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Self-Directed Brokerage and Fiduciary Responsibility

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As participants clamor for greater investment choices, more and more sponsors are adding self-directed brokerage accounts or a brokerage window to their lineup to satisfy participant demand. In doing so, however, fiduciaries must consider the responsibilities regarding the selection, diversification and monitoring of investment options at the time the decision is made and in the future.

According to the Department of Labor "*the act of designating a plan investment option is not a direct and necessary result of any participant direction and section 404(c) plan fiduciaries are thus still obligated by ERISA's fiduciary responsibility provisions to prudently select the investment options under the plan and to monitor their ongoing performance*." [1] How then does a fiduciary "select prudently" a self-directed brokerage account and "monitor its ongoing performance"?

What is a self directed brokerage account or brokerage window?

A self-directed brokerage account or "brokerage window" allows plan participants to set up individual trading accounts in which they can buy and sell almost any security [2] including individual stocks, bonds, and mutual funds. And while technically each participant could establish his or her own brokerage account with any broker of choice, most plan fiduciaries select a designated broker through the plan's custodian with whom participants would establish trading accounts.

This selection of a designated broker, along with the other decisions regarding brokerage windows, is a fiduciary act that could create potential liability.

How to determine if a brokerage window is a prudent investment option?

The first question a plan fiduciary should ask when considering the investment lineup is: "*What is the appropriate diversification for the investments in the plan and should such diversification include a brokerage window?*" No specific guidance exists to answer this question. A good place to start may be to ask if a prudent expert [3] would think a brokerage window would be appropriate for the plan sponsor's workforce. Factors that might help determine the appropriateness or inappropriateness of adding a brokerage window could include:

- the nature of the workforce, education level, investment knowledge and sophistication,
- if any individualized investment advice, education or training is available to participants on investments or investing,
- the plan's ability to effectively educate eligible employees about the risks of investing in a brokerage window,
- if appropriate communication methods and disclosure exists regarding those risks, and
- the diversification opportunities and number of other investments already offered under the plan.

[1] Langbecker v. EDS Corporation, Corrected Brief of the Secretary of Labor, Elaine L. Chao, as Amicus Curiae in support of Plaintiffs-Appellees, US Court of Appeals for the Fifth Circuit, Case No. 04-41760, page 5.

[2] ERISA expressly forbids the purchase of certain investments like options, futures, derivatives and commodities as well as prohibits certain leveraging strategies such as margin trading.

[3] ERISA imposes a Prudent man standard of care that requires a fiduciary to discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries …with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; 29 U.S.C. §1104 (a)(1)(B).

How to select a brokerage provider?

Once a fiduciary determines that a brokerage window is an appropriate diversification investment option for its plan, the fiduciary needs to determine the design of the brokerage window and select a provider. Design considerations may include such factors as:

- any limitations on the percentage of the account a participant can transfer to the brokerage window,
- minimum initial brokerage investment amounts required to set up the account,
- restrictions on certain investment types otherwise allowable (e.g. limited partnerships), and
- fiduciary disclosures to participants about risks of investing in a brokerage window.

With a design in mind, fiduciaries can then review providers. And while nothing in ERISA requires that a provider with the lowest fees be selected, the fees (transaction, maintenance and expenses) associated with a brokerage account will be one significant factor in their consideration. Another will be the ability of the designated broker to assist the fiduciary in meeting other obligations such as:

- restricting access to inappropriate or non-allowed investments,
- conforming to any plan document, ERISA, IRS or other regulatory limitations,
- providing timely and accurate information for the participant daily recordkeeping system,
- provide periodic reports so that performance of the brokerage window can be monitored,
- assisting with the reporting and disclosure obligations of the plan at both a participant level (e.g. prospectuses) and plan level (audit, Form 5500).

Once the plan fiduciary has determined a brokerage window is appropriate, finalized the design and selected a designated broker, he should make certain that appropriate documentation, such as service agreements, (including an indemnification or acknowledgment of liability for any failure to satisfy agreed upon terms and limitations) are completed. In addition, required plan amendments and updated communications must be prepared to incorporate and describe the brokerage window. Then the fiduciary will need to decide how they will:

- monitor the brokerage window for performance, and
- monitor the designated broker going forward.

Monitoring a brokerage window for performance.

With regular designated investments most plan sponsors have an Investment Policy Statement and a procedure for monitoring and benchmarking the offered funds. With a brokerage window a prudent fiduciary can:

- use quantitative and/or qualitative measures to compare the performance of the aggregate brokerage window against the overall performance of the designated investments in the plan,
- monitor cost paid in annual fees, transaction cost and commissions, and
- monitor utilization of the window to determine if the overall cost impact on plan administration, if any, is warranted by actual participant use.

Regardless of the method utilized, fiduciaries should review the brokerage window on a similar schedule to the regular investment reviews performed on the designated investments under the plan.

Monitoring the designated provider.

Monitoring the selected brokerage provider is probably an easier task than monitoring the brokerage window for performance. Many of the criteria fiduciaries use in annual reviews of service providers and investment managers will generally apply. Considerations should include:

- adherence to the service contacts and obligations thereunder,
- compliance with any investment limitations imposed by ERISA and the plan,
- delivery of all required reports and disclosures in a timely and useful way,
- meeting industry standards, license requirements and procedures, or
- being subject to any regulatory or legal actions.

ERISA fiduciary liability is not about the outcome of the investment decisions or the actual performance. Fiduciary liability regarding investment options is all about the fiduciary decision making process. While a brokerage window may offer plan sponsors benefits to help meet the diversification requirements under §404(c) [4], it also requires the fiduciary to fulfill many obligations. By discussing, documenting and monitoring these obligations fiduciaries will be better prepared to explain the brokerage window, why it was selected, and, if necessary, to defend against potential investment claims in the future.

About the Author:

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[4] See Hecker v. Deere, 7th Circuit Court of Appeals, Nos. 07-3605 & 08-1224 where the court concluded that the brokerage window that offered more then 2,500 funds with varying fees, presented ample opportunity for participants to select from a wide range of funds and control the risk of loss from fees.