Regulatory Notice 13-45

Rollovers to Individual Retirement Accounts

FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers

Summary

FINRA is issuing this *Notice* to remind firms of their responsibilities when (1) recommending a rollover or transfer of assets in an employer-sponsored retirement plan to an Individual Retirement Account (IRA) or (2) marketing IRAs and associated services. Reviewing firm practices in this area will be an examination priority for FINRA in 2014.

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Background and Discussion

Saving for retirement is a top financial concern for Americans and many are confused about their retirement savings options.[1] Because broker-dealers often advise customers regarding retirement plans, this *Notice* addresses these interactions. In particular, the *Notice* addresses firms' recommendations to participants in employer-sponsored 401(k) retirement plans who terminate their employment and must determine how to invest their plan assets.[2] FINRA reminds firms of their responsibilities when they recommend that such an investor roll over or transfer plan assets to an IRA.[3]

A plan participant leaving an employer typically has four options (and may engage in a combination of these options):

- leave the money in his former employer's plan, if permitted;
- roll over the assets to his new employer's plan, if one is available and rollovers are permitted;[4]
- roll over to an IRA; or
- cash out the account value.[5]

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Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics

- Communications with the Public
- 401(k) Plans
- Individual Retirement Accounts
- Suitability
- Supervision
- Training

Referenced Rules & Notices

- FINRA Rule 2010
- FINRA Rule 2111
- FINRA Rule 2210
- NASD Rule 3010
- NASD Rule 3012
- Regulatory Notice 13-23

FINRA

Financial Industry Regulatory Authority

Each choice offers advantages and disadvantages, depending on desired investment options and services, fees and expenses, withdrawal options, required minimum distributions, tax treatment, and the investor's unique financial needs and retirement plans. The complexity of these choices may lead an investor to seek assistance from a financial adviser, including a broker-dealer. Investors also may be solicited by financial services firms, including broker-dealers, regarding IRAs and retirement services.[6]

A broker-dealer's recommendation that an investor roll over retirement plan assets to an IRA typically involves securities recommendations subject to FINRA rules. A firm's marketing of its IRA services also is subject to FINRA rules.[7] Any recommendation to sell, purchase or hold securities must be suitable for the customer and the information that investors receive must be fair, balanced and not misleading.[8] This *Notice* provides guidance on these activities and is intended to help firms ensure that they have policies and procedures in place that are reasonably designed to achieve compliance with FINRA rules.

1. IRAs in the U.S. Retirement Market

IRAs account for about 28 percent of all U.S. retirement assets, which totaled $19.5 trillion at the end of 2012. Of this amount, IRA assets were $5.4 trillion, compared with $5.1 trillion in defined contribution plans and $9 trillion in other retirement plans.[9] Approximately 98 percent of IRAs with $25,000 or less are brokerage accounts.[10]

Rollovers from employer-sponsored retirement plans are the largest source of contributions to IRAs. A June 2013 Employee Benefits Research Institute report states that in 2011, assets rolled over into IRAs were almost 13 times the amount of direct contributions. This is not a new trend; ICI data indicates that from 1996 to 2008 more than 90 percent of funds flowing into traditional IRAs came from rollovers, primarily from plans.[11] In 2013, 49 percent of the traditional IRAs held by U.S. households included rollover funds.[12]

2. The IRA Rollover Decision

A recommendation to roll over plan assets to an IRA rather than keeping assets in a previous employer's plan or rolling over to a new employer's plan should reflect consideration of various factors, the importance of which will depend on an investor's individual needs and circumstances. Some of the factors include:

- **Investment Options**—An IRA often enables an investor to select from a broader range of investment options than a plan.[13] The importance of this factor will depend in part on how satisfied the investor is with the options available under the plan under consideration. For example, an investor who is satisfied by the low-cost institutional funds available in some plans may not regard an IRA's broader array of investments as an important factor.

