

Approved by the Investor Advisory Committee at the December 2, 2021 Meeting

Recommendation of the Investor as Purchaser Subcommittee of the SEC Investor Advisory Committee regarding Individual Retirement Accounts

I. Introduction

Since mid-2020 the Investor Advisory Committee has been discussing investor protection issues affecting self-directed IRAs. Prompted by the Commission's concerns regarding the risks associated with IRAs that may be invested in alternative assets, and the enormous amount of investors' retirement savings invested in IRAs and 401(k)s,¹ the IAC began researching the state of investor protection in this area.

The Commission first highlighted concerns about self-directed IRAs in a 2018 Investor Alert, acknowledging that while most IRA assets are invested in stocks, bonds, and mutual funds, certain self-directed IRAs are invested in alternative assets such as real estate, digital assets, tax liens and private placement securities, among others.² These alternatives may be custodied with banks, trust companies or other IRS approved IRA custodians who do not have specific investor protection responsibilities. Overall, the risks associated with these types of IRAs include a lack a complete disclosure and limited liquidity. In addition, given the limited role of custodians of these assets, these investments and accounts may be more susceptible to fraud.

The IAC sponsored a panel discussion about self-directed IRAs at its September 2020 meeting. The panelists discussed a wide range of issues relating to IRAs, concluding that IRAs invested in traditional asset classes are reasonably well protected, but that there are investor protection gaps when it comes to investment in alternatives.³

In March 2021, the IAC hosted a follow-on panel on self-directed IRAs and challenges that arise when 401(k) participants leave or change jobs.⁴ The IAC focused on the reasons for a startling \$3.83 trillion shortfall in retirement savings in households representing 35-64 year olds.⁵ While the 2006 Pension Protection Act greatly improved participation in employer-sponsored retirement plans, according to the Employee Benefit Research Institute (EBRI), the retirement

¹ As of year-end 2020, assets in employer-sponsored retirement plans, IRAs, and annuities totaled \$34.9 trillion at year-end 2020. The largest components of retirement assets were IRAs and 401(k) plans, which together totaled \$18.9 trillion, or 54 percent of all retirement market assets at year-end 2020. See 2021 Investment Company Institute Fact Book at figure 8.5, available at https://www.icifactbook.org/21_fb_ch8.html.

² SEC Investor Alert, Self-Directed IRAs and the Risk of Fraud (Aug. 8, 2018), available at <https://www.sec.gov/investor/alerts/sdira.html>.

³ See SEC Investor Advisory Committee, Minutes of the Meeting of September 24, 2020, available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac092420-minutes.pdf>.

⁴ See SEC Investor Advisory Committee, Minutes of the Meeting of March 11, 2021, available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac031121-minutes.pdf>.

⁵ Figure is based on modeling by the Employee Benefit Research Institute's (EBRI) Retirement Security Projection Model®. See EBRI Issue Brief, How Much More Secure Does the SECURE Act Make American Workers: Evidence From EBRI's Retirement Security Projection Model® (Feb. 20, 2020), available at https://www.ebri.org/docs/default-source/ebri-issue-brief/ebri_ib_501_secure-20feb20.pdf?sfvrsn=db6f3d2f_4.

savings shortfall stems from lack of coverage and access to savings plans, low contribution rates, and leakage in the form of defined contribution plan loans, withdrawals, and cashouts.⁶ In particular, the March panel discussion focused on the harm to investors attributable to the lack of portability options in employer sponsored retirement plans. Lack of portability of 401(k) plans results in significant leakage of retirement savings when employees change jobs and either cash out their retirement nest egg or allow it to sit idle in an IRA that is invested in a cash preservation vehicle. Either way, the individual investor is not well served.

Over the course of several months, the IAC explored the multidimensional issues around these individual retirement accounts, particularly for underserved communities. The Committee consulted the Commission staff, as well as representatives from FINRA, professional associations, state regulators, law firms, universities, and industry groups.

