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FINRA Holiday "Reminder" – Broker-Dealer Responsibilities for IRA Rollover Recommendations

The In the final days of 2013, Financial Industry Regulatory Authority ("FINRA") published Regulatory Notice 13-45 "Rollovers to Individual Retirement Accounts: FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers" ("Notice"). The Notice reminds broker-dealer firms ("BDs") and their registered representatives of their responsibilities under several key FINRA rules, including rules addressing suitability, communications with the public, and supervisory control when recommending a rollover of assets from a tax-qualified retirement plan ("Plan") to an individual retirement account ("IRA") or marketing IRAs and associated services. FINRA intends to make firm practices in this area an examination priority in 2014.[1]

While the Notice implies that they have always applied, most registered representatives and the BDs that supervise them will be surprised by the breadth and depth of the challenging compliance requirements outlined by FINRA in the Notice. The Notice cites the Government Accountability Office's 2013 report entitled "Labor and IRS Could Improve the Rollover Process for Participants," strongly suggesting that FINRA believes that more fulsome guidance is needed. While the Notice applies only to FINRA members, the guidance it contains appears to be a harbinger of the more broadly applicable approach that the Department of Labor ("DOL") is likely to take in its effort to change the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA"). Opponents of the DOL initiative have argued that the timing of the fiduciary definition regulation's re-proposal needs to be coordinated with the Securities Exchange Commission ("SEC") and FINRA. The Notice suggests that, at least with respect to the rollover question, FINRA's views are moving into alignment with DOL's and concerns about uncoordinated guidance may be somewhat less compelling.

Overview of Rollover Rules

Upon termination of employment, retirement, or some other distribution event, a Plan participant or beneficiary generally has one or more of the following four options available:

1. Leave the money in the former employer's Plan (this may not be possible in certain circumstances such as when the employee's account balance falls below a certain specified minimum, *e.g.* $5,000, so that a "cash out" distribution is permitted – or once the participant reaches normal retirement age and all amounts may be forced out – if the plan so provides);

[1] In a related development, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations recently announced that its 2014 examination priorities will include a focus on retirement vehicles and rollover recommendation activities of investment advisers and broker-dealers. *See* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

2. If available, roll the assets over to a new employer's Plan;
3. Roll the assets over to an IRA; or,
4. Simply receive a taxable distribution from the Plan.

Often, BDs and their representatives consult with their clients or prospective clients prior to the point a distribution event occurs about the option to rollover to an IRA. In the event a rollover occurs, the representative will recommend to the client securities that may be purchased with the IRA assets as long as the security is suitable and the representative otherwise complies with the requirements of FINRA and the securities laws.

FINRA Focuses on the Rollover Recommendation

In the Notice, FINRA states that to the extent that a BD's recommendation to the Participant to roll over a distribution from a Plan to an IRA involves a "recommendation to sell, purchase or hold securities," the suitability standard in Rule 2111 applies. In fact, FINRA states that a BD's "recommendation that an investor roll over retirement plan assets to an IRA *typically* involves securities recommendations subject to FINRA rules." (emphasis added) Further, FINRA emphasized that the marketing of IRAs and related services must comply with Rule 2210, which requires that communications with the public be "fair and balanced, and provide a sound basis to evaluate the facts about any particular security or type of security."

In effect, FINRA uses the Notice to establish the premise that a "recommendation" not only includes the recommendation of what securities to purchase once the rollover occurs, but also includes the recommendation to rollover in the first place. Apparently, FINRA's basis for this conclusion is that the natural consequence of a rollover recommendation is a corresponding recommendation to invest the new IRA assets in one or more securities. As further discussed below, in order to meet the suitability requirement under the FINRA rules, the BD and its representatives need to understand the nature of tax-qualified plans (not just the nature of the securities being recommended).

