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Common Questions: What Every Fiduciary Should Know About a Self-Directed Brokerage Account (SDBA)

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Introduction

Charles Schwab & Co. sponsors the Personal Choice Retirement Account ("PCRA"), a self-directed brokerage account ("SDBA") that is offered within an employer-sponsored retirement plan. The PCRA provides participants with access to a vast array of investment options that participants would not otherwise have access to within their employer-sponsored retirement plan. The PCRA also offers participants premium research and tools to help them make their own investment decisions.

In response to both participant demand and plan fiduciaries' own interests in providing as much choice and diversity as possible in the investment options made available to plan participants, plan fiduciaries of retirement plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA") often turn to SDBA products, which have increasingly become staple features of defined contribution plans. In this regard, plan fiduciaries often view SDBAs as practical solutions that can accomplish the goal of providing greater choice and diversity in investment options without significantly increasing fiduciary risk.

While SDBAs have been around for a long time, plan fiduciaries often have questions about their fiduciary responsibilities under ERISA with respect to SDBAs. Unfortunately, there is limited clear guidance addressing the broad array of issues facing plan fiduciaries. In an effort to help clear up some confusion regarding the fiduciary considerations of including a SDBA within a retirement plan, we provide the following answers to some common and pressing issues in this evolving area of the retirement services industry.[1]

1. Is the establishment of a SDBA within a plan considered to be a fiduciary decision subject to ERISA?

While not free from doubt, the addition of a SDBA as a plan feature through a plan amendment could be viewed as a non-fiduciary, settlor function that would not implicate ERISA's fiduciary responsibility provisions.

However, the implementation of the decision to offer a SDBA and the ongoing monitoring of the SDBA will likely be considered a fiduciary act subject to ERISA. Thus, a plan sponsor's selection of the SDBA vendor and any product features should be performed in accordance with ERISA's fiduciary provisions. Examples of factors that a plan fiduciary may consider

[1] The analysis contained in this white paper is general and educational in nature and does not constitute a legal opinion or legal advice that may be relied upon by third parties. You should consult your own legal counsel for information on how these issues apply to your individual circumstances. Changes in the law may have occurred since this paper was drafted, and you should consult with your own legal counsel to determine if there have been any relevant developments since its publication.

relevant when selecting a SDBA provider include the provider's experience and reputation in providing the service as well as the fees charged by the provider.

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2. What are the fiduciary responsibilities in picking the investment options offered within a SDBA? Separately, are fiduciaries exposed to additional risk if they limit the types of investments in the SDBA?

In our experience, it is not uncommon for plan fiduciaries to limit the investment options in a SDBA. Plan fiduciaries may choose to limit the options within a SDBA for several reasons which may include (i) the fiduciary's belief that certain investments are not appropriate as part of a retirement investment strategy, (ii) tax issues attendant to certain investment products, (iii) limiting or avoiding investments that could result in a loss in excess of the participant's account balance, or (iv) avoiding investment options that could lead to prohibited transactions under ERISA (e.g., company stock in certain circumstances).

The responsibility of fiduciaries over the types of investments offered within a SDBA largely depends on whether the fiduciary would be viewed as "designating" the investments under the plan. The Department of Labor ("Department") has explained that the act of designating investment alternatives is a fiduciary function for which the limitation on liability under ERISA section 404(c) does not apply. In this regard, a key question is compliance with ERISA section 404(c), which limits fiduciary liability for the individual investment decisions of plan participants within a self-directed retirement plan (provided that the conditions are met).

For purposes of the disclosure requirements under ERISA section 404(c), the Department has acknowledged that not every investment option under a plan need be "designated" by a plan fiduciary.[2] This means that where a plan qualifies as an ERISA section 404(c) plan, plan fiduciaries may still benefit from the liability protections under ERISA section 404(c) even though not all investment options are "designated" by a plan fiduciary. This protection most likely also extends to a participant's individual investment decisions regarding the investment options within a SDBA.

Although not free from doubt, we do not view a plan fiduciary as "designat[ing]" the investment alternatives under the SDBA where it selects the SDBA product that is made available by the provider without making changes to the investments available under the SDBA. This view is supported by informal guidance issued by the Department where it has tacitly acknowledged that fiduciaries may not have liability with respect to the investments that are included within

[2] Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. 46906, 46910-46911 (Oct 13, 1992).

