Regulatory Notice 19-04

529 Plans

FINRA's 529 Plan Share Class Initiative Encourages Firms to Self-Report Potential Violations

January 28, 2019

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics
- 529 Plans
- Share Classes
- Suitability
- Supervision

Referenced Rules & Notices
- MSRB Rule G-19
- MSRB Rule G-27

Summary

Over the past several years, FINRA has found that some firms have failed to reasonably supervise brokers' recommendations of multi-share class products.[1] FINRA has raised concerns specifically regarding firms' supervision of share-class recommendations to customers of 529 savings plans ("529 plans").[2]

FINRA is launching a 529 Plan Share Class Initiative to promote firms' compliance with the rules governing 529 plan recommendations, to promptly remedy potential supervisory and suitability violations related to recommendations that customers of 529 plans buy share classes that are inconsistent with the accounts' investment objectives, and to return money to harmed investors as quickly and efficiently as possible. As described in this *Notice*, to encourage voluntary reporting under this initiative, FINRA's Department of Enforcement (Enforcement) will recommend that FINRA accept favorable settlement terms for firms that self-report these potential violations and provide FINRA with a detailed remediation plan.[3]

Questions concerning this *Notice* should be directed to:

- Christopher Kelly, Senior Vice President, Enforcement, at (732) 596-2082; or
- Christopher Burky, Senior Director, Enforcement, at (312) 899-4348.

Background & Discussion

529 plans are tax-advantaged municipal securities that are designed to encourage saving for the future educational expenses of a designated beneficiary. Because 529 plans are municipal securities, the sale of 529 plans are governed by the rules of the Municipal Securities Rulemaking Board (MSRB).[4] MSRB Rule G-19 (Suitability of Recommendations and Transactions)

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requires, in part, that firms and brokers that sell municipal securities have a reasonable basis to believe that a recommended transaction is suitable in light of the customer's investment profile. MSRB Rule G-27 (Supervision) requires firms to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable MSRB rules.[5]

Shares of 529 plans are commonly sold in different classes with differing fee structures.[6] Class A shares typically impose a front-end sales charge but charge lower annual fees compared to other classes.[7] Class C shares typically impose no front-end sales charge but impose higher annual fees than Class A shares. These classes have a differing cost impact depending on the length of time the customer holds the securities. The MSRB has stated that information known about the designated beneficiary generally would be relevant in weighing the investment objectives of the customer, including information regarding the age of the beneficiary and the number of years until the funds will be needed to pay qualified education expenses of the beneficiary.[8] Further, the MSRB has stated that information regarding the designated beneficiary should be treated as information relating to the customer's investment objective for purposes of Rule G-19.[9]

Similarly, in the mutual fund context, FINRA has repeatedly cautioned that firms must supervise recommendations to purchase higher-expense share classes, particularly when an investor is seeking a long-term investment.[10] With regard to Class C share sales, for example, FINRA has cautioned that customers should be informed "of the potential long-term effect of the higher ongoing sales charges" associated with holding Class C shares, and that firms should "maintain written records of [such] discussions in their files."[11]

Effective in January 2018, amendments to the Internal Revenue Code expanded the use of 529 plans for tuition for grades K-12, subject to certain limitations. While 529 plan distributions were tax-free when used to pay for qualified higher education expenses (*i.e.*, expenses incurred at or around the time the beneficiary is college-aged, typically 18 years or older), now, in addition, up to $10,000 per year in 529 plan withdrawals would be tax-free if used for elementary or secondary educational expenses (*e.g.*, expenses incurred when the beneficiary is as young as four or five years old). These additional considerations underscore the importance of recommending a share class that is tailored to the unique circumstances and needs of the customer, as well as the importance of supervising such recommendations.

FINRA is concerned that because of the unique features of 529 plans, some member firms may not provide adequate supervision. For example, 529 plan transactional data, including account asset levels, may not be available in the systems that firms use to monitor other types of transactions. This initiative is intended to encourage firms to assess their supervisory systems and procedures governing 529 plan share-class recommendations, to identify and remediate any defects, and to compensate any investors harmed by supervisory failures.

The 529 Plan Share Class Initiative

Who should consider self-reporting?

