Self-Directed Plan Services

One pathway to more personalized investment portfolios

Self-Directed Brokerage Accounts

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Executive summary

When an employer designs a retirement plan and selects investment options for its employees, it seeks to designate options that accommodate the distinctive demographic characteristics of its 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 options 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] Self-Directed Brokerage Accounts (SDBAs) are one alternative for providing employees more choice and more control over their investment portfolio, without complicating the core investment options offered to participants. 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 through their retirement years.

What’s driving the growing attention on SDBAs?

Background

A “Self-Directed Brokerage Account” (SDBA), sometimes referred to as a “Brokerage Window,” allows plan sponsors to offer investment options that are outside the plan’s core investments and enable more sophisticated investors, or participants working with an advisor, to create a uniquely personal investment portfolio using plan assets. The greater choice and control can be very appealing to certain participants.

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

Accommodating the needs of a broad spectrum of investors

Each employee has his or her own set of unique financial needs. As a plan sponsor builds the plan's core investment line-up, the intention is to provide investment options to address the varied savings needs of the employees. It is not uncommon for plan sponsors to find they have a few – sometimes very important – 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 line-up to accommodate these requests may not be an optimal solution for the general employee population. Studies in behavioral economics have indicated that too many core plan menu choices can have a negative effect on plan participation rates.[1]

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 line-up (e.g., individual stocks, socially responsible investments). This option enables more experienced investors to pursue their investment strategies without adding a large number of complex additional investment options to the plan. A brokerage window may also be appealing if some participants have engaged an investment advisor or investment manager to design an investment strategy for their plan assets and 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 a plan sponsor wants to pursue a passive, low-cost investment strategy (e.g., offer primarily passive, indexed investment choices), the SDBA feature gives participants who want to pursue actively managed investment strategies access to the investments they desire via the brokerage window.

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 wide range of investment experience and objectives across the employees participating in the plan.

Assume 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 of the doctors have significant assets outside the plan and have advisors they would like to consult regarding their plan investments. On the other end of the continuum, some of the employees have limited assets outside the plan and little investment experience.

To accommodate the broad spectrum of participant investment objectives and experience levels, the medical clinic's advisor suggests a three-tiered investment menu.

Figure 1: Three-tiered investment menu

Core investments	▪ Select a menu of core investments for those employees who want to build their own portfolio from options that have been selected by the plan sponsor, keeping the number of options in check to avoid choice overload. ▪ Provide employee education and planning resources to support employees in making investment selections.
Professionally-managed investments	▪ Provide professionally-managed investment options, such as target-date funds or managed accounts, for those employees who are inexperienced investors. ▪ Evaluate whether to use the professionally-managed investment options as the default investment for those employees who fail to make investment selections. Consider the options available as qualified default investment alternatives (QDIAs), which provide plan fiduciaries added protection against fiduciary challenges.
Self-Directed Brokerage Account (SDBA)	▪ For the plan's more sophisticated investors, open a brokerage window with access to a broad range of investment options. ▪ The SDBA provides a solution for employees who have their own advisor or who have a specific investment focus that may not be appropriate to include in the core investment line-up (e.g., socially responsible investments, individual equities, ETFs or mutual funds).

The new "in-plan rollover" option

Today, most participants who retire or change jobs take their assets out of the employer plan. Billions of dollars in assets are leaving retirement plans each year and being rolled over to an IRA, a retail account.[2]

A 2013 Government Accountability Office (GAO) study concluded that in some cases, plan participants could benefit from leaving assets in the plan.[3] Some of the benefits commonly associated with leaving assets in the plan versus rolling it to an IRA include:

1. **Fiduciary oversight –** Plan fiduciaries are subject to the high standards mandated by the Employee Retirement Income Security Act of 1974 (ERISA) when managing the 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 –** DOL regulations require plan sponsors to provide participants fee information intended to make it easier for participants to understand and compare fees related to plan investments and administrative services.[4] 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 permit participants to take a loan from their plan account. Loans give participants 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.

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.[5] 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.[6] 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 estate planning strategies while 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 line-up may not provide a sufficiently flexible range of investments to accommodate a participant's retirement income or estate planning strategy. Because expanding the investment line-up 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 the participant's investment portfolio to meet his or her unique objectives – without losing the benefits associated with holding assets in an ERISA plan.

When is an SDBA a good fit for a business?

Plan sponsors considering whether an SDBA is a good fit for their plan should look at the distinctive demographic characteristics of its workers. Plan attributes that favor an SDBA option include:

1. Financially sophisticated plan participants who desire more flexibility and diversity in the investment options available through the retirement plan.
2. Participants who wish to engage their own registered investment advisor to build a personalized investment portfolio using plan assets.
3. Plans that have a sufficient investment menu to accommodate employees who are not likely to use the SDBA options (e.g., core investments, professionally-managed investments).
4. Plan sponsor is open to allowing participants to leave assets in the plan through retirement years.
5. Plan sponsor is comfortable offering diverse investment options.

What special considerations should be factored into the SDBA decision?

Plan sponsors considering adding an SDBA option for their plan should consider the SDBA impact on their fiduciary responsibilities and on their 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, a plan sponsor 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, the plan sponsor must follow a prudent process in evaluating the SDBA services.

