Why FINRA's 529 Plan Self-Reporting Initiative Matters a Year Later For Participating Firms and for Firms That Did Not Participate

By Kamran Fotouhi, John Ivan, Christine Cornejo, Brian Rubin, and Sarah Sallis

About the Authors:

Kamran Fotouhi is a managing director at Capital Forensics, Inc.
He may be reached at Kamran.Fotouhi@CapitalForensics.com

John Ivan is a managing director at Capital Forensics, Inc.
He may be reached at John.Ivan@CapitalForensics.com.

Christine Cornejo is a managing director at Capital Forensics, Inc.
She may be reached at Christine.Cornejo@CapitalForensics.com.

Brian Rubin is a partner at Eversheds Sutherland.
He can be reached at brianrubin@evershedssutherland.com.

Sarah Sallis is an associate at Eversheds Sutherland.
She can be reached at sarahsallis@evershedssutherland.com.

Over a year ago, on January 28, 2019, FINRA announced its 529 Plan Share Class Initiative (the Initiative) to encourage firms to self-report potential violations of rules governing 529 plan share class recommendations.[1] FINRA's concern centered around the potential that supervisory programs were not reasonably designed to determine whether representatives were making suitable share class recommendations given the varying time horizons of beneficiaries. The initiative had a focus on client restitution and relatively expeditious remediation that would have been slower through routine or targeted examinations and individual enforcement actions.

According to FINRA, approximately 100 broker-dealers elected to participate; whether a firm will be formally sanctioned depends upon the facts of each case.[2] Other firms decided not to participate. The deadline for participation in the Initiative has long since passed,
however, the issues and regulatory concerns underlying the Initiative remain relevant for both participating and non-participating firms. Here is why:

- **Remediation is here.** Participating firms are now entering into the critical remediation phase of their discussions with FINRA, the results of which will impact firms' financials, compliance and supervisory systems for years to come.[3]
- **Examinations continue.** FINRA is continuing to incorporate 529 sales practice issues into firms' examination schedules, particularly for non-participating firms.
- **Suitability analysis has evolved**. Fundamental changes in 529 plans and Mutual Fund C shares have altered the underlying suitability analysis.
- **Regulation Best Interest (Reg. BI) is around the corner.** The effective date for Reg. BI is June 30, 2020.[4] The Care Obligation component of Reg. BI will largely replace FINRA Rule 2111 (Suitability) for securities recommendations, including 529 plan recommendations made by firms and associated persons. Both the SEC and FINRA will examine firms' compliance with Reg. BI.

Initiative Participants: Remediation Developments

a. Disclosure period substantially extended by FINRA staff

According to Regulatory Notice 19-04, the Initiative's disclosure period ran from January 1, 2013 through June 30, 2018. However, footnote 16 of the same notice states that "[t]he relevant time periods under any settlement, including the period for calculating any restitution, may differ from the disclosure period."[5]

And, indeed, much to the surprise of participating firms, FINRA has been focusing on a remediation period beginning in 2008.

FINRA never formally declared 2008 as the remediation start date of the Initiative; there was no such indication in subsequent videocasts[6] or regulatory announcements related to the Initiative.[7] Rather, firms learned of the lengthier remediation period through word of mouth, or through discussions with FINRA staff. Despite the lack of formal announcement, the remediation period for participating firms

1. FINRA Regulatory Notice 19-04, FINRA's 529 Plan Share Class Initiative Encourages Firms to Self-Report Potential Violations (Jan. 29, 2019) available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-04.pdf. For more details on the Initiative, including factors member firms may have considered in choosing to participate, see "Understanding FINRA'S 529 Plan Share Class Initiative," by Kamran Fotouhi, John Ivan and Brian Rubin, Currents (Feb. 2019), available at https://www.capitalforensics.com/wp-content/uploads/2019/03/NSCPCurrents-February-2019-Reprint-Fotouh-Ivan-Rubin.pdf ; and Eversheds Sutherland Legal Alert: FINRA's 529 Plan Share Class Initiative (Feb. 7, 2019), available at https://us.eversheds-sutherland.com/NewsCommentary/Legal-Alerts/217798/Legal-Alert-FINRAs-529-plan-share-class-initiative.
2. ALI-CLE, Life Insurance Company Products 2019: Featuring Current SEC, FINRA, Insurance, Tax, and ERISA Regulatory and Compliance Issues (Nov. 7, 2019), available at www.my.ali-cle.org.
3. The coronavirus pandemic will likely delay these negotiations. See FINRA's dedicated CoVID-19 information webpage for more updates and guidance related to the pandemic, available at https://www.finra.org/investors/insights/fraud-and-coronavirus-covid-19.
4. On June 5, 2019, the US Securities and Exchange Commission (SEC) adopted Reg. BI, a new rule establishing a "best interest" standard of conduct for broker-dealers and their natural associated persons when making recommendations to retail customers of any securities transaction or investment strategy involving securities or regarding the opening of an account. See "Regulation Best Interest: The Broker-Dealer Standard of Conduct," SEC Release No. 34-86031 (June 5, 2019) (the Adopting Release), available at https://www.sec.gov/rules/final/2019/34-86031.pdf. For more detailed information on Reg. BI, see Eversheds Sutherland Legal Alert: Getting the full picture – The emerging best interest and fiduciary duty patchwork (July 12, 2019), available at https://us.evershedssutherland.com/NewsCommentary/Legal-Alerts/223517/The-emerging-patchwork-of-fiduciary-investment-adviceregulation-Putting-the-pieces-together-update
5. Reg. Notice 19-04.
6. https://www.finra.org/rules-guidance/guidance/few-minutes-with-finra/529-plan-share-class-initiative
7. https://www.finra.org/media-center/news-releases/2019/finra-launches-new-initiative-member-firms-self-report-529-savings-plan

