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BEFORE THE

2021 ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS

REGARDING

UNDERSTANDING BROKERAGE WINDOWS IN SELF-DIRECTED RETIREMENT PLANS

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The views expressed in this testimony reflect those of the presenters and not necessarily the views of Faegre Drinker Biddle & Reath LLP

Understanding Brokerage Windows in Self-Directed Retirement Plans

The Advisory Council is examining the usage of self-directed brokerage windows in individual account retirement plans. In its issue statement, the Council said:

> The 2021 Advisory Council will examine brokerage windows in participant-directed individual account retirement plans that are covered by ERISA to gain a better understanding of their design, prevalence, and usage. The examination will focus on the number and types of plans that offer a brokerage window and the extent to which assets are invested in brokerage windows. The Council also will study the nature and extent of disclosures that plan participants receive, which plan participants use brokerage windows, and in what manner.

The Council also referenced the request for information issued by the Department of Labor in 2014 related to the role of brokerage windows in participant-directed individual account plans. Regarding the RFI, the Council stated:

> The Department was interested in whether guidance would be appropriate and necessary to ensure that plan participants and beneficiaries with access to a brokerage window are adequately informed and protected under ERISA. The work of the Council is intended to assist in this effort.

Our comments are focused on the latter issue, that is, our view that additional guidance is needed for the protection of participants and assistance to plan sponsors. While we submit that such guidance would be appropriate and necessary, we do not advocate any specific structure for that guidance.

Recommendations

As discussed more fully later, we recommend the issuance of guidance on the following:

1. A clear definition of what constitutes a brokerage account or brokerage window and under what circumstances, if any, the investments in such an account would be considered designated investment alternatives (DIAs) of a plan that must be monitored by plan sponsors. (For ease of reference, we use the term "plan sponsor" to refer to the fiduciaries of plans. We also refer to these brokerage arrangements as both accounts and windows; however, we do not intend any substantive differences by the use of those words.)
2. Guidance on the issues that should be considered in deciding whether to offer a brokerage account.
3. Guidance on the factors to be considered in selecting a particular broker-dealer to provide the brokerage services, including the costs within the brokerage accounts. The guidance on costs should include information including but not limited to commissions and other fees or expenses the broker will charge, as well as information about any revenue sharing paid by or applied to recordkeeping fees or other service provider charges. This

information is needed by plan sponsors in selecting the brokerage account and provider and by participants in deciding whether to invest through a brokerage account.

4. Guidance on the information that must be disclosed to participants about the services to be offered, investments and costs in the brokerage account.
5. Guidance on whether recordkeeping expenses should be allocated to participant using brokerage accounts.
6. Guidance on fiduciary responsibilities for monitoring brokerage accounts.

Existing Guidance

The published guidance on which plan sponsors can rely is limited. The regulation under ERISA Section 408(b)(2) and ERISA Regulation 2550.404a-5, along with FAB 2012-02R, provide some guidance on disclosures to plan sponsors and participants, but these are not sufficient in our view. The Department's 2014 RFI about brokerage accounts also provides little assistance to plan sponsors on how to prudently select a brokerage account. While FAB 2007-01 provides helpful guidance for the selection of service providers generally (in the context of investment advisers), it would be helpful if guidance were provided that applied the principals in other guidance to brokerage accounts specifically.

Definition of Brokerage Window or Account

It is important to understand what a brokerage window or brokerage account is. Unfortunately, there is no clear definition. For example, would a "mutual fund window" which offers a relatively limited number of mutual funds fall under the definition? Or must the brokerage account make it possible for participants to invest in a much wider array of alternatives?

Two recent cases (*Moitoso v. FMR LLC,* 451 F. Supp. 3d 189 (D. Mass. 2020) and *Ramos v. Banner Health,* 461 F.Supp.3d 1067 (D. Colorado 2020)) considered the issue. In the *Moitoso* case, the plan offered DIAs, a platform of Fidelity mutual funds, and a separate platform of non-Fidelity funds. In the *Ramos* case, the plan offered a mutual fund window consisting of several hundred mutual funds. In both cases, the plaintiffs sued the fiduciaries for failing to monitor the funds offered through the mutual fund windows.

The court in *Moitoso* struggled to find a clear definition in order to decide whether a duty to monitor existed. It referred to a number of cases that had considered issues related to brokerage accounts and further noted that "The Department has treated the term very broadly, but only in the preamble to a request for information that lacks the force of law." The court then added that "in the absence of other regulations explicitly imposing such a duty [to monitor], it is hesitant to state unequivocally that there either is, or is not, a fiduciary responsibility to monitor self-directed brokerage accounts." The decision makes it clear that a definition is needed to understand what is meant by the term.

