations are based on our research in designing target-date funds, as well as ongoing analysis of real savings rates and employer contributions from 850,000 plan participants. The first recommendation is to eliminate the 50% equity maximum requirement. Our research showed that exposure to equities early in an investor's career is key. We feel that funds should have a high exposure to equities and nontraditional strategies early in the glide path of a target date fund. The second insight from our research is that nontraditional investments and TIPS can potentially boost return and reduce volatility. Exposure to commodities, private real estate, and TIPS can offer significant risk/return benefits, by offering a low correlation to stocks and bonds. These investments have the potential to help both moderate portfolio risk and boost returns. Our recommendation is to recognize commodities, private real estate, and TIPS as permitted investments.

¹² Money market funds are diversified, and permit redemptions at net asset value on any day the fund is open. Stable value allows withdrawals at book value for benefit-responsive withdrawals. Past performance is not indicative of future results.

7) What recommendations would you make to ensure an effective risk management system is in place to monitor risk levels of the Program and ensure risks taken are prudent and properly managed?

To ensure that an effective risk management system is in place to monitor the risks in the investment portfolio, and that risks taken are prudent and properly managed, we suggest that the Board establish an investment monitoring program. The program should cover evaluation and selection of fund managers, monitoring of performance, and replacing managers when necessary. The program should establish guidelines for the program’s investment options, monitor the manager’s adherence to those guidelines, and encourage effective communications between the parties, including fund managers and the board. The program should be comprehensive in scope, easy to articulate, and supported by investment professionals, technology, and educational efforts.

Below is guidance for the establishment of monitoring requirements:

ACTIVITY	FREQUENCY	OBJECTIVE
Monitor Holdings	Daily	Adherence to investment guidelines
Holding Attribution	Monthly	Identify sources of value added
Returns-Based Analysis	Monthly	Monitoring of poor performers
Performance Monitoring	Monthly	Identify significant underperformance
Manager Calls	Quarterly	Understand current strategies/results
Quarterly Review	Quarterly	Identify funds with performance issues
Due Diligence reviews	Quarterly	Enhanced Analytics, style-consistency validation
Site Visit	18-24 months	Due Diligence

In addition to monitoring investment returns period by period, part of an effective risk management system is benchmarking outcomes in retirement. Best practices for benchmarking outcomes are to run multi-scenario Monte Carlo simulations with the goal of looking at retirement success over the lifetime of the participant. For participants who are not invested in a guaranteed lifetime income option, one can use Monte Carlo simulations to evaluate such metrics as average level of income over time, the probability of running out of money, and the amount of the gap if the participant does run out of money. One can also look at account balances over time.

PLAN DESIGN AND FEATURES

8) What would you recommend as the automatic, or “default,” contribution level for participants who do not opt out, but who do not make an affirmative decision to contribute at a higher rate than the default rate?

We suggest a default contribution of 6%.

In September 2012, the Employee Benefits Research Institute (EBRI) produced research titled “Increasing Default Deferral Rates in Automatic Enrollment 401(k) Plans: The Impact on Retirement Savings Success in Plans with Automatic Escalation.” It measured “success,” which was defined as providing a real replacement ratio of 80% when combined with Social Security. The research modeled increasing the default contribution from the previous plan-specific rate (generally 3%) to 6%, with automatic escalation of 1% of compensation. Specific behavioral assumptions were modeled around opting out of automatic escalation. Under the set of specified behavioral assumptions, more than a quarter of those in the lowest-income quartile who had previously not been successful under actual default contribution rates were found to be successful as a result of the change in deferral percentage. When employees in the highest-income quartile were analyzed under the same set of assumptions, the percentage of those who had not previously been successful (under the actual default contribution rates) who now are successful as a result of the change in deferral rate was 18.4%.

9) What options, if any, would you recommend for an automatic escalation feature that increases participants’ contributions over time?

Automatic escalation can increase contributions from 6% to 10% in 1% increments. Please see the above answer for additional details.

10) Are there any other plan design features that should be included (or eliminated) to ensure the plan meets the goals and objectives of the Program? Please explain.

We would recommend that portability to another IRA should only be available upon separation of service. The goal of this is to minimize preretirement “leakage,” and is described more fully in the next question.

