Bloomberg BNA

Pension & Benefits Daily ™

Reproduced with permission from Pension & Benefits Daily, 38 PBD, 2/26/14. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

View From Groom: Rollovers to IRAs From Employer-Sponsored Retirement Plans—Emerging Legal and Regulatory Standards

BY THOMAS ROBERTS

Regulatory initiatives seeking to improve the way American workers save for retirement have been primarily focused on the employer-sponsored Section 401(k) plan for quite some time. The Department of Labor's plan and participant-level fee disclosure initiatives under sections 408(b)(2) and 404(a) of the Employee Retirement Income Security Act are prime examples of those efforts; in both cases, the regulatory objective was to facilitate more informed decision making by plan fiduciaries and participants and hopefully improve the efficiency and effectiveness of the 401(k) plan as a retirement savings vehicle.

Ironically, during the same time period that the 401(k) plan has been front and center in the regulatory spotlight, it is the individual retirement account that has emerged as America's preeminent retirement savings vehicle. Consider the following statistics:

- Total IRA assets were recently measured at approximately $6.2 trillion. In comparison, 401(k) assets total a relatively modest $4 trillion. Even when 401(k) assets are combined with the assets of all other defined contribution plans, including tax code Section 457 and 403(b) plans, the resulting defined contribution asset total of $5.6 trillion falls well below total IRA savings.[1]

- The amount of retirement savings flowing into IRAs exceeds $300 billion annually and continues to grow.[2]

- The overwhelming majority of assets flowing into IRAs—by some estimates as high as 95 percent—are in the form of rollover contributions from 401(k) and other defined contribution plans.[3]

These figures suggest that the marketplace for retirement plan services and products has developed in such a way that 401(k) and other employer-sponsored defined contribution plans are now effectively functioning as ''feeder'' vehicles for IRAs. Plan participants, and particularly higher-balance plan participants, are choosing to exercise distribution rights when changing jobs or at retirement by rolling plan account balances into IRAs. ''Capturing the rollover'' is a strategy that numerous financial advisers and their firms, both broker-dealers and registered investment advisers, actively pursue. Financial institutions that offer rollover products have engineered and re-engineered their operations and systems to make the rollover experience as streamlined and effortless for the 401(k) participant as possible.

A number of recent developments suggest that federal regulators and policy makers may be engaged in a reassessment of the IRA rollover phenomenon. More importantly, several announcements seem to signal a regulatory interest in either imposing new duties on financial intermediaries when interacting with distribution-eligible plan participants or in reinterpreting existing duties and standards of care in new ways

Thomas Roberts (troberts@groom.com) is a member of Groom Law Group Chartered's fiduciary practice group. His expertise focuses on ERISA fiduciary matters and laws affecting defined contribution plan product and service offerings.

[1] Asset totals are as of Sept. 30, 2013. *See* Investment Company Institute release: quarterly market data, third quarter 2013, available at http://www.ici.org/research/stats/retirement/ret_13_q3.

[2] *See* Cerulli Associates, ''Evolution of the Retirement Investor 2013,'' as reported by Planadviser, Nov. 20, 2013.

[3] *See* Government Accountability Office Report 13-30, ''401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants'' (65 PBD, 4/4/13; 40 BPR 875, 4/9/13). http://www.investmentnews.com/article/20130403/FREE/130409971.

as a means of influencing and reconfiguring the rollover discussion.

This article briefly summarizes these important developments and highlights some of the challenges that financial institutions and advisers may face in light of regulatory efforts to reconfigure the operation of the rollover marketplace. While it is clearly too soon to tell what ultimate impact, if any, these regulatory initiatives may have, recent announcements from Financial Industry Regulatory Authority (FINRA) and the Security and Exchange Commission's Office of Compliance Inspections and Examinations signal a clear intent to test and further develop the standards of conduct that may apply to individuals and firms doing business in the rollover space.

