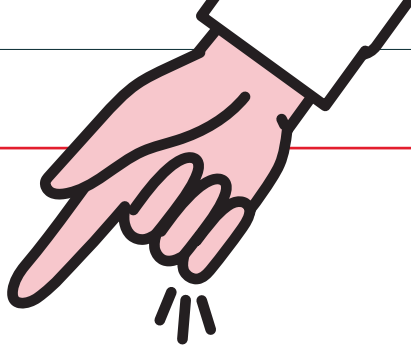


An illustration featuring a hand holding a document. The hand is rendered in a light pink color with black outlines. The document is white with a spiral binding on the left side. The background consists of several diagonal stripes in red and light blue. Two large red arrows point from the top-left towards the bottom-right, overlapping the stripes. The text 'Considerations for offering a brokerage account to retirement plan participants.' is written in white, sans-serif font across the upper portion of the top arrow.

Considerations for offering a
brokerage account to retirement
plan participants.

Sheets Smith Wealth Management Marketing Commentary Disclaimer:

Sheets Smith Wealth Management, Inc. ("Sheets Smith") offers investment advisory services and is registered with the U.S. Securities and Exchange Commission ("SEC"). SEC registration does not constitute an endorsement of the advisory firm by any regulatory authority, nor does it indicate that the advisory firm has attained a particular level of skill or ability. All content available in this publication is general in nature, not directed or tailored to any particular person, and is for informational purposes only. Neither this publication nor any of its content is offered as investment advice and should not be deemed as investment advice or a recommendation to purchase or sell any specific security. The information contained herein reflects the opinions and projections of Sheets Smith as of the date hereof, which are subject to change without notice at any time. Sheets Smith does not represent that any opinion or projection will be realized. The information contained herein has been obtained from sources considered reliable, but neither Sheets Smith nor any of its managers, officers, advisers, employees, agents, or affiliates represents that any third party information presented in this publication is accurate, current, or complete, and such information is subject to change without notice. The information contained in this publication does not purport to be a complete description of the securities, markets, or developments referred to in this material. Any performance information must be considered in conjunction with applicable disclosures. Past performance is not a guarantee of future results. Neither this publication nor its contents should be construed as legal, tax, or other advice. Individuals are urged to consult with their own tax or legal advisors before entering into any advisory contract. Any investment is subject to risks, including the possible loss of principal. Individual investor's results will vary. Investing involves risk, and you may incur a profit or loss, including the entire loss of investment.



A “Self-Directed Brokerage Account” (SDBA) is a special type of brokerage account that a defined contribution plan like a 401(k) or 403(b) plan may adopt for the use of its participants to direct their investments toward publicly traded securities available on the brokerage platform selected for the plan. A SDBA feature is also commonly referred to as a “brokerage window” or an “Individually Directed Account” (IDA).

OVERVIEW

Benefits

The primary benefit of this account is that it enables the investor (plan participant) to select their investments and customize their portfolio to meet their unique goals and preferences from a nearly unlimited set of investments (separate and apart from the plan provided menu of core investment options, known as “Designated Investment Alternatives” (DIA) – typically mutual funds, exchange-traded funds (ETF), or Collective Investment Trusts (CIT)).

Another frequently cited benefit is the ability to conform investor preferences into a portfolio (i.e. ESG or sustainability, religious convictions, climate-aware investment preferences, etc.).

In addition, plan participants with deep subject matter expertise in a particular area can leverage their specialized knowledge by selecting investments most suited to their professional or other skill set in order to pursue their overall retirement goals.

Lastly, a SDBA can be utilized when working with a third-party investment professional, such as a Registered Investment Advisor (RIA) firm. These firms will typically construct a variety of “model” portfolios which can be implemented, monitored, and updated as needed based on the model selected by the participant.

Background & Growth

In 1978, reforms adopted in the IRS code led to the development of the 401(k) plan. The first plan was implemented in 1980 by Ted Benna of the Johnson Companies. Brokerage windows were introduced shortly thereafter.

For mass market providers, Charles Schwab and Fidelity Investments were early adopters, launching their “Personal Choice Retirement Account” (PCRA) and “Brokerage Link” respectively in 1994. Schwab is now the market leader by asset size in this space, followed by Fidelity.

Regulatory Provisions

Surprisingly, the first guidance on what constitutes a brokerage window was not issued until 2010. The Department of Labor (DOL) directed certain disclosures under ERISA Section 404(a) which defined a DIA and defined a brokerage window by EXCLUDING it from the definition of a DIA, stating that a brokerage window “enables participants and beneficiaries to select investments beyond those designated by the plan”.