Based on this work, the IAC believes investor protection can be improved for certain IRA investors and retirement savers and offers several recommendations for consideration. In doing so, however, the IAC is acutely aware that jurisdictional authority over this area is shared by several federal agencies and departments and that the SEC's authority is limited to activities directly affecting the capital markets, certain types of investments and their providers and anti-fraud measures. Nevertheless, given the size of this segment of the market⁷ and the Commission's leadership in protecting the interests of investors, the IAC believes it is important to share its views and recommendations with the hope that all government agencies that touch this area will coordinate their efforts to improve retirement savings and investment. In addition, the Dodd-Frank Act, which established the IAC, clearly charges the committee with the duty to advise and consult with the Commission regarding a wide range of matters, including initiatives to protect investor interests, and to promote investor confidence and the integrity of the securities markets. The Dodd-Frank Act also contemplates that the IAC may offer suggestions for legislative changes.⁸

To that end, the IAC makes the following recommendations as described and supported more fully below:

1. The Commission should encourage the DOL and Treasury departments to improve the portability of retirement accounts and the rules relating to force outs.
2. The Commission should continue to focus on the use of alternative assets in IRAs and look for opportunities to enable better coordination with other regulators, pursue anti-fraud investigations and improve disclosure.

⁶ *See id.*

⁷ *See supra* note 1.

⁸ *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 911, 124 Stat. 1822 (2010) (codified at 15 U.S.C. § 78pp) (“The Committee shall . . . submit to the Commission such findings and recommendations as the Committee determines are appropriate, including recommendations for proposed legislative changes.”).

3. The Commission should seek opportunities to coordinate closely with state and federal agencies to enhance investor protection and retirement savings, and when appropriate, advise the relevant Congressional oversight committees of regulatory gaps that threaten the protection of Americans saving for retirement.

II. Investor protection concerns arise when 401(k) participants leave or change jobs.

Each year, 15 million, or 22% of all defined contribution plan participants will change jobs. Of these, 4.7 million, or 31%, will cash out their retirement savings completely within the first year after job change. In 2013, a [case study at a mega plan sponsor](#) proved that retirement savings portability can reduce post-separation cash outs by over 50%. Further, in March 2017, [EBRI](#) found that [as much as \\$2.0 trillion](#) could be retained in the U.S. retirement system if auto portability were fully implemented.

The 2021 Retirement Confidence survey found that 85% of workers would find it valuable if their retirement plan savings with a previous employer were automatically transferred to their current employer's plan if/when they changed jobs. Eighty-nine percent of Black workers reported that they would find this valuable, and 91% of Hispanic workers did so as well.

The Federal Retirement Investment Board has announced its intention to implement auto portability within the Federal Thrift Savings Plan by 2022. Moving investments automatically into an employer plan with an already vetted menu of investment options should be cheaper and easier than the retail market. Auto portability also improves the ease of tracking accounts, updating beneficiaries, and financial planning. Auto portability is aligned with the goal of financial inclusion, particularly for Black, Hispanic, and underserved communities who are largely in favor of auto portability.

Impact of the Existing Safe Harbor for Small Account Force Outs

In 2005, the Department of Labor (DOL) created a safe harbor for plan sponsors with provisions to force out balances between \$1,000 and \$5,000 from 401(k) plans. The safe harbor included a requirement that the forced-out balances must be invested in a capital preservation vehicle with reasonable expenses. Recent EBRI research finds that 76% of balances less than \$5,000 reside in money funds. This compares to 25% of balances greater than \$5,000 in money funds.⁹

It is important to note that 52.9% of traditional IRAs with balances between \$1,000 and \$5,000 are held by workers ages 25-44. This is not a demographic that financial planners generally recommend hold high allocations of money funds. Further, 44.5% of traditional IRAs with balances between \$1,000 and \$5,000 were established at least four years earlier. Most financial advisors would not recommend large allocations to money funds for long-term investors. And

⁹ See EBRI Issue Brief, Comparing Asset Allocation Before and After a Rollover From 401(k) Plans to Individual Retirement Accounts (Nov. 7, 2019), available at https://www.ebri.org/docs/default-source/ebri-issue-brief/ebri_ib_495_assetallocation-7nov19.pdf?sfvrsn=85cc3c2f_4.

for workers ages 25-29, 76.3% had IRA balances of \$1,000 to \$5,000 in money assets even though the accounts were established at least seven years prior.