SDBA.[3] However, the Department noted that fiduciaries are subject to ERISA's duties of prudence and loyalty when selecting the SDBA provider.[4]

It is less clear whether the Department or the courts would characterize a fiduciary as "designating" investments made available within a SDBA where the fiduciary limits those investment options made available within the SDBA beyond the limitations imposed by the SDBA provider. Where the SDBA platform of investments is meaningfully limited by the plan sponsor, the Department or plaintiffs could argue that the act of modifying the SDBA's menu of investments is a fiduciary act subject to ERISA. Thus, while excluding investments that may issue K-1s to plan participants may not generate scrutiny from plaintiffs' attorneys, limiting the investments under the SDBA to specific fund families could. In light of this possibility, plan fiduciaries likely assume greater risk if they significantly modify the options made available through the SDBA product offering.

Moreover, while not specifically considering whether investments offered in a SDBA were "designated" by plan fiduciaries, courts have recognized that plan fiduciaries can satisfy their duties of prudence and loyalty when offering a brokerage window that maintained over 2,500 investment options.[5]

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3. What is the fiduciary impact if the plan sponsor and/or recordkeeper limit the amount or percentage of assets that participants may invest into their SDBA?

The decision to impose a limitation on the percentage of assets that participants may invest into their SDBA does not come without risk. A plan fiduciary is required to follow plan terms (which may include a limitation on investment selection) and should generally not incur legal liability for doing so.[6] Administering investment selection limitations may present challenges for both recordkeepers and plan fiduciaries, and may even lead to inadvertent violations of plan terms—which constitute breaches of fiduciary duty under ERISA—if the limitations cannot be administered. Thus, prior to adopting any investment limitations into a plan document, plan sponsors would be wise to consider both their own and their recordkeeper's administrative capability for enforcing any such limitations.

Notwithstanding the foregoing, the imposition of a cap likely will not affect the plan's ability to rely upon ERISA section 404(c) for purposes of the participant's investment decisions. This view is supported by guidance the Department has issued in the employer securities context, where it noted that imposing a comparable limitation on the percentage of assets that a

[3] FAB 2012-02R, Q39.

[4] *Id.*

[5] *See, e.g., Hecker v. Deere & Co.*, 556 F. 3d 575 (7th Cir. 2009).

[6] *See* ERISA section 404(a)(1)(D).

participant may invest in employer securities would not affect the plan's relief under ERISA section 404(c).[7]

4. Should plan fiduciaries request performance and investment data about the participants' SDBAs? Could a plan fiduciary's review of performance data subject them to litigation if the SDBA investments selected by the participant perform poorly?

A plan fiduciary would likely have no obligation to monitor the investments offered under the SDBA where the investment options offered within the SDBA are not considered "designated investment alternatives."

However, plan fiduciaries that monitor the SDBA's performance and investment data risk exposing themselves to claims that the investments offered within the SDBA are "designated investment alternatives" under the plan. Due to this risk, while plan fiduciaries should consider general SDBA usage, provider cost, and other broad trends and factors in order to discharge their monitoring responsibilities, plan fiduciaries may want to avoid more specific reviews relating to performance and other investment data concerning a SDBA's offerings.

5. Does providing access to investment advisers to assist with the participant's investments in a SDBA expose plan fiduciaries to additional liability? What level of oversight should a fiduciary exert in reviewing the fees charged, investments selected, or investment management fees paid from the SDBA? Can investment fees be deducted directly from the SDBA?

Whether a plan fiduciary is responsible for investment advisers that provide advice to participants within their SDBA largely depends on whether the plan fiduciary "designates" the investment adviser under the plan. Similar to investment options that are available under the SDBA, plan fiduciaries generally take on more legal responsibility where they "designate" advisers to provide services to participants within the SDBA.

Thus, a plan fiduciary would not have responsibility to monitor an adviser that a plan participant retains that is not designated by the plan fiduciary.[8] On the other hand, a fiduciary would be responsible for prudently selecting and monitoring an investment adviser that it "designate[s]"

[7] 29 C.F.R. § 2550.404(c)-1(f).

[8] *See* 2550.404c-1(f)(9); *see also* Interpretive Bulletin 96-1(e) ("[T]he Department also notes that a plan sponsor or fiduciary would have no fiduciary responsibility or liability with respect to the actions of a third party selected by a participant or beneficiary to provide education or investment advice where the plan sponsor or fiduciary neither selects nor endorses the educator or adviser, nor otherwise makes arrangements with the educator or adviser to provide such services.").

to provide participant investment advice under the terms of the plan.[9] This means that the plan fiduciary will be responsible for prudently selecting and monitoring the investment adviser and avoiding prohibited transactions in connection with such selection. Factors that may be relevant to the plan fiduciary's decision to retain an investment adviser include the adviser's services, fees, and reputation. However, the plan fiduciary's designation of the investment adviser does not mean that the plan fiduciary has co-fiduciary responsibility for purposes of the investment adviser's investment advice or decisions.[10]

The payment of investment advisory fees from a plan (or directly through a participant's SDBA) can be a reasonable plan expense.[11] Whether the fees are reasonable and can be paid from the plan does not depend on whether or not the investment adviser is designated by a plan fiduciary. In either circumstance, the same analysis applies to whether the investment adviser's fee is a reasonable plan expense. However, in our view, to avoid assuming potential liability for investment advisers independently retained by participants, we often suggest that plan fiduciaries refrain from taking any action that could suggest an assumption of responsibility over such advisers (e.g., reviewing the fees for such advisers).

