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Commentary

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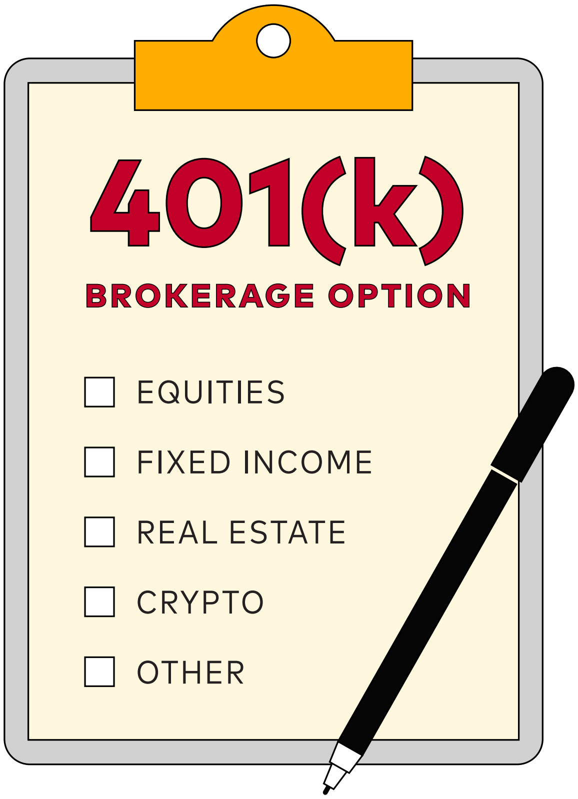
Determining the suitability of a brokerage option in a 401(k) plan

Over the last 40 years, 401(k) plans have experienced extraordinary growth. As the number of 401(k) plans has increased, they have evolved in structure and sophistication. Today, most employers consider 401(k) plans to be the retirement vehicle of choice. This evolution has increased demand on plan sponsors to offer greater investment flexibility and even greater sophistication. Some plan sponsors have responded by introducing a brokerage option to their plan's investment lineup.



A brokerage option (brokerage account option, brokerage window, self-directed brokerage option, or self-directed brokerage account) allows plan participants to invest beyond the plan's menu of investments. The brokerage option may be limited to allow investment in a wide range of mutual funds only or may also include individual stocks and bonds as well as exchange-traded funds.

A brokerage option is not appropriate for all plans. Plan sponsors need to understand and evaluate their participant population, including investment sophistication, as part of the process of deciding whether a brokerage option is appropriate. Furthermore, the inclusion of a brokerage option brings with it fiduciary considerations under the Employee Retirement Income Security Act (ERISA) of 1974. The applicable employer considerations and the relevant fiduciary requirements are discussed in this commentary to assist plan sponsors in determining whether a brokerage option is appropriate for their 401(k) plan.

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Plan design considerations

The purpose of a 401(k) plan is to provide a vehicle in which an employee can accumulate an adequate level of retirement financial security. In such a plan, an employee's account typically consists of the employee's elective deferrals, matching contributions made by the employer, often additional employer contributions in the form of profit-sharing contributions, and investment earnings on these amounts. With a 401(k) plan, as with all defined contribution plans, the employee assumes the investment risk, and their benefit is based solely on the value of the account balance. Good investment performance results in a larger account balance at retirement. On the other hand, less than optimal performance will result in a smaller account balance at retirement. The investment options offered in a 401(k) plan directly influence the likely retirement outcomes for plan participants—clearly illustrating the importance of designing an appropriate investment menu.

Most participants do not have the level of investment expertise to properly use a brokerage option. Nevertheless, a plan sponsor may receive pressure from a relatively small percentage of participants to add a brokerage option. These participants are typically highly paid and feel qualified to choose investments outside of the plan's menu of options. In response, the plan sponsor needs to step back and consider the benefits and risks of offering a brokerage option.

A benefit is that a brokerage option gives participants access to investment choices that would not otherwise be available in their plan. Furthermore, offering a brokerage option will satisfy participants who have been requesting it and believe they have the expertise to use it.

However, offering a brokerage option provides all participants—those with investment expertise and, importantly, those without it—with the ability to invest retirement money in investments outside those prudently chosen by the plan's fiduciaries.

Many participants lack the knowledge to make appropriate investment choices within a brokerage option, which can negatively impact their long-term investment results. Participants with a suboptimal level of expertise could squander their retirement savings by failing to properly diversify by investing in a single fund, industry, or stock. The availability of a brokerage option also raises the possibility of overtrading or even day trading, both to the detriment of long-term investment performance.

A brokerage option within a plan is considered a "benefit, right, or feature," subject to regulatory nondiscrimination rules. This nondiscrimination requirement prevents a plan from offering a brokerage option to only highly compensated employees or employees who have an account balance above a plan-determined threshold.

While a brokerage option may be an attractive choice for some plans, many sponsors choose to not add one, and in plans offering brokerage, only a very small number of participants utilize it.