- **Fees and Expenses**—Both plans and IRAs typically involve (i) investment-related expenses and (ii) plan or account fees. Investment-related expenses may include sales loads, commissions, the expenses of any mutual funds in which assets are invested and investment advisory fees. Plan fees typically include plan administrative fees (*e.g.,* recordkeeping, compliance, trustee fees) and fees for services such as access to a customer service representative. In some cases, employers pay for some or all of the plan's administrative expenses.[14] An IRA's account fees may include, for example, administrative, account set-up and custodial fees.
- **Services**—An investor may wish to consider the different levels of service available under each option. Some plans, for example, provide access to investment advice, planning tools, telephone help lines, educational materials and workshops. Similarly, IRA providers offer different levels of service, which may include full brokerage service, investment advice, distribution planning and access to securities execution online.
- **Penalty-Free Withdrawals**—If an employee leaves her job between age 55 and 59½, she may be able to take penalty-free withdrawals from a plan. In contrast, penalty-free withdrawals generally may not be made from an IRA until age 59½. It also may be easier to borrow from a plan.
- **Protection from Creditors and Legal Judgments**—Generally speaking, plan assets have unlimited protection from creditors under federal law, while IRA assets are protected in bankruptcy proceedings only. State laws vary in the protection of IRA assets in lawsuits.
- **Required Minimum Distributions**—Once an individual reaches age 70½, the rules for both plans and IRAs require the periodic withdrawal of certain minimum amounts, known as the required minimum distribution. If a person is still working at age 70½, however, he generally is not required to make required minimum distributions from his current employer's plan. This may be advantageous for those who plan to work into their 70s.
- **Employer Stock**—An investor who holds significantly appreciated employer stock in a plan should consider the negative tax consequences of rolling the stock to an IRA. If employer stock is transferred in-kind to an IRA, stock appreciation will be taxed as ordinary income upon distribution.[15] The tax advantages of retaining employer stock in a non-qualified account should be balanced with the possibility that the investor may be excessively concentrated in employer stock. It can be risky to have too much employer stock in one's retirement account; for some investors, it may be advisable to liquidate the holdings and roll over the value to an IRA, even if it means losing long-term capital gains treatment on the stock's appreciation.

These are examples of the factors that may be relevant when analyzing available options, and the list is not exhaustive. Other considerations also might apply to specific circumstances.

3. **Conflicts of Interest**

Firms and their registered representatives that recommend an investor roll over plan assets to an IRA may earn commissions or other fees as a result. In contrast, a recommendation that an investor leave his plan assets with his old employer or roll the assets to a plan sponsored by a new employer likely results in little or no compensation for a firm or a registered representative. This conflict is not limited to the broker-dealer distribution channel. An investment adviser who recommends an investor roll over plan assets into an IRA may earn an asset-based fee as a result, but no compensation if assets are retained in the plan. Thus, a financial adviser has an economic incentive to encourage an investor to roll plan assets into an IRA that he will represent as either a broker-dealer or an investment adviser representative.[16]

Conflicts also may exist for firms and their associated persons that are responsible for educating plan participants about their choices. For example, if an associated person receives compensation for the number of IRAs that participants open at his firm, he has an incentive to encourage participants to open IRAs rather than maintain their assets in their plan.

FINRA urges broker-dealers to review their retirement services activities to assess conflicts of interest.[17] Firms must supervise these activities to reasonably ensure that conflicts of interest do not impair the judgment of a registered representative or another associated person about what is in the customer's interest and that they neither confuse investors nor interfere with important educational efforts.

4. **Suitability and Fair Dealing**

Implicit in all broker-dealer and associated person relationships with customers and others is the fundamental responsibility for fair dealing.[18] Rule 2111, FINRA's suitability rule, requires that a broker-dealer and its associated persons have a reasonable basis to believe that a recommended transaction or investment strategy involving a security is suitable for the customer.[19] A firm and its registered representatives, in making a recommendation, must consider the customer's investment profile, including the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the broker-dealer or registered representative in connection with the recommendation.

A recommendation concerning the type of retirement account in which a customer should hold his retirement investments typically involves a recommended securities transaction, and thus is subject to Rule 2111. For example, a firm may recommend that an investor sell his plan assets and roll over the cash proceeds into an IRA. Recommendations to sell securities in the plan or to purchase securities for a newly-opened IRA are subject to Rule 2111.[20]

If Rule 2111 is triggered, a registered representative must have a reasonable basis to believe that the recommendation is suitable for the customer, based on information about the options obtained through reasonable diligence, and taking into account factors such as tax implications, legal ramifications, and differences in services, fees and expenses between the retirement savings alternatives.[21]

Retirement plan assets typically constitute long-term investments by a customer. A registered representative must consider not only the immediate consequences of the recommendation, such as the potential tax penalties of early withdrawal from an employer sponsored plan, but also the eventual treatment under the Internal Revenue Code and other long-range effects of a particular choice. The registered representative should discuss with the customer the various factors related to the decision, in a manner reasonably likely to facilitate the investor's understanding. Some firms have adopted effective procedures under which an exception report is generated if a customer adds significant assets to an IRA.