The Regulation of Rollover Distribution Recommendations Under ERISA: The DOL's *Deseret* Opinion and Pending Initiative to Redefine Fiduciary Investment Advice. In a 2005 Advisory Opinion issued to Deseret Mutual Benefit Administrators,[4] the Department of Labor addressed the question of whether ERISA's fiduciary standards apply where a recommendation is made to a participant to take a distribution from his 401(k) plan account for reinvestment in an IRA that would generate management or other fees to the adviser making the recommendation. Back then, the department expressed the view that, in and of itself, a recommendation to a participant to take an otherwise permissible distribution from an employer-sponsored plan, even when combined with a recommendation as to how the distribution should be invested, would not constitute investment advice under ERISA. In the absence of circumstances under which the person providing the rollover recommendation would already be a fiduciary, as discussed below, the department's 2005 view was that the provider of the rollover recommendation would *not* be subject to ERISA's fiduciary standards.

Interestingly, in *Deseret* the department took into consideration and rejected a theory similar to one currently being advanced by FINRA and discussed below—namely, that the recommendation to take a distribution might implicitly involve a recommendation to sell a particular asset or security and therefore implicate standards of conduct applicable to securities sales recommendations. The *Deseret* opinion explained that the department did not view ''a recommendation to take a distribution as advice or a recommendation concerning a particular investment (*i.e.*, purchasing or selling securities or other property)'' as contemplated by department regulations and therefore wouldn't arise to the level of fiduciary investment advice.

The department also addressed the scenario in which someone who was *already* a plan fiduciary advised or recommended that a participant take a rollover distribution for purposes of reinvesting in an IRA. Under those circumstances, the department's view was that the plan fiduciary's recommendation, although still not investment advice under ERISA, would amount to a use of fiduciary authority respecting the management of the plan and control over the assets of the plan, and would therefore implicate ERISA's fiduciary standards. The department warned that an exercise of fiduciary discretionary authority and control, when coupled with a recommendation to invest the proceeds of the distribution in an IRA managed by the fiduciary, could involve prohibited fiduciary self-dealing.

Financial institutions that provide services to 401(k) plans have criticized *Deseret* as creating an uneven playing field that unfairly impairs their efforts to retain rollover-eligible assets in proprietary IRA products. The department's reasoning in *Deseret* suggests that service provider firms maintaining one or more fiduciary relationships to a 401(k) plan (for example, as the plan's directed trustee or as the investment manager of one or more plan investment options) may risk allegations of improperly leveraging that fiduciary status when recommending a proprietary IRA rollover product to a distribution-eligible participant. By contrast, financial institutions with no pre-existing relationships to a plan or its participants would seem to have been left with a relatively free hand to sell rollover products and to make rollover distribution recommendations.

The department has hinted strongly that it may soon create a more level playing field by revisiting its opinion in *Deseret* in the context of its regulatory initiative to redefine fiduciary investment advice under ERISA. In the preamble to its 2010 proposed regulation (since withdrawn) the department noted the concern that plan participants may not be adequately protected from advisers who provide distribution recommendations that subordinate participants' interests to those of the adviser and solicited input on other applicable laws and whether and how those laws safeguard the interests of plan participants. It is possible, if not likely, that the department will seek to recharacterize the nature of certain rollover recommendations as investment advice under ERISA, perhaps by adopting the view recently articulated by FINRA but rejected in *Deseret* that a recommendation to take a distribution from a plan is tantamount to a recommendation that a participant sell a particular plan asset or security.

The GAO's Report on 401(k) Rollovers: Plan-to-Plan Versus Plan-to-IRA Rollover Considerations. The GAO report undertook an examination of the IRA rollover marketplace using investigative techniques that included undercover calls to financial institutions that service 401(k) plans and also offer IRA products. The GAO expressed numerous concerns about the operation of the rollover marketplace and made a number of recommendations about how regulators should take action to reform and reshape the rollover market.

The report identified problems with what it perceived as efforts by 401(k) plan service providers to ''steer'' participants into proprietary IRA products as well as pervasive marketing of IRA rollover products in general. The report expressed concern that rollover product marketing may have created the false impression in the minds of participants that at termination of employment, a rollover to an IRA is the only distribution choice available, or at least the only sound one. The report also noted that IRAs may often involve higher levels of fees and expenses relative to 401(k) plans and posed the question of whether participants might be better off remaining in their prior employer's plan or rolling their account balance to the plan of a new employer than rolling over to an IRA.

