

Understanding FINRA'S 529 Plan Share Class Initiative

By Kamran Fotouhi, John Ivan and Brian Rubin

Stealing a page from the US Securities and Exchange Commission's (SEC) Share Class Selection Disclosure playbook, on January 28, 2019, FINRA announced its 529 Plan Share Class Initiative (the "Initiative") to encourage firms to self-report potential supervisory and suitability violations relating to 529 savings plans. FINRA's primary concern relates to share class recommendations that are inconsistent with the accounts' investment objectives. Typically, Class A shares impose a front-end sales charge but charge relatively low annual fees, while Class C shares impose no front-end sales charge but impose higher annual fees than Class A shares. According to FINRA, the aggregate cost of C shares tends to exceed the aggregate cost of A shares after approximately six to seven years. Therefore, when assets are expected to be invested for this time frame, an A share will often be less expensive. In particular, FINRA highlighted that if a beneficiary is younger than 12 years old, an A share might be "more cost-effective." On February 20, 2019, FINRA's senior executives provided additional guidance about the Initiative, and answered questions submitted by participating member firms.

FINRA is using a "carrot and stick" approach. Firms that voluntarily self-report violations will likely settle enforcement actions with FINRA through Letters of Acceptance, Waiver and Consent (AWCs) alleging violations of MSRB Rule G-27 (Supervision), and ordering restitution for affected customers and a censure, but no fine. FINRA also indicated that the AWC will not subject the firm to a statutory disqualification process. If firms do not self-report, but possibly should have, and FINRA later identifies supervisory violations, any resulting disciplinary action will likely result in sanctions beyond those described under the Initiative. This probably means assessing fines against the firms and possibly alleging additional violations.

To be eligible for the Initiative, firms need to self-report to FINRA with written notification by "12:00 a.m. E.T. on April 1, 2019." And then, by May 3, 2019, firms must submit certain information for the period of January 2013 through June 2018 (the "disclosure period"). It is important to note that the "disclosure period" differs from the restitution period. According to Endnote 16 of the Notice, "[t]he relevant time periods under any settlement, including the period for calculating any restitution, may differ from the disclosure period." Based on discussions with firms currently negotiating 529 settlements, it appears that the restitution period will begin in 2008, requiring firms to gather data starting then.

According to [Regulatory Notice 19-04](#), unless FINRA grants an extension, firms must provide the following information by May 3:

- List of the 529 Plans sold by the firm, including plan name and dates offered.
- Total aggregate principal amount invested in each 529 Plan.
- Description of the firm's supervisory systems and procedures relating to 529 Plan sales.
- Description of changes to the firm's supervisory systems and procedures that have been or will be implemented to strengthen compliance with its supervisory obligations, including the name of the supervisor responsible for changes that have not yet been made.
- Assessment of the potential impact of supervisory weaknesses on customers, including the firm's methodology for assessing customer impact and the firm's proposed restitution payments to harmed customers. FINRA stated that firms may assess the potential impact through either (1) a customer-specific analysis to review investment objectives and investment horizons, or (2) 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.
- Any other information the firm believes would assist FINRA in understanding the firm's assessment of expected investment horizon, suitability recommendations, or the supervisory system for share class recommendations

About the Authors

Kamran Fotouhi is a Managing Director at [Capital Forensics, Inc.](#) He can be reached at kamran.fotouhi@capitalforensics.com.

John Ivan is a Managing Director at [Capital Forensics, Inc.](#) He can be reached at john.ivan@capitalforensics.com.

Brian Rubin is a Partner at [Eversheds Sutherland](#). He can be reached at brianrubin@eversheds-sutherland.com.

Self-Reporting Considerations

During the February 20th conference call, FINRA emphasized that firms should focus on their overall supervisory systems, including whether they had a process for obtaining and reviewing all relevant information.

In order to assess whether there were supervisory deficiencies during the period to merit self-reporting, firms may want to first consider whether their 529 Plans were the previously the subject of:

- Regulatory Examination Reviews and Findings
- Annual Rule 3120 Internal Control Reports
- Firm Audits, Compliance Risk Assessments, and Testing
- 4530 Self-Reporting Process Logs

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Such findings, enhancements and resolutions will need to be carefully assessed. If FINRA previously examined firms on 529 plan supervision, through Compliance or through counsel, firms may want to discuss this fact with FINRA.

