

# 401(k) Gambling and the Self Directed Brokerage Option

By Ary Rosenbaum, Esq.

Growing up as a kid in the late 1970's, my favorite baseball player was Reggie Jackson (before I met him, but that's another story). Reggie brought a lot of excitement to the game as he hit 563 homeruns, but he only batted .262 lifetime and struck out 2597 times, which is an all-time record. So Reggie could hit out of the park, but he failed to make contact a lot more times (he only had 2584 hits). On the other hand, Tony Gwynn had only 135 career home runs, but he had 3141 hits and a .338 lifetime average. When it comes to retirement investing, I believe that plan participants need to invest like Tony Gwynn played instead of the way Reggie Jackson played. That means more contact, more singles and doubles, and less striking out. That means investing for the long term through the use of asset allocation, dollar cost averaging, and the use of diversified investment options (whether they are mutual funds or exchange traded funds) instead of the use of high risk investments or speculative stocks. Retirement savings should be about long term growth, outpacing inflation, and having enough savings to last through retirement. A retirement account is not a get quick rich scheme or gambling, because as many times that you win a big bet on a speculative stock, there are more times that you strike out like Reggie Jackson. Sometimes Reggie swung so hard and failed to contact that he fell on his rear end. A plan participant should never let that happen to them in their retirement savings.

Many 401(k) plans, especially professional organizations offer self directed

brokerage accounts to plan participants. While some plan sponsors offer it to offer more choices to their plan participants (it's usually the owner-employees who demand it), it is fraught with many hazards. The hazards are to the participants who use them, the cost of running the plan, as well as possible qualification and liability issues for the plan sponsor. The self directed brokerage option is a gamble that 401(k) plan sponsors should considering taking a pass on before rolling the dice.

I used to joke that the only employers that offer brokerage options in their plan are law firms and medical practices. That



stopped being a joke when many financial advisors agreed with me. Regardless of what kind of company it is, the plan sponsor can offer self directed brokerage accounts as an alternative to the regular menu of investment options that the plan offers through its omnibus trust account. One caveat of adding the self directed brokerage account is that this option must be offered to all plan participants on a non-discriminatory basis. While these accounts will have separate costs to set up, maintain, and for actual trading which will be borne by the participant that elects that

option, it cannot be offered only to those that choose it. The reason is that under qualified plan rules, a benefit, right, or feature under the plan cannot be offered on a basis that discriminates in favor of highly compensated employees. The rules don't require non-highly compensated employees to pursue that option, just that the option is available to them if they choose. I am sure that there are a few plans that violated this rule, I know I used to work for one law firm that forgot that despite having an ERISA partner.

While the ides of unlimited investment choices under a 401(k) plan that a self directed brokerage account offer may be a nice idea, it is an idea that looks greater on paper that it does in action. A 2005 study indicated that over 70 percent all self-directed brokerage account investment returns lag behind equally weighted managed model portfolios constructed from the plan's fund lineup. When comparing the self-directed accounts to the managed portfolio, the average annual return of the brokerage accounts was -4.70%. In a 2007

study, Vanguard found that 57 percent of 401(k) participants make asset allocation errors in terms of diversification and/or equity weighting (meaning they are too aggressive or not aggressive enough). Since 401(k) self directed brokerage accounts are usually not limited in what they can invest in, the error percentage for participants who opt for brokerage accounts is probably higher. As plan fiduciaries, plan sponsors should be concerned about the retirement savings for plan participants. So why should they offer a self directed brokerage option that they

know will lag in returns as compared to those participants who use the investment options offered under the plan?