Importantly, the GAO undertook a detailed analysis of what it perceived as administrative obstacles that discourage participants from consolidating 401(k) balances when changing jobs by rolling their old 401(k)

---

[4] DOL Advisory Opinion 2005-23A.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

plan account balance to the new employer's plan and recommended a number of reforms in that area. As discussed below, this concentrated focus on the potential availability of a new employer's plan to accept rollovers from a prior employer's plan has strongly influenced FINRA's views in this area.

The report urged the DOL to include, as part of its fiduciary definition initiative, a requirement that plan service providers assisting participants with distribution options provide conflicts-of-interest disclosures and the conditions under which they are subject to regulatory standards, such as ERISA fiduciary standards or securities law standards, and what those standards mean for the participant. The GAO report also urged the Internal Revenue Service and the DOL to work together to reduce impediments for plan-to-plan rollovers.

FINRA's "Reminder" to Broker-Dealer Firms of Their Responsibilities Concerning IRA Rollovers. In December 2013, FINRA issued Regulatory Notice 13-45, addressing the obligations of broker-dealer firms that make recommendations to 401(k) retirement plan participants to roll over or transfer their plan account balance to an IRA. Although styled as a "reminder" to member firms of already existing obligations to recommend suitable products, to be fair and balanced in customer communications, and to appropriately supervise firm representatives, the notice essentially reinterprets the application of those responsibilities in the context of a rollover discussion with a plan participant. In FINRA's view, a member firm's obligation to make securities recommendations that are "suitable" typically extends not just to the securities that the firm recommends that a client purchase, but also to the type of retirement account in which securities are held. Moreover, when a firm recommends that an investor sell his or her 401(k) plan assets and roll over the cash proceeds into an IRA, the recommendation to sell the plan-held securities is subject to the Rule 2111 suitability standard to the same degree as the recommendation to purchase securities in the IRA.[5] The notice indicates that in FINRA's view, rollover-related suitability obligations extend even further to encompass not merely a consideration of the pros and cons of the plan maintaining the distribution-eligible account, but also to the plan of the participant's current employer.

The implications of the notice for member firms are potentially profound. Under the notice, member firms seeking to "capture the rollover" opportunities presented by distribution-eligible 401(k) and other employer-sponsored plan account balances cannot simply urge clients to take an IRA rollover distribution as a means of selling IRA-related products and services, even if the securities they recommend be held by the IRA would be suitable. Instead, the member firm needs to have a reasonable basis to support the suitability of the rollover distribution recommendation itself by undertaking an evaluation of the pros and cons of remaining in-plan, rolling over to the plan of the participant's current employer or rolling over to the IRA product that the firm is authorized to sell. In many, if not most scenarios, demonstrating the suitability of a rollover recommendation in the manner contemplated by the notice will be no small task.

The nonexclusive list of factors identified by the notice that may be relevant to determining the suitability of rollover distribution recommendations includes:

■ *How satisfied an investor is with the range of investment options available under the plan.* Several examples of publicly available sales and marketing literature suggest that a distribution to a rollover IRA will permit investors to "take control" of their retirement savings by making available a broader universe of investments than those available in-plan. Yet many 401(k) plans already make brokerage windows available in addition to plan-designated investment alternatives, thereby making a virtually unlimited range of investments available through the plan.

■ *Fees and expenses.* Both plans and IRAs typically involve some combination of investment-related and administrative fees and expenses. In many cases, the purchasing power and scale of 401(k) plans allows them to offer investments with lower levels of fees and expenses than those of similar investments made available to retail investors. But how exactly does a member firm go about facilitating an apples-to-apples comparison of the fees and expenses borne by an investor remaining in-plan against the fees and expenses of an IRA? Under the DOL's participant-level fee disclosure, plan participants receive a chart comparing the fees and expenses of in-plan investments. The notice raises the question of the extent to which a member firm might be under an obligation to generate a side-by-side comparison of the fees and expenses associated with the investments it would recommend be held by the IRA against those of the in-plan investments.

