
INDIVIDUALLY DIRECTED ACCOUNTS IN DEFINED CONTRIBUTION PLANS

RECENT TRENDS IN RETIREMENT PLANS

Preference for Defined Contribution Plans

Over the past decade, retirement plan sponsors have placed increasing emphasis on defined contribution programs, particularly 401(k) plans, while de-emphasizing the role played by traditional defined benefit plans. Between 1984 and 1993, the percentage of employers offering defined contribution plans increased from 68% to 88% while the percentage of employers offering defined benefit plans decreased from 24% to 9%. Over the same time period, the percentage of employers offering both defined contribution and defined benefit plans decreased from 8% to 3%. Between 1986 and 1996, the number of active participants in 401(k) plans increased from 8.6 million employees to 20.8 million employees, while 401(k) plan assets grew from \$155 billion to \$690 billion over this period.

More Fund Choices

Coincident with the trend toward defined contribution arrangements has been a trend towards offering plan participants greater flexibility in investment choices offered through retirement plans. By 1995, 74% of plan sponsors offered five or more investment options to employees. Between 1985 and 1995, the average 401(k) account balance more than doubled, growing from \$31,246 to \$65,294. As 401(k) accounts grow larger, plan participants tend to express greater interest in how their funds are invested, and seek more investment choices to bring greater diversification into their 401(k) portfolio. Anecdotal evidence indicates that many employers regularly receive employee requests and suggestions for specific 401(k) fund choices. But despite employees' increasing interest in participating in the plan's fund selection process, responsibility (and concurrent fiduciary liability) for selecting appropriate investment funds remains with the plan sponsor.

Influence of ERISA Section 404(c)

In October, 1992, the Department of Labor (DOL) issued final regulations under Section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA). The 404(c) rules limit the liability of plan fiduciaries for investment decisions made by plan participants. But the protection afforded by the new rules merely shields fiduciaries from claims that the participant made poor selections from the available fund menu; fiduciaries continue to be liable if the plan's menu includes demonstrably imprudent offerings. Thus the 404(c) rules represent somewhat of a conundrum for many plan sponsors. Since plan participants have responsibility for investment decisions, they clamor (not unreasonably) for addi-

tional investment choices. However, since the plan sponsor retains responsibility for designing the investment menu, the plan sponsor seeks to restrict menu choices to a sub-set of funds that can be defended as reasonable and appropriate selections.

Emergence of the "Invest-in-the-World" Approach

Faced with this 404(c) compliance conundrum, many plan sponsors prefer to duck the issue entirely. This became possible with the emergence of the "Invest-in-the-World" (also known as individually directed accounts, or IDAs) approach. Various 401(k) plan service providers offer the apparently ideal solution—individual brokerage accounts for each plan participant. Participants have the opportunity to choose whatever investments they prefer. The plan sponsor bears no liability for investment selection, since no funds are selected or otherwise endorsed. The "Invest-in-the-World" approach has been particularly popular with professional practices, such as law firms and medical groups, which tend to be operated by owner-employees with strongly held and often conflicting opinions regarding the most appropriate investments for the organization's retirement program.

INDIVIDUALLY DIRECTED ACCOUNTS MAY INTRODUCE UNEXPECTED PITFALLS

Unfortunately for the plan sponsor, an IDA structure has the potential to introduce numerous new administrative and operational problems. Most of these problems stem from the brokerage account structure used to support the plan's investment arrangements. As part of the desired investment flexibility implicit in an "Invest-in-the-World" arrangement, many plan sponsors permit participants to custody their accounts with any broker and/or brokerage firm that the participant may select. Not only does this approach tend to fragment plan assets, depriving participants of the opportunity to benefit from economies of investment scale, and complicating the plan's aggregate reporting functions, but it tends to confound the employer's ability to provide necessary oversight functions. A plan with an IDA structure may suffer from:

- Delayed and/or inaccurate reporting functions;
- Poor understanding and acceptance by many plan participants;
- Increased administrative and investment costs; and
- Increased liability for the plan sponsor and other designated fiduciaries.

As a practical consideration, it is virtually impossible for plan fiduciaries to supervise assets held in brokerage accounts at numerous broker dealers... However, if (an impermissible) transaction were executed, the plan sponsor and other fiduciaries (not necessarily including the brokerage firm) would be liable.

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Reporting Problems

Over the past decade, the investment management industry, including the sector specializing in supporting qualified retirement plans, has made enormous investments in systems and technology designed to streamline the investment reporting process. As the number and type of investments proliferate, the systems designed to capture accurate and timely transaction, price and position records have become increasingly sophisticated. However, they have also become increasingly proprietary. Fidelity's systems are different from Merrill Lynch's systems, which, in turn, are different from Schwab's systems. For a plan permitting IDAs at multiple brokerage firms to consolidate reporting functions effectively requires a reliance on a particularly low tech solution—keypunch of hard copy statements. In a larger plan, one or more brokerage statements will invariably be lost or delayed. Since plan level reports cannot be completed until all the statements are received, reconciled and input, it's not surprising that reporting for plans offering brokerage account investments is often delayed.

