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Fiduciary Focus: Risk of Self-Directed Brokerage Accounts in 401(k)s

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Those of you that are investment advisors to fiduciaries of 401(k) plans are probably familiar with what is referred to as a "self-directed brokerage account" (SDBA). A SDBA is also know as a "individually directed account," "personal brokerage account," "self-directed option," "self-directed brokerage option," "self-directed brokerage window," and "self-directed investment account."

Fiduciaries of 401(k) plans have the authority under the Employee Retirement Income Security Act (ERISA, the comprehensive federal law that governs the implementation and operation of 401(k) plans) to add a SDBA option to their plans. This option allows every participant in a self-directed 401(k) plan to open an individual brokerage account. Although a plan participant's SDBA is a separately designated account, it is still part of the participant's overall 401(k) account.

Although long permitted by ERISA law, SDBAs were not particularly popular until the bull market of the 1990s came along. Professional groups particularly seized on this seldom-used option. Suddenly, attorneys, doctors, engineers, architects, and accountants discovered that they could day-trade inside their own 401(k) retirement accounts. (While it's probable that many among these groups made some quick money through day-trading in their SDBAs on the way up, it is equally probable that they lost just as much, or more, money on the way back down. That's another story, though, not appropriate for telling in polite company.)

In a SDBA, a participant in a 401(k) plan has the ability to invest in virtually anything--apart from certain investments specifically forbidden by ERISA, such as options, futures, commodities, derivatives, and even municipal bonds. Nor can a participant in a SDBA sell short or margin his or her 401(k) account. In general, such participants cannot employ an investment strategy that will result in losing more than the total value of their account (i.e., a leveraging strategy).

Brokerage firms (and other vendors), of course, have been all too happy to peddle the SDBA option to fiduciaries of the 401(k) plans for these professional groups. Part of their sales pitch to fiduciaries is that they will incur less liability by offering a greater number of investment options to plan participants. The general counsel of a large brokerage house adds that a SDBA option enables fiduciaries to give plan participants more choices without the expense of due diligence, management, and recordkeeping for multiple funds.

So there you have it: The SDBA option is good for plan participants because they get to invest in virtually anything under the sun, it is good for plan fiduciaries because they get to reduce their liability and save money, and it is good for brokerage firms because they get to make more money.

That sure seems like a win-win-win situation. Things, unfortunately, are a bit more complicated than that.

Not so, of course, for brokerage firms. Their win is simple and secure because they most assuredly get to make more money since a SDBA allows them additional distribution channels.

What about the win for participants in SDBAs? Well, I have seen the SDBA accounts of far too many attorneys, doctors, and other professionals who not only have not won but have lost horribly--during one of the greatest bull markets on record.

And what about the win for fiduciaries of 401(k) plans that offer the SDBA option? Brokers contend that a SDBA option is good for plan fiduciaries because they incur less liability. That, in a nutshell, is simply false. Here's why.

When fiduciaries of 401(k) plans offer a SDBA option, a plan participant can establish a SDBA with his or her favorite broker either on a standalone basis or through a plan's master custodian.

Fiduciaries of 401(k) plans that offer a SDBA option are asking for trouble if they allow plan participants to establish a SDBA with their favorite brokers on a standalone basis, apart from a plan's master custodian. ERISA charges investment fiduciaries of 401(k) plans with the duty to make sure that their participants make prudent asset-allocation decisions for their plan accounts. How is it at all possible for plan fiduciaries to live up to that duty--not to mention the equally critical duty of monitoring such asset allocations to ensure that they remain prudent--if the fiduciaries don't have any idea what SDBA participants have invested in?

It isn't even close to being a fair fight: A few fiduciaries of a 401(k) plan up against 30 attorneys in a law firm or 20 doctors in a medical practice with each professional having his or her own broker, together cooking up unimaginable investment schemes. It's a lot worse than herding cats. And don't forget, plan fiduciaries aren't investment fiduciary pros; they're simply other attorneys in a law firm or other doctors in a medical practice incurring, according to ERISA, personal liability that in some cases can be virtually unlimited. ("Hey, doc, I know that you say that your partners will never sue you for imprudent investment conduct in your role as a plan fiduciary, but what about the newest partner's wife who hates you and is now filing for divorce and wants 50% of her husband's 401(k) plan, which she is now charging you with having managed imprudently?")

