ETFs and
Defined Contribution Plans

If the DOL's new fiduciary rule triggers a $1 Trillion shift in assets to ETFs [1], can the industry's recordkeeping systems process them?

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[1] http://www.investmentnews.com/article/20160403/FREE/304039997/dol-rule-silver-lining-it-may-trigger-a-shift-of-1-trillion-to-etfs?issuedate=20160417&sid=ETF042016&issuedate=20160420&sid=ETFREPORT&utm_source=ETF-20160420&utm_medium=email&utm_campaign=investmentnews&utm_visit=576778

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Purpose and Audience

VMS has written this paper to provide a high level perspective on why ETFs are not more broadly held in retirement plans today, and to summarize the solutions we've developed to address the issue. It was written with ETF stakeholders in mind, but it should also prove informative for others in the financial services industry who are asking the same kinds of questions.

Background

According to the Investment Company Institute (ICI),
"[*ETFs] accounted for 13 percent of total net assets managed by long-term mutual funds, ETFs, closed-end funds, and unit investment trusts, at the end of 2014.*" [2]

If ETFs have managed to garner 13% of the market for pooled fund-type investments, the question must be asked, why has there been almost no ETF penetration of the defined contribution marketplace, which is entirely dominated by pooled funds?

After all, ETFs are generally:
(1) Less expensive;
(2) Have no built-in 12(b)1 distribution fees to pay investment advisors and
(3) Have no surrender penalties for early redemptions

Looked at this way, ETFs seem like they should be the Goldilocks Investment for retirement plans.

The reason for this lack of traction is that the vast majority of the $6 trillion in defined contribution assets in the U.S.[3], are administered on 30+ year old recordkeeping systems. These systems are incapable of accounting for investments that may be traded more than once per day and only after market close. These are hard facts to believe, especially in the year 2016, but they are true.

This design flaw effectively locks today's recordkeeping systems into offering only NAV-based investments; typically mutual funds or Common Trust Funds.

[2] https://www.ici.org/etf_resources/background/faqs_etfs_market
[3] https://www.ici.org/pdf/ppr_14_rec_survey_q1.pdf

Said another way, legacy recordkeeping systems require that within a given investment CUSIP, all buys and sells for the day must be executed after hours, at the exact same price, across all participants transacting in that CUSIP. There are exceptions to this rule on some systems when it comes to trading and pricing company stock. In these cases however, the solution is so shoe-horned into the recordkeeper's manual processes, there's no way the process would scale effectively if all the investments on the system were managed the same way.

Legacy design flaws that produce these limitations

There are two kernel-level design flaws in legacy recordkeeping systems that have sealed their fate, preventing them from trading non-mutual fund securities while the markets are open.

1. A fundamental lack of awareness of cash
   Today's recordkeeping systems were not designed to be custodial accounting systems. They were created as "balance forward" systems to simply keep a record of how much of a given investment a participant owned, after some other system actually made the purchases or redemptions.

   As a result, the concept of cash as either (1) a legitimate form of property, or (2) a medium of exchange, was never planned on, and is prohibitively complex to engineer into these systems 30+ years after the fact.

2. Absence of proper securities processing
   In general, every transaction of any sort involves the exchanging of one form of property for another. This is a universal commercial pattern across any tradable good or service. When transacting in financial securities in particular, we exchange cash for shares when buying, and shares for cash when selling.

   When an accounting system has no awareness of cash at its core, as discussed in the first point above, it makes it very difficult—or dare we say impossible—to participate in electronic marketplaces with counter-parties when buying and selling securities.

   This lack of standard securities processing, makes it impossible to buy non-unitized ETFs using today's recordkeeping systems.

Just about every recordkeeping system in use in the U.S. today has these two design flaws. Therefore, just about every retirement plan in the U.S. is unable to allow participants to hold and transact in ETFs naturally. ***This is a nearly industry-wide, systemic limitation.***

Today's workaround given these design flaws

To hold ETFs in DC plans today, the workaround is to unitize them in common trust fund-like vehicles where NAVs are struck on the trust funds once per day. This then allows the ETF to "masquerade" as a traditional mutual fund, from the recordkeeping system's perspective.