While 401(k) plan assets that are forced out into IRAs are required to be invested in capital preservation funds, automatic enrollment safe harbors within 401(k) plans require that assets be invested in diversified investments such as target date funds. Further, state IRA programs such as Illinois Secure Choice Savings Program have successfully found a middle ground by implementing default investment options that initially place worker savings into capital preservation vehicles, and then if no action by the worker has been taken after 90 days (such as withdrawing the money or moving it to another fund), the assets are automatically transferred to an age appropriate target date fund.

Recommendations

1. The SEC should encourage the Department of Labor and Treasury to improve the portability of 401(k) plan accounts.

The Department of Labor (DOL) issued an advisory opinion in 2018 supporting programs designed to automatically move an individual's small account from a prior employer's defined contribution plan to a default IRA -- and then ultimately into that individual's account in a new employer's defined contribution plan. In 2019, the DOL also published a prohibited transaction exemption on auto portability requested by Retirement Clearinghouse, LLC (RCH). RCH'S technology aims to help employees "consolidate small accounts held in a prior employer's individual account plan and rollover IRA into a new employer's 401(k) or other defined contribution individual account plan."

While a couple of major recordkeepers have adopted such auto portability to date, broad adoption of auto portability remains slow. Notably, this was also the case with such auto features as automatic enrollment, automatic escalation, and target date funds: Adoption was slow until the Pension Protection Act of 2006 established a safe harbor for these solutions. Once the safe harbor was established, adoption greatly increased and now such features are the norm in private DC plans.

The IAC recommends that the SEC encourage the DOL to consider an auto portability safe harbor, especially for small accounts (e.g., \$5,000 or less). DOL also should consider comparable proposals that encourage participants to retain, coordinate, and monitor their retirement accounts.

Further, under the current system, one of the most difficult ways for defined contribution plan participants to maintain their money in the retirement system is to roll their balances from their former employers to their current employers' defined contribution ("DC") plan. Plan-to-plan transfers of existing DC balances involves a burdensome process for plan participants including extensive paperwork, certification processes, and lack of electronic processing. In April 2014, the U.S. Department of Treasury issued Revenue Ruling 2014-9 titled "Rollovers to Qualified Plans." The ruling sought to simplify the process of rolling monies from one qualified

plan to another by giving an example of steps that can be taken for receiving administrators to reasonably conclude that rollover contributions are valid. While a step in the right direction, there is more that should be done to simplify and automate plan to plan transfers, including further easing certification requirements, encouraging automation by recordkeepers, and reducing paperwork. As such, the SEC should also encourage the Treasury to consider additional proposals that make it easier for participants to transfer plan balances from the former to the current employer's qualified DC plan.

2. Revisiting the Force Out Safe Harbor

Regarding the safe harbor for 401(k) force outs into IRAs, the IAC recommends that the SEC advise the DOL to change the default so that money remaining in capital preservation funds after 90 days is transferred to an age-appropriate target date fund, similar to what state programs like Illinois Secure Choice have in place. The IAC also recommends considering other innovative proposals that encourage participants to retain, coordinate, and monitor their retirement accounts.