Timing may not be the only problem. A process relying on keypunch input introduces enormous potential for keypunch error, and automated error checking and audit systems are largely ineffective, since there are no control totals or consolidated figures to be matched. Exacerbating the problem is the varied terminology used by the different organizations that custody plan assets. For example, an employee's 401(k) contribution might be called a pre-tax contribution, an elective deferral or a salary reduction contribution. The organization responsible for consolidating the various brokerage statements into a uniform reporting format is likely to be relying on a low-paid clerk to accurately and consistently characterize the plan's transactional activity. Even if the numbers are input correctly, the transaction type may be misclassified.

Fiduciary Liability for Improper Investment Transactions

A plan sponsor seeking to adopt an IDA structure to mitigate liability for investment selection may find that they introduce other fiduciary investment issues. In brief, the ERISA Section 404(c) rules don't protect fiduciaries from responsibility for certain prohibited investment transactions. These include transactions that:

- contravene the provisions of the plan documents;
- cause the indicia of ownership of plan assets to escape U.S. jurisdiction;
- could result in a loss exceeding the balance of the participant's account; or
- are enacted with parties-in-interest to the plan.

As a practical consideration, it is virtually impossible for plan fiduciaries to supervise assets held in brokerage accounts at numerous broker dealers. Thus, if a participant were to request a withdrawal from a brokerage account, or were to direct that assets be transferred to an offshore account, or were to purchase an options contract that could more than wipe out the account, plan fiduciaries would have to rely on the brokerage firm's compliance monitoring functions to prevent the problematic transaction from being executed. However, if the transaction were executed, the plan sponsor and other fiduciaries (not necessarily including the brokerage firm) would be liable.

Liability for investments may be present in unexpected ways. For example, if a plan participant were to purchase a limited partnership through the plan, the plan's trustees could be liable for fiduciary breaches committed by the general partner. BNA reports: "Thus, for example, if assets of a limited partnership are deemed plan assets, the general partner who has responsibility for management of the partnership's assets could incur ERISA's fiduciary responsibilities. Trustees of the investing plans remain fully liable for fiduciary breaches committed by the general partner in managing such plan assets, unless the trustees had appointed such general partner an 'investment manager' under ERISA Section 402(c)(3)".

Unrelated Business Taxable Income (UBTI)

Certain types of direct investment could result in unrelated business taxable income (UBTI) for the plan. Although UBTI does not present a fiduciary or regulatory issue for the plan, a plan generating UBTI is required to file additional tax returns to the Internal Revenue Service (IRS), and may be required to withhold and remit taxes to the IRS. For this reason, the

Section 404(c) regulations indicate that plan fiduciaries are not required to follow participant directions that could result in UBTI for the plan. Of course, as indicated earlier, this presumes that plan fiduciaries are capable of tracking and monitoring proposed participant brokerage account transactions before they are executed.

Valuation Concerns

ERISA generally requires that all plan assets be valued at least annually. Although a precise determination of fair market value is not always required, certain types of assets can be extremely difficult to value. These include:

- Limited partnerships;
- Land and real estate;
- Deeds of trust; and
- Notes.

Administrative and Investment Costs

Permitting separate brokerage accounts for individual participants adds to administrative and investment costs in several ways. First, and most obvious, is the fee charged for each brokerage account. Next, the plan sponsor can expect additional costs for recordkeeping services required to consolidate reporting for the individual accounts. Less obvious are the additional costs for the plan auditor (for plans covering over 100 participants), and the higher asset based investment management and brokerage fees charged on the individual accounts, relative to the institutional arrangements that would otherwise be available to the plan as a whole. And finally, most 401(k) service providers don't support IDAs, hence the few providers that offer this feature probably charge a premium for offering the structure.

HOW IDA STRUCTURES SHOULD BE OFFERED

Given the costs and potential liabilities involved with unrestricted investment structures, many plan sponsors may conclude that they aren't worth the trouble. While this may be the case for many employers, IDAs may still be appropriate for certain plans. IDA programs tend to work well when the employer's workforce is familiar with investment issues and concepts, and plan participants have accumulated relatively large individual account balances. However, to protect the employer and the plan fiduciaries from excessive liability, plans offering

IDAs should be structured with the following characteristics:

- 1) Plan participants should not be able to purchase inappropriate investments, such as limited partnerships, options contracts, deeds of trust, land, real estate and collectibles (art, jewelry, etc.).
- 2) The plan sponsor should be able to easily monitor participant investment transactions to ensure adherence to trading rules.
- 3) The brokerage firm(s) used to custody plan assets should agree to monitor transactions such that plan provisions are not violated (e.g., if the plan does not permit in-service withdrawals, withdrawals would not be permitted from the brokerage account).
- 4) All brokerage accounts should be electronically linked to the master plan account to facilitate consolidated reporting and plan sponsor oversight.

