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BEFORE THE ERISA ADVISORY COUNCIL

REGARDING

"UNDERSTANDING BROKERAGE WINDOWS IN SELF-DIRECTED RETIREMENT PLANS"

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My name is Kent Mason and I am a partner in the law firm of Davis & Harman LLP. Thank you for holding this meeting and for inviting me to address the topic of "Understanding Brokerage Windows in Self-Directed Retirement Plans."

In 2012, I was heavily involved in the public policy discussions regarding Q&A-30 in Field Assistance Bulletin ("FAB") 2012-02, which resulted in the Department of Labor ("Department" or "DOL") reconsidering that Q&A and addressing plan concerns by issuing FAB 2012-02R with new Q&A-39. This presentation reviews the critical issues discussed in 2012 and again in 2014 and provides my perspective on the issues faced by the ERISA Advisory Council ("EAC").

Much of my prior work on brokerage windows was performed on behalf of the American Benefits Council, and my current presentation draws very materially from that work, but also provides updates based on developments in the seven years since DOL issued its 2014 request for information on brokerage windows. However, the views expressed in this document are solely my own.

In brief, I believe that DOL has already provided sufficient guidance on brokerage windows to serve the needs of plan sponsors and to protect participants. ***In this regard, I would be concerned about the potential for additional guidance or requirements related to brokerage windows to (1) have an adverse effect on the ability of plan sponsors to offer brokerage windows to their employees and (2) consequently, reduce both plan participation and sponsorship.***

In Q&A-39, the Department noted with respect to brokerage windows that "plan fiduciaries and service providers may have questions regarding the situations in which fiduciaries may have duties under ERISA's general fiduciary standards apart from those in the [participant-level disclosure regulation]." I believe, however, that ***the participant-level disclosure regulation and FAB 2012-02R, which helpfully addressed many of the concerns raised by Q&A-30, together are working very well to give plan sponsors and service providers appropriate, workable requirements and the guidance they need to understand the scope of their responsibilities while also ensuring that participants are not exposed to undue risks.***

SUMMARY

As explained in more detail below, set forth below are my thoughts on the key issues before the EAC.

1. Brokerage windows are important tools that allow plan sponsors to both meet the needs of the majority of participants who benefit from a concise plan menu of designated investment alternatives ("DIAs") and satisfy the small portion of participants and plan sponsors who desire access to a broad array of investment options. Restrictions on brokerage windows would lead to pressure for more designated investment options, which may not be beneficial for many participants.

2. The imposition of greater fiduciary responsibilities to monitor and evaluate brokerage window investments and provide additional investment-specific disclosures would be

administratively unworkable for many plan sponsors. In addition, the existing disclosure requirements with respect to brokerage windows strike an appropriate balance by providing participants with sufficient information to make informed decisions without inundating them with an overwhelming volume of material.

3. Plan sponsors and participants would be adversely affected if new fiduciary or disclosure requirements force plan sponsors to unwind their brokerage window, likely by liquidating all brokerage window investments.

4. Great care must be taken to ensure that any new guidance or requirements with respect to brokerage windows do not produce unintended consequences for other types of plans or accounts that use a brokerage window or similar feature, such as SEP and SIMPLE plans. Prior to its retraction, DOL's 2012 position would have threatened the continued viability of those plans.

5. The Department should maintain the current definition of "brokerage window," which is working well. In this regard, DIAs are investment options that are designated by the plan fiduciary as having been pre-screened, whereas brokerage window investments are investments that are presented as having not been pre-screened. This regulatory distinction works effectively.

DISCUSSION

1. Brokerage windows are an important tool for plan sponsors that can benefit all participants, whether they utilize the feature or not.

Low participant usage. For purposes of context, it is helpful to keep in mind that, although the availability of brokerage windows within a plan is relatively common, usage of brokerage windows by participants in plans that have DIAs is low. There are various estimates of the percentage of plans that contain brokerage windows as options. The estimates seem to vary primarily based on the size of the plan sponsor. For example, a Vanguard study shows that 17 percent of Vanguard plans with between 500 and 999 participants offer a brokerage window, while 38 percent of Vanguard plans with greater than 5,000 participants offer such a feature.[1] Similarly, a Plan Sponsor Council of America ("PSCA") survey shows that 21.5 percent of plans offer an open brokerage window[2]. So, brokerage windows are certainly common.