Firms are encouraged to review their supervisory systems and procedures governing 529 plan share-class recommendations and self-report to FINRA areas where their supervision may not have been reasonable.[12] Potential areas of concern include the failure to:

- provide training regarding the costs and benefits of different 529 plan share classes;
- understand and assess the different costs of share classes for individual transactions;
- receive or review data reflecting 529 plan share classes sold; and
- review share-class information, including potential breakpoint discounts or sales charge waivers, when reviewing the suitability of 529 plan recommendations.

Firms that identify and self-report issues with 529 plan share-class supervision should also assess and self-report the potential impact of such supervisory failures. Firms may choose to assess the potential impact by conducting a customer-specific analysis, reviewing each customer's investment objectives and investment horizon, and assessing whether the firm recommended a suitable share class for that customer given his or her facts and circumstances. Alternatively, firms may choose to assess the potential impact of supervisory failures using a statistical approach to identify categories of 529 plan customers invested in share classes that are not economically advantageous if held for the accounts' expected investment horizon. For example, in many plans that offer both A and C share classes, the aggregate costs of a C share tend to exceed the aggregate costs of an A share after approximately six to seven years. Therefore, when assets are expected to be invested for more than six to seven years (for example, in a 529 plan purchased for the future college expenses of a beneficiary younger than 12), an A share might be the more cost-effective choice. Thus, firms could consider identifying 529 plan customers who invested in Class C shares for the future college expenses of beneficiaries younger than 12.[13] FINRA will work with firms that prefer to develop different statistical models as a more effective way to assess potential impact.

When and what firms should self-report?[14]

To be eligible for the 529 Plan Share Class Initiative, firms must self-report by providing written notification to FINRA Enforcement by 12:00 a.m. E.T. on **April 1, 2019**. Notification can be made by email to *529Initiative@finra.org* or by mail to 529 Plan Initiative, FINRA, Department of Enforcement, Brookfield Place, 200 Liberty Street, New York, New York 10281. A firm that has timely self-reported must, by **May 3, 2019**,[15] confirm its eligibility for the 529 Plan Share Class Initiative by submitting all of the following information for the period of January 2013 through June 2018 (the "disclosure period").

- **i.** A list of the 529 plans sold by the firm, including the 529 plan name and the dates the firm offered each 529 plan.
- **ii.** The total aggregate principal amount invested in each 529 plan sold by the firm during the disclosure period.
- **iii.** A description of the firm's supervisory systems and procedures relating to 529 plan sales during the disclosure period.
- **iv.** A description of the changes to the firm's supervisory systems and procedures that the firm has implemented or will implement in order to strengthen compliance with its supervisory obligations. To the extent the firm identifies changes that have not yet been implemented, the firm should identify the individual supervisor at the firm who is responsible for the implementation.
- **v.** The firm's assessment of potential impact on customers of supervision weaknesses, including a description of the firm's methodology for assessing impact on customers and a description of the firm's proposal to make restitution payments to harmed customers.
- **vi.** Any other information the firm believes would assist Enforcement in understanding the firm's assessment of an account's expected investment horizon, the suitability of the firm's recommendations, or the reasonableness of the firm's supervisory system regarding share class recommendations.

Standardized Settlement Terms

To the extent that a firm meets the requirements of the 529 Plan Share Class Initiative, and Enforcement decides to recommend a formal enforcement action based on the facts disclosed by the firm through the 529 Initiative and any other relevant information, Enforcement will recommend that FINRA accept a settlement that includes restitution for the impact on affected customers[16] and a censure, but no fine.[17] Recommended settlements also will include either an acknowledgement that the firm has voluntarily taken corrective actions or undertakings to do so. Enforcement anticipates that settlements entered into pursuant to this 529 Initiative will include charges under MSRB Rule G-27 (Supervision). Settlements under this rule would not result in a firm's "statutory disqualification" as that term is defined in Section 3(a)(39) of the Securities Exchange Act of 1934.

No Assurances for Firms That Do Not Self-Report

In 2019, FINRA's Member Supervision and Enforcement departments will continue to examine and investigate firms' supervision of share-class recommendations to customers of 529 plans. If a firm does not self-report under the 529 Initiative but FINRA later identifies supervisory failures by that firm, any resulting disciplinary action likely will result in the recommendation of sanctions beyond those described under the initiative.[18]

No Assurances Offered With Respect to Individual Liability

The 529 Plan Share Class Initiative covers only member firms. Enforcement provides no assurance that individuals associated with these firms will be offered similar terms if they sold 529 plans to customers in violation of MSRB rules, or violated any securities laws. Enforcement may recommend enforcement action against such individuals and may seek sanctions beyond those resulting from the initiative. Assessing whether to recommend enforcement action against an individual necessarily involves a case-by-case assessment of specific facts and circumstances.