appears to be consistent with the remediation period FINRA discussed with firms examined prior to the Initiative's inception. Consistent with that approach, FINRA announced two settlements after the Initiative that included remediation periods beginning in 2008. The firms subject to those settlements were not part of the initiative, as they were investigated prior to January 2019.[8]

The longer remediation period presented recordkeeping-related challenges to participating firms due, in part, to the books and records rules of FINRA and the SEC, which call for a six-year retention period.[9] Participating firms believed that 529 plan recordkeepers would be unable or unwilling to assist firms in producing data extending beyond the regulatory requirements. However, it appears that many participating firms and recordkeepers have been able to obtain the necessary information.

b. Alternative Remediation Methodologies

Initially, FINRA identified two alternative methodologies for participating firms to assess customer impact. Under one methodology, firms can conduct a customer-specific analysis, which includes "reviewing each customer's investment objectives and investment horizon and assessing whether the firm recommended a suitable share class."[10] The second methodology allows firms to take a more statistical approach, identifying "categories of 529 plan customers invested in share classes that are not economically advantageous if held for the accounts' expected investment horizon."[11]

FINRA subsequently told participating firms that they could use a third "simplified" remediation methodology by using a combination of 529 plan holdings data for a shorter time period and by removing the standard of reviewing each individual transaction going back to 2008.

Remediation Methodology Alternatives

Customer-Specific	Statistical	Simplified
Remediation based on account supporting information at point of sale	*Remediation based on transactions*	*Remediation based on holdings*

As participating firms review the three remediation methodology alternatives, they may want to consider the following:

Customer-Specific Methodology

This methodology is the most labor intensive; participating firms must conduct detailed, individualized analyses of every customer who purchased C shares for 529 plan accounts. As noted, this includes each customer's investment objective, time horizon and the share class selected, along with other factors. While time consuming, a review of individual account information could substantiate the reason the share class selection was suitable, whether it was solicited, and whether transactions reflect automatic investments based on a prior firm recommendation. The Customer-Specific Methodology is the most accurate way to assess actual customer harm; however many firms (and FINRA, if it analyzes a firm's transactions) may find the approach impractical and costly if the volume of 529 sales is large.

Statistical Methodology

A Statistical Methodology utilizes actual 529 plan C share purchase dates and amounts, and calculates the share class cost differential (i.e., the difference in cost to the investor had A shares been purchased instead of C shares). Rather than analyzing the activity in an individual account, this methodology utilizes: (1) assumptions for breakpoints that would have been available to the

8. https://www.finra.org/media-center/newsreleases/2019/finra-orders-merrill-lynch-pierce-fenner-smith-raymondjames; https://www.finra.org/sites/default/files/2019-11/merrill-awc-110619.pdf; https://www.finra.org/sites/default/files/2019-11/rja-awc-110619.pdf.
9. Blotters and Ledgers of all purchase and sale transactions are required to be kept for six years pursuant to Securities Exchange Act Rule 17a-3 and 4 and incorporated into FINRA Rule 4512.
10. Reg. Notice 19-04.
11. Id.

customer; and (2) application of a growth of the fund and a share class cost differential percentage (75 bps) to calculate if and when a C share became more expensive and by how much prior to June 30, 2018. Calculations will identify period held by incorporating sales, transfers and other items. This methodology covers accounts with C share transactions for 529 beneficiaries under the age of 12 years and allows for certain accounts to be removed from remediation based on value of total remediation (de minimis).