Key participants in the assessment will be Supervision, Compliance and other control areas such as Risk Management and Legal. Because of the unique features, benefits and certain risks of the 529 Plans, the product knowledge of the person or team heading up the self-reporting assignment is of critical importance. Since 529 Plans have unique “Product” specific supervisory factors, firms might want to review their documentation of New Product Approval and Product Review processes during the period. A firm may also want to have its 529 Mutual Fund Product experts, along with its Mutual Fund Operations professionals participate in the assessment process.

Cataloguing Information & Documents with Key Risk Factors

Most 529 Plan transactions were conducted directly, making it more challenging to obtain the documentation and data files required. FINRA is expecting firms to request and capture information from Fund Companies, if not readily available within the firm’s current books and records.

Of the requirements listed above for self-reporting, the first two are easily summarized by highlighting the 529 Plans sold, dates offered, and the principal amounts invested in each plan. Knowing which 529 Funds have the most dollars invested will provide a high-level risk assessment by fund or fund family.

The firm may have developed its own data sources or employed a third-party vendor to provide supervisory reports for direct 529 Plan business. Firms should work with their Compliance, Product and Information Technology departments to develop a comprehensive list of relevant supervisory reports and data files that will be required to complete this assessment. Below is a sample report identifying this information:

| Report/ File Name | Data Source & Frequency | Date Available | Brief Description | Purpose/ Usage |
|-----------------------------|--------------------------------|------------------------|---|--------------------------------------|
| 529 Exception Report | Proprietary/ monthly report | March ‘10 - Present | Identifies transactions in C Shares when the beneficiary’s age is 12 years or younger | Supervisory/Branch and Compliance |
| 529 Transaction File | Fund Family/ daily life | Jan ‘10 - Present | Contains 529 Plan transactions occurring the previous day | Central Supervision |
| Missed Breakpoint Alerts | Trade Blotter Review/daily | May ‘01 - Present | Alerts to identify missed breakpoints | Branch |
| RR Contact Management Notes | Firm CRM notes/ as needed | Jan ‘05 - Present | Used to record client communications notes and reason for share class chosen | RR and Ranch |

This information will be valuable in providing a description of the firm’s supervisory systems and processes. This exercise may identify weaknesses in the firm’s supervisory structure for further enhancements.

Change Control – Written Supervisory Procedures (WSPs)

Assemble each version of the firm’s Written Supervisory Procedures (WSPs) and Compliance Policies regarding sales of 529 Plans for the Review Period. Equally important are the myriad of supervisory checklists, client documents and compliance forms that supplement those Policies and Procedures. A 529 Policy may have addressed appropriate share class in general terms of time horizon, while the checklists and forms specifically go into more detail regarding the age of the beneficiary. Charting revisions will help the firm quickly identify details needed for the analysis, and for designing unique considerations – known as “business rules” – to be used in the impact assessment.

| Description | Location | Date Made | Description of Change |
|------------------------------|---------------------------|-----------------|--|
| 529 Plan Suitability | WSP 1Q - 2000 | January 7, 2009 | A Shares only for beneficiary age 10 years or younger |
| 529 Supervision Requirements | Notice to Branch Managers | May 5, 2010 | Investment objectives should align to the beneficiary age and time horizon |
| 529 Plan Suitability | WSP 1Q - 2015 | January 5, 2016 | C Shares only for beneficiary over 12 years old |

A firm may want to consider aggregating a timeline of key dates, events and factors covering training, testing and internal control changes. The Firm Training and Continuing Education Materials for both Registered Representatives and Supervisory personnel are an important part of effective supervision. Also, a review of the firm’s compliance testing and oversight controls as reflected in the sources listed above might produce information that could support a sound supervisory program.

Assessment – Determine Strengths and Weaknesses

Once the 529 Plan policies, supporting documents, data and relevant personnel have been identified, the next step to consider is assessing the design, implementation and oversight of the Supervisory procedures and controls.

Who: Determine who made the assessments of appropriate share class recommendations - local Branch Supervision, Centralized Supervision with escalation to local Supervision or some type of hybrid combination. Determine whether supervisors were adequately trained on the unique features and risks of 529 Plans and, in particular, share class and breakpoint opportunities.

When: Determine whether the firm had daily or periodic supervisory reports and exception reports, or if supervision was limited to 529 Plan applications. Did the firm periodically review additional contributions or breakpoints for suitability?

