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“Understanding Brokerage Windows in Self-Directed Retirement Plans”

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Thank you to all the members of the ERISA Advisory Council for the opportunity to speak to you today. It’s an honor.

My name is Kevin Mahoney and I’m the Business Development Officer of FinDec. I’ve spent my entire 27-year career in the financial services industry with FinDec working with hundreds of clients on retirement plans.

With offices in California and Arizona, FinDec works with clients across the nation to provide workplace benefit plan consulting, third party administration, investment management and wealth planning services. With over 350 plans and 15,000 plan participants along with 700 wealth services clients, FinDec oversees over $1 billion in assets under management or administration.

I’m excited to speak with you today about brokerage windows in self-directed retirement plans to shed light on who is using them, how they are being used and trends to note and understand.

This is an important topic that’s becoming increasingly popular for a portion of participants. I’ll get into the details and cover the following topics today:

- Design, prevalence and usage of brokerage windows in participant-directed individual account retirement plans
- Type of plans offering a brokerage window and extent to which assets are invested
- Nature and extent of disclosures that participants receive
- Is guidance appropriate or necessary?

Design, prevalence and usage of brokerage windows

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A brokerage window may be offered as an option in a workplace benefit plan that permits participants to direct their account investments. The Plan Sponsor makes that decision as part of authorizing the investment choices available within the plan. Self-directed brokerage accounts expand retirement offerings beyond a preselected investment lineup. Participants who use the self-directed brokerage account have more flexibility and expanded investment options in addition to the core investment line-up the plan offers.

Plan sponsors set the plan level guidelines for use of the brokerage window by a participant. This may include limiting the percentage of a participant's account that may be held in the brokerage account. The plan sponsor completes a brokerage window plan application and agreement with the Plan's directed trustee or custodian before a participant may open a self-directed brokerage account. The agreement, among other terms, establishes the plan trading menu available to participants. In most cases the custodian does not allow for trading on collectibles, currencies, precious metals, real estate, futures, commodities, private placements, margin accounts, or short sales. The plan sponsor selects the types of securities a participant may or may not hold in their account.

These types of accounts have been growing in popularity and with the rise of trading apps, meme-stocks and cryptocurrencies, there is a general interest in retail trading in society and media.

But when it comes to brokerage windows in workplace benefit plans, how prevalent are they?

According to the Plan Sponsor Council of America's 63rd Annual Survey of Profit-Sharing and 401(k) Plans, a little less than a quarter (23.2%) of all plans offer a self-directed brokerage account (SDBA), and nearly 40% of those with more than 5,000 participants do. But while they are being offered, they don't yet seem to be used on a wide scale, as only 1.5% of plan assets are invested in SDBAs.[1]

In its Q1 2021 "Schwab Self-Directed Brokerage Account Indicators™" report[2] Charles Schwab provides detailed insights into how SDBAs are being used within its Schwab Personal Choice Retirement Account® (PCRA). The average account balance through Q1 2021 for all participants in the PCRA was up 32.07% to $333,712 from $252,675 a year ago and by 0.62% from $331,664 last quarter.

Worth noting too: Trading volumes were significantly higher from the previous quarter, with an average of 19.6 trades per account compared to 13.9 in Q4 of 2020. Most trades were in equities holdings, followed by ETFs and mutual funds. Participants held 12.2 positions in their PCRA, which is a little higher than the previous year and quarter's average.

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[1] As reported in a June 15, 2021 article published on the National Association of Plan Advisors' website (https://www.napa-net.org/news-info/daily-news/playing-fire). PSCA survey published in 2020.
[2] Previous quarterly reports are available for public access at https://workplacefinancialservices.schwab.com/

Type of plans offering a brokerage window and extent to which assets are invested

Employer-sponsored 401(k), 403(b) and 457 plans can all offer a brokerage window, though there are limits or fees imposed depending on the type of retirement plan, the sponsor or the plan advisor. While the brokerage window is available to all plan participants, it is intended for those with advanced investment experience or who use the services of an investment advisor to manage their investments.