Simplified Methodology

FINRA came up with the Simplified Methodology to assist participating firms in calculating potential customer harm using holdings data beginning January 2013 (as opposed to using transactions from 2008). This methodology resolves the potential books and records retention issues associated with a remediation period dating back to 2008. Firms are also not required to calculate remediation for thousands (or millions) of individual transactions.

FINRA's Simplified Methodology applies to accounts that were opened and contained C shares for 529 beneficiaries under the age of 12 years, as of January 1, 2013. Remediation is then calculated each year for those accounts each year from June 2015 through June 2018, at a rate of 75 bps annually for C share holdings. FINRA's Simplified Methodology excludes smaller accounts by applying a $5,000 de minimis balance in C share holdings, as of June 30, 2015. The Simplified Methodology assumes that, on average, clients must have held such C share positions for approximately six to seven years (which is the average breakeven of A vs. C shares) to receive remediation; thus, by starting the remediation calculation in 2015, the positions would have been held since approximately 2008. FINRA created these assumptions to simplify the remediation but this methodology may result in an overpayment to clients. Customer harm or impact is likely to be more accurate if a firm calculates the performance differential using transactions (Statistical Methodology) instead of holdings data (Simplified Methodology).

Regardless of the chosen methodology, FINRA will review the firm's description of its process and test samples using formulae provided by firms, their counsel and consultants. The following examples illustrate the estimated outcomes, based on the methodology chosen:

Hypothetical Example 1 (Remediation at Account Level)

A $10,000 purchase of XYZ Funds 529 C shares in January 2013 will be compared to an A share purchased with a 5% fee. Under the Statistical Methodology, the C share position would typically not receive any remediation since breakeven (C share vs. A share) would occur *after* June 2018. However, if the purchase had been made in 2011, there would have been remediation of $72. Under the Simplified Methodology, due to the holdings on the calculation dates, this position would cost the firm approximately $365 dollars in remediation.

Remediation for the firm using the Simplified Methodology is $365.00.
Remediation for the firm using the Statistical Methodology is $0.00.

Hypothetical Example 2 (Remediation at Firm Position Level)

A firm has total holdings of $750,000 in XYZ Funds 529 C shares (all account balances are greater than $5,000 based on FINRA's de minimis rules), as of June 2015. This example also assumes all purchase transactions were made between 2013 and 2014.

There is no remediation using the Statistical Methodology. The customer was not harmed because the holding period is 6 years or less and the actual purchase date is utilized to calculate the breakeven point.

Remediation for the firm using the Simplified Methodology is $26,174.50.
Remediation for the firm using the Statistical Methodology is $0.00.

Hypothetical Example 3 (Firm Position Level)

A firm has total holdings of $550,000 in XYZ Funds 529 Plan C shares. Several hundred accounts had C share balances of less than $5,000 each, totaling less than $300,000. The remaining $250,000 positions were purchased in or before 2010.

The above example illustrates that there are many circumstances in which the Simplified Methodology may be more advantageous for a participating firm. If a significant percentage of accounts have account balances of $5,000 or less in C shares, and most of the purchases occurred over 6 to 7 years ago, the Simplified Methodology should be considered. It would be a fair representation of total harm to customers, without the time and cost associated with gathering the transaction information.

Remediation for Firm using the Simplified Methodology is $10,567.93.
Remediation for Firm using the Statistical Methodology is $9,691.28.

Note: Regardless of the methodology chosen, FINRA will expect remediation to include interest.

Non-Participating Firms – Lessons from the Initiative Regarding Supervision Analysis

Participation in the Initiative was voluntary. FINRA further stated that, unlike the SEC in its share class selection initiative,[12] FINRA would "not increase the sanctions that it otherwise would have imposed solely because the firm did not participate in the Initiative."[13] Nonetheless, non-participating firms should be prepared to explain why they did not participate. Firms may want to create a contemporaneous non-privileged written analysis supporting the conclusion not to self-report, which can be provided to FINRA upon request in future FINRA examinations related to 529 plans.

Regulatory Notice 19-04 and the corresponding FAQs set forth a wide variety of factors supporting a firm's decision not to self-report:

- FINRA examined the firm prior to the Initiative and the firm implemented appropriate enhancements;
- The supervisory weaknesses were minor in nature and self-corrected;
- Customer impact was minimal as demonstrated by data regarding C shares and the age of beneficiaries for 529 accounts; and
- Supervisory weaknesses were limited to isolated and unique factors during the Review Period.

Changes to 529 Plans and Mutual Fund C Shares – Lessons for both Participating and Non-Participating Firms

The Initiative dealt with supervision of a seemingly straightforward issue. According to FINRA, for the vast majority of 529 plans, time horizon could be measured by subtracting the age of the beneficiary from the age of intended use of funds for typical college attendance. Thus, a C share purchased for a very young beneficiary would