This data supports a key point discussed below. There is important demand for the investment flexibility that a brokerage window permits. As discussed below, if this demand cannot be satisfied through a brokerage window, the fear is that the number of DIAs may be increased. Second, although the data shows greater prevalence of brokerage windows among larger plans, it is our understanding that in the case of the small plans that offer brokerage

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[1] *See* Vanguard, *How America Saves*, at 61 (2020).

[2] *See* citation in Investment Company Institute, *ICI Research Perspective: The Economics of Providing 401(k) Plans Services, Fees, and Expenses, 2019*, at 19, fn. 11 (2020).

windows, the windows may be a particularly critical element in the owner's decision to move forward with sponsoring a plan.

Importantly, although the data shows that *offering* a brokerage window is relatively common, participant *use* of the window is relatively uncommon. For example, a recent Vanguard report found that only one percent of participants actually use brokerage windows when they are available.[3] Other estimates are slightly higher, with a few estimates as high as three or four percent. But the key point is that usage is extremely low, underscoring another important point. The availability of the window serves a significant purpose, but the vast majority of participants do not use the window at all, showing that any concerns based on the possible proliferation of window investments may not be well founded.

Maintaining a smaller group of DIAs. The very low participant utilization rate of brokerage windows naturally leads one to question why a plan sponsor would offer the feature in the first place. The data supports what we understand is the most common reason provided for adding a brokerage window: it offers a solution to the requests that generally come from a small group of employees for significantly expanded investment opportunities beyond those provided in a typical plan menu. Brokerage windows allow plan sponsors to meet the desires of these few employees, while keeping the number of DIAs on the plan menu at a lower number, which is very often more appropriate and beneficial for the vast majority of participants.

The consequences of providing too many designated investment choices can be adverse in some cases. ***In fact, studies have shown that 401(k) plan participation actually declines as the number of investment options offered increases***.[4] This has led many companies to use brokerage windows to avoid this very problem. Brokerage windows allow plans to avoid the very real risks of confusing or even paralyzing a large portion of their employees, while at the same time satisfying the desires of a smaller group of participants for more investment flexibility. If brokerage windows become unavailable as a practical matter due to the imposition of unworkable rules, more investment options will likely be designated, which may not be the optimal result in many circumstances.

Avoidance of fiduciary or disclosure obligations not a factor. I am not aware of any company that uses a brokerage window to reduce its fiduciary or disclosure obligations. It is certainly possible that such a perspective exists somewhere, but it would do the retirement system a great disservice to impose unworkable burdens on thousands of plans to address what is at most a very isolated problem. For small employers in particular who are understandably more likely to consider the fiduciary and disclosure obligations related to sponsoring a plan, the system has already provided them with options to reduce these burdens, such as through payroll deduction IRAs and SEP and SIMPLE plans.

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[3] *See* Vanguard, *How America Saves*, at 67 (2020).

[4] *See, e.g.*, Sheena Sethi-Iyengar et al., *How Much Choice is Too Much?*, *in* PENSION DESIGN AND STRUCTURE: NEW LESSONS FROM BEHAVIORAL FINANCE 83, 88-91 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004), *available at* http://www.columbia.edu/~ss957/articles/How_Much_Choice_Is_Too_Much.pdf.

Brokerage windows can be key to plan formation for small employers. The ability to offer a brokerage window is itself a factor that many employers consider when deciding whether to sponsor a retirement plan in the first place. Small business owners in particular often insist on providing a mix of core plan menu options together with the investment and cost flexibility of a brokerage window. Commentators have observed informally that the unavailability of brokerage windows—or an increase in the burdens associated with offering brokerage windows—would have a significant adverse effect on the maintenance and adoption of retirement plans by small employers.

2. The imposition of greater fiduciary responsibilities to monitor and evaluate brokerage window investments and provide investment-specific disclosures would be unworkable and would significantly increase costs and administrative complexity for plan sponsors.