III. Investor protection concerns regarding the oversight of self-directed Individual Retirement Accounts

So-called "self-directed individual retirement accounts" (SDIRAs) are IRAs held by a custodian¹⁰ that allow investment in a broader set of assets than is permitted by other types of IRAs. The broader set of options may include real estate, promissory notes, tax lien certificates, private placement securities, and so-called "digital assets" such as cryptocurrencies, coins, and tokens. Generally, the SDIRA custodians do not (1) research, investigate, or recommend investments to accountholders; (2) verify the accuracy of information on the investor's statement; (3) ensure a full and accurate disclosure of all details regarding the investment; or (4) hold the investment funds or assets.¹¹ Moreover, in most cases, the so-called "alternative" or "unconventional" investments permitted in SDIRAs are subject to fewer disclosure requirements than conventional IRA investments such as stocks and bonds.¹²

¹⁰ Generally, financial institutions offer SDIRAs with and without "checkbook control." Checkbook control gives SDIRA owners complete signing authority over an account that gives them access to their retirement funds. To establish checkbook control, SDIRA owners set up a limited liability company (LLC), fund the LLC using SDIRA assets, and then establish an LLC checking account. "Checkbook control" accounts are advertised as faster, easier, and cheaper because they reduce the role of the custodian.

¹¹ The U.S. Government Accountability Office (GAO) has found in recent years that the custodial agreements for SDIRAs often shift full legal responsibility to the account owners for the selection, management, monitoring, and retention of all investments in the account. In addition, the agreements shift essentially all responsibility to the account owners for noncompliance with applicable rules, including tax rules. *See* GAO, Individual Retirement Accounts: IRS Could Better Inform Taxpayers about and Detect Noncompliance Related to Unconventional Assets, [GAO-20-210](#) (Jan. 2020) at 4.

¹² *See, e.g.*, North American Securities Administrators Association, Inc. (NASAA), Webinar to Help Raise Awareness of Challenges and Opportunities of Self-Directed IRA Investing (July 9, 2012), *available at*

The government divides the responsibility for overseeing SDIRAs among several federal, state, and independent entities. At the federal level, Congress has the authority to conduct oversight and legislate in this area.¹³ At the federal and state levels, the U.S. Department of Labor, the SEC, the Financial Industry Regulatory Authority, Inc., the state securities regulators, the Office of the Comptroller of the Currency, state banking regulators, and the IRS¹⁴ all provide some oversight of some aspect of SDIRA-related investing. The specific mix of regulators varies depending on the type of financial institution that provides the account, the state in which the financial institution conducts the business, and the type of plan offered.¹⁵

For years, securities regulators have received reports or complaints of fraudulent investment schemes that use a SDIRA as a key feature. Experience indicates that fraudsters prey on and amplify any misperceptions that SDIRA owners have regarding the duties and responsibilities of SDIRA custodians or investment promoters. To protect prospective and existing SDIRA owners, regulators have published multiple educational resources to warn investors of the potential risks associated with investing through SDIRAs.¹⁶ In addition, they have brought enforcement actions where appropriate.¹⁷

<https://www.nasaa.org/13831/webinar-to-help-raise-awareness-of-challenges-and-opportunities-of-self-directed-ira-investing/?qoid=newsroom>.

¹³ See NASAA, Legislative Agenda for the 117th Congress (2021) at 13, available at <https://www.nasaa.org/wp-content/uploads/2021/03/NASAA-Legislative-Agenda-for-117th-Congress.pdf> (calling on Congress to examine the relationship between SDIRAs and fraud, including what, if any, steps the industry is taking to address these problems or whether legislation may be in order).

¹⁴ The IRS maintains an electronic list of entities approved, under Treasury Regulation Section 1.408-2(e), to serve as nonbank trustees or custodians. See IRS, Approved Nonbank Trustees and Custodians (last updated on July 1, 2021), available at <https://www.irs.gov/retirement-plans/approved-nonbank-trustees-and-custodians>; Treasury Inspector General for Tax Administration, Oversight of Nonbank Trustees Has Improved, but Resources Expended on the Program Should be Reevaluated, 2012-10-055 (May 11, 2012), available at <https://www.treasury.gov/tigta/auditreports/2012reports/201210055fr.html>; GAO, Individual Retirement Accounts: IRS Could Better Inform Taxpayers about and Detect Noncompliance Related to Unconventional Assets, GAO-20-210 (Jan. 2020) at 7, available at <https://www.gao.gov/assets/gao-20-210.pdf>.

