Self-Directed Brokerage Accounts Expand Fiduciary Liability

By Sheldon M. Geller

Participant-directed 401(k) plan investment has expanded from an investment menu to include a self-directed brokerage account option. Service providers market these accounts to provide participants access to a large universe of mutual funds, stable value portfolios, and individual securities. Nevertheless, these self-directed accounts customarily include higher share class expense funds available to retail investors than those that have been negotiated by the plan sponsor or advisor for the plan's investment fund menu. 401(k) plans, however, generally include larger pools of assets than that held in the average retail investor's account. Stewards of larger pools of assets are required to secure lower expenses and monitor fund performance on behalf of their beneficiaries and participants.

Fund Selection and Retention Duties

The distinction between personal investments and 401(k) account investments is that 401(k) accounts receive favorable tax treatment and consequently are subject to rules, including the need to minimize the risk of large investment losses, the requirement to use plan assets to pay reasonable fees, and the duty to monitor fund performance. Plan fiduciaries have an obligation to prudently select the investment vehicles made available to participants. They also have the residual obligation to periodically evaluate the performance of these investment vehicles to determine whether they should continue to be offered as participant-directed options.

It is unclear whether a plan sponsor has an obligation to monitor all of the investment vehicles in the very large universe made available in a self-directed account. It is also unlikely, however, that a plan sponsor would not be subject to federal pension law's prudent fund selection and retention duties with respect to the mutual funds made available in such an account. Furthermore, if a plan's investment policy statement scope specifically excluded self-directed accounts, it would not mitigate the plan sponsor's duties of loyalty and prudence relating to fund selection and retention.

Restoring Plan Losses

Federal pension law entitles a participant to restoration of losses resulting from a fiduciary's breach in duty, arguably including the failure to monitor self-directed account offerings. A fiduciary in breach may also be required to pay a monetary sanction equal to 20% of the loss.

A claim would allege that the plan sponsor used plan assets to pay unreasonable compensation as it offered the self-directed brokerage account option. Plan sponsors are plan fiduciaries and determine which investments are made available, including whether to offer self-directed brokerage accounts and automated investment advice services.

A 401(k) lawsuit targeting investment advice and self-directed brokerage accounts was recently brought against Fidelity Management Trust Company (Fidelity) based on the premise that Fidelity is a plan fiduciary because it selects which share classes are made available in the self-directed accounts, thus exercising discretion over plan asset investment (*Fleming v. Fidelity Management Trust Co. et al*, D. Mass., No. 1:16-cv-10918). The lawsuit alleges that Fidelity breached its fiduciary duties by receiving unreasonable compensation from the higher-expense mutual funds it made available through self-directed brokerage accounts at the expense of plan participants. It further alleges that retail classes of shares were offered when institutional shares existed for the same funds and that self-directed accounts constitute one institutional account. The lawsuit asks the court to order the defendants to restore the plan for the losses caused by the alleged breach.

If the court does not deem Fidelity a fiduciary, then the case will not be successful. A credible claim could be brought, however, against in-house plan fiduciaries in connection with the share classes made available in the self-directed accounts.

Plan Sponsor as Responsible Fiduciary

In a similar case, Merrill Lynch was found to not have acted as a fiduciary by offering a roster of mutual funds from which a plan sponsor could choose (Walker v. Merrill Lynch & Co. Inc. et al., S.D. N.Y., No. 1:15-cv-01959). The court determined that the plan sponsor had the final say and thus made the decision whether to offer certain mutual funds and share classes, notwithstanding discussions and negotiations with Merrill Lynch. Accordingly, the plan sponsor was the responsible fiduciary and thus ultimately liable for offering the proper share class and using

revenue generated on plan investment to pay reasonable fees.

Federal pension law holds plan sponsors and their in-house fiduciaries, rather than 401(k) plan vendors, responsible for determining reasonable plan cost and quality of plan services. Vendors have an informational advantage over plan fiduciaries and thus are able to conceal conflicts of interest and charge excessive fees. These conflicts and fees create significant liability for in-house plan fiduciaries.

Fiduciary Breach Lawsuit Settlements

A law firm brought one excessive fee case to full trial, whereas it has secured nine excessive fee case settlements. Most fiduciary breach lawsuits, however, end in settlement, with no clearance of wrongdoing. This gives future plaintiff's attorneys leverage to secure settlements from similarly situated plan sponsors offering self-directed brokerage accounts and computerized investment advice. These lawsuits could have been defended more effectively and monetary settlements avoided had a documented monitoring process been in place to demonstrate reasonable fee arrangements and proper share class/fund selection and retention.

Plan sponsors and their investment advisors need to understand all facets of their 401(k) platforms and the service providers used to support their 401(k) plans. All fees, expenses, and markups paid with plan assets need to be disclosed, and there must be fair value provided for each service. Plan sponsors should trade in their high-cost retail fund shares for low-cost institutional share classes. Plan sponsors do not necessarily have to trade in their publicly traded mutual funds for lower-cost collective investment trusts and their actively managed mutual funds for lower-cost index funds. Mutual funds provide regulatory protections under the Investment Company Act of 1940, and actively managed funds provide added performance in many asset categories.

Plan fiduciaries are given the benefit of the doubt when they apply best practices and document their monitoring process to select service providers, share classes, and funds, replace poorly performing funds, and negotiate reasonable fees paid with plan assets. ❑

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