One pathway to more personalized retirement plan investment portfolios

Self-Directed Brokerage Accounts
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Executive summary

When you design a retirement plan and select investment options for your employees, you look for options that accommodate the distinctive demographic characteristics of your workers. The challenge is that each employee presents a unique picture in terms of:

1. Age
2. Net worth
3. Investment expertise
4. Risk tolerance
5. Availability of outside assets
6. Retirement income objectives

Expanding the core investment menu so that it contains choices that can accommodate the full spectrum of investors may not always be the best solution. Studies in behavioral economics have indicated that too many plan menu choices may have a negative effect on plan participation rates.¹ A Self-Directed Brokerage Account (SDBA), sometimes referred to as a “brokerage window,” is one specialized for providing employees more choice and more control over their investment portfolios, without complicating the core investment choices offered to participants. For example, many younger investors, particularly millennials, want the opportunity to invest in alternatives to traditional long-only mutual funds, such as exchange-traded-funds (ETFs) and environmental, social and governance (ESG) investments. Access to desired investment strategies, combined with simplified core investment lineups, could elevate plan participation rates. And given the growing focus on retirement income strategies, SDBAs may also play an increasingly important role by giving participants access to a diverse investment mix that enables them to leave assets in the plan throughout their retirement years.

What’s driving the need for SDBAs?

Background

An SDBA allows plan sponsors to offer investment options that are outside a plan’s core investment lineup, including ETFs and specialized investments such as ESG portfolios. It enables more sophisticated investors, or participants working with an advisor, to create uniquely personal investment portfolios using plan assets. The greater choice and control can be very appealing to certain people.

Some of the early SDBA solutions were essentially retail brokerage accounts that used employer-sponsored retirement plan assets. They were not administratively integrated with the retirement plan to any significant degree. SDBAs products have evolved over time, and today there are solutions that better integrate with the recordkeeping service provider to enhance a participant’s overall retirement plan experience.

As a result, the use of SDBAs is steadily growing and their implementation and use is becoming more sophisticated. Today, significant demand for SDBAs is driven by those engaged with a Registered Investment Advisor (RIA). When combined with the trend of almost one-third of high-net-worth investors professing to be self-directed, brokerage windows are no longer just a vehicle through which a participant can buy their stock du jour. Instead, they have become an integral part of an overall retirement investment strategy, just like managed accounts for in-plan advice.²

Accommodating the needs of a broad spectrum of investors

Each employee has his or her own set of unique financial needs. A plan’s core investment line should provide investment options that address the varied savings needs of employees. It is not uncommon to find a few employees who desire a great deal of investment flexibility. For example, the plan may lack a small-cap growth fund that the employee considers critical to their investment portfolio, or perhaps an employee is adamant about having access to individual stocks. Expanding the investment lineup to accommodate these requests may not be the best solution for the general employee population. Studies in behavioral economics indicate that too many choices can have a negative effect on plan participation rates.3

Participant demographics are also shifting. Tomorrow’s savers, including millennial investors, are looking for different retirement plan options than baby boomers and Gen Xers. For example, 25% of millennial investors state that they intend to use specialized investment strategies. They are also twice as likely as other investors to put their money into social or environmental investments. Almost 77% of affluent millennials state that they are involved in impact investing, such as ESG strategies or tech startups that produce cybersecurity or sustainability products, as compared to just 30% of affluent baby boomers.4 At the same time, these younger investors are searching for income solutions and are sensitive to plan fees and costs.

One option for expanding investment flexibility for financially sophisticated participants is to add an SDBA option to the plan. The SDBA allows participants to set up a brokerage account through which they can use their plan assets to purchase investments that are not included in the plan’s core lineup, such as individual stocks and socially responsible investments. This option enables more experienced investors to pursue investment strategies without adding a large number of complex additional investment options to the plan. A brokerage window may also be appealing for participants who have engaged an investment advisor or wealth manager to design wealth planning strategies that include their plan assets, and who desire more freedom in their range of investment options. Keeping the number of core investments to a reasonable number may also help simplify investment communications and education efforts, which can have a positive impact on plan costs. There is another way the SDBA option may impact plan costs: If you want to pursue a passive, low-cost investment strategy like offering primarily passive, indexed investment choices, the SDBA feature gives participants who want to pursue actively managed investment strategies access through the brokerage window.5

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Building an investment menu

Let’s look at a simple scenario that illustrates how the SDBA can support a plan’s investment objectives when there is a wide range of investment experience and objectives across the employees participating in the plan.