One of the major misconceptions is that self directed brokerage accounts limit the plan sponsor's fiduciary liability since the accounts are under the control of the participants who use it. There is nothing in ERISA that supports that. A plan sponsor is a fiduciary for all plan assets, regardless of whether these assets are in brokerage accounts or the plan's omnibus trust account. The problem is that a plan sponsor has to be diligent in its fiduciary duty and must keep their eye on these accounts. One of the reasons that plan participants choose the brokerage account option is the fact that they would be able to use their own individual broker while the participants using the investment opinion menu in the omnibus account would be using the services of the plan's financial advisor. The problem with allowing participants to select their own broker to work with 401(k) plans is about selecting plan providers. Plan sponsors have the fiduciary duty in selecting plan providers and monitoring them, so plan sponsors would be required to vet the brokers that their plan participants would use in these accounts. Since the process is rather burdensome and requires documentation, it would be wise for the plan sponsor to restrict the use of outside brokers in working with participants, who use self directed accounts.

Another problem with self directed brokerage accounts is the investments that would be allowed for participants to invest in. ERISA Section 404(c) generally protects plan fiduciaries only from losses that result from plan participants' exercise of control over the assets in their accounts. Offering self-directed brokerage accounts is a liability risk that plan sponsors are unaware of. ERISA imposes a responsibility on the plan sponsors as fiduciaries to act prudently and for the exclusive purpose of providing benefits for participants. So plan fiduciaries must decide whether it is prudent to offer brokerage accounts to participants and if they do so, whether they should limit the type of investments allowed under these accounts. They must decide whether the participants have the background to make intelligent buy-and-sell decisions about individual stocks. If they do not, offering brokerage accounts in a 401(k) plan could be a breach of fiducia-

ry duty. The plan sponsor has a fiduciary duty of prudence in the selection and retention of investment choices, including those in self-directed brokerage accounts. DOL regulations make it clear that the plan sponsor needs to review the investments that are purchased in the self-directed brokerage account. Prudent fund selection and retention duties appear to continue to apply, even if the plan sponsor places no limits on the investment universe of the account. The problem is that I have yet to find a plan sponsor that actually reviews the investments in self directed brokerage



accounts and its appropriateness; I have yet to find one that limits the investments in these accounts. Plan sponsors have the fiduciary duty to make sure that these brokerage accounts don't invest in risky investments like options or derivatives, because it may be considered a breach of fiduciary duty to allow such investments in these accounts and the plan especially if participants "gambling" in these investment options lose their entire retirement savings. Having self-directed brokerage accounts creates MORE, not less, liability for the plan sponsors than plans that don't offer them.

The use of self directed brokerage accounts also can increase the costs of plan administration. In the world of daily 401(k) administration, assets mean everything in terms of pricing because in most plans, the participants pay for the plan's recordkeeping and financial advisor. Thanks to economies of scale, plans with more assets pay less in fees as it relates to a percentage of their assets. A financial advisor may charge 50 basis points (.50%) if the plan is \$5 million and may charge 35 basis points (.35%) if the plan is \$10 million. If the plan offers self directed brokerage accounts and the

participants can use their own individual broker for them, the assets from these brokerage accounts won't count towards the assets that the financial advisor of the plan will have under management which means that the other participants may be paying more in management fees that if the plan didn't offer brokerage accounts. The same is with plan administration and recordkeeping. So often, the third party administration (TPA) receives revenue sharing payments from certain mutual funds held in 401(k) plans to defray the cost of plan administration (note that index funds and exchange traded funds don't pay revenue sharing). Investments in self directed brokerage accounts won't pay revenue sharing which means that the plan will pay higher expenses. It also means the participants who are using the revenue sharing paying funds in the plan are paying the freight of those participants who opt for self directed brokerage accounts because their revenue sharing funds are subsidizing those who don't use them since revenue sharing is reducing plan cost.

In America, we love freedom of choice. Self directed brokerage accounts allow unlimited choices instead of the limited investment option menu that 401(k) plans offer. As with most freedom, there is a cost. Self directed brokerage accounts will most likely increase plan expenses, increase liability, and decrease the retirement savings of those who use them. Self directed brokerage accounts are just one dice that plan sponsors shouldn't roll.

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