
employee benefits/
investment management lawflash

February 6, 2014

FINRA and SEC to Focus on IRA Rollover Practices in 2014

Financial institutions should prepare for increased regulatory scrutiny.

The Financial Industry Regulatory Authority (FINRA) and the U.S. Securities and Exchange Commission (SEC) released their examination priorities for 2014 on January 2 and January 9, respectively.¹ Among both organizations' priorities are practices related to recommendations to transfer, or "roll over," assets from an employer-sponsored retirement plan to an individual retirement account (IRA). These announcements follow FINRA's Regulatory Notice 13-45,² which was issued on December 30, 2013 and which provides guidance on brokers' responsibilities concerning IRA rollovers. FINRA also recently issued an investor alert, "The IRA Rollover: 10 Tips to Making a Sound Decision," highlighting issues (including tax consequences, fees and expenses, and conflicts of interest) that FINRA believes an investor should be aware of in deciding whether to roll over assets to an IRA.³ Broker-dealers and registered investment advisers that offer advice and recommendations regarding IRA rollovers should prepare for increased regulatory scrutiny of their services and should consider reviewing their practices and marketing materials against applicable FINRA and SEC guidance and regulations.

Background

A person with savings invested in an employer-sponsored retirement plan, such as a 401(k) plan, may be eligible to roll over certain distributions from the plan to an IRA without having to pay taxes on the distribution. This may occur when, for example, the person leaves his or her employer and is eligible to receive a lump-sum distribution from the plan. In addition to an IRA rollover, the individual may also have the option to keep his or her investment in the employer-sponsored plan, transfer the account to another employer's plan, or take a cash distribution. Individuals may contact financial professionals or other experts (e.g., a broker-dealer or an investment adviser) for guidance on the various options and their costs and benefits.

Last year, the U.S. Government Accountability Office (GAO) published a report⁴ urging the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS)—the primary regulators of employer-sponsored retirement plans and, with respect to the IRS, IRAs—to take action to improve the rollover process for participants. The GAO report was particularly critical of the information and disclosures that financial services firms provide to participants when counseling them on distribution options. Specifically, the GAO report concluded that financial services firms generally encourage IRA rollovers without fully explaining the options available to their clients and without making sound determinations that an IRA rollover is in particular investors' best interests. The GAO particularly noted that "[much] of the information participants receive is through the marketing efforts of service providers touting the benefits of IRA rollovers and is not always objective." Perceived issues with the IRA rollover process have become of increasing concern because assets held in IRA accounts represent an increasing percentage of all U.S. retirement assets and currently exceed those held in employer-sponsored 401(k) plans (and other similar plans) and traditional pension plans.

1. View FINRA's examination priorities at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf>. View the SEC's examination priorities at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>.

2. View Notice 13-45 at <https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p418695.pdf>.

3. View the investor alert at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/RetirementAccounts/P436001>.

4. View the report at <http://www.gao.gov/assets/660/652881.pdf>.

FINRA and SEC Examination Priorities

FINRA, in its 2014 examination priorities, stated that it “shares the GAO’s concerns that investors may be misled about the benefits of rolling over assets . . . to an IRA.” FINRA indicated that it will review brokers’ marketing materials and supervision with respect to IRA rollover practices and will evaluate securities recommendations made in the context of IRA rollovers to determine whether they comply with FINRA’s suitability standards under Rule 2111. FINRA further urged brokers to review its guidance in Notice 13-45 (discussed in more detail below) and its prior guidance in Notice 13-23 regarding marketing materials that claim an IRA is “free” or has “no fee.”

Similarly, the SEC’s 2014 examination priorities indicate that it will focus on the practices of broker-dealers, as well as investment advisers, with respect to IRA rollovers. The SEC, noting that advisers and broker-dealers “may have incentives to recommend that assets be placed with an IRA or other alternative offered by a financial services firm,” will:

- Examine the sales practices of investment advisers targeting retirement-age workers to roll over assets in 401(k) plans to “higher cost investments,” including whether advisers are “misrepresenting their credentials or the benefits or features of IRAs or other alternatives”
- Examine investment advisers and broker-dealers for “possible improper or misleading marketing and advertising, conflicts, suitability, churning, and potentially misleading professional designations” when recommending IRA rollovers

Thus, both broker-dealers and investment advisers should be prepared for examiners to focus on their practices with respect to IRA rollovers. Officials from both FINRA and the SEC have indicated that they may focus on those firms, or representatives within a particular firm, that have been particularly successful at encouraging clients to roll over assets to IRAs. Broker-dealers and investment advisers should review their practices with respect to recommendations, investor education, disclosures, marketing materials, supervision, and training to determine whether any changes should be made.