How: How did supervisors assess 529 Plan transactions? Did the tools include all transactions (direct and cleared)? Firms may have been requiring a mutual fund analyzer at point of sale to support recommendations and supervision. Determine if 529 Plan transactions were included or excluded from other mutual fund supervisory controls and reports for items including breakpoints, and C share concentrations. Validate that 529 supervision was included in annual branch examination samplings, regular compliance surveillance controls, and annual or periodic control testing. Examine whether firm-based or vendor-supplied supervisory data reports were tested during the Review Period and if any parameters changed. Were there periods when data was simply not available or in a form that was not useable in effective supervision?

What: Determine whether 529 accounts with beneficiaries under a certain age were subject to any extra supervisory steps for share class recommendations. Important considerations include:

- Exceptions to Policy - Were there required disclosures that Registered Representatives needed to make and were disclosures needed to be sent to and/or received from clients?
- Did supervisory procedures address longer term holdings of C shares? Were additional supervisory contacts required?
- Confirm that 529 Plans offered household breakpoints when available per Fund and Plan information. If 529 Plan data was not included in breakpoint Reports, determine how the firm addressed this.

Assessing the Financial Impact to Customers

FINRA allows for an individual client-by-client assessment of share class cost impact. However, this may be impractical for many firms based on the large volume of relatively small transactions.

Determining an alternative statistical methodology for this analysis can prove challenging, including gathering all required information and data elements. Calculations will need to address:

- ▷ Cost share class analysis based on designated beneficiary age
- ▷ Cost share class analysis based on length of time the customer held the securities
- ▷ Breakpoint calculations
- ▷ C share class auto-conversion

FINRA has requested a description of the firm's methodology for assessing impact on customers and each firm's proposed restitution to harmed customers. After the analysis has been completed, firms should consider setting up a call with Counsel, and eventually with FINRA, to discuss the methodology prior to the final submission.

Analytics

FINRA has historically been comfortable with applying a 75 basis point differential (C vs. A) as documented in Mutual Fund Fee Waiver Settlements. FINRA is aware of certain limitations in client data that may exist for a lookback to 2008. Firms may want to consider employing conservative assumptions. For example, if householding information is not available for a fund family that allows for aggregation (ROA) to achieve breakpoints for 529 purchases, the firm may want to provide for a lower sales charge (breakpoint achieved) in its comparison calculations. Firms should consider sharing these assumptions with FINRA staff for feedback. Most C share purchases will become more expensive compared to A shares at approximately year 6. From a simplified scoping approach, a specific fund held for nine years will receive remediation for a three-year period. Firms may want to also include interest for accounts that no longer hold C shares but are due remediation from historical activity; this is similar to FINRA settlements covered under Mutual Fund Fee Waivers for Retirement and Charitable Accounts. Please note that when performing 529 analytics, there may be considerations stemming from the amendments to the Internal Revenue Code, effective January 2018, as explained in Regulatory Notice 19-04.

After firms have put in place a remediation methodology, the final item of importance is enhanced processes/procedures and increased training. Firms now may want to consider an approach for dealing with the 529 C shares remaining on the books that would be better suited in A shares. Should a firm wait for an auto conversion (close to date) or begin the conversion process proactively with the mutual fund carriers? The process of proactive conversion will require operational coordination with funds, supported by communication/letters to clients identifying the actions taken by the firm. There has not been specific guidance provided by the Municipal Securities Rulemaking Board (MSRB) on whether such a conversion would require negative or positive consent. However, based on informal discussions with FINRA, negative consent will likely be sufficient. Firms may want to consider verifying with FINRA through Compliance or through Counsel.

It should be noted that most mutual fund companies have been modifying their 529 C shares over the last 18 months to include auto conversions for various periods including 10 years and seven years.

Summary

As with any of the recent significant regulatory initiatives involving Mutual Fund share classes, FINRA's 529 Plan self-reporting initiative requires an experienced perspective on industry 529 Supervisory practices. Similar to the SEC's share class selection disclosure playbook, there are legal considerations on both the self-reporting decision and the results of any prior FINRA examinations relating to 529 Plans.

Calculating assessments and customer impact will be difficult due to the data challenges inherent in most firms' 529 business platforms for such a lengthy review period. The tight window offered for self-reporting and assessment will require immediate data gathering and project planning. A well-designed data analytics platform that addresses fund share class expenses (C vs. A) and breakpoint schedules will be critical to support the assessment methodology, as well as future remediations.

Finally, on the February 20th call, FINRA announced that they would be issuing FAQs, along with "A Few Minutes with FINRA" video presentation, discussing this Initiative.