Shortly thereafter, *Field Assistance Bulletin (FAB) 2012-02* was issued, which caused confusion as it raised the issue of the potential need for “affirmative obligation” to treat an investment obtained through a brokerage window as a DIA if certain thresholds were met (one percent of all participants choosing the same non-DIA investment, for instance). Very quickly, the DOL reversed course by issuing *FAB 2012-02R*.

Since then, the only published guidance has been a December 2021 report to the DOL issued by the Advisory Council on Employee Welfare and Pension Benefit Plans (“Understanding Brokerage Windows in Self-Directed Retirement Plans”). The gist of the report was that existing regulations were working fine.

The only area of concern noted was regarding plans that offered ONLY a brokerage window. These plans have no DIA menu and offer only a SDBA for participant

investments. They are typically used by small plans because they cost less than fully bundled plans. The report noted that inexperienced investors may have a “sub-optimal experience,” while further noting that they may not have access to features found in a typical institutional quality plan like loans, auto-enrollment, and auto deferral increases.

Current Utilization

According to PSCA's most recent survey, 26 percent of plans have a brokerage window, with higher adoption among larger plans.

Percentage of Plans That Offer a Brokerage Window

Plan Size by Number of Participants	Percentage of Plans
1-49	19.0%
50-199	11.9%
200-999	21.2%
1,000-4,999	34.4%
5,000+	45.2%
All Plans	26.1%

Data from other studies also confirm that larger plans are more likely to offer a SDBA.

CONSIDERATIONS BEFORE ADDING A SDBA

Compatibility with Recordkeeping System

Any consideration of a brokerage window must be coordinated with a plan's recordkeeper, whose systems must be able to accommodate data feeds from brokerage accounts. Larger SDBA providers like Fidelity and Schwab have nearly unlimited compatibility with recordkeeping systems. Smaller to mid-tier providers may lack the same integration.

Brokerage windows offered by organizations with investment banking operations (Morgan Stanley, Merrill Lynch etc.) are technically "introducing broker/dealers" (IBD) who use a clearing firm like Pershing to settle trades and handle all activity. These IBDs have specialized data needs related to compliance with SEC and FINRA rules and "levelized compensation," and some data restrictions may apply. Asking your current recordkeeper which SDBA providers are approved on their platform is a good starting place.

Cost Analysis

Like any brokerage account, the participant will have to bear any trading costs and other fees/costs associated with providing a brokerage window. A careful

review and comparison of the standard fee schedule for each SDBA under consideration is a crucial initial task.

The fee schedule will disclose any commissions to trade stocks or ETFs, mutual funds, option trades etc. Note that plans which authorize investing using individual bonds (U.S. Treasury securities, corporate bonds, etc.) should pay close attention to the fee schedules for bond trading, especially when the bond dealer is acting as "Principal" rather than "Agent." Is the mark-up when acting as Principal disclosed to the buyer?

Establishing A Plan's Trading Menu

Any SDBA operates within a "restricted framework" due to the plan sponsor's obligation to define what investments are and are not allowed in their plan. Every SDBA agreement will contain a "Plan Trading Menu Establishment" document which lists the variety of trading restrictions that can be imposed.

For example, Schwab's PCRA agreement states that "PCRA may not include trading on collectibles, currencies, precious metals, real estate, futures, commodities, private placements, margin accounts, or short sales." (But the agreement notes these blanket exclusions do not apply to mutual funds or ETFs that use these instruments.)

At one end of the spectrum, to provide full and unlimited access to all publicly

traded securities for participants, a plan sponsor may choose "Open Brokerage" (no restrictions). However, it is common (and probably prudent) to prohibit investments in some types of securities, such as purchasing funds offering "leveraged" or "inverse leveraged" strategies, typically found in certain ETF offerings which aim to deliver "magnified" index returns.

Another common exclusion is to prohibit trading in "OTC Pink Sheets/Gray Sheets/Bulletin Board" stocks, which are considered speculative, as well as prohibiting investments in exchange listed limited partnerships that produce a Form K-1. Initial Public Offerings (IPO) are another area that may be "gated" (for those SDBAs operated by investment banking franchises who underwrite IPOs).

Mutual Funds

Great care must also be used when examining the plethora of mutual fund share classes offered. Institutionally priced "retirement" share classes (R, R3, R6 etc.) may or may not be offered in an SDBA, so be sure to find out. If not, participants will pay higher costs (operating expense ratios) levied by retail priced share classes. Some retail share classes also charge an additional "12(b)1 fee" (usually 25 basis points).