Stable value contracts are designed with certain features that protect both the issuers of stable value wrap contracts and the participants in the stable value fund. One such feature is an equity wash provision. An equity wash provision requires any transfer a participant makes from the stable value investment option to a competing option to first be directed to any other investment option not designated as a competing option for a period of time (usually 90 days). A competing investment option is defined as an investment option offered to participants (in addition to the stable value investment option) that has principal preservation as a primary objective (such as a money market option or short-term bond option) or other characteristics similar to stable value. Additionally, self-directed brokerage or mutual fund windows may be deemed competing if a competing option is made available through the window. The presence of competing options subjects stable value investment options, invested participants, and investment contract issuers to the risk of arbitrage, so the addition of such an option by the plan sponsor usually requires issuer consent and the use of an equity wash to restrict direct transfers from the stable value investment option to the competing option.

11) What plan design elements would you recommend to minimize preretirement “leakage”?

The plan structure should be designed to promote a long-term investment horizon. This type of design should encourage participant rollovers of other tax-favored retirement assets into the plan, and minimize leakage out of the plan.

We would suggest that portability to another IRA should only be available upon separation of service. Portability as traditionally permitted in the IRA market could promote preretirement “leakage” by allowing employees to roll money out of the plan to a retail solution while still employed. Portability as traditionally permitted in the IRA market challenges the goals and objectives of the program of preservation of benefits. With no safeguards against rollovers out of the plan, protection solutions other than money market become a

challenge to offer. Traditional IRA liquidity, without any safeguards, would lead to an investment horizon that is shorter than needed to make available a traditional stable value option. The more safeguards against leakage that are instituted, the more competitive the rate of return that can be offered. Competing funds restrictions are another safeguard that would incent a more competitive rate of return for a stable value fund.

Investment education materials should include information helpful to a participant on a path to a secure retirement, including the value of keeping assets in the plan upon separation from the employer.

COSTS AND FEES

12) Provide an estimate of the ongoing administrative costs and fees of the investment options you recommend, and identify the components of those costs and fees.

Each of the investment options has an associated management fee. In addition to the standard investment management fee, an annual guarantee fee is triggered when the guarantee is activated. This fee will reduce the fund's investment return and is reflected in the market value on a daily basis. This fee takes effect when the guarantee is activated. Participants can cancel guarantees by transferring some or all of what they have invested into another investment option in the plan at any time, with no surrender fees or charges. Our fee for an in-plan guarantee is currently 1%. Given the scale and unique aspects of this plan, the fee structure will be uniquely underwritten.

13) How would you propose to assess fees to cover the costs required to start up the plan? Please identify the components of those costs and fees.

Prudential will work with the State to support the preferred method of the recordkeeper. Given the startup nature of the plan, a per-participant fee may be the best method to assess those fees.

14) How would you recommend the Board ensure transparency of fee and expense information available to the Board and Secure Choice participants, including transparency of service providers' relationships or potential conflicts that may increase costs and/or conflict with the interests of plan participants?

We understand that the State would not be subject to ERISA. The State should consider, however, imposing disclosure standards on service providers that parallel ERISA's requirements in the private employer market for fee and compensation disclosure for service providers and investment options. These would apply at both the Board level (paralleling DOL's regulations under ERISA section 408(b)(2)) and at the participant level (paralleling DOL's regulations under ERISA section 404(a)).

ERISA requires plan fiduciaries, when selecting and monitoring service providers and plan investments, to act prudently and solely in the interest of the plan's participants and beneficiaries. Responsible plan fiduciaries also must ensure that arrangements with their service providers are "reasonable" and that only "reasonable" compensation is paid for services. Fundamental to the ability of fiduciaries to discharge these obligations is obtaining information sufficient to enable them to make informed decisions about an employee benefit plan's services, the costs of such services, and the service providers. DOL's regulations under ERISA 408(b)(2) establish minimum standards for the information that fiduciaries must obtain and, in our view, provide a best practice standard for the Board to follow.

ERISA also requires plan administrators of a participant directed defined contribution plan to provide certain information about plan investment options and fees to plan participants so that participants can make informed investment decisions. DOL's regulations under ERISA 404(a) establish minimum standards for the information that fiduciaries must obtain and, in our view, provide a best practice standard for the Board to follow.