It is important to note that current law is structured to require exactly the type of fiduciary oversight of brokerage windows that is appropriate. Plan fiduciaries must monitor their service providers with respect to fees and services, which is exactly what is needed by participants. This is an appropriate level of oversight given the very idea behind brokerage windows – that a participant be given freedom to choose from a broad range of investments *outside of* those designated by the plan fiduciary.

DOL has previously asked how plan fiduciaries monitor investments made through their plan's brokerage window, if at all, and whether fiduciaries view this information as important to effectively monitoring the inclusion of a brokerage window feature in their plan. It is important to stress how unworkable and cost-prohibitive it would be to impose a general obligation on plan fiduciaries to monitor a plan's brokerage window investments. Just as unworkable would be a requirement to provide disclosures with respect to a plan's brokerage window investments that are similar in nature to the disclosures provided to participants with respect to DIAs.

As background for my comments, Q&A-30 of FAB 2012-02 (prior to its modification by FAB 2012-02R) set forth for the first time a requirement that plan fiduciaries examine all brokerage window investments in which a "significant number" of participants and beneficiaries have invested and determine whether plan disclosures should be provided with respect to one or more of such investments. This position was contrary to the [still current] participant-level disclosure regulation under which disclosure *is* required with respect to the DIAs on the plan menu, but disclosure *is not* required with respect to the thousands of investments available through the brokerage window. The current rule makes sense because (1) it is impractical for plan sponsors to make disclosures with respect to tens of thousands of different public and private investments, and (2) any applicable disclosure should be governed by the securities laws, since the plan sponsor has not endorsed investments available only through the brokerage window.

For the reasons noted below, I would urge DOL to not impose unworkable fiduciary responsibilities to monitor and examine brokerage window investments that will give many plan sponsors no choice but to terminate the brokerage window feature, or even the entire plan.

- ***Manual monitoring.*** In 2012, very few plan service providers, including brokerage window providers, had a system that can determine the number of participants who are invested in any particular brokerage window investment. Thus, generally, determinations such as those that would have been required by Q&A-30 would have needed to be done manually, triggering enormous costs and added complexity in plan administration. I have been provided updated information in this regard:

    - One national recordkeeper said that it can now track brokerage window investments, but small recordkeepers do not always have that capacity.

    - A second national recordkeeper reported to me that they have no ability to track brokerage window investments except manually.

    - A third national firm recognized that it might be a challenge to have a brokerage window integrated into a recordkeeping system.

  In short, it appears that a very large number of plans would find tracking brokerage window investments unworkable.

- ***Fiduciary issues.*** If the imposition of a new fiduciary responsibility results in a plan sponsor's determination that disclosure with respect to brokerage window investments is needed because of, to use the example of Q&A-30, the number of participants invested in a brokerage window investment (or by some other standard), such disclosure may cause the investment to be treated as or deemed to be a DIA. This in turn could result in the designation of investments that are not suitable to be included in the fiduciary-reviewed investment offerings or that are inappropriate for the plan sponsor, such as stock of a competitor. Accordingly, a plan sponsor may need to immediately liquidate the newly designated investments or close access to a particular investment once it is possible that the "significant" participation [or other similar] threshold will be exceeded.

In sum, I do not agree that the monitoring of investments made through a brokerage window is important in order to effectively monitor the inclusion of a brokerage window feature by plan sponsors in their plan. The investments available through a brokerage window are not presented to participants as having been screened by the plan fiduciary; such investments are presented as market investments that may be used outside the oversight of the fiduciary. Thus, there is no duty to monitor those investments. Moreover, if the law is changed so that an employer is forced to exercise oversight over the entire market available through a brokerage window, such a change would be the functional equivalent of prohibiting brokerage windows. In light of the critical role that brokerage windows play in keeping the number of DIAs down, the system would not be well served by such an effective prohibition.

In a matter closely related to the monitoring issue discussed above, the Department has asked whether any additional information about brokerage windows should be disclosed to participants. In addition to my concern over new monitoring duties, I am also concerned about the unworkability of plan sponsors being required to provide new disclosures with respect to specific investments within a brokerage window. Not only does this raise enormous cost and procedural concerns for the plan, but such a requirement would very likely result in participants being flooded with new disclosures. Further, participants electing to use a brokerage window are already expected to complete account level documentation with the brokerage window provider and are provided with account information from the brokerage firm. Those steps ensure that a participant has access to information about his or her new account, and it further supports the fact that an individual is acting in an independent manner with respect to the brokerage window.