Application of Suitability Rule

Rule 2111, FINRA's suitability rule, requires a BD and its representatives to have a reasonable basis to believe that a recommended transaction or strategy is suitable for its customer. Under this rule, a recommendation to roll over Plan assets to an IRA – rather than keeping assets in the employer's Plan or rolling them 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 FINRA believes should be included in a recommendation are:

1. the range of investment options available under though the Plan versus the IRA;
2. the fees and expenses associated with the Plan versus the IRA;
3. the services provided through the Plan versus the services that could be provided through the IRA;
4. the tax consequences of investing through a Plan versus an IRA (e.g., the tax effects of rolling over employer stock versus leaving it in the Plan, application of the required minimum distribution rules, the long term and short term tax implications of a rollover decisions, etc.); and,
5. other legal protections, such as protection from creditors, offered by a Plan versus an IRA.

A fair reading of the Notice strongly suggests that BDs need to conduct a very thorough analysis about the "pros and cons" of rolling over the assets of a Plan to an IRA and significant training of representatives may be needed to meet these requirements. Further, the requirements potentially call for a substantial understanding of the individual Plan from which the distribution will be made (e.g., the fees and investments associated with a Plan almost always vary by Plan).

Conflicts of Interest

FINRA also highlights the fact that a recommendation whether or not to roll over the assets of a Plan contains an implicit conflict of interest. A BD is unlikely to earn commissions or other fees on assets that remain in an investor's former employer's Plan or that are rolled into a new employer's Plan. However, in some cases, such a decision may be the only suitable investment advice. As a result, FINRA "urges" broker-dealers to review their retirement services activities to assess conflicts of interest and for firms to supervise these activities to "reasonably ensure" that conflicts of interest do not impair a broker-dealer's judgment. Further, NASD Rules 3010 and 3012 require broker-dealers to:

1. ensure that marketing materials are fair and balanced;
2. establish written supervisory procedures designed to ensure that appropriate customer-specific suitability analyses are performed; and,
3. verify that these written procedures are reasonably designed to ensure compliance with federal securities laws and FINRA rules.

BDs should evaluate their marketing materials and compliance procedures to assure that FINRA's concerns are adequately addressed.

Alternative – Do Not Make Recommendations

FINRA noted that not all firms make recommendations. Rather, they simply make available educational information concerning their retirement choices. Such firms, according to FINRA, should adopt procedures designed to help assure that the representatives do not make recommendations. Such procedures should include training of representatives on how to present the choices without triggering a recommendation. BDs should also consider whether compensation arrangements might incent the representative to make a recommendation. Given the potential challenges of complying with the aforementioned requirements involved with recommending a rollover, firms might even consider limiting its personnel to providing education.

Looking Forward – DOL Regulatory Efforts

The Notice does not address a BD's obligations under ERISA, but the Notice does raise some interesting questions regarding what we might see in the DOL's proposed fiduciary regulation. Currently, except in limited circumstances, DOL guidance provides that a BD providing advice regarding a rollover does not result in fiduciary status under ERISA. *See* Advisory Opinion No. 2005-23A (Dec. 7, 2005). However, the DOL has indicated an interest in reversing its prior position and determining that a BD (or other party) provides investment advice in its regulation redefining the definition of "fiduciary."

We anticipate that the type of review described in the Notice may generally align with what the DOL would expect in the event the BD is an ERISA fiduciary. Further, because the conflict of interest prohibited transaction provisions under ERISA section 406(b) would apply, the BD would need to comply with an available statutory or administrative exemption or eliminate the conflict. Of course, how the DOL will interpret and apply the exemptions under a proposed new definition of fiduciary remains to be seen.

Conclusion

While in the eyes of FINRA the Notice may not contain any "new" guidance, we believe that many BDs will be surprised how the FINRA guidance will impact their current business models. Further, BDs will need to determine whether and how to meet the requirements outlined in the Notice. Finally, given the DOL's interest in further regulating the rollover marketplace, BDs should be aware that they may be facing further regulatory scrutiny in the not too distant future.