FINRA Regulatory Notice 13-45: Rollovers to Individual Retirement Accounts

FINRA issued Notice 13-45 to “remind [broker-dealer] firms of their responsibilities” when recommending rollovers to IRAs and marketing IRAs and associated services. FINRA noted that a recommendation to roll over retirement plan assets to an IRA typically involves securities recommendations subject to FINRA rules regarding suitability and that related marketing must be “fair, balanced and not misleading.” Highlights of Notice 13-45’s guidance include:

- **IRA rollover recommendations should reflect consideration of various factors related to the investor’s individual needs and circumstances.** FINRA suggested that a broker-dealer evaluating whether to recommend that a client roll over retirement assets to an IRA should consider the importance of various factors to particular investors. The factors FINRA specifically identified include:
 - The broad range of investment options available through an IRA, compared to the potentially more limited options available in a client’s plan
 - The various investment-related and plan or account fees that a client may incur for investments in an IRA or plan
 - The levels of service available under an IRA and a client’s plan
 - The tax consequences of each option, including with respect to penalties that may be assessed if a client withdraws funds before age 59½, the IRS’s required minimum distribution rules that apply when a client attains age 70½, and the tax consequences of rolling over employer stock held in a plan to an IRA
 - **Employer Stock:** With respect to employer stock, IRS rules provide that—if an investor receives a lump-sum distribution of his or her retirement plan assets, including an in-kind distribution of employer stock, and holds the stock in a nonretirement account—the investor will pay tax at the ordinary income rate on his or her cost basis in the stock. But, when the stock is sold, the investor

will pay tax on the stock's subsequent appreciation at the more favorable rate for long-term capital gains. In contrast, if the stock is rolled over in kind to an IRA, the stock's subsequent appreciation (along with its cost basis) will be taxed as ordinary income when it is distributed from the IRA. FINRA notes that brokers will need to balance the possible negative tax consequences of rolling over the stock to an IRA and liquidating the holdings against the possible risks of the investor holding high concentrations of stock. This issue highlights the complexity of the matters FINRA believes brokers should consider in recommending investors roll over assets to IRAs.

- The different levels of protection that assets held in IRAs and plans have from creditors and legal judgments (such as in the event of a bankruptcy filing)

To evaluate these factors, a broker-dealer may need to obtain detailed information about the plan in which a client's assets are currently invested, including information about investment options and related expenses, plan-level fees (including recordkeeping, compliance, and trustee fees), and plan features (including distribution rights and services related to the plan). Further, if the participant is also eligible to transfer assets to a new employer's plan, the broker-dealer may find it necessary to obtain and evaluate similar information about the new employer's plan as well. Based on these factors, FINRA seems to expect that representatives should have some knowledge of a number of areas that may go beyond their traditional training, including taxation of retirement distributions, bankruptcy protection of retirement assets, and the rules governing qualified retirement plans (including a particular plan's provisions). FINRA also notes that the list of considerations above is not exclusive and other considerations may apply depending on a client's circumstances.

- **Broker-dealers should review their retirement services activities to assess conflicts of interest in recommending IRA rollovers.** Notice 13-45 explains that financial advisers (including broker-dealers and investment advisers) typically have incentive (e.g., receipt of a commission or asset-based fee) to recommend that a client roll over assets to an IRA. But, financial advisers typically have no incentive to recommend that a client leave assets in his or her previous employer's plan or transfer them to a new employer's plan. FINRA indicated that similar conflicts may exist for brokers and associated persons responsible for educating plan participants about their distribution options if their compensation depends on the number of IRAs opened at the broker. Notice 13-45 urges brokers to evaluate activities with respect to rollovers to determine whether their supervision is adequate "to reasonably ensure that conflicts do not impair the judgment" of registered representatives and associated persons about a client's best interests and that they "neither confuse investors nor interfere with important educational efforts."
- **Broker-dealers should ensure their recommendations and educational information regarding IRA rollovers do not violate FINRA's suitability rule.** FINRA's Rule 2111, the suitability rule, requires that broker-dealers and their associated persons have a reasonable basis to believe that a recommended transaction or investment strategy involving a security is suitable for a customer. Notice 13-45 indicates that recommendations regarding IRA rollovers would typically be subject to this rule and, thus, must be supported by a reasonable basis that the recommendation is suitable for a client. FINRA noted that, in the case of an IRA rollover recommendation, a broker-dealer must obtain information about a client's options, including "tax implications, legal ramifications, and differences in services, fees and expenses," and that both the immediate consequences and long-range effects of a recommendation should be considered.

Where a broker's associated person offers educational information to participants regarding rollovers, FINRA indicates that the broker should adopt procedures that ensure that the educational information does not result in recommendations for purposes of the suitability rule. According to FINRA, these procedures should include training on which statements and compensation arrangements could be viewed as resulting in recommendations.