So, who is using these accounts and which assets are they investing in? Indicators from Schwab's Q1 2021 report offer answers.

The most prevalent users are Gen X (ages 41-56) who account for 44.3% of SDBA participants. Baby Boomers (57 and older) account for 32.7% of participants, while Millennials (29-40) account for 17.2%.

In terms of balances across age groups, all SDBA balances were up compared to last quarter. Baby Boomers averaged $506,395, Gen X averaged $288,616, and Millennials averaged $98,124 in SDBA balances.

We can drill down further to understand investing behavior and investing characteristics for participants using SDBAs.

Equities held the majority of participant assets at 36.11%, a fairly significant increase from last year at 26.83%. Mutual funds were the second largest holding at 29.61% with ETFs at 19.17%, Cash & Equivalents at 12.81% and Fixed Income at 1.50%. Overall, participant holdings remained similar to last quarter, with a slight uptick in equities holdings.

A few other interesting notes about investing behavior in Schwab PCRA accounts: Roth PCRA account holder balance is far lower than non-Roth: $82,043 vs. $340,364. As a percentage of users, Gen X have the most Roths (47.7%).

Gen X also leads when it comes to having the most PCRA advised accounts (47.3% of accounts use an adviser). Baby Boomers come in at 37%. Only 12.6% of Millennials use an advisor for their PCRAs.

Taking into account all PCRAs, those with advised accounts had higher average balances ($530,914 vs. $288,513) and traded a little less during the quarter (18.3 trades for advised accounts vs. 19.9 for non-advised). Those who used advisors had a more diversified portfolio and a lower concentration of assets in particular securities.

When it comes to ETF holdings, advised participants had more balance among all holdings, not having more than 3.65% of any one ETF.

As aforementioned, while brokerage windows are increasing in popularity, the extent to which assets are actually being invested is still not very widespread. Our data illustrates this too.

From our internal data, we are seeing an increase in the number of plans that offer a self-directed brokerage account—a Schwab Personal Choice Retirement Account® (or PCRA)—alongside core investments. We are not, however, seeing a significant increase over the past five years in the number of participants opening PCRA accounts.

For more context on the prevalence of PCRAs in plans served by FinDec, 85 participants opened PCRA accounts in 2017, while 96 opened PCRA accounts in 2020. For our book of business, there are 160 plans with currently at least one open PCRA participant account. There are 800 open PCRA accounts across those 160 plans. That number represents less than 5% of the total participants across all plans in our book.

PCRA accounts hold $97 million as of June 2021, which is roughly 8% of total workplace benefit plan assets in our book. A portfolio analysis of our PCRA book shows they include individual stocks, exchange traded funds, mutual funds, CDS, individual fixed income securities (bonds), while one plan holds options.

Nature and extent of disclosures that participants receive

When a participant decides to open a Schwab PCRA, they receive a welcome kit brochure that outlines the account details (i.e., how to fund the account, how to make transfers, commissions and fees) as well as the fees and expenses associated with trading activities in the account.

Before opening an account, there are general disclosures a participant must agree to on the Schwab brokerage site before starting the electronic account opening of a PCRA account.

When an employee becomes eligible to participate in the plan, they receive a plan information kit. Included in that kit is a participant fee and investment notice which has disclosures about the self-directed brokage account option. They are notified that:

“This feature makes it possible for you to invest some or all of your account in investments available through the selected brokerage service that are not one of the plan's designated investment alternatives. These investments may include individual stocks, bonds, exchange traded funds, and mutual funds according to your plan sponsor's plan-level elections. Even though a self-directed brokerage account allows for a broader array of investments than you may have available to choose from in your plan's core fund line-up, not all types of investments are available.”

