FINRA
Financial Industry Regulatory Authority
Investor Education Series
Investor Alert

Key Topics:

- Early Retirement
- Older Investors
- Fraud
- Free Seminars
- IRS Section 72(t)

WHAT'S INSIDE

Look Before You Leave: Don't Be Misled By Early Retirement Investment Pitches That Promise Too Much

Early retirement is an alluring prospect. When faced with a pitch that promises that you can cash in your company retirement savings in your 50s, reinvest the money and live comfortably off the proceeds for the rest of your life, many simply can't say no. But usually they should. This Alert is being issued because we are aware of instances in which employees who had built up sizeable retirement savings have been misled, and financially harmed, by flawed, even fraudulent, early-retirement investment schemes.

Misleading Statements and Excessive Withdrawals

A recent enforcement action identified one such scheme. Employees of a major corporation attended free seminars where a broker pitched a strategy that recommended investors take one or more of the following actions:

- Retire earlier than they might otherwise have done
- Opt out of the company's retirement plan (opting out typically required the employee to cash out of his or her 401(k) plan or take a lump-sum payment for the cash value of his or her pension)
- Open a traditional Individual Retirement Account at the broker's firm
- Invest in variable annuities, Class B and C mutual fund shares, and exchange-traded fund shares, which were substantially more risky than the fixed benefit pension they had given up

During the seminars, these investments were represented as being able to generate aggressive annual returns as high as 18 percent. Little mention was made of the risks associated with such an aggressive growth scenario, such as the fact that the value of the investments would fluctuate with changes in market conditions. The pitch also failed to adequately explain that the overall return to customers on their investments would be reduced by various fees and expenses associated with the purchase and ongoing administration of the investments.

Furthermore, the strategy recommended annual withdrawal amounts generally starting at 7.5 percent to 9 percent of the customer's initial investment, with increases at five-year intervals. While materials given to individual customers in one-on-one meetings portrayed these rates as being sustainable for more than 30 years, they assumed returns of 11 to 14 percent. The reality is that these rates proved unrealistic and were not achievable. Customers who followed the broker's program could not maintain the recommended withdrawal amounts without depleting their retirement accounts to levels that threatened their retirement security. By the time many of the customers realized this, they had lost a significant portion of their retirement nest egg. Thirty-three customers who invested more than $22 million will be paid restitution of more than $13.8 million by the broker's firm.

Finally, the broker in this case misrepresented his own qualifications as a Certified Public Accountant (his CPA certification had long since become inactive), overstating his ability to handle the complicated tax planning associated with taking early withdrawals from a qualified retirement plan.

What the IRS Says About Early Withdrawals from Your Retirement Plan

Alert. In addition to the income tax you pay on most retirement plan withdrawals, Section 72(t) of the Internal Revenue Code imposes an additional tax of 10 percent on distributions from qualified retirement plans—including traditional IRAs—made before age 59 ½. The IRS does, however, allow you to avoid this 10 percent penalty if the distributions from your retirement plan "are part of a series of substantially equal periodic payments." These payments must last for five years or until you reach age 59 ½, whichever is longer, and IRS rules govern how you calculate the amount of the payments. For more information on Section 72(t) and methods for calculating payments, see the IRS's FAQs regarding Revenue Ruling 2002-62: *www.irs.gov/retirement.*

Be Skeptical of Early Retirement Investment Claims

Smart Thinking. Because the allure of a leisurely retirement can be quite tempting, and those who promote early retirement schemes can be extremely persuasive, it's critical that you think carefully before you act.

Taking early retirement presents risks, and only makes sense if you have saved enough to begin with, make smart investment choices during your retirement years and withdraw money at a rate that does not deplete your savings too early. While there is no perfect consensus on what this withdrawal rate should be, the uncertainty of return, market fluctuations and increased life expectancies, among other factors, argue for being conservative with your withdrawals, especially during the first years of retirement. While FINRA can make no recommendation, many experts recommend withdrawal rates between 3 to 5 percent per year—considerably less than the 7 to 9 percent withdrawal rates being recommended in the scheme above.

Be especially skeptical if you hear comments such as the following:

- **"Everyone can retire early!"** The reality is that not everyone has the resources to do so. Early retirement is not feasible for many people and is particularly risky for workers who haven't saved enough for an extended retirement and who have limited opportunities for other employment.
- **"You can make as much in retirement as you can by continuing to work!"** Promises like this usually hinge on unrealistically high returns on investments and unsustainably large yearly withdrawals.
- **"You can expect returns of 12 percent or more!"** First of all, no one can predict what an investment will do from one year to the next—and even if an investment performed well in the past, this is no guarantee it will do so in the future. Second, any return over 10.4 percent exceeds the historical long-term returns for the stock market (assuming all dividends were reinvested rather than spent), and greatly exceeds long-term returns for less risky

investments such as bonds, for which the average annual return over the long term is less than 6 percent. Finally, the stock market is inherently volatile—it goes up, and it goes down. Over the past 80 years, there have been many short term periods that produced returns well below the historical average of 10.4 percent.

➤ **"You can withdraw 9 percent or more and never run out of money!"** Unless you have substantial retirement assets, withdrawing this amount can lead to rapid depletion of your principal, and even smaller withdrawal amounts may cause you to outlive your retirement assets.

Tips to Avoid Being Taken In.