■ *Services.* The notice suggests that consideration of this factor might involve some comparison of the services available to the participant through the plan, such as investment advice, help lines, planning tools and educational workshops, versus those offered by IRA providers, including investment advice, full brokerage service, distribution planning and online securities execution. Interestingly, the notice cites the availability of "investment advice" both through the plan as well as through the IRA as a point of comparison.

■ *Penalty-free withdrawals.* The notice points out that for individuals who have not yet reached age 59-1/2, penalty-free withdrawals may be more readily available from a 401(k) plan than from an IRA. The notice also mentions the availability of 401(k) loans as a point of distinction.

■ *Protection from creditors and legal judgments.* The notice notes that although state laws vary in the degree of protection afforded to IRA assets, as a general matter, 401(k) plan assets enjoy higher degrees of protection from creditors than do IRA assets.

■ *Required minimum distributions.* The notice points out that individuals who remain in service beyond age 70-1/2 may be able to avoid taking minimum required distributions (and therefore enjoy a longer tax deferral period) by maintaining 401(k) balances with their current employer's plan versus rolling to an IRA.

[5] In FINRA's view, even in instances in which no actual sale of plan-held securities occurs because the rollover is accomplished through an in-kind transfer of 401(k) plan account assets to the IRA, the transfer will nonetheless be regarded as involving a securities sale and purchase recommendation for purposes of the Rule 2111 suitability standard.

■ *Employer stock.* Participants holding employer stock through their 401(k) accounts may forgo their ability to enjoy net unrealized appreciation tax advantages if they roll those assets to an IRA.

FINRA does not address in the notice the ''selling away'' concern that would seem to arise under Rule 3040 where a registered representative conducts the suggested analysis, concludes that it would be more suitable for a participant to remain in-plan or seek to roll over his or her account balance to the 401(k) plan of a successor employer than to take an IRA rollover distribution, and recommends that path. Generally, under Rule 3040 a registered representative of a broker-dealer firm may not sell securities that are not approved for sale by the firm (*i.e.*, may not ''sell away'' from the firm). Also it is questionable whether the notice realistically takes into account the informational and logistical difficulties associated with conducting an informed comparison of these points on not just one but in many cases two 401(k) plans (the plan of the former employer and the plan of the current employer). Nonetheless, the notice indicates that the review of firm practices in this area will be a 2014 enforcement priority.

The notice also restates FINRA's previously expressed view[6] that under its rule governing broker-dealer communications with the public, Rule 2210, a firm may not claim that its IRA products are ''free'' or carry ''no fee'' if the investor will incur costs relating to the account or account investments.

SEC Notice of 2012 Enforcement Priorities. The SEC Office of Compliance Inspections and Examinations has announced that its priorities for 2014 will include a focus on rollovers. Part of that focus will involve examining the sales practices of investment advisers that target rollovers of 401(k) assets into higher cost investments, including whether advisers may be misrepresenting the benefits and features of IRAs. A related enforcement priority will be to examine broker-dealers and investment advisers for conflicts when recommending the movement of assets from a retirement plan to an IRA rollover account in connection with a client's change of employment.

Some Concluding Thoughts. The DOL, FINRA and the SEC are clearly engaged in a re-examination of the nature of the rollover discussion—a process that may result in heightened duties of care for service providers, broker-dealers firms and registered investment advisers that market IRA rollover products and services. Any new or reinterpreted standards of care are likely to focus at least in part on highlighting the financial interests that financial product or service providers have in winning new business by garnering IRA rollovers. Whether those heightened standards of care turn out to be realistic or appropriate remains an open question. As FINRA and the SEC move forward on their 2014 enforcement and examination priorities in this area, litigation challenges that could generate new law on appropriate standards of conduct are also possible. On the ERISA front, it is highly likely that if the DOL moves forward with a re-proposed definition of investment advice fiduciary, it will also revisit the conclusions it reached in *Deseret* and impose a higher level of care on individuals and firms in a position to influence participant rollover distribution decision making.

[6] *See* FINRA Regulatory Notice 13-23.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC.