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401(k) Plans

Is Your 401(k) Plan Singing with the Choir or Catering to Soloists?

As the Department of Labor ERISA Advisory Council has recently taken testimony on 401(k) plans using self-directed brokerage accounts (SDBAs) and issued a cryptocurrency "compliance assistance release" it may be time to review the use of SDBAs as part of the 401(k) investment platform.

By Michelle G. Murphy

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Over the holidays I was asked to sing with our very small and ad hoc church choir. I did a lot of performance singing throughout my school years (now many years ago) and particularly enjoyed chamber music with four- or six-part harmonies, but those opportunities dropped significantly after graduation. It was a delight to sing a couple of acapella songs in harmony with a small group again. Music written for a group singing together is very different from that for a soloist. For a soloist, the accompaniment, even though it may be intricate and grand, follows the singer and features the soloist's voice, whereas a piece for a choir is written for the voices and the interplay between voices and instruments is a critical part of the music in a different way. While I have sung a few solos, my joy was always the interplay with the other voices in a choir, particularly acapella with chamber music.

Four-Part Harmony

Last year the Advisory Council on Employee Welfare and Pension Benefit Plans, frequently referred to as the ERISA Advisory Council, invited testimony on the use of self-directed brokerage accounts (SDBAs) within retirement plans. My friend and colleague Shannon Edwards and I were honored to provide testimony about usage seen by third-party administrators (TPAs) of SDBAs within the small plan environment, usually under 100 participants. The title of the resulting report is Understanding Brokerage Windows in Self-Directed Retirement Plans. What we discovered is that even within the 401(k) plan industry, many people don't understand the difference between a brokerage window and a plan strictly using brokerage accounts as an investment platform, when they are two different things.

What the ERISA Advisory Council, and those working in the large plan arena, are accustomed to is a brokerage window being offered in conjunction with a standard investment platform. For example, the plan sponsor may choose on the Empower platform to offer their usual full line up of mutual funds and, for an additional fee, permit a plan participant to invest via an SDBA in which the participant manages their own selection of funds or investments. The investment platform will specify which brokerage house may be used (generally TD Ameritrade or Schwab) and the accounts are set up to trade via connection with the Empower investment platform. The plan sponsor sends all contributions to Empower and those related to a participant with the SDBA get forwarded to the appropriate place and traded within the SDBA. Empower has a feed that reports back transactions on a regular basis and the periodic reporting shows correctly the total contributions and updated earnings and market values. At year-end, the plan sponsor and/or TPA can pull reports that include all cash flows, gains and losses, and market values, including those occurring in the SDBA. The general process is similar among the investment platforms that provide a brokerage window option.

You may be familiar with musical works that use a descant. We hear them frequently in Christmas carols such as the last verse of Hark the Herald Angels Sing, where in addition to the regular choir parts the sopranos break out in a high, floating bit that goes above the music. Or you may be more familiar with the same approach used in the Rolling Stones song, *It's Just a Shot Away*, where the soprano toward the end is singing lyrically but above Mick Jagger and in a wonderful alteration of the melody that works perfectly with Jagger and the instruments. That's a descant.

Working with a brokerage window within an investment platform allows all the structure, notification, and participant verification that the investment platform has built into the system to be applied to online access, enrollments, fee notifications, and distributions, as well as built-in omnibus reporting. This process works quite well for the employer, the participant, and whomever is providing compliance and reporting. The choir of investment options is together and all doing their parts, and the SDBA is working along with the choir like a descant. It is with the choir of investment options, working differently but is still with the choir, and they are all part of the same piece.

Marching to the Beat of a Different Drummer

TPAs who cater to retirement plans for business entities that are prone to partnerships, for example medical, legal, or other professional partnerships, deal with a different type of arrangement. It is not unusual to find that each one of the owners already has a relationship with a different financial advisor for their personal financial wealth. Or perhaps the owners realize that they enjoy investment trading and have done it for years and don't want anyone else's advice, so they decide each person will maintain a SDBA registered in the name of the 401(k) with his or her advisor. There is no harmony. They will be lucky to have one of the owners agree to be the point person for the plan. If they have been wise, they have chosen a TPA who will agree to figure out the score and try to conduct, for this is a choir of soloists. Not infrequently, the owners may have at least one diva among them who insists that someone must pick out all of the green M&Ms from their backstage snacks or they won't participate in the production, or the equivalent form of individual investment treatment.

But can they really all have the lead? The answer is yes, with a caveat. They must establish a shared structure or form for their songs. All the things that are built into the investment platforms that work with retirement plans—notices, combined reporting, etc.—must be accommodated either through the individual brokerage account statements or through notices and statements that the TPA will provide. Additionally, unless every single employee is an owner, equivalent opportunities, benefits and advice must be offered to the rank-and-file employees.