¹⁵ See GAO, Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets, GAO-17-102 (Dec. 2016) at 11-13, available at <https://www.gao.gov/assets/gao-17-102.pdf>.

¹⁶ See, e.g., NASAA and the SEC, Self-Directed IRAs and the Risk of Fraud (Sept. 28, 2011), available at <https://www.nasaa.org/5866/self-directed-iras-and-the-risk-of-fraud/?qoid=investor-education>; NASAA, Informed Investor Advisory: Third-Party Custodians of Self-Directed IRAs and Other Qualified Programs (Dec. 2014), available at <https://www.nasaa.org/33698/informed-investor-advisory-third-party-custodians-self-directed-iras-qualified-programs/?qoid=investor-education>; SEC Investor Alert, Self-Directed IRAs and the Risk of Fraud, *supra* note 2.

¹⁷ For example, in 2020, 30 states and the Commodity Futures Trading Commission (CFTC) obtained an asset freeze and a receivership in a \$185 million precious metals scam targeting senior citizens nationwide that made use of SDIRAs to execute the scheme. See CFTC Press Release, CFTC and 30 States Charge Los Angeles Precious Metals Dealers in Ongoing \$185 Million Fraud Targeting the Elderly, Rel. No. 8254-20 (Sept. 25, 2020), available at <https://www.cftc.gov/PressRoom/PressReleases/8254-20>. See also Ohio Department of Commerce, Division of Securities, Pitfalls and Precautions of Self-Directed IRAs, Securities Bulletin Issue 2016:1, available at https://www.com.ohio.gov/documents/secu_Bulletin2016FirstQuarter.pdf. Texas State Securities Board, In a Self-Directed IRA, Make Sure You're Not Your Own Worst Enemy (May 16, 2019), available at <https://www.ssb.texas.gov/news-publications/self-directed-ira-make-sure-youre-not-your-own-worst-enemy>; Appendix A hereto—William Carrigan comments to the U.S. Securities and Exchange Commission Investor

To the knowledge of the IAC, however, nobody in the federal or state government has led a coordinated effort to better understand and analyze the extent of the potential and actual harms to SDIRA owners.

SDIRA custodians generally do not perform the same services as a traditional IRA custodian. Specifically, SDIRA custodians generally do not have the fiduciary duties associated with investment advisers. Further, these SDIRA custodians expressly disclaim a role in the evaluation of investments and rely on the issuer to provide all valuation information. Enforcement actions taken by state securities regulators each year involve fraudsters accessing retirement funds in SDIRAs after they have been rolled over into the SDIRA, and this can be devastating to an investor's retirement. This is exacerbated by the fact that custodians generally do not evaluate the quality of the investments in the SDIRA or its promoters.¹⁸ Even though custodians do not act as fiduciaries of SDIRAs, they may be perceived as such by the accountholders—lending an air of credibility to the issuer—and bad actors can often prey on and amplify this misperception.

Recommendations

- 1. The SEC should enhance its current activities regarding SDIRAs and create an internal task force to focus on and learn from these activities.***

The SEC has been active in considering the investor protection challenges of SDIRAs and has used the tools available to it to oversee this area. For example, the Commission's Division of Corporation Finance and Investment Management regularly have opportunities to review certain underlying investments such as real estate investment trusts, business development companies and certain funds. The Division of Trading and Markets governs the role of broker-dealers as custodians.¹⁹ When it comes to promotional and sales activities, Trading and Markets, the Division of Investment Management and FINRA have the opportunity to determine whether risk disclosures are adequate and whether the fiduciaries involved in these promotions are meeting their best interest obligations to investors. The anti-fraud rules have been applied to SDIRAs and the SEC's Divisions of Examinations and Enforcement should continue to scrutinize these activities.

The IAC suggests that the Commission would enhance its coverage of SDIRAs by establishing an internal task force of representatives from each Division and Department that touches IRAs to coordinate more closely with each other to prevent investor protection issues from arising due

Advisory Committee Follow-On Panel Discussion Regarding Self-Directed Individual Retirement Accounts (Mar. 11, 2021) (listing examples of frauds that included self-directed IRAs).