Good Idea. Don't let the promise of easy money lure you into an early retirement you weren't otherwise considering. Before you quit your day job (or night job) and invest your retirement savings, follow these tips:

1) **Be skeptical of "free lunch" training sessions** and other seminars that promote early retirement strategies, even if those events take place at the workplace. Don't assume that your employer is behind the event.
2) **Be wary of early retirement pitches that invoke exceptions to IRS Section 72(t)** as a "little-known loophole" that allows you to retire early. There's a lot more to a successful early retirement than avoiding a 10 percent tax penalty.
3) **Think hard before trading the relative certainty of a company pension**—which may offer steady and predictable payments for as long as you live—for the uncertainty of investments such as variable annuities and mutual funds whose value fluctuates, creating an unpredictable income stream and putting your nest egg at risk.
4) **Many employers allow former employees to leave their 401(k) assets** in the company's plan. If that's a choice you have, you may find that it's the safest and least costly option. For more information on how to make smart decisions concerning your retirement nest egg, please see Smart 401(k) Investing: *www.finra.org/InvestorInformation/SmartInvesting*.
5) **Before quitting and cashing in a 401(k)**, do a little math. Remember that even if you avoid the 10 percent early withdrawal tax penalty, you won't be able to spend every penny. Instead, you will have to pay ordinary income taxes on your withdrawals. Be sure to ask a tax professional about any other potential tax consequences of your decision.
6) **You may also wish to consult an attorney** about any other unintended consequences, especially if you are in debt or owe child support or alimony. Depending on the laws in your state, cashing out of your retirement plan may mean that your creditors can collect against that payment you receive—even if you're rolling the assets to a traditional IRA.
7) **If the strategy involves mutual fund investing**, keep in mind that Class A mutual fund shares may be the best choice if the investment amount is large enough to qualify for a discount on front-end sales loads that may be offered for larger mutual fund investments and usually starts at $50,000, but sometimes can be as low as $25,000. Use FINRA's Mutual Fund Expense Analyzer to compare and calculate mutual fund expenses: *www.finra.org/investor*.
8) **If the strategy involves variable annuities**, be aware that most variable annuities have sales charges, including asset-based sales charges or surrender charges. In addition, variable annuities may impose a variety of fees and expenses when you invest in them, including mortality and expense fees, administrative costs, and investment advisory fees. Some products offer, for an extra fee, enhanced benefits that go beyond standard contract features, such as living benefits—which are designed to protect a client's future income stream—as well as death benefits—which are designed to protect a client's death benefit payable to a beneficiary. The bottom line: Variable annuities can be complex and expensive relative to other investments.
9) **Check out whether the person offering you early retirement investments is registered** with FINRA by checking FINRA BrokerCheck or calling our Hotline at (800) 289-9999. If he or she is registered, be sure to check out any red flags raised by employment or disciplinary history at *www.finra.org/brokercheck*.

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10) Seek a second opinion before committing to an early retirement strategy. Consider taking the initiative to set up an appointment with a financial professional before taking the advice of someone who "found you." To get started, read the Securities and Exchange Commission's *How to Pick a Financial Professional: www.sec.gov/investor/pubs/roadmap/pick.htm*

Keep in mind that your retired life may be as long as, or longer than, your working life. Take the time to research your retirement options carefully—before you leave the working world behind.

More Information

- Investor Alert: *Variable Annuities: Beyond the Hard Sell*
- Investor Alert: *Mutual Fund Breakpoints: A Break Worth Taking*
- Investor Alert: *Understanding Mutual Fund Classes*
- Investor Alert: *Think Twice Before Cashing Out Your 401(k)*
- Securities and Exchange Commission's Variable Annuities: *What You Should Know*
- IRS's FAQ related to Section 72(t): *FAQ regarding Revenue Ruling 2002-62*

Investor Resources

FINRA Investor Information—Investor Alerts, tools and much more to help you invest smarter and safer.

- Investor Alerts
- Smart Saving for College
- Mutual Fund Expense Analyzer
- Smart Bond Investing
- Smart 401(k) Investing
- Financial Calculators

Web site: *www.finra.org/investor*
Phone: (202) 728-6964

FINRA Market Data—Data on equities, options, mutual funds and a wide range of bonds, including real-time corporate bond prices and the FINRA-Bloomberg Corporate Bond Indices.

Web site: *www.finra.org/marketdata*

FINRA BrokerCheck—Check the background of a broker or brokerage firm.

Web site: *www.finra.org/brokercheck*
Toll Free: (800) 289-9999

FINRA Investor Complaint Center—If you feel you've been treated unfairly.

FINRA Investor Complaint Center
9509 Key West Avenue
Rockville, MD 20850-3329

Web site: *www.finra.org/complaint*
Fax: (866) 397-3290

FINRA Dispute Resolution—If you seek to recover damages.

FINRA Dispute Resolution
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

Web site: *www.finra.org/ArbitrationMediation*
Phone: (212) 858-4400
Fax: (212) 858-4429

About FINRA

FINRA, the Financial Industry Regulatory Authority, is the largest nongovernmental regulator for all securities firms doing business with the U.S. public. The FINRA Investor Education Foundation is the largest foundation in the U.S. dedicated to investor education. The Foundation's mission is to provide investors with high-quality, easily accessible information and tools to better understand the markets and the basic principles of saving and investing.

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 1/08