Endnotes

1. *See* 2017 Report on FINRA Examination Findings, at 7 (Dec. 2017).
2. FINRA's 2016 Regulatory and Examination Priorities Letter, at 7 (Jan. 2016). A 529 plan is structured as a trust. The trust is divided into investment options and those investment options then may invest in mutual funds. A customer purchases units in the trust. Most 529 plans offer different "unit" class pricing options similar to the share class pricing offered by open-end mutual funds. For purposes of this initiative, the terms "unit class" and "share class" are used interchangeably.
3. FINRA settlements must be accepted by Enforcement prior to submission to the Office of Disciplinary Affairs (ODA) or the National Adjudicatory Council (NAC) Review Subcommittee. The NAC, or ODA on behalf of the NAC, must then approve the Letter of Acceptance Waiver and Consent (AWC) before it becomes final.
4. FINRA is responsible for examining FINRA members that are municipal securities dealers or municipal advisors and for enforcing MSRB rules.
5. In addition, MSRB Rule G-17 (Conduct of Municipal Securities and Municipal Advisory Activities) requires that firms and their associated persons deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice. *See* Interpretation on Customer Obligations Related to Marketing of 529 College Savings Plans (Aug. 7, 2006) ("[D]ealers must ensure that they do not engage in transactions primarily designed to increase commission revenues in a manner that is unfair to customers under Rule G-17.").
6. Direct-sold 529 plans, versus broker-sold 529 plans, may have different share-class fee structures.
7. Breakpoint discounts typically cause the front-end sales charge to decrease as the amount invested increases.
8. *See* Interpretation on Customer Obligations Related to Marketing of 529 College Savings Plans (Aug. 7, 2006).
9. *Id.*
10. *See Notices to Members 94-16* (March 1994) and *95-80* (Sept. 1995).

11. NASD Regulatory & Compliance Alert (Summer 2000), at 15.
12. Firms that already have been contacted by Enforcement as of the date of this announcement regarding potential violations related to 529 plan share class sales are not required to self-report under the initiative. Firms that are subject to pending examinations by FINRA are eligible to self-report under the initiative.
13. Importantly, a recommendation that a customer purchase 529 plan Class C shares for an account with a beneficiary age 12 or younger is not *per se* unsuitable. There may be circumstances in which the recommendation of higher-expense Class C shares is suitable in light of the customer's facts and circumstances.
14. Self-reporting under the initiative does not replace firms' obligations to determine whether to self-report under FINRA Rule 4530. However, a firm's reporting obligation under Rule 4530 is triggered only if the firm concludes that it violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization. Further, for purposes of FINRA Rule 4530(b), only those violations that meet the reporting threshold under FINRA Rule 4530.01 are required to be reported. With respect to violations by a firm, FINRA Rule 4530.01 requires the firm to report only conduct that has widespread or potential widespread impact to the firm, its customers or the markets, or conduct that arises from a material failure of the firm's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts. If the firm concludes (or reasonably should have concluded) that such a violation has occurred, it is obligated to report pursuant to FINRA Rule 4530(b). However, under the 529 Plan Share Class Initiative, FINRA is asking member firms to self-report *any* areas of concern regarding the reasonableness of their supervisory policies and procedures.
15. Enforcement may grant an extension of time to submit the required information. To obtain an extension, member firms must email requests to *529Initiative@finra.org* at least two days before the deadline.
16. Enforcement will confer with the firm on an acceptable methodology for calculating restitution. The relevant time periods under any settlement, including the period for calculating any restitution, may differ from the disclosure period.
17. Alternatively, Enforcement may, based on the particular facts and circumstances presented, determine that formal action is not appropriate and instead resolve the matter informally or with no further action. FINRA also will consider whether widespread violations are best addressed through the issuance of additional regulatory guidance.
18. Assessing whether to recommend enforcement action necessarily involves a case-by-case assessment of specific facts and circumstances.