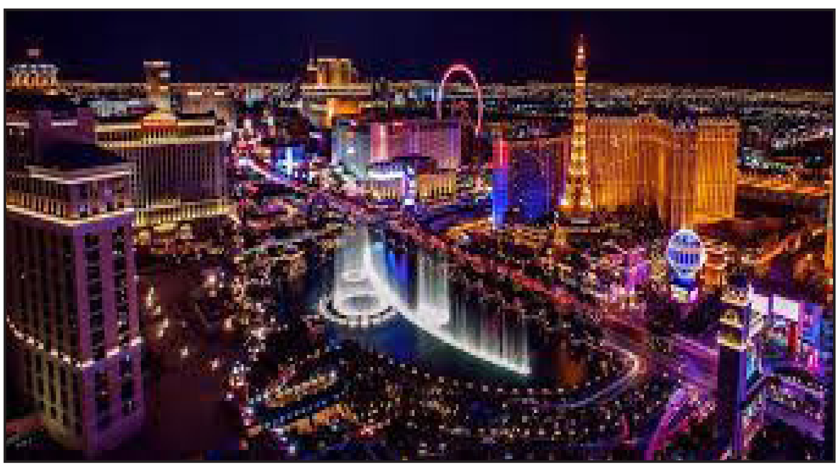
The Bad Bet Of Self-Directed Brokerage 401(k) Options

By Ary Rosenbaum, Esq.

I love Las Vegas and I hate to gamble, haven't gambled a nickel since 2002, even though I've been to Vegas about 4 times since. I love the sights, sounds, entertainment, food, and everything but gambling. I hate gambling because I don't like to lose and no matter what people say, the casinos win in the end. As Sam "Ace" Rothstein played by Robert DeNiro said in the movie Casino, "In the casino, the cardinal rule is to keep them playing and to keep them coming back. The longer they play, the more they lose, and in the end, we get it all." 401(k) plans with self-directed brokerage accounts that allow participants to choose almost any type of investment is another form of gambling and a plan sponsor may unknowingly expose themselves to liability by offering this feature when plan participants "crap out." This article is about the hidden dangers of 401(k) plans in offering self-directed brokerage accounts to plan participants.



It's fraught with hazards

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 consider taking a pass on before rolling the dice. I used to joke that the only employers that offer brokerage options in their plans 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 can¬not 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 (Sorry Pat).

A nice idea on paper

While the idea of unlimited investment choices under a 401(k) plan that a self directed brokerage account offers may be a nice idea, it is an idea that looks better on paper than it does in action. A 2005 study indicated that over 70 percent of 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% less. 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 of 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?

The fallacy of limited liability for plan sponsors

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 them. 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 an 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 par-

ticipants 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 of 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.

The problem with ERISA §404(c) liability protection

Another problem with self-directed brokerage accounts is the investments that would be allowed for participants to in¬vest 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 fiduciary 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 their 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.

It can actually increase plan costs

The use of self-directed brokerage accounts could increase the cost 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, 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 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 plan 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 which can also be a liability risk when the participants who use revenue sharing funds claim they are subsidizing the costs of participants who use self-directed brokerage accounts.

Bitcoin and Crypto

Through self-directed brokerage windows, certain plan providers are pushing for plan participants to have the option to invest a small portion of their 401(k) account balance into Bitcoin and other crypto investments. While Bitcoin has rallied back to the north of $30,000, cryptocurrency is unregulated, prone to cyber theft, and had wild price swings. Offering this type of investment in a brokerage window is a bad idea when the DOL has provided guidance, warning plan sponsors not to offer a crypto investment option.

The cost of investment freedom

In America, we love the 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 pair of dice that plan sponsors shouldn't roll.

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