Some firms and their associated persons provide educational information to plan participants concerning their retirement choices. Firms that permit educational information only should adopt measures reasonably designed to ensure that the firm and its associated persons do not make recommendations for purposes of Rule 2111 to plan participants. These measures should include training concerning what statements may trigger application of Rule 2111, and consideration of the compensation arrangements that could cause an associated person to make a recommendation. To the extent that a firm prohibits recommendations to plan participants, supervisory personnel of the firm should reasonably monitor the communications to ensure that the prohibition is not compromised.

5. **Supervision and Supervisory Control System**

Under NASD Rule 3010, broker-dealers must establish written supervisory procedures that are reasonably designed to ensure that their recommendations and marketing of IRA accounts and related services comply with applicable securities laws and FINRA rules. Written supervisory procedures should be reasonably designed to ensure that (i) registered representatives perform appropriate customer-specific suitability analyses and (ii) marketing materials are fair and balanced. Firms also are reminded that NASD Rule 3012 requires firms to test and verify that their written supervisory procedures are reasonably designed to ensure compliance with the federal securities laws and FINRA rules.[22]

6. **Training of Registered Representatives**

Firms must ensure that a registered representative who recommends a rollover to an IRA has been properly trained concerning retirement savings options and the tax, investment and other implications of the decision. Firms should update their training as needed if regulatory changes occur that are relevant to the decision whether to roll over plan assets. Firms should emphasize that performance of the suitability responsibilities of a broker-dealer or registered representative should never be compromised by their financial interest in recommending an IRA rollover or another action.

7. **Communications With the Public**

Under FINRA Rule 2210, firms must ensure that their communications with the public are based on principles of fair dealing and good faith, are fair and balanced, and provide a sound basis to evaluate the facts about any particular security or type of security, industry or service. No broker-dealer may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading. No broker-dealer may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public, or publish, circulate or distribute any public communication that the broker-dealer knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

Rule 2210 applies to a broker-dealer's marketing of IRAs and related services. Whether in written sales material or an oral marketing campaign, it would be false and misleading to imply that a retiree's only choice, or only sound choice, is to roll over her plan assets to an IRA sponsored by the broker-dealer. The marketing of the IRA rollover services offered by the broker-dealer must be balanced by a discussion of other available options and how they compare to the IRA offered, particularly with regard to fees. As stated in *Regulatory Notice 13-23*, any discussion of IRA fees must be fair and balanced. The broker-dealer may not claim that its IRAs are "free" or carry "no fee" when the investor will incur costs related to the account, account investments or both. If in marketing IRA rollovers a broker-dealer describes the various benefits of an IRA, the communication may be deemed misleading if it omits information needed to cause the description to be fair and balanced in terms of its comparison to other options.

8. **FINRA Examinations of Firms**

A determination to roll over plan assets to an IRA rather than keeping them in a previous employer's plan or rolling over to a new employer's plan should reflect consideration of various factors, the importance of which will depend on the customer's individual needs, circumstances and options. The recommendation and marketing of IRA rollovers will be an examination priority for FINRA in 2014.

Endnotes

1. *See, e.g.,* Gallup video on retirement planning and the Employee Benefit Research Institute's 2013 Retirement Confidence Survey. According to the Gallup poll, 61 percent of Americans are very or moderately worried about not having enough money for retirement. *See also* Department of Labor, "Taking the Mystery Out of Retirement Planning." ("The whole retirement scene has changed and many American workers find it a mystery.")

2. For ease of reference, this *Notice* addresses rollovers from 401(k) plans to IRAs. Similar considerations may arise in rollover decisions involving other types of employer-sponsored plans, such as 403(b) plans.

3. In a transfer, an investor does not take physical custody of plan assets; the assets move directly from the 401(k) plan to the IRA. In a rollover, an investor receives a check from the 401(k) plan after requesting liquidation and deposits the check into a rollover IRA within a certain period of time. For ease of reference, this Notice generally uses "rollover" to refer to both situations.

4. Not all employer plans accept rollovers. *See* Government Accountability Office 13-30, "Labor and IRS Could Improve the Rollover Process for Participants" at 8 (March 2013) ("GAO Report").

5. This option—taking a lump sum distribution that is not rolled over into another plan or an IRA—may be costly for many younger individuals. In general, tax penalties will apply if the employee is below age 59½ and the distribution will be taxed as ordinary income.