Consolidating With A Single Custodian Simplifies Compliance

As a practical matter, to provide this structure requires that the plan sponsor consolidate individual brokerage accounts with a single custodian. Where multiple custodians are involved, it would be extremely difficult for the plan sponsor to provide sufficient oversight over each of the custodial accounts. Further, determining that each provider has appropriate internal transaction monitoring screens and compliance protocols would be extremely difficult. Finally, mandating that brokerage accounts all be established through a single custodian simplifies the plan's consolidated reporting functions. Although certain plan participants may prefer to transact investments through "their" broker, the plan sponsor bears too great a potential liability to permit participant preferences to jeopardize the tax-qualified status of the plan.

Of course, the selection of the designated brokerage account custodian is also extremely important. The ideal custodian would offer automated systems and procedures to ensure that inappropriate investment transactions are never executed. Further, the ideal custodian would offer participants access to the broad-

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est possible range of investment products, within the guidelines established by the plan sponsor and the definitions set forth by regulations under ERISA Section 404(c). And the ideal custodian would offer integrated and consolidated plan level reporting for aggregate investment activity among the various brokerage accounts.

What To Do if the Current Structure is Less Than Ideal

Many plan sponsors currently have an IDA structure in place, without the necessary safeguards and restrictions discussed earlier. Brokerage accounts may have been established with multiple custodians, and certain accounts may hold problem assets, such as limited partnerships or deeds of trust. The plan sponsor may have pursued consolidating brokerage accounts with a single custodian, only to find that the custodians that offer the compliance structure needed to protect the plan against inappropriate transactions are unwilling to take custody of the problem assets that the plan currently holds. So how does a plan sponsor transition from an IDA arrangement with no constraints imposed, to a safer, more structured arrangement, that still affords participants significant investment flexibility? At some point, the transition will require liquidating the problem assets, establishing brokerage accounts with the selected custodian, and transferring all brokerage account assets to each individual's new brokerage account with the selected custodian. Although these steps could theoretically be implemented in a relatively brief period of time, by mandate of the plan sponsor, in most cases, the transition will require more time.

The following workplan represents a reasonable plan for transitioning from a totally wide open IDA arrangement, to a more structured arrangement using a single custodian. The steps are as follows:

- 1) Select a custodian who will eventually act as the sole custodian for all brokerage accounts and brokerage account assets;
- 2) Review all current brokerage account statements to identify problem assets (the selected custodian will probably be willing to assist with this review);
- 3) Establish a policy that all new brokerage accounts must be established with the selected custodian;
- 4) Contact participants whose brokerage accounts do not hold problem assets to notify them that the plan will be transitioning to a new custodian, and that at some designated future date, their brokerage accounts will be transferred to the new custodian. Depending on the new custodian's pricing and transition policy, you may want to encourage participants to voluntarily transfer their accounts to the new custodian prior to the designated date.
- 5) Contact participants who own problem assets to notify them that they will need to liquidate these assets prior to the designated plan transition date, and that on the transition date, their brokerage accounts will be transferred to the new custodian. (Note: over the past several years, markets have developed for traditionally illiquid assets, such as limited partnerships. Although selling problem assets may not be easy, it should be possible. The plan sponsor may choose to seek assistance from the new custodian or other financial advisor regarding appropriate venues for selling the plan's problem assets.)
- 6) Establish procedures for monitoring transactions in existing brokerage accounts to ensure that no new problem assets are acquired. If a participant purchases a problem asset, have the transaction reversed immediately.
- 7) If, at the designated transition date, the plan still owns problem assets through one or more individual brokerage accounts, consider establishing a separate trust to hold the problem assets.
- 8) Establish brokerage accounts with the selected custodian for all participants with existing brokerage accounts.
- 9) Journal assets from the existing brokerage accounts to the newly established brokerage accounts on the designated plan transition date.

Although IDAs may appear attractive to many plan sponsors, where the program truly offers no structure and no restrictions, the plan sponsor faces additional liability and cost that outweighs the advantages gained from the IDA.

The amount of time required to accomplish these steps will vary between employers, but can typically be accomplished over a period of six months to three years.

CONCLUSION

Although IDAs may appear attractive to many plan sponsors, where the program truly offers no structure and no restrictions, the plan sponsor faces additional liability and cost that outweighs the advantages gained from the IDA. By imposing some structure on IDAs, such as requiring that all brokerage accounts be run through a single custodian, and ensuring that the selected custodian employs reasonable screening and compliance procedures to avoid violating plan, IRS or DOL rules, the plan sponsor can take advantage of the benefits of the IDA approach, without becoming subject to unreasonable fiduciary liability. Where the plan sponsor currently offers a less structured arrangement, making the transition to a more structured arrangement will require some work and a well developed plan. However, the benefit from reduced fiduciary liability and more effective plan administration is likely to be well worth the effort expended.

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