The Department acknowledged the risk of overwhelming participants in FAB 2012-02R. In Q&A-13, which very helpfully describes the information required to meet the existing disclosure requirements with respect to brokerage windows, the Department states that the plan sponsor need only provide a general statement regarding brokerage window fees. A general statement is explained as being sufficient in part because plan sponsors may not always know all the various fees associated with each investment option. But the Department also cautioned that ***more detailed fee information "might inundate participants and beneficiaries with information about the cost of buying or selling all the various securities available through a window" despite the fact that they might not either utilize the brokerage window or have interest in any such securities***.

More recently, the Department similarly acknowledged the risk of overwhelming participants in 2019 when it requested comments in connection with its then-proposed rule on default electronic disclosure by employee pension benefit plans under ERISA.[5] This risk was also discussed at length in 2017 by the EAC itself—the EAC's report on mandated disclosure for retirement plans observed that providing too much information to participants in a disclosure can be overwhelming and confusing.[6]

I believe that the existing disclosure rules strike the right balance in providing enough information to protect participants without being so burdensome that they become overwhelming and irrelevant to participants and increase costs and complexity for plan sponsors. Thus, I believe that additional disclosure rules – especially with respect to the investment options available through a brokerage window – are not necessary; on the contrary, such additional rules would be very counterproductive.

3. Plan sponsors and participants would be placed in an extremely difficult position if new fiduciary or disclosure requirements force plan sponsors to unwind their brokerage window.

If the Department decides to impose new fiduciary responsibilities or substantial disclosure requirements on plan sponsors who offer brokerage windows (especially where the requirements in any way resemble the position in Q&A-30), certain negative outcomes are likely. As described above, some brokerage window investments may need to be liquidated. For

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[5] 84 Fed. Reg. 56,894, 56,909 (Oct. 23, 2019) ("Some people have indicated that at least some ERISA documents may be too voluminous, complex, or both. These individuals highlight a need to strike a balance between providing too little information for participants to gain an adequate understanding of what the disclosure is trying to convey and providing too much information, which can become overwhelming and confusing. Please identify each ERISA document in these categories.").

[6] *See* ERISA Advisory Council, *Mandated Disclosure for Retirement Plans – Enhancing Effectiveness for Participants and Sponsors*, at 37 (2017).

example, if new guidance results in a brokerage window investment option being treated as or deemed to be a DIA, this could result in a plan sponsor needing to immediately liquidate the newly designated investment or close access to a particular investment if (1) the fiduciary is not prepared to include that investment among the options presented to participants as having been screened, or (2) the investment is inappropriate for the plan sponsor, such as stock of a competitor.

In fact, if affected plan sponsors determine that, as a practical matter, they cannot comply with a new requirement or afford its cost, many will likely conclude that they will be effectively forced to terminate their brokerage window arrangements entirely and liquidate all participants' brokerage window investments. Such liquidations of some or all brokerage window investments could be very harmful to participants:

- The liquidation could occur at a disadvantageous time, forcing participants to sell long-term investments "at the bottom."
- The liquidation could disrupt long-term investment and retirement strategies, undermining a participant's plans regarding how to achieve retirement security.
- The liquidation could deprive participants of the use of certain investment tools not available among the DIAs.
- Participants who do not make affirmative elections regarding reinvestment of the liquidation proceeds may be defaulted into investments that are quite different from their brokerage window investments and do not fit with their other investments.

4. Great care must be taken to ensure that any new guidance on brokerage windows does not have unintended consequences, such as threatening the continued viability of SEP and SIMPLE plans.

The Department's position in Q&A-30 would have called into question the viability of all SEPs and SIMPLE IRAs, two of the most popular forms of small business plans. Although the participant-level disclosure regulations do not apply to such plans, the position expressed by DOL in Q&A-30 seemed to operate independently of (and in contradiction to) the applicable regulations. As described above, Q&A-30 would have imposed an affirmative obligation on plan fiduciaries to examine those investment options that were selected through a brokerage window by a "significant number" of participants and beneficiaries. The fiduciary would then have been required to determine whether those investments should be treated as DIAs for purposes of the participant-level disclosure regulation. Because many SEPs and SIMPLE IRAs are essentially comprised of just a brokerage window, the application of Q&A-30 to these arrangements would have raised enormous problems and for all practical purposes could have shut them down.