The *Ramos* court had less concern, though the rationale for its decision is not entirely clear. The opinion concludes that the "Banner Defendants did not monitor investments available in [the brokerage window], *nor were they required to do so."* [Emphasis added]

Given the absence of clear authority defining what constitutes a brokerage account, and thus the duties, if any, of plan sponsors related to the monitoring of how participants use such accounts, additional guidance on this issue would be appropriate and necessary.

Fiduciary Duties With Regard to Selection and Monitoring of Investments in Brokerage Window.

There is also a lack of clear understanding on the issue of selection and monitoring of the investments in brokerage accounts. This is due in large part to statements in Field Assistance Bulletin 2012-02 and the modified version, FAB 2012-02R.

In Q&A 30 in FAB 2012-02, the Department indicated:

> *Paragraph (h)(4) of the regulation specifies that a brokerage window or similar arrangement is not a "designated investment alternative." A platform consisting of multiple investment alternatives would not itself be a designated investment alternative.* ***Whether the individual investment alternatives are designated investment alternatives depends on whether they are specifically identified as available under the plan.*** [Emphasis added]

The FAB then added:

> *If, through a brokerage window or similar arrangement, non-designated investment alternatives available under a plan are selected by significant numbers of participants and beneficiaries,* ***an affirmative obligation arises on the part of the plan fiduciary to examine these alternatives and determine whether one or more such alternatives should be treated as designated for purposes of the regulation.*** [Emphasis added]

Finally, the FAB indicated that in certain instances, at least some of the investments available through a brokerage account would be treated as DIAs for purposes of disclosure to participants:

> *Pending further guidance in this area, when a platform holds more than 25 investment alternatives, the Department, as a matter of enforcement policy, will not require that all of the investment alternatives be treated, for purposes of this regulation, as designated investment alternatives* ***if*** *the plan administrator—*
>
> > *(1)* ***makes the required disclosures for at least three of the investment alternatives on the platform*** *that collectively meet the "broad range" requirements in the ERISA 404(c) regulation, 29 CFR § 2550.404c-1(b)(3)(i)(B);* ***and***
> >
> > *(2)* ***makes the required disclosures with respect to all other investment alternatives on the platform in which at least five participants*** *and beneficiaries, or, in the case of a plan with more than 500 participants and beneficiaries,* ***at least one percent of all participants*** *and beneficiaries,* ***are invested*** *on a date that is not more than 90 days preceding each annual disclosure.*

Q&A 30 was replaced in FAB 2012-02R with Q&A 39, where the Department backed off of the prior guidance. But the FAB still leaves open questions.

> *nothing in this Bulletin prohibits the use of a platform or a brokerage window, self-directed brokerage account, or similar plan arrangement in an individual account plan….**Nonetheless, in the case of a 401(k) or other individual account plan covered under the regulation, a plan fiduciary's failure to designate investment alternatives, for example, to avoid investment disclosures under the regulation, raises questions under ERISA section 404(a)'s general statutory fiduciary duties of prudence and loyalty. Also, fiduciaries of such plans with platforms or brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan are still bound by ERISA section 404(a)'s statutory duties of prudence and loyalty to participants and beneficiaries who use the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement,** including taking into account the nature and quality of services provided in connection with the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement.* [Emphasis added]

In this language, the Department leaves an open question as to whether investments available through a brokerage account could be considered DIAs and thus require both disclosure to participants and monitoring by plan sponsors. Despite the statement to the contrary in the *Ramos* decision noted earlier, our point is that there is no clarity on whether or when investments in brokerage windows must be prudently selected or monitored. In our view, the Department should make this clear.

Decision to Offer a Brokerage Window

Decisions about plan investments and services are generally treated as fiduciary decisions under ERISA. That raises the issue of whether the decision to offer a brokerage window to participants is a fiduciary decision that must be made prudently. Unfortunately, there isn't any guidance on whether that is the case and, if so, the factors that plan sponsors, in their fiduciary capacities, should consider. For example, should a plan sponsor, in making that decision, assess the needs and sophistication of its workforce and, if so, how could that assessment be made? Alternatively, would it suffice to offer information about the fact that the investments were not prudently selected and monitored by the plan sponsor and perhaps about the risks inherent in investing in non-diversified securities?