6. GAO stated that many experts indicate "[much] of the information and assistance participants receive is through the marketing efforts of service providers touting the benefits of IRA rollovers and is not always objective." *See* GAO Report at 22.

7. These rules include FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2210 (Communications with the Public) and 2111(Suitability), and NASD Rules 3010 (Supervision) and 3012 (Supervisory Control Systems).

   See also Regulatory Notice 13-23 (July 2013) (guidance concerning the marketing of "no-fee" IRAs.)

8. Rule 2111 applies only to explicit hold recommendations, and does not apply when a broker-dealer is silent regarding security positions in an account. *See* Frequently Asked Questions FINRA Rule 2111 (Suitability).

9. *See* Investment Company Institute (ICI) Frequently Asked Questions About Individual Retirement Accounts and 2013 Investment Company Fact Book at 114. In calculating defined contribution plan assets, the ICI included 401(k) plans, 403(b) plans, 457 plans, Keoghs and other defined contribution plans "without 401(k) features." In calculating IRA assets, the ICI included traditional IRAs, Roth IRAs and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs and SIMPLE IRAs). The $9 trillion in other retirement plans includes, among others, private-sector defined benefit plans, federal, state and local pension plans and all fixed and variable annuity reserves at life insurance companies less annuities held by IRAs, 403(b) plans, 457 plans and private pension funds.

10. *See* letter to Employee Benefits Security Administration from Davis & Harman, April 12, 2011 (transmitting study prepared by Oliver Wyman Inc.).

11. *See* ICI, *The U.S. Retirement Market*, Second Quarter 2012 (September 2012).

Endnotes (continued)

12. *See* ICI Research Perspective, "The Role of IRAs in U.S. Households' Saving for Retirement, 2013."

13. Not all IRAs permit a broad range of investments. For example, an IRA held with a mutual fund complex may limit investment to the complex's funds.

14. *See* U.S. Department of Labor publication *A Look At 401(k) Plan Fees*. See also Society for Human Resource Management article citing the 12th edition of the 401k Averages Book. The average total plan cost for a small retirement plan (no more than 100 participants) for all expenses bundled together, including investment fees deducted from participants' assets and administrative, recordkeeping and trustee fees, paid by the plan sponsor or passed along to participants, was 1.3 percent of assets under management in 2011. The average total plan cost for a large plan (at least 1,000 participants) was slightly lower, at 1.08 percent.

    Individual service fees are charged separately to the accounts of participants who choose to take advantage of a particular plan feature, such as taking a loan from the plan. Other services may include, for example, provision of a toll-free telephone number for help and assistance. U.S. Department of Labor publication *A Look At 401(k) Plan Fees*.

15. Generally, to obtain favorable tax treatment, an investor must (i) take a lump-sum distribution of all of his assets in the plan; (ii) request an in-kind distribution of the employer stock; and (iii) place the employer stock into a non-retirement account. Upon doing so, the investor will pay ordinary income tax on his cost basis (and a 10 percent penalty if under age 59½); when he sells the stock, however, he will pay long-term capital tax, not ordinary income tax, on the stock's appreciation.

16. Similar conflicts may be presented for banks and other financial services firms that hold IRAs.

17. Firms should consider FINRA's October 14, 2013, *Report on Conflicts of Interests*, which highlights effective conflicts management practices that may go beyond current regulatory requirements.

18. *See* Rule 2111, Supplementary Material .01.

19. In addition to a customer-specific suitability determination, Rule 2111 requires reasonable-basis suitability (a determination that the recommendation is suitable for at least some investors) and quantitative suitability.

20. Many plans allow for in-kind distributions, which permits securities held in the plan by a participant to be transferred to a new qualified account. Certain holdings, however, such as institutional mutual funds that are available only to plan participants, may not be transferrable; such assets must be sold if an investor seeks to roll over to an IRA.

21. The rule generally does not apply to a communication that only describes a plan. *See* Rule 2111, Supplementary Material .03(b).

22. On December 23, 2013, the SEC issued an order approving FINRA's proposed rule change to adopt rules regarding supervision in the consolidated FINRA rulebook. *See* Securities Exchange Act Release No. 71179 (December 23, 2013) (Order Approving File No. SR-FINRA-2013-025). FINRA will issue a *Regulatory Notice* announcing the effective date of the consolidated supervision rules.

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