In 2023, 21% of Vanguard full-service clients offered a brokerage option.[1] Larger plans are somewhat more likely to offer the feature.[2] Even in those plans offering a brokerage option, only about 1% of participants with such access used it.[3] The most striking difference between brokerage participants and all participants is their account balances.[4] Participants with higher account balances tend to utilize a brokerage option more than other participants.

[1] *How America Saves 2024*. Vanguard.

[2] According to *How America Saves 2024*, a brokerage option was found in 16% of plans with less than 500 participants; 19% of plans with between 500 and 999 participants; 24% of plans with between 1,000 and 4,999 participants; and 38% of plans with more than 5,000 participants.

[3] *How America Saves 2024*. Vanguard.

[4] *The Brokerage Option in DC Plans*. Vanguard, 2021.

Fiduciary considerations

Under ERISA, a plan fiduciary is charged with always acting in a prudent manner and solely in the best interests of plan participants. Plan fiduciaries must determine whether offering a brokerage option, and its structure, is consistent with ERISA fiduciary requirements.

For the average participant, the brokerage option may prove confusing, or, even worse, hazardous because of the access to nondiversified assets such as individual stocks and bonds.[5] Plan fiduciaries need to evaluate this risk as part of a careful and deliberate process.

If they decide to offer a brokerage option, plan fiduciaries must consider the qualifications, reputation, and expertise of the provider, as well as the quality of services provided and the reasonableness of fees. As with all investment options offered by the plan, fiduciaries have an ongoing duty to monitor the brokerage provider. Plan fiduciaries should look to determine whether any information about the provider has changed over time, confirm the provider has satisfied its contractual commitments, and conclude the fees being charged continue to be reasonable considering the quality of services provided.

> Once the decision is made to offer a brokerage option, clear and thorough communication and education are essential.[6] Participants need to be explicitly warned of the potential risks involved, including the risks of failing to diversify or excessive trading.

The Department of Labor (DOL) outlines that certain disclosures relative to the brokerage option be distributed to all eligible participants and those former employees with an account balance remaining in the plan. Eligible participants include those making elective deferrals as well as those who have chosen to not make elective deferrals. According to the DOL, the disclosures must provide information that enables participants to understand how the brokerage option works; an explanation of any fees and expenses that may be charged against their account; account balance requirements, if any; restrictions or limitations on trading, if any; how the brokerage option differs from the plan's designated investment alternatives; and whom to contact with questions.[7]

Plan fiduciaries often seek to mitigate the risks associated with a brokerage account by limiting the percentage of the participant's account that may be invested in the brokerage option. Another manner of risk mitigation is to limit the brokerage option to specific sources of money, such as only allowing the participant's elective deferrals to be invested within the brokerage option and/or limiting the brokerage options to include only mutual funds.[8]

Other considerations: Employer stock and cryptocurrency

Some employers may be tempted to add company stock to the brokerage option to offer additional flexibility to participants. Generally, however, employer stock is not an appropriate investment in a plan's brokerage account because of ongoing operational risks. This is because employer stock controls are weakened and recordkeepers cannot automatically support certain activity. These concerns include, but are not limited to (i) tracking and reporting on Section 16 insider trading activity, (ii) pass-through voting on general and/or hostile proxies, which impacts 404(c) protection, (iii) tracking company stock as a single line item on plan financial statements and for 5500 reporting, (iv) tracking the cost

[5] *Best Practices for Plan Fiduciaries*. Vanguard, 2018.

[6] *Best Practices for Plan Fiduciaries*. Vanguard, 2018.

[7] The U.S. Department of Labor's *Field Assistance Bulletin 2012-02R*, specifically the answer to Question 13. https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2012-02r.

[8] *Best Practices for Plan Fiduciaries*, Vanguard, 2018.

basis associated with the company stock fund,[9] and (v) added complexity to SEC filings related to employer securities.

Cryptocurrency, although a popular topic of broader investment discussions, is a questionable investment alternative in a plan's brokerage account. In 2022, the DOL issued Compliance Assistance Release No. 2022-01. In the release, the DOL cautioned plan fiduciaries to "exercise extreme care as they consider adding a cryptocurrency option to a 401(k) plan's investment menu." Furthermore, the DOL extended its warning to include concerns about allowing such cryptocurrency investments in a plan's brokerage window.

Vanguard has formally and publicly advised against speculating in Bitcoin and other cryptocurrencies, which are largely unregulated and accompanied by considerable risks. This general warning is even more relevant for retirement savings.

Conclusion

There is no one-size-fits-all brokerage option, and such options are not appropriate for all plans or all participants. Careful analysis and thought are required before offering one. Once the decision is made to include a brokerage option under the plan, a prudent procedural process to monitor the brokerage provider on an ongoing basis is required of the plan fiduciaries. As with all fiduciary considerations, the decisions and process followed need to be well documented.

[9] Unlike shares purchased by individuals privately outside of a retirement plan, where the cost basis of each share is determined at the time of purchase, the cost basis of shares acquired in the retirement plan is the average cost of shares acquired by the trustee on an ongoing basis.

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