I do not believe that the Department intended for Q&A-30 to apply to SEP and SIMPLE plans, and any concerns in that regard were very helpfully addressed when the Department subsequently published FAB 2012-02R, which removed the issue. However, in the event that the Department decides additional guidance is needed with respect to brokerage windows, I believe DOL should carefully consider what impact the guidance might have on all types of plans or accounts that utilize a brokerage window or similar feature, including SEPs and SIMPLE IRAs.

5. The current definition of “brokerage window” is effective and clear.

DOL has previously asked, as a regulatory or interpretive matter, how “brokerage window” should be defined if a more specific definition is provided.[7] The term “brokerage window” is currently defined in the participant-level disclosure regulation, the service provider fee disclosure regulation, and FAB 2012-02R, as those investments that “[enable] participants and beneficiaries to select investments beyond those designated by the plan.”[8] In addition, the term brokerage window is excluded from the meaning of “designated investment alternative.”[9]

I recommend that DOL maintain the current definition of a brokerage window. Very importantly, the current definition of brokerage window enables plan sponsors and participants to easily distinguish between a particular investment option that is one of the plan’s DIAs (*i.e.*, an option on the plan “menu”) and one that is not a DIA but is simply made available through a brokerage window. This definition works just as it should. If the plan fiduciary designates specific investment options, those designations convey to participants that the plan fiduciary is standing behind those options, and fiduciary obligations (including disclosure responsibilities) should and do apply. On the other hand, if the plan fiduciary allows participants to invest in options that are not designated by the plan fiduciary, such as the options available through a brokerage window, it is clear to the participants that the plan fiduciary has not screened such options, so no fiduciary or disclosure obligations should or do apply with respect to such options. That is the rule under the current definitions of “DIA” and “brokerage window,” and we believe that the rule and the definitions are working very well for both plans and their participants.

In this regard, it is critical that, as under current law, the mere action by a plan sponsor to *exclude* certain types of investments from a brokerage window does not result in the remaining investments available through the window being treated as having been specifically pre-selected or designated by the fiduciary.[10] For example, some plan sponsors may offer a mutual fund “supermarket” that allows participants to invest in thousands of available mutual funds. Under current law, the exclusion of individual securities from this window does not transform the funds available under the window into DIAs because clearly the thousands of available funds have not been “designated.” Moreover, if this logical current-law rule were changed, the result in many cases would be for the plan sponsor to have to permit individual securities to be purchased through the window, so as to avoid the unworkable duty to screen and provide disclosures with

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[7] References in this document to “brokerage windows” also generally encompass the term “self-directed brokerage account” and other similar plan arrangements.

[8] 29 C.F.R. §§ 2550.404a-5(c)(1)(i)(F), 2550.404a-5(h)(4), and 2550.408b-2(c)(1)(viii)(C) (substituting the term “covered plan” for “plan”); FAB 2012-02R questions 13, 14, 29, and 39

[9] *See, e.g.*, 29 C.F.R. § 2550.404a-5(h)(4). Designated investment alternative means any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term “designated investment alternative” shall not include “brokerage windows,” “self-directed brokerage accounts,” or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

[10] As recognized by the Department of Labor regulations under section 404(c) of ERISA, it may be necessary for a fiduciary to place certain restrictions on plan investments in order to, for example, maintain a plan’s qualified status or avoid prohibited transactions. *See* 29 C.F.R. § 2550.404c-1(d)(2)(ii) and (d)(3).

respect to thousands of mutual funds. No policy purpose would be served by treating the mutual fund supermarkets in this example or similar arrangements as DIAs.

In a related question, the Department has also previously asked at what point the number of investment options available to plan participants might warrant treating the options as a brokerage window rather than as a menu of DIAs. In short, and as described above, the current definition of brokerage window works very well and should not be altered so that the number of investment options dictates how an option is categorized. The critical distinction between a DIA and a brokerage window should remain whether the plan fiduciary pre-selected and "designated" the investment.