What "NTF" ("no transaction fee" funds) are offered (usually through a pre-approved mutual fund marketplace like Schwab's One Source)? If a fund is not an NTF, what is the fee to transact? Finally, how does the SDBA handle funds with sales charges or redemption fees?

Asset Class or Security Exclusions

A plan sponsor may also exclude specific asset class/group or individual security (CUSIP/symbol level) restrictions on the application via "Plan Trading Menu Establishment" parameters, including investing in company stock and options (if publicly traded).

Note that cryptocurrencies present a special challenge after the SEC approved the use of them via ETFs in January of 2024 (thus making them eligible for purchase in any SDBA allowing ETF trading). While some consider them a highly speculative asset suitable only as a short-term trading vehicle, others view them as a long-term store of value. If a plan sponsor excludes these assets, can a participant claim they have been harmed?

Risks

This highlights a broader question: how does the obligation to act as a fiduciary extend to the plan sponsor's decisions when establishing the plan's trading menu (i.e., excluding or omitting certain asset classes or individual securities)? (If a (3)(38) Investment Manager is a plan fiduciary, the same question can apply.) This is an important item which should be reviewed with a plan's legal counsel.

Hold Harmless Agreements

For the participant, SDBA providers have developed standard but extensive risk disclosures/agreements that a participant must review and sign before a SDBA is opened in their name.

Some plan sponsors find this agreement to be sufficient as a “hold harmless” defense, while others utilize a separate “acknowledgement” of the special risks inherent in self-management of a brokerage account that a participant is required to sign (a “hold harmless” letter). Overall, the idea is that a special level of care must be exercised and is assumed by any participant who chooses to select their own investments/strategy.

Restricted Investment Lists

Plan sponsors whose companies (consulting, investment banking etc.) provide advice to publicly traded companies will typically restrict their employees from investing in securities of their clients via a “Restricted List.” Most SDBA platforms have well-established methods for complying with these restrictions, so be sure to examine these closely if your company has a “Restricted List” for employees.

CONSIDERATIONS FOR ILLIQUID AND NEW ASSET CLASSES IN THE SDBA

Finally, there has been considerable talk and interest around adding illiquid asset classes like Private Equity (PE) and Private Credit (PC) to 401(k) plans as investment alternatives, as well as “hedge funds.” Similarly, relatively new asset classes like “cryptocurrencies” or “digital assets” etc. have also generated interest.

At its core, the reason for adding these new illiquid assets is to generate potentially higher returns for participants. As an example, the long-term historical return premium for PE vs. small, mid, or large-cap US stocks ranges from +3 to +6 percent (depending on the index provider). The case can also be made that PE serves as an effective equity diversifier.

Regulations Around Private Equity

Currently, direct investments in PE are only available to “Accredited Investors” (AI) or “Qualified Purchasers” (QP) as defined by the SEC. The former must have an investment portfolio worth \$1 million or more AND an annual income of \$200,000 or more for the last two tax years. The latter must have an investment portfolio of more than \$5,000,000. Both are considered to have the financial acumen needed to invest in and bear the risk of complex and unregulated investments.

Clearly very few plan participants would meet these high thresholds, and most would be considered relatively unsophisticated investors, so the current discussion around PE is in effect an attempt to figure out how to “democratize” access to PE by small investors. The practical solution is to offer these

“alternative strategies” as part of a managed investment strategy, such as a CIT or Target Date Fund (TDF).

Interval Funds

Note that the investment industry for several years has been offering illiquid investments (PE, PC, and private real estate) via a special type of mutual fund called an “interval fund.” These funds do not offer daily liquidity. Instead, they generally offer only quarterly liquidity via a “tender offer” structure. The tender offer is used to “gate” redemptions to a manageable level in the event of mass redemptions flooding the fund sponsor at an inopportune time.

Even though many interval funds now have minimums as low as \$25,000 to invest, (making it eminently reasonable to include PE in an overall asset allocation), SDBAs do not permit the use of this vehicle due to its lack of daily liquidity and onerous documentation process.

Potential Solutions

A natural solution for the inclusion of PE in a 401(k) plan is via a TDF. Just as some ETF providers now include annuity (lifetime income) allocations within their TDF series, it is possible to extend the equity allocations beyond public markets to private markets with direct subscriptions by the TDF to the PE fund sponsor. TDF managers have the research capability to select appropriate PE investments, conduct

ongoing due diligence, and make appropriate disclosures to fund investors.