The Department should also consider whether it is appropriate for a plan to only make brokerage accounts available to their participants (without also offering the alternative of investing in a lineup of DIAs). That raises the question of whether a plan that only offered brokerage accounts could qualify as a 404(c) plan, and the Department should consider clarifying whether the "broad range" of investments condition, and the "safe" investment condition, in the 404(c) regulation can be satisfied through investment alternatives in brokerage accounts or whether those investment

options must be specifically designated and therefore prudently selected and monitored by the plan sponsor.

On another issue, the Department should consider guidance that would clarify the application of ERISA's fiduciary standards to the situation in which a plan document specifies that brokerage accounts must be made available to participants, *i.e.*, where the decision to offer a brokerage account is "hardwired" into the plan document. While we have not researched this issue in detail, the "hardwired" decision to offer such an account would presumably be a settlor rather than fiduciary decision. But, even if this were an approach that would limit the fiduciary responsibility, it appears that ERISA requires that a plan sponsor, acting in its fiduciary capacity, would need to consider whether following the terms of the plan would be consistent with the obligation under ERISA Section 404(a)(1)(D), requiring fiduciaries to discharge their duties "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title…." *See also* the Supreme Court's assessment of this issue in the case of ESOPs, where the plan is required to invest in employer securities. In *Fifth Third Bancorp v. Dudenhoeffer.* 573 U.S. 409 (2014)*,* the Court said:

> *This provision [section 404(a)(1)(D)] makes clear that the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary.*

While the Supreme Court has spoken on this issue, it would be helpful to employers and plan fiduciaries if the Department clarified how 404(a)(1)(D) applied to plan provisions that require the inclusion of a brokerage account in terms of the fiduciary responsibility to include (and monitor) such a feature.

Selection and Monitoring of Provider of Brokerage Window

The Department has offered some guidance on this topic in Field Assistance Bulletin 2012-02R, but it is incomplete. In the FAB, the Department indicated that plan sponsors need to consider "*the nature and quality of services provided in connection with the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement.*" To help plan sponsors in this task, more guidance is needed regarding the "nature and quality of services" to be reviewed.

In our experience, with clear guidance on the factors to be considered in fiduciary process, plan sponsors will comply. One of the most frequent comments we hear in advising plan sponsors is "Tell me what I have to do and I'll do it." Te Department could help plan sponsors, and enhance compliance, by issuing guidance to address the following:

- The factors to be considered in the assessment of the brokerage firm.
- The need to assess the costs that participants will incur in the account, including commissions and any other fees related to the account, as well as the communications with participants about those costs and fees. This would include how the costs compare to those

of other providers, taking into consideration the quality and quantity of services being offered.

- Whether plan sponsors need to consider the allocation of plan costs among participants, that is, whether participants who invest through a brokerage account will (or should) pay a share of administrative costs of the plan unrelated to the investments, such as recordkeeping, plan qualification testing, or other similar costs.
- Monitoring requirements.
- The services offered by the provider to the plan sponsor and the participants, including the quality of the services.
- The provider's experience and history in providing similar services to retirement plans.

Other Considerations: Benefits, Rights and Features

Though not an issue over which the Department has jurisdiction, it is important to note that, in designing a brokerage account structure for their plans, brokerage accounts are "benefits, rights and features" under the non-discrimination requirements of section 401(a)(4) of the Internal Revenue Code. That is, brokerage window would need to be both currently and effectively available to all, or at least a non-discriminatory group of, participants (*see* Treas. Reg. §1.401(a)(4)-4(b) and (c)). This would be an issue in a plan if, for example, the minimum account size for using a brokerage window or the cost assessed for using a brokerage account were set at a level at which many non-highly compensated employees would effectively be limited in participating.

Participant Communications

The Department should also consider guidance on the information to be provided to participants about brokerage windows offered in a plan. For example, one approach would be to require that participants be given the information that a knowledgeable investor would want to know about investing in a brokerage account, *i.e.,* costs, services, available investments, etc. That is, disclosures may be needed beyond those required in Regulation 2550.404a-5. In that regard, the Department should evaluate whether the disclosure requirements of other regulators (*e.g.*, the SEC and FINRA) are adequate for the retirement plan setting. For example, an individual investor may understand that the investments in a brokerage account are not selected and monitored by a fiduciary, while a plan participant may not understand that is the case.

Concurrence with Other Testimony

Several groups that have provided testimony to the Advisory Council have suggested additional guidance that would be helpful (including FinDec, ERIC, and the U.S. Chamber of Commerce), and we generally support their suggestions. Others have noted that, in providing such guidance, the Department should not impose a requirement that plan sponsors monitor the investments in brokerage accounts. We generally agree with the latter concern, since it would not be possible for

plan sponsors to effectively conduct such monitoring in a brokerage window that provided a large number of investments.