ADMINISTRATIVE ISSUES

- 15) What are your recommendations for identifying and disseminating information to eligible employers and employees (including employees of nonparticipating employers)? Consider the potential roles that could be played by California’s Employment Development Department, any other state agencies or departments, and/or private-sector vendors.**
- 16) What are your recommendations for managing enrollment, the receipt and recordkeeping of employee payroll contributions and transactions, and managing rollovers in and out of Program accounts, including potential roles for the Employment Development Department, any other state agencies or departments, and/or private-sector vendors?**
- 17) Do you have any particular concerns about, or anticipate any significant challenges with administering the Program? If so, how would those concerns and challenges best be addressed?**

LEGAL ISSUES

- 18) What approach would you recommend to demonstrate the Program is not subject to ERISA and that Secure Choice accounts would qualify for favorable federal income tax treatment generally granted IRAs?**
- 19) What further statutes and/or regulations would you recommend be enacted in order to strengthen the legal basis for this retirement savings program?**

ESTABLISHING A RETIREMENT INVESTMENTS CLEARINGHOUSE

SB 1234 grants the Board the authority to establish an online clearinghouse, and to register for inclusion on the website vendors who offer employer-sponsored retirement plans and payroll deduction plans and who meet specified requirements. The cost of establishing the registration process and the online clearinghouse would be borne equally by registered vendors.

- 20) Please provide your assessment as to whether there would, or would not, be sufficient interest from vendors to establish an online Retirement Investments Clearinghouse.**
- 21) How would you recommend the Board establish a process to register participants and operate the clearinghouse effectively, efficiently, and in a manner that eliminates or reduces any liability on the part of the Board associated with registering participants and operating the clearinghouse?**

DEVELOPING THE RFP FOR THE MARKET RESEARCH, PLAN DESIGN AND FEASIBILITY STUDY

- 22) Do you have any recommendations for the type of firm, or firms, that would be most qualified and able to conduct the work necessary for the market research, feasibility and plan design study?**
- 23) Are there firms that would be able to successfully conduct all aspects of the work, or is it likely the Board will have to contract with more than one firm?**
- 24) Do you have recommendations about requirements that should be included in the RFP, either in terms of the scope of work required or the qualifications of bidders?**

STRATEGIES FOR SEEKING AND SECURING FUNDING FOR THE MARKET RESEARCH, PLAN DESIGN AND FEASIBILITY STUDY

By statute, funding to complete the market and feasibility study can only be obtained from the contributions of private individuals, private non-profit or for-profit entities, from federal sources, or from any combination of such sources. The use of State funds or borrowing funds for the study is prohibited.

- 25) Do you have suggestions and/or examples for the types of organizations that might be able and willing to donate significant funding, or sources of federal funds that might be available for the study?**
- 26) Given that some organizations do not or cannot donate directly to governments, will the fact that donated funds must be placed in a State of California account make it more difficult to raise money? If so, can you suggest funding solutions or arrangements that might help to avoid this difficulty while maintaining the state's independent oversight and jurisdiction over the study?**

TIMELINE FOR THE MARKET RESEARCH, PLAN DESIGN AND FEASIBILITY STUDY

Below is a timeline Secure Choice staff presented to the Board at their first meeting. The Board directed staff to revise the timeline and aim to implement the program and begin enrolling participants in 2015.

27) Do you have recommendations for revising the timeline in a manner that would allow for an earlier implementation date?

Activities	Dates
Release the Request For Information and receive responses from experts and scholars	Sept. 2013 – Nov. 2013
Prepare RFP for the market and feasibility study	Sept. 2013 – Jan. 2014
Release RFP and choose vendor(s) to conduct the study	Jan. 2014 – April 2014
Vendor(s) conduct market and feasibility study	April 2014 – Oct. 2014
Board considers study recommendations and transmits final report with recommendations to the Legislature, including a request for the authority to make the Program operational if the study's findings are favorable	Oct. 2014 – Jan. 2015
If the Board recommends making the Program operational, and in anticipation of receiving Legislative authority to do so, develop RFPs for administrator, record keeper, investment consultant and other contracts necessary to operate the program.	Jan. 2015 – July 2015
Enactment (or failure) of an authorizing statute expressing the approval of the Legislature to fully implement the Program	July 2015
If authorizing statute is enacted, begin the bidding process for vendors and consultants necessary to administer the Program	July 2015 – Oct. 2015
Secure Choice begins enrolling participants	Early 2016