Say a medical organization has 575 employees: doctors, nurses, administrative and financial personnel, and janitorial staff. The employees have a broad spectrum of investment experience, ages, and income levels. For example, some employees have significant assets outside the plan and have advisors they would like to consult regarding their plan investments. Their advisors might even have discretionary access to those investments. On the other end of the continuum, some of the employees have limited assets outside the plan and little investment experience. For this group, participating in a 401(k) plan is their first foray into investing.

To accommodate the various participant investment objectives and experience levels, the medical clinic’s advisor suggests a three-tiered investment menu.

<table>
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<th>Three-tiered investment menu</th>
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<td><strong>Professionally managed investments</strong></td>
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<tr>
<td>– Provide professionally managed investment options, such as target-date funds or managed accounts, for inexperienced investors</td>
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<tr>
<td>– Decide if professionally managed investment options should become the default investment for those who fail to make investment selections</td>
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<td>– Consider the options available as qualified default investment alternatives (QDIAs), which provide plan fiduciaries with added protection</td>
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<tr>
<td><strong>Core investments</strong></td>
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<tr>
<td>– Select a menu of core investments for those who want to build their own portfolio without being overwhelmed</td>
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<tr>
<td>– Provide education and planning resources to support employees in making investment selections</td>
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<tr>
<td><strong>SDBA</strong></td>
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<td>– For the plan’s more sophisticated investors, open a brokerage window with access to a broad range of investment options</td>
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<td>– Offer this solution for employees with their own advisor or an investment focus that may not be appropriate to include in the core investment lineup, like socially responsible investments, individual equities, ETFs, or mutual funds</td>
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Benefits of staying in the plan

Most participants who retire or change jobs take their assets out of the employer plan. Each year, Individual Retirement Accounts (IRAs) receive billions of dollars that have been rolled over from retirement plans. Just over half (54%) of IRA-owning households with rollovers indicated that they rolled over to an IRA to get more investment options. ⁶

A Government Accountability Office (GAO) study concluded that, in some cases, plan participants could benefit from leaving assets in the plan. ⁷ Some of the benefits commonly associated with leaving assets in the plan versus rolling them to an IRA include:

1. **Fiduciary oversight**
   Plan fiduciaries are subject to the Employee Retirement Income Security Act of 1974 (ERISA) when managing a retirement plan and are required to act in the best interests of plan participants and beneficiaries. IRA owners are considered the plan fiduciary, responsible for selecting IRA service providers and investments.

2. **Fee disclosures**
   Department of Labor (DOL) regulations require plan sponsors to provide participants with fee information that make it easier to understand and compare fees related to plan investments and administrative services. ⁸ IRAs are not subject to the DOL fee disclosure requirements.

3. **Protection from creditors**
   ERISA protects retirement plan assets from the reach of a participant’s creditors. While protection of certain assets varies from state to state, many IRAs and other accounts can be reached by creditors.

4. **Access to loans**
   Most retirement plans allow participants to take a loan from their plan account. Loans give them the option to use their savings in the near term but restore their retirement nest egg so that it is available when they need it. Loans are not permitted from IRAs.

5. **Investment pricing**
   The institutional investment pricing available to employer-sponsored retirement plans can make the cost of investing less expensive as compared to purchasing retail investments in an IRA.

6. **Special plan features**
   Some participants spend time and money designing and establishing an investment plan. This may include using SDBAs, managed accounts, or other platforms provided by their 401(k) plan sponsor. Many don’t want to roll their balances to an IRA that doesn’t have comparable features to their current 401(k).

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Both the DOL and IRS, recognizing some of the benefits of leaving assets in an ERISA-covered retirement plan, have examined how they can adapt retirement plan rules to help participants keep more assets in the plan. One example is the Treasury regulations that make it easier for plans to include qualified longevity annuity contracts (QLACs) that enable participants to create a retirement stream of income. 9 Congress recently stepped into the picture with the passage of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. The SECURE Act, which became effective on December 31, 2019, makes it easier for plan sponsors and fiduciaries to include lifetime income annuities in defined contribution retirement plans.

Another example is the expanded Roth in-plan rollover option that allows participants to more freely roll over assets from one type of account within the plan, such as pre-tax deferrals, to a Roth account. 10 In-plan rollovers result in participants paying taxes on the assets at the time of the in-plan rollover but open the door to tax-free savings (if the distribution from the Roth account meets certain requirements). This flexible conversion option was previously only available within an IRA. By allowing participants to adjust the tax character of their plan assets, it becomes more feasible for participants to build tax diversification and achieve estate planning strategies while their assets remain in the employer-sponsored retirement plan.

Access to an SDBA may make leaving assets in the plan even more appealing to plan participants. A plan’s core investment lineup may not provide a sufficiently flexible range of investments to accommodate a participant’s preference for ESG or other specialized investments or a participant’s retirement income strategy. Because expanding the investment lineup may not be appropriate for the other plan participants, an SDBA may offer a solution.