Similarly, sophisticated investment managers (including ERISA 3(38) investment managers retained by the plan) can manage or advise on a CIT utilized by a plan. Large plans commonly can access these customized vehicles per their status as “Qualified Institutional Buyers” (QIB) (\$100 million in plan assets) or as a “Qualified Purchaser” (QP) (\$25 million in assets). CITs in general have less of a regulatory burden than mutual funds and ETFs and may be better positioned to include direct PE investments as part of their strategies.

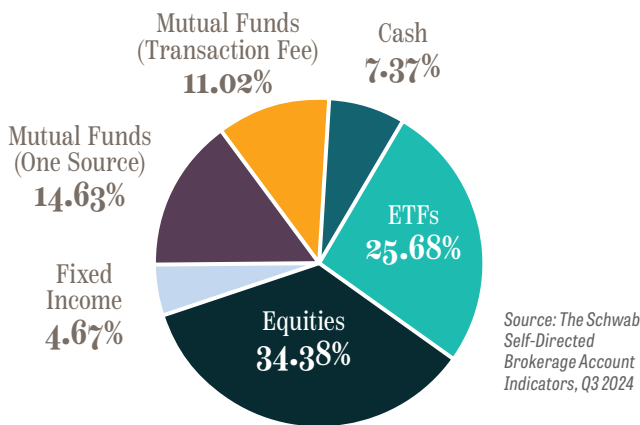
Special Requests

Finally, plan sponsors must also wrestle with special requests from participants to include newer “flavor of the month” investments (cryptocurrencies come to mind). Having written guidelines in the plan’s Investment Policy Statement (IPS) can help to provide firm guidance for these requests.

EVALUATING THE SDBA

Each quarter, Schwab publishes a comprehensive review and analysis (“The Schwab Self-Directed Brokerage Account Indicators”) of all PCRA’s on their platform, which can be found here. (<https://workplacefinancialservices.schwab.com/resources-events/sdba-indicators>)

Schwab's latest report (Q3, 2024 report) revealed some notable metrics. Individual stocks (equities) made up the largest investment type at 34.4 percent, with mutual funds second at 27.9 percent. ETFs were the third largest at 25.7 percent but have seen the largest increase over the last year (consistent with broad market experience of the rise of ETFs vs. mutual funds). Cash stood at 7.4 percent and Fixed Income at 4.7 percent. (Note that this is not an asset allocation summary as both mutual funds and ETFs can hold any manner of equity, fixed income/other security type).



Interestingly, the top equity holdings mirror the technology-centric growth and investor preference for technology.

Equity Holding	Percentage
APPLE INC	10.92%
NVIDIA CORP	10.40%
TESLA INC	6.11%
AMAZON.COM INC	4.77%
MICROSOFT CORP	3.80%
BERKSHIRE HATHAWAY CLASS B	2.27%
META PLATFORMS INC CLASS A	2.02%
ALPHABET INC CLASS A	1.62%
MICROSTRATEGY INC CLASS A	1.22%
ALPHABET INC CLASS C	1.18%

Source: The Schwab Self-Directed Brokerage Account Indicators, Q3 2024

Similarly, the top mutual fund holdings are index funds, reflecting again the overall market direction and preferences of investors.

Mutual Fund Holding	Percentage
SCHWAB S&P 500 INDEX	7.23%
SCHWAB TOTAL STOCK MARKET INDEX	2.98%
VANGUARD 500 INDEX ADMIRAL	2.24%
VANGUARD TOTAL STOCK MKT IDX ADM	1.92%
PFG AMERICAN FUNDS GROWTH STRATEGY R	1.05%
SCHWAB INTERNATIONAL INDEX	0.93%
PIMCO INCOME INSTL	0.86%
SCHWAB US AGGREGATE BOND INDEX	0.86%
FIDELITY CONTRAFUND	0.66%
SCHWAB SMALL CAP INDEX	0.62%

Source: The Schwab Self-Directed Brokerage Account Indicators, Q3 2024

SDBAs provide DC plan participants with significant flexibility in customizing their investment portfolios. There is an added level of effort involved for both the plan sponsor and participant to select the plan trading menu and implement the investment strategy. The plan sponsor's fiduciary standard of care must be considered in all actions. With proper due diligence and good records, a plan sponsor can offer a robust SDBA that enhances the participant experience.

Robert E. "Emery" Pike, CFA, AIF, is a member of PSCA's Investment Committee and is a Senior Advisor at Sheets Smith Wealth Management Inc. John Doyle, Senior Vice President of Capital Group and a member PSCA's Investment committee contributed to this article.