This is far from ideal however, because:

(1) It introduces yet another service provider into the servicing supply chain—the extra custodian doing the unitization and ultimately holding the ETF in their trust or separate account,

(2) It costs additional money to do the unitization—typically five basis points or more, and;

(3) Probably most importantly, the unitization process itself adds a layer of non-transparency that the retirement industry is trying to move away from, given the DOL's recent fiduciary mandate

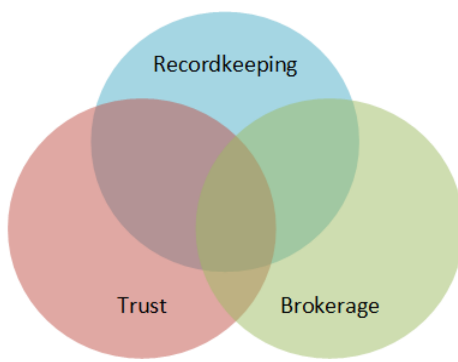
There <u>is</u> an elegant answer to including ETFs in retirement plans, however. It is to let participants transact in and hold actual shares of the investments directly in their plan account, just like they already do in their IRA or retail brokerage account*. *Given the limitations just discussed however, this is not an option on legacy recordkeeping systems.

Wealth management accounting—a better approach

VMS is the first financial technology company to step up and address the impossibility of trading ETFs real-time, side-by-side with traditional mutual funds, within the same retirement plan.

To accomplish this, the way recordkeeping systems are thought about today had to be completely abandoned. What emerged in their place, is a technical mashup of 3 distinct accounting paradigms: Trust, Brokerage *and* Recordkeeping.

The resulting technology combines the best design concepts found at the intersection of these three approaches. Its abilities are unique and distinct enough that we consider it a whole new category of accounting system, something we call a retirement centric wealth management platform.



Platform design

To design the platform, we started from scratch, borrowing from ideas from the brokerage world for its core accounting and securities processing framework. As such, a plan participant's contributions would be deposited in a proper custodial brokerage account—one that is free to transact in, and hold title to, any security that is accessible through the platform and to which the rules on the account or plan allow. This ***includes ETFs***.

From there, we layered in trust features like custodian-level omnibus account relationships and the automated controls that are so critical to doing omnibus well. We also included the master/sub-account relationship and reporting constructs, trust systems are great at.

And finally, we extended these brokerage and trust ideas with all the features one would expect from a typical recordkeeping system, in particular, the ability to take in participant contribution deposits through a company-sponsored payroll process and to keep participant records according to ERISA rules. These include rules for governing plan participation, automatic and manual plan enrollment, contributions, distributions, account lending and many more.

Commercial networking fabric

Wrap and integrate this new approach to retirement accounting, with a modern day commercial networking fabric (browser-accessible of course), and what VMS has built is a pure, cloud-based retirement servicing platform that is unlike anything our industry has seen to-date.

With a simple registration process and a couple clicks of a mouse, any TPA, Investment Advisor, Trustee, Plan Custodian [1], Asset Custodian [4], 3(38) Fiduciary or Managed Account Provider, can be associated to a plan in our cloud. And once associated, users at the firm can proceed to log on, and supply the services they've been hired by the sponsor to provide, and do so side-by-side with their other service provider partners.

In short, VMS has imagined the retirement servicing supply chain as the inter-connected commercial network that it is. We then built a pure, cloud-based technology to frictionlessly enable its members to collaborate in the joint servicing of their retirement plans. In the process, we've embraced tried-and-true accounting patterns that allow for participants to finally have access to modern-day investments like ETFs, and in the future, stocks, bonds and other investment types.

Conclusion

Traditional mutual funds were an outstanding improvement in the efforts to bring professional investment outcomes to the masses. They introduced economies of scale and efficiencies that were all but impossible to deliver to account holders with small balances, and for that mutual funds should be revered.

Times have changed, however, and the retirement industry needs to change with them. ETFs take the already brilliant concept of mutual funds to the next level and deliver a number of improvements on the basic concept of asset pooling and collective investing.

[1] **Requires upfront technical integration if the custodians prefer that the assets sit in omnibus on their accounting system**

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Just as the investment manufacturing industry has had to adapt and change to the market for mass-supplied investment management, so too does the retirement industry need to change, to accommodate that new management.

As industry participants ourselves, VMS’s retirement technology is our contribution to that effort.