**By opening a brokerage window and rolling assets into the SDBA, the participant (and a wealth manager) will be able to diversify and personalize their investment portfolio to meet his or her unique objectives while retaining the benefits associated with holding assets in an ERISA plan.**

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When is an SDBA a good fit for a business?

When considering whether an SDBA is a good fit, look at the distinctive demographic characteristics of your workers. Plan attributes that favor an SDBA option include:

1. Desiring more flexibility and diversity in the investment options available through the retirement plan, such as ETFs and specialized investment strategies like ESG-compliant portfolios

2. Giving participants the choice of engaging their own RIA to build a personalized investment portfolio using plan assets

3. Wanting to provide more investment choices for sophisticated investors within the plan, without complicating the core investment options offered to less experienced investors

4. Being open to allowing participants to leave assets in the plan through retirement years and include special provisions that reduce distribution costs for retiree withdrawals

5. Willing to offer diverse investment options, including retirement income strategies
Special considerations when choosing an SDBA plan

If you’re considering adding an SDBA option for your plan, you should consider the SDBA impact on your fiduciary responsibilities and on your participants’ investment behavior.

**ERISA fiduciary considerations**

Selecting and monitoring plan investments is a fiduciary responsibility. Therefore, deciding to add an SDBA option to a plan and selecting a provider to perform SDBA services are also fiduciary decisions.

In many cases, however, you may have only one or two SDBA options that are available through the plan’s recordkeeper. Most recordkeepers will engage in the process of evaluating SDBA options and integrating only with a select few. Even though options may be limited from a practical standpoint, you must follow a prudent process in evaluating the SDBA services.
Some of the considerations you may wish to include when evaluating a recordkeeper’s SDBA feature include:

1. Ensuring there are no discriminatory barriers to SDBA access, like setting a high minimum amount to open an SDBA is problematic if only a few employees or owners could satisfy that requirement

2. Identifying any potential conflicts of interest with the SDBA provider, including providers with ancillary services and products who attempt to market to plan participants once they attain personal and plan information

3. Evaluating the nature and quality of services relative to the fees charged for the SDBA services, to confirm that the fees are reasonable and not rely on a range of fees or simple industry benchmarks

4. Satisfying participant fee disclosure requirements by confirming that fee information can be provided by the SDBA provider. Although an SDBA is not considered a designated investment alternative subject to the detailed investment information requirements, certain plan-related information is required, including:
   - A disclosure when initially eligible, and annually, explaining the SDBA option and describing any fees that may be charged against a participant’s individual account if they open an SDBA and notifying participants where they can obtain additional information
   - A statement disclosing the amount of any fees actually charged against a participant’s account in connection with the SDBA

5. Confirming that they are complying with all regulatory and legal obligations

As with any due diligence activity, you should keep a written record of the steps you followed in evaluating the SDBA provider and establish a process and schedule with your recordkeeper for monitoring the SDBA provider.

The DOL has explored whether it should provide additional guidance regarding the fiduciary duties related to selecting an SDBA and an SDBA provider. In August 2014, the DOL published a Request for Information Regarding Standards for Brokerage Windows in Participant-Directed Plans (RFI).12 The purpose of the RFI was to gather information that would help the DOL better understand how SDBAs are being used and “determine whether, and to what extent, regulatory standards or other guidance concerning the use of brokerage windows may be necessary to adequately protect participants’ retirement savings.”13 To date, no action has been taken on the responses to the RFI.

You may want to review Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan (www.dol.gov).14

Offering a brokerage window: A discussion of the fiduciary considerations is an informative white paper that provides a more in-depth discussion of the fiduciary considerations in deciding to offer an SDBA and analyzes the impact of the participant fee disclosure rules on fiduciaries who offer SDBAs. The white paper was drafted by attorneys Fred Reish and Bruce Ashton and is available compliments of TD Ameritrade Institutional.

**Plan design considerations**

The plan document may need to be amended to accommodate the SDBA feature. Say a plan document limits the range of permissible investments; an amendment may be necessary. If your objectives for the SDBA include retirement income opportunities from the plan, an amendment may also be in order. Many plans restrict the types of distributions offered and do not permit partial distributions or may charge a distribution fee for every payout, making a monthly or quarterly stream of payouts costly.

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13. Ibid.

Summary

In an effort to better accommodate a wide range of participant investors, employers are turning to SDBAs as a viable option. SDBAs seem to work for both the increasing demand by younger generations for ETFs and ESG-focused investments and technology tools for managing investments, along with older generations’ demand for in-plan solutions for retirement income and decumulation strategies. SDBAs remain a viable tool for meeting the diverse investment needs of plan participants.
About the author

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