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6. Are fiduciaries required to educate participants before offering SDBAs to participants? Should fiduciaries explain SDBAs to participants (e.g., only experienced investors, additional educational quiz, etc.)?

The Department has stated that SDBAs are not themselves "designated investment alternatives" for purposes of participant disclosure rules.[12] SDBAs are instead a service and participants are not required to receive investment related information regarding a SDBA.[13]

The Participant Disclosure Regulation describes the information plan fiduciaries are required to provide participants regarding the SDBA.[14] In this regard, a Plan Administrator must provide a general description of the SDBA,[15] as well as an explanation of any fees and expenses that may be charged against the individual account of a participant or beneficiary in connection with the SDBA.[16]

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[9] *See* Interpretive Bulletin 96-1(e).

[10] *See* ERISA sections 404(c)(2) and 405(d)(1); 29 C.F.R 2550.404c-1(f)(8).

[11] FAB 2003-3.

[12] *See* 29 C.F.R. § 2550.404a-5(h)(4).

[13] *See* FAB 2012-02R, Q29.

[14] 29 C.F.R. § 2550.404a-5

[15] *See* 29 CFR § 2550.404a-5(c)(1)(i)(F).

[16] *See* 29 CFR 2550.404a-5(c)(3)(i)(A).

A plan fiduciary may decide to provide participants with more information or education than is required by ERISA section 404(c) and the Participant Disclosure Regulation. Historically, plan fiduciaries have not provided education to participants due to the risk that such education could "cross the line" into providing investment advice that could result in the plan fiduciary being held to a fiduciary standard of care for providing investment advice under ERISA.[17] Notwithstanding the foregoing, appropriately tailored communications that adequately explain that the participant, and not the fiduciary, is responsible for the selection of investments in the SDBA, and that the plan fiduciary has not analyzed or approved the investment options made available through the window could be helpful information to help explain the risks of investment through a SDBA to participants.

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7. Can a sponsor reduce its liability by discussing the risks of SDBAs with participants?

Appropriately tailored discussions with participants regarding the SDBA may be helpful in mitigating risk. In this regard, it may be useful to discuss with participants the potential risks of investing in a SDBA and costs associated with investments within a SDBA, provided that the provision of such information is coupled with an explanation of the respective responsibilities of the plan fiduciaries and participants regarding investment decisions.

Plan sponsors may consider using the PCRA Memorandum of Understanding as a guide for having such discussions with interested participants. The Memorandum of Understanding explains the general requirements and limitations for investing within the Schwab PCRA. The Memorandum of Understanding also describes the responsibilities of the parties and makes clear for the participant that the participant alone is responsible for evaluating and monitoring the participant's investment choices. Thus, using the PCRA Memorandum of Understanding as a guide, plan sponsors may mitigate risk by fully explaining the risks and responsibilities associated with investments within the PCRA.

Conclusion

SDBAs, including the PCRA offered by Charles Schwab & Co., can be a valuable service for plans that are interested in providing additional choice and options to plan participants. Plan fiduciaries offering SDBAs should be mindful of guidance issued by the courts and Department when making SDBAs available so to not take on unnecessary risk in making SDBAs available.

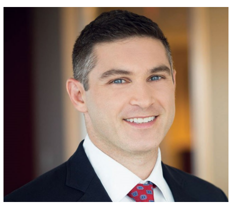
[17] *See* ERISA sections 3(21)(A)(ii) and 404(a).

GROOM LAW GROUP

Authors

Stephen M. Saxon and George M. Sepsakos are attorneys with the Groom Law Group, Chartered, a law firm focused on retirement, health and benefits.

Stephen M. Saxon works on a wide variety of administrative, litigative, and legislative matters involving tax-exempt organizations and ERISA. He specializes in matters relating to Title I of ERISA, with respect to which he has obtained scores of advisory opinions and exemptions. Stephen heads up the firm's special practice groups on pension plan investments and on 401(k) plan administrative and investment management matters. Among other things, these groups focus on the ERISA, securities, banking, and tax issues that arise in connection with the offering of products to employee benefit plans.



George M. Sepsakos represents clients on a broad range of ERISA, federal tax and securities law matters. His practice is primarily focused on issues related to Title I of ERISA, including fiduciary responsibility and prohibited transaction issues. He has worked on many DOL investigations of plans and financial institutions that provide services to plans.