The second way that a participant in a 401(k) plan can establish a SDBA with a favorite broker is through the plan's master custodian. The ideal master custodian (who also serves as the plan's record-keeper) must be able to accomplish the goals of the plan set by its fiduciaries. One of the most important of these goals is to fulfill the oversight duty of plan fiduciaries by providing them with accurate and readily accessible information. This involves a trading platform that processes trades efficiently and affords accurate record-keeping.

The ideal master custodian is also an effective gatekeeper. Such a custodian will crosscheck the investment traded through the SDBA against the permitted investment options listed in the 401(k) plan's investment policy statement to make certain that the trade is permitted. A truly valuable master custodian will maintain the integrity of the investment options allowed by the 401(k) plan by allowing only those investments within a SDBA.

This proactive approach to investigating each trade made through a SDBA helps to ensure that the

trade is in conformance with plan documents--not to mention rules set by the IRS and Department of Labor. The immediate benefit is to keep a plan participant from going off the deep end and investing in, say, ATM machines, raw land in Bolivia, a complete mint set of *MAD* magazine, or gold doubloons. Another benefit is that the fiduciaries of a 401(k) plan get to step back and be the "good cop" to the "bad cop" of the master custodian, who will forbid such investment trades because they're not allowed under plan documents or ERISA and because, well, they're just plain nutty investments.

It's easy to understand why uninformed fiduciaries of 401(k) plans for professional groups give in to their fellow attorneys or doctors and allow them as plan participants to establish a SDBA with their favorite broker on a standalone basis. But it's difficult to understand why fiduciaries who understand the risk they run--exposing themselves to virtually unlimited personal liability--would do so.

Nor should truly knowledgeable fiduciaries allow a SDBA to be established through a plan's master custodian. The simple reason: costs. The typical SDBA held by a professional such as a doctor or attorney is worth hundreds of thousands of dollars. But the typical 401(k) plan--apart from the value of the SDBAs--is worth millions of dollars. This means that a SDBA pays retail prices on its investments, while a 401(k) plan pays (or should pay) institutional prices.

By offering a 401(k) plan without a SDBA option, fiduciaries do their plan beneficiaries a favor by requiring them to invest in the core menu of plan investment options that bears institutional costs rather than giving participants a SDBA that bears much higher retail costs. Even a differential of 50 basis points in costs when applied to the large lump sums of money earned by professionals over their working lives can result in huge differences in accumulated wealth. (Professionals such as doctors and attorneys who are plan participants, in turn, can do their partner fiduciaries a favor, too, by avoiding nutty investments so that they aren't placed at risk unnecessarily. These participants can invest in such investments on their own, outside a retirement plan.)

Going without a SDBA option, plan fiduciaries also do themselves a favor by fulfilling one of the most important fiduciary duties they have under ERISA: permitting a 401(k) plan to incur only reasonable investment costs. How is it reasonable for plan fiduciaries to allow participants to burden themselves with retail costs when they should be incurring only institutional costs?

In responding to the desire of attorneys, doctors, engineers, architects, accountants, and other professional groups during the bull market of the 1990s to increase the investment options available to them in a 401(k) milieu, brokerage houses have come to control a game whose rules they say they're not required--and, indeed, outright refuse--to follow. These rules have to do with fiduciary investment standards.

Brokerages, by the very terms of the contracts their legal departments draft, eschew any sort of obligation to live up to fiduciary investment standards. Indeed, when such firms are confronted, particularly in legal pleadings, with evidence of their wrongdoing, they invariably point right back at the plan sponsor, and plead that, after all, the sponsor is the only fiduciary in this game.

That defense is the very antithesis of what it means to be a fiduciary: putting the interests of your beneficiary ahead of your own. This is yet another example where (self-alleged) non-fiduciaries (brokers, in this case) have set the rules of the game to the detriment of those that must actually follow those rules: fiduciaries (sponsors of 401(k) plans, in this case). Plan fiduciaries that allow

themselves to be controlled by these rules do so at the risk of their own personal net worth.

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