Is It Prudent to Offer Brokerage Accounts to 401(k) Participants?

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In a previous column, we discussed ERISA 404(c) protection where plans offer participants the choice of a brokerage account.

As we pointed out in that column, when the fiduciaries limit the investment options to a finite number—whether it is 3 or 300—those options are "designated" and, as a result, they must be prudently selected, periodically monitored and removed from the plan if they are no longer prudent and suitable for the participants. However, when a plan offers all the investments that are "administratively feasible," those investment options are not considered to be designated (which we have labeled "nondesignated") and, as a result, the specific investments do not need to be prudently selected and monitored. If a plan offers both designated and nondesignated investments, though, the plan's investment fiduciaries (that is, the decision-makers) must prudently select, monitor and remove the designated options.

For most 401(k) plans, a brokerage account is the medium for offering the widest range of investments which are administratively feasible. At first blush, participant-directed brokerage accounts are attractive because they offer two advantages: the individual investments do not need to be prudently selected and monitored and, if the 20 or so 404(c) requirements are met, the fiduciaries are not responsible for the investment allocation decisions of the participants.

However, there is more risk to directed brokerage accounts than meets the eye. ERISA imposes an overriding responsibility on plan fiduciaries to act prudently and for the exclusive purpose of providing benefits for participants. A plausible interpretation of that general requirement is that plan fiduciaries must decide whether it is prudent to offer brokerage accounts to participants. (In informal discussions, DOL officials have opined that fiduciaries must consider the nature of the workforce in selecting 401(k) investments.) That is, do the participants have the education, experience and ability to make intelligent buy-and-sell decisions about individual stocks. If not, it could be a breach of fiduciary duty to offer brokerage accounts in a 401(k) plan.

As a further complication, if the plan fiduciaries attempt to minimize the risk by limiting the availability of the brokerage accounts—based on factors such as a participant's investment experience, the account size, and so on—the plan runs a risk of violating the tax-qualification rules prohibiting discrimination in favor of highly compensated employees.

As a result, 401(k) brokerage accounts should be approached with caution. Among the issues that the plan fiduciaries should consider in deciding whether to offer that option are: the investment sophistication of the workforce; the scope and effectiveness of the investment education programs; whether investment advice is made available to the participants; and the communication needed to inform the participants of the risks.

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