¹⁸ In addition to disclaiming any duty to independently value the assets in the SDIRA, when the custodian reports a distribution to the IRS it may be for an inflated value if the issuer has not provided any updated information to the custodian regarding a fraudulent, worthless investment.

¹⁹ SEC and FINRA Staff, Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities (July 8, 2019), available at <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities>.

to regulatory gaps. In addition, these internal experts would be well positioned to interact with other interested regulators such as the IRS and the State Securities regulators who are in a position to further protect IRA investors.

Regulatory oversight of SDIRAs is imperative to promote safe investing, wealth accumulation, and financial inclusion, but the IRS and other federal regulators have not asserted jurisdiction over the practices of these custodians, and state securities regulators have not been consistently successful in their attempts to assert such jurisdiction. The IAC recommends that the SEC further examine the relationship between SDIRAs and the types of fraud that may target accountholders.

2. *The SEC should coordinate with and assist other regulators in developing more comprehensive disclosures.*

The SEC could promote more simplified and standardized IRA disclosures—similar to a summary prospectus. The goal should be to determine whether there are additional disclosures that need to be made accountholders so that IRA accountholders understand that custodians of SDIRAs do not act as fiduciaries to these IRAs, that product providers are not overseen by custodians in a fiduciary role, and further that custodians disclaim all duties beyond recordkeeping and acting similarly to an escrow agent for the transaction.

The following categories of disclosure would help unsophisticated retail investors understand the role of the SDIRA custodian better:

- A clear statement disclaiming the lack of fiduciary oversight or other duty of the custodian, as the custodian does not review the product for any purpose or in any way.
- Full disclosure of fees charged – especially continuing management fees when there is nothing in the account to manage as well as those charged to close the account when the funds are lost, and the investment is worthless. Custodians should also disclose that they will report a “distribution” to the IRS in these cases.
- The relationship between the promoter and the custodian, including complete and understandable disclosure of any compensation and/or benefit between the two and the impact of this conflict of interest on their investment.
- Possible tax consequences if investment is in a product not allowable by the IRS. The custodian does not provide any guidance on whether the product meets the IRS standards, and the investor is fully responsible for the tax consequences and penalties if the product is not allowable by the IRS.
- The awareness that the investor can use any SDIRA custodian, not just the one approved by the promoter.

- The explanation that the funds are merely funneled through the custodian to the promoter, and that the custodian does not hold any funds, conduct any due diligence, or otherwise approve the product for the account, but serves as a record-keeper of the transaction and valuations provided to it by the issuer at the issuer’s discretion.
- The clarity that the custodian is not regulated by any securities regulator or the IRS.

IV. The Commission should seek appropriate opportunities to advise the relevant Congressional oversight committees of regulatory gaps that threaten the protection of Americans saving for retirement.

The IAC also recommends that the SEC direct its internal taskforce to identify regulatory gaps that diminish the protection of investors in IRAs. The Commission could then share this information with other interested regulators as well as the relevant Congressional oversight committees, and advocate for better, more comprehensive regulatory authority necessary to enhance retirement savings for American workers.

V. Conclusion

The IAC strongly believes that there are multiple opportunities to improve investor protections for certain IRA investors and retirement savers. Clearly jurisdictional authority over this area cuts across a number of federal agencies and departments. However, given the size of the IRA and retirement market—and understanding the Commission’s leadership in protecting the interests of investors—the IAC believes it is important to share its views and recommendations with the hope that all government agencies that touch this area will coordinate their efforts to improve retirement savings and investment. In addition, as noted earlier, the Dodd-Frank Act establishing the IAC clearly charges the committee with the duty to advise and consult with the Commission regarding a wide range of matters, including initiatives to protect investor interests. The Dodd-Frank Act also contemplates that the IAC may offer suggestions for legislative changes. It is within the framework that the IAC has made its recommendations to the SEC.