Some of the considerations plan sponsors may wish to include in their due diligence process when evaluating a recordkeeper's SDBA feature include:

1. Make sure there are no discriminatory barriers to SDBA access. For example, setting a high minimum amount to open an SDBA may be impermissible if only a few highly compensated employees or owners could satisfy that threshold requirement.
2. Identify any potential conflicts of interest with the SDBA provider.
3. Evaluate the nature and quality of services relative to the fees charged for the SDBA services to confirm the fees are reasonable.

4 Make certain adequate fee information can be provided by the SDBA provider to enable the plan sponsor to satisfy the participant fee disclosure requirements. 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 then 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 quarterly statement disclosing the amount of any fees actually charged against a participant's account in connection with the SDBA.[7]

5 Confirm they are otherwise complying with all regulatory and legal obligations.

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

The DOL is exploring whether it should provide additional guidance regarding the fiduciary duties related to selecting an SDBA and an SDBA provider. Pending any additional guidance, plan sponsors may want to review the DOL's suggested list of variables to consider when selecting service providers – Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan (www.dol.gov).[9]

A more in-depth discussion of the fiduciary considerations in deciding to offer an SDBA is provided in a white paper entitled Offering a Brokerage Window, drafted by attorneys Fred Reish and Bruce Ashton, and is available compliments of TD Ameritrade Institutional. The white paper also analyzes the impact of the participant fee disclosure rules on fiduciaries who offer SDBAs.

Plan design considerations

The plan document may need to be amended to accommodate the SDBA feature. If the plan document limits the range of permissible investments, for example, an amendment may be necessary. If a plan sponsor's 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.

DOL RFI: What Will It Mean for SDBAs?

In August 2014, the DOL published a Request for Information Regarding Standards for Brokerage Windows in Participant-Directed Individual Account Plans (RFI).[8] The purpose of the RFI is to gather information that will help the DOL better understand how SDBAs are being used today 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."[10]

The RFI contains 39 questions covering a broad range of issues related to the use of SDBAs including:

- The scope of investment options typically available through an SDBA.
- Demographic and other information about participants who commonly use SDBAs.
- The process of selecting an SDBA and a provider for a plan.
- The costs of SDBAs and the kind of information about SDBAs and underlying investment options typically available and disclosed to participants.

The RFI is not the DOL's first foray into SDBA guidance. In 2012, the DOL issued Field Assistance Bulletin (FAB 2012-2) to address a number of issues stemming from ERISA 404a-5 participant disclosure regulations. The DOL initially indicated that certain investments selected through the SDBA would be subject to the detailed performance, fee, and other investment-related information for options available through the brokerage window.

In response to retirement industry input and other comments explaining the challenges presented by that new requirement, the DOL revised its position, issuing FAB 2012-2R to confirm that a brokerage window is not a "designated investment alternative" under the participant-level fee disclosure requirements.[7] Currently, the brokerage window disclosure requirements include:

- A description of the brokerage window.
- An explanation of fees that may be charged.
- A statement of the dollar amount of fees actually charged to the participant's account.

Summary

A growing number of employers have concluded that an SDBA option is a solution for providing more investment choice for sophisticated investors within their plan, without complicating the core investment options offered to less experienced investors. An increased focus on retirement income strategies will ensure SDBAs remain the subject of intense discussion and increased interest over the coming months.

[1] "How Much Choice is Too Much? Determinations of Individuals Contributions in 401(k) Retirement Plans," Iyengar, Huberman, and Jiang; In: Pension Design and Structure: New Lessons from Behavioral Finance, edited by O.S. Mitchell and S. Utkus, Oxford University Press, Oxford, 2004; "Save More Tomorrow: Practical Behavioral Finance Solutions to Improve 401(k) Plans," Shlomo Benartzi; Portfolio/Penguin, 2012.
[2] Investment Company Institute (ICI), Research Perspective, Vol. 23, No. 1, "The Role of IRAs in US Households' Saving for Retirement, 2016, January 2017, https://www.ici.org/pdf/per23-01.pdf.
[3] U.S. Government Accountability Office, GAO 13-30: 401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants, March 2013, http://www.gao.gov/products/GAO-13-30.
[4] Department of Labor Regulation 404a-5, Fiduciary requirements for disclosure in participant-directed individual account plans. https://www.gpo.gov/fdsys/pkg/CFR-2015-title29-vol9/xml/CFR-2015-title29-vol9-sec2550-404a-5.xml
[5] Internal Revenue Service, TD 9673: Longevity Annuity Contracts, http://www.irs.gov/irb/2014-30_IRB/ar07.html.
[6] Internal Revenue Code Section 402A(c)(4)(E); IRS Notice 2013-74: In-Plan Rollovers to Designated Roth Accounts in Retirement Plans, http://www.irs.gov/pub/irs-drop/n-13-74.pdf.
[7] Department of Labor, Field Assistance Bulletin No. 2012-02R, July 2012, https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2012-02r
[8] Department of Labor, Request for Information Regarding Standards for Brokerage Windows in Participant-Directed Individual Account Plans (RFI), August 2014, http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=27743.
[9] Department of Labor Fact Sheet, Tips For Selecting And Monitoring Service Providers For Your Employee Benefit Plan, http://www.dol.gov/ebsa/pdf/fs052505.pdf.
[10] Department of Labor News Release: Labor Department requests information on use of brokerage windows in 401(k) plans, August 20, 2014, http://www.dol.gov/opa/media/press/ebsa/EBSA20141523.htm.

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