- **Broker-dealers should ensure that communications with the public regarding IRA rollovers are fair and balanced.** FINRA's Rule 2210 requires that brokers' communications with the public are based on the principles of fair dealing and good faith, are fair and balanced, and provide a sound basis to evaluate the facts about securities and services. With respect to broker-dealers' marketing of IRAs and related services, Notice 13-45 states that oral and written sales materials should not imply that a client's "only choice, or only sound choice, is to roll over her plan assets to an IRA sponsored by the broker-dealer" and must include a discussion and comparison of other available options and their fees. Notice 13-45 further notes, as previously

stated in FINRA Regulatory Notice 13-23, that marketing materials should not include claims that an IRA is “free” or carries “no fee” if investors will, in fact, incur account- or investment-related fees.

Notice 13-45 further indicates that written supervisory procedures and training programs should be reviewed and updated as necessary in light of Notice 13-45’s guidance. FINRA followed Notice 13-45 with the investor alert, “The IRA Rollover: 10 Tips to Making a Sound Decision,” which includes tips for investors that generally parallel the concerns that FINRA raised in Notice 13-45.

Implications

The issuance of Notice 13-45 and the inclusion of IRA rollovers as examination priorities, along with the recent GAO report discussed above, are consistent with the trend toward increasing regulatory scrutiny of the IRA market. IRA rollovers are also receiving attention from the DOL, which indicated in its comments to the GAO report that its pending project to revise its regulation on the definition of a “fiduciary” may address many of the GAO’s concerns. Because IRA rollovers will likely increase as more Americans reach retirement age, we can expect further regulatory activity in this area—including possibly from the IRS. Accordingly, in light of the converging regulatory scrutiny involving IRA rollovers, broker-dealers and investment advisers—as well as other financial institutions that provide IRA services—should consider reviewing and updating their IRA rollover practices, marketing activities, supervisory procedures, and training programs.

Contacts

Morgan Lewis—with its strong practice in the regulation of financial institutions, including experience in fiduciary and tax issues related to IRAs and employee benefit plans—is uniquely qualified to assist with this review. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

Broker-Dealer

John F. Hartigan	Los Angeles	213.612.2630	jhartigan@morganlewis.com
Ethan W. Johnson	Miami	305.415.3394	ejohnson@morganlewis.com
Joy Crutcher Harrison	Miami	305.415.3411	jcharrison@morganlewis.com
Jennifer L. Klass	New York	212.309.7105	jklass@morganlewis.com
Robert C. Mendelson	New York	212.309.6303	rmendelson@morganlewis.com
Lloyd H. Feller	New York	212.309.6263	lfeller@morganlewis.com
Sean Graber	Philadelphia	215.963.5598	sgraber@morganlewis.com
Steven W. Stone	Washington, D.C.	202.739.5453	sstone@morganlewis.com
Daniel R. Kleinman	Washington, D.C.	202.739.5143	dkleinman@morganlewis.com
Lindsay B. Jackson	Washington, D.C.	202.739.5120	ljackson@morganlewis.com
John V. Ayanian	Washington, D.C.	202.739.5943	jayanian@morganlewis.com
Mark Fitterman	Washington, D.C.	202.739.5019	mfitterman@morganlewis.com
Ignacio A. Sandoval	Washington, D.C.	202.739.5201	isandoval@morganlewis.com

ERISA

Louis L. Joseph	Chicago	312.324.1726	louis.joseph@morganlewis.com
Marla J. Kreindler	Chicago	312.324.1114	mkreindler@morganlewis.com
Julie K. Stapel	Chicago	312.324.1113	jstapel@morganlewis.com
Craig A. Bitman	New York	212.309.7190	cbitman@morganlewis.com
Robert L. Abramowitz	Philadelphia	215.963.4811	rabramowitz@morganlewis.com
Vivian S. McCardell	Philadelphia	215.963.5810	vmccardell@morganlewis.com
Steven D. Spencer	Philadelphia	215.963.5714	sspencer@morganlewis.com
David B. Zelikoff	Philadelphia	215.963.5360	dzelikoff@morganlewis.com
Lisa H. Barton	Pittsburgh	412.560.3375	lbarton@morganlewis.com
Michael B. Richman	Washington, D.C.	202.739.5036	mrichman@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 25 offices across the United States, Europe, Asia, and the Middle East, Morgan Lewis provides comprehensive litigation, corporate, transactional, regulatory, intellectual property, and labor and employment legal services to clients of all sizes—from globally established industry leaders to just-conceived start-ups. Our international team of lawyers, patent agents, benefits advisers, regulatory scientists, and other specialists—more than 1,600 legal professionals total—serves clients from locations in Almaty, Beijing, Boston, Brussels, Chicago, Dallas, Dubai,* Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Moscow, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

*In association with Mohammed Buhashem Advocates & Legal Consultants

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. © 2014 Morgan, Lewis & Bockius LLP. All Rights Reserved.