Brokerage houses have not been in the practice of catering to small retirement plans using SDBAs, therefore there are quite a few things that must be accommodated outside of the regular financial statements provided for retirement plan investors. These include the following considerations regarding plan-level trust accounting, vesting information, fee disclosures, lifetime income illustrations, and addressing inexperienced investors.

Plan-Level Trust Accounting

Contributions frequently show on statements just as “Deposits,” not distinguished by source type, so there may be one deposit that represents employer contributions and employee pre-tax dollars. This must be tracked by someone, normally the TPA. If Roth contributions are involved, a separate source must be tracked to preserve taxable basis. Distributions typically are posted as “Withdrawal” and may not be distinguishable between withholding tax paid to the IRS or a rollover to another qualified plan or transfer to another brokerage account. The TPA will spend a good amount of time on the reconciliation of the various accounts in which each participant has investments.

Brokerage houses send paper statements to TPAs. While they provide electronic transactions to investment platforms and financial advisors for their platforms, there is not a universal way to provide that information to TPAs, therefore the majority of the time, the TPA must request duplicate copies, then open and scan copies when received, and reconcile 12 monthly statements in order to produce annual trust accounting, then repeat that process for each participant with an SDBA. This is a time-consuming process, and it is not unusual for a participant to open another account and forget to send duplicate statements to the TPA or trustee, which increases the complexity and time needed to correctly reconcile the plan accounting.

Vested Balances

Participants in 401(k) plans must receive an annual statement showing vested percentages. Although the participants are receiving quarterly or monthly brokerage statements reflecting their transactions and the market value of assets, brokerage statements don’t have vesting information, therefore a TPA must provide a statement reflecting the market value and vested value at least annually for distribution to participants.

Notices and Fee Disclosures

Plans are subject to a significant number of required disclosures. Brokerage statements don’t include any of the required notices regarding diversification or contribution formulas using integration or cross-tested formulas. Nor do they produce fee disclosure statements that include fees other than fees directly related to the brokerage account. The TPA typically provides disclosure notices and includes the language for other required notices either on annual statements which reflect vesting or in some other manner.

Lifetime Income Illustrations

The Department of Labor now requires, effective for reporting following September 18, 2021, that all 401(k) plans must provide at least annually, an illustration of how the participant’s ending market value will translate to a lifetime income stream based on a set of given factors. That is not going to be provided by a brokerage statement. Once again, if the plan is not using an investment platform that accommodates the Department of Labor and IRS requirements for retirement plans, the TPA typically fills the gap and will make provision to include these illustrations with the annual statements that reflect vesting and diversification information.

Inexperienced Investors

What happens to the employee or owner who is not an experienced investor, the new person right out of college who is making a living wage for the first time or the rank-and-file employee who struggles to make their budget every month? Does the 401(k) have a way to accommodate the employees who don’t have a favorite financial advisor or have a minimum amount to invest in the funds they might be interested in? Individual brokerage accounts may encounter mutual fund minimums or minimum to even open a separate account. The plan sponsor must be made aware of the fiduciary responsibility to provide the same opportunity and benefit to all eligible employees. Our recommendation to clients is that even if they don’t use a brokerage window, they should provide an investment platform that will allow their employees not interested in using an SDBA the ease of investing and opportunity for a base selection of investments. This is followed with a discussion about the employer paying fees outside of the plan for such an arrangement so as not to cause the possibly disproportionate expense to maintain the account with only smaller balances.

As this illustrates, there are a number of requirements that are not automatically met by brokerage accounts. Unless one owner is willing to be the conductor and establish the needed structure addressing these requirements, the individual owner-soloists need to hire a TPA to serve in that role.

The Grand Finale

As the Department of Labor called for better understanding of the use of SDBA accounts within 401(k) investing, some of the questions that they ask are related to the expense of these arrangements and who is paying for it. While their recommendation as a result of their investigation last fall was that no additional regulations needed to be imposed, there may be a need to clarify a certain standard of care, for example recommending that there be an investment platform with an investment advisor assigned as available for employees not making use of SDBA accounts.

The Department of Labor's Employee Benefits Security Administration (EBSA) is paying attention to investments and fiduciary responsibility, pushing the boundaries once again on what exactly a fiduciary should be monitoring. They recently issued a "compliance assistance release" regarding cryptocurrency, which resulted in a good bit of concern over whether the EBSA is changing tempo by dropping their historical hands-off approach to SDBA oversight.

Fiduciaries need to be aware that while using SDBAs to accommodate key employees' and owners' desires to maintain their own financial advisors and investment whims, there are still many regulations to be accommodated as well as watching out for their employees. And even though the trustees may all be soloists, they are going to need a pretty good TPA for accompaniment to ensure they are keeping time with regulations and requirements. Either that or join the choir and settle for doing a really good descant with a brokerage window. ■