And further:

"If you choose to invest a portion of your account in the self-directed brokerage option, you are responsible for monitoring and reviewing the investment choices you have made. Applicable additional trading fees and restrictions will apply, along with other individual fees. Actual amounts charged to your brokerage account will be listed on your transaction confirmations and periodic brokerage statements that you receive directly from the brokerage service. These fees and charges will not be separately disclosed on your plan account on the plan website or related plan account statements. You should obtain and review the brokerage account disclosure brochure and pricing guide prior to using this service. The plan's fiduciaries may allow or restrict certain security types or specific securities, but they do not monitor the investments available through the self-directed brokerage account."

Is guidance appropriate or necessary?

I do believe that, in general, providing participants with more choices about where to invest the money they save for retirement in their workplace benefit plan can be a positive. We ultimately want to encourage Americans to save more for retirement, while doing so in a responsible manner. Having participants be more engaged in all aspects of their retirement plan, including starting at an earlier age, and offering broader investment options, may encourage higher participant rates and increased savings in the plan. This could result in better outcomes and higher levels of retirement readiness. Trade volume is on the rise within SDBAs, and average account balances are rising modestly. However, there are potential risks involved with self-directed accounts, particularly if participants do not understand investments or how markets tend to work in the long run.

Whatever responsible way they are choosing to prepare for retirement, people are not saving enough to comfortably retire. The average American between the age of 60-69 has a 401(k) balance of just under $230,000.[3] That's far less than what is needed to retire comfortably. Using the median household income as a baseline, a household in that age range would need roughly one million dollars to retire comfortably. The average 401(k) balance for people between the ages of 30-39 is just over $50,000. They will need a more than $1.8 million dollar nest egg to retire comfortably.[4]

[3] This is according to data from Fidelity made available to CNBC, published in a March 1, 2021 article: "Here's how much Americans have saved in their 401(k)s at every age." https://www.cnbc.com/2021/02/24/how-much-americans-have-saved-in-their-401k-by-age.html

[4] There are a number of online retirement calculators. This estimate assumes a median household income of 63,179 (as of 2018) and a 65-year-old looking to retire in two years. According to personal finance site NerdWallet, they would need a $1.01 million nest egg to retire and maintain their lifestyle. The same median income for a 35-year-old indicates they need $1.82 million for retirement.

As brokerage windows in retirement accounts increase in popularity—at least when it comes to usage, less so with assets invested currently—some guardrails would be appropriate for plan sponsors and other industry professionals to make sure everyone is protected.

While we want to encourage more savings, we also want to ensure people are not losing hard-earned money by making poor decisions about where to invest the money in retirement accounts.

There are three areas potential areas to consider when issuing guidance or creating guardrails for self-directed accounts:

1. Disclosures

While self-directed brokerage accounts offer greater choice and flexibility for participants, it's important to share with them the additional risks associated with them.

This is one area for potential guardrails. Disclosures regarding the risks surrounding these accounts is one thing. But it is also important to have clear language limiting the plan sponsor and plan advisors' fiduciary liability regarding participant investment decisions. Having guidance for all service providers to follow would be helpful to standardize the disclosure process.

2. Accessibility

Accessibility is another important area to consider when developing and analyzing guardrails. It's important that all plan participants have the ability to take part in a self-directed brokerage account. Sometimes, fees may prohibit participants with smaller balances from participating.

It is important to make sure brokerage accounts, if available in a plan, are accessible to all plan participants on a non-discriminatory basis.

In addition, when a participant wishes to hire an investment advisor outside the circle of the plan service provider, it would be helpful to have guidance on the outside advisor's role and what fiduciary standing the advisor has in relation to the plan sponsor and participant.

3. Investment options

A third area to consider is investment options. It is important that in self-directed brokerage accounts the menu of investment options in a brokerage window is clear about what is available under ERISA and what is not.

Additionally, guidance needs to stay updated when it comes to new investment options emerging (this comes to mind with the increasing interest and demand for cryptocurrencies). Clear guidance and guardrails need to be in place for emerging investment choices.

I’m grateful to all of you for the opportunity to share my statement. I look forward to answering additional questions on self-directed brokerage accounts and providing you valuable information on this important topic.