Pension Plan Fix-It Handbook

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Plan Sponsors Need to Take Advantage Of Regulators' IRA Rollover Scrutiny

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It seems as though you can't pick up a newspaper or read a retirement industry publication without seeing something being written about rollovers. Why all the attention? Quite simply, there is a lot of money sitting in the individual retirement accounts that receive most of the rolled-over retirement funds of working or retired Americans.

To illustrate that point, an October 2014 U.S. Government Accountability Office report titled "Individual Retirement Accounts" indicated that for the 2011 tax year, IRAs had a total fair market value of $5.2 trillion.

While financial institutions will bear the brunt of expanded regulatory scrutiny of IRAs, it is important that employer plan sponsors be aware of financial institution practices regarding these accounts. Having knowledge of current guidance about IRAs also can be of use when highly compensated employees in the plan seek direction from the benefits office on decisions about their outside retirement savings.

In this column, we will provide a brief overview of the GAO report (GAO-15-16), which scrutinizes very large IRA account balances and how they got so large. The report indicated that:

- 43 million taxpayers had IRAs with a total fair market value of $5.2 trillion; and
- while only a few taxpayers had IRA balances greater than $5 million, those large-IRA owners tended to have high annual incomes (greater than $200,000) and be 65 or older.

The report notes that taxpayers' large IRA balances could have amassed them through investments not available to most people, such as those held by company founder using IRAs to invest in shares of their new company. In some cases, founders can realize millions from investing in their firm, if the company is successful.

The federal government is concerned about extra-large IRAs because, according to estimates for 2014 by the U.S. Treasury Department, about $17.45 billion in net income tax revenue is due to be lost in the year from the tax-preferred treatment accorded IRAs.

"Congress envisioned IRAs as a moderate tax benefit to help individuals not covered by employer-sponsored plans to obtain income sufficient for a secure retirement, not as a vehicle for accumulating significant tax-preferred wealth," the GAO report said.

While the number of actual taxpayers with IRA balances greater than $25 million (314) and between $10 million and $25 million (791) is relatively small when compared with the 42 million taxpayers with IRAs valued at less than $1 million, the government is concerned with abuse.

The GAO recommends that Congress revisit the legislative vision for IRAs, and includes recommendations to uncover undervalued assets and prohibited transactions in these accounts. Specific recommendations include compiling and digitizing data from Forms 5498, which are used to record information about IRA contributions, and using that data to analyze possible areas where IRS enforcement efforts can be stepped up (for example, oversight of non-publicly traded assets).

We can expect to hear more about these large IRAs.

Perhaps First Shot Across Rollover Bow

In 2013, the GAO issued a report called "401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants" (see August 2013 column) that may have foreshadowed the latest report on large IRA

See *Andersen*, p. 2

Andersen (continued from p. 1)

balances. Concerns noted in the 2013 report focused mostly on participants, and included:

- potentially higher fees for IRA participants. Staying in an employer's qualified plan allows the participant to benefit from institutional share investing, while an IRA generally offers retail share-class investments that may cost more;
- lost ERISA protection when the retirement account balance is transferred to an IRA; and
- financial benefits enjoyed by IRA service providers and, in some cases, the service provider representative, after placing the participant's account balance in their affiliated IRA.

Another worry raised in the 2013 report was that if the service provider is also the plan's recordkeeper, the participant may believe that the plan sponsor is actually endorsing the service provider as an IRA repository.

Both the Financial Investment Regulatory Authority, a non-governmental regulator for securities firms doing business with the U.S. public, and the U.S. Securities and Exchange Commission included examination of IRA rollovers among their priorities in 2014. In October 2014, the GAO also issued a report about IRAs (see above).

Regulatory Reaction?

Financial Industry Regulatory Authority: While it is not clear if FINRA and the U.S. Securities and Exchange Commission were responding directly to the 2013 GAO report on IRAs, both organizations increased their focus on rollovers in 2014. FINRA released Regulatory Notice 13-45[1], which reminded investment firms of their responsibilities toward IRA rollovers. The notice is an easy-to-read and informative document. It is worth the time because it could provide potential interview questions for plan sponsors selecting a rollover provider/investment adviser or for those monitoring current providers (see box on p. 3). In addition, there is a wealth of resource material in the footnotes.

Note: In 2010, the U.S. Department of Labor proposed regulations on the definition of a fiduciary. In response to more than 200 comment letters and two days of public hearings, DOL announced that it would issue new proposed regulations (see November 2011 column) for this area. One of the goals of DOL's Employee Benefits Security Administration is to ensure that potential conflicts of interests do not compromise investment advice. As of December 2014, these proposed regulations have not been released. This theme is also emphasized by both FINRA and the SEC. Comment letters indicated the need for coordinated guidance from the federal agencies; perhaps we are in the early stages of a coordinated effort.

Key takeaways from the FINRA report include the following points for investment advisers and broker-dealers:

- avoid conflicts of interest[2]: FINRA urges financial service firm representatives not to confuse investors considering establishing an IRA, and to always consider the investor's investment profile when suggesting IRA services, rather than the firm's interests;
- recommend only investments that are suitable for a particular investor; and
- use clear communications material. There can be no false, misleading or exaggerated statements in marketing material.

SEC: In its 2014 examination priorities[3], the SEC noted that there may be incentives for investment advisers and broker-dealers to recommend a particular investment or financial services firm, and that can be especially problematic for retirement plan distributions.

The SEC indicated that it would examine:

- Rollover sales practices of investment advisers targeting retirement-age workers. In particular, the SEC planned to examine sales practices that would result in greater costs to the participant, as well as the adviser's credentials and the actual investment product.
- Financial representatives' communications, including marketing and advertising material, with an eye

See *Andersen,* p. 3

Andersen (continued from p. 2)

toward ensuring investor suitability, conflicts of interest and presentation of misleading credentials.

What Does This Mean for the Plan Sponsor?

While much of the activity noted above is geared toward the financial industry, plan sponsors should be aware of industry/regulatory expectations for financial investment advisers. Knowing some basic requirements will help ensure a prudent selection and monitory process. ❖

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Using FINRA Notice 13-45 to Select Or Monitor a Service Provider

Plan sponsors can frame questions of rollover investment service providers to incorporate the FINRA notice's requirements. Some examples would be:

- How do you determine if an investment is suitable for a participant?
- What steps have you taken to prevent potential broker/adviser conflicts of interest?
- Do your supervisory procedures comply with federal securities law and FINRA rules?
- Have you ever been cited for providing misleading or exaggerated communication material?

[1] https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p418695.pdf

[2] http://www.finra.org/web/groups/industry/%40ip/%40reg/%40guide/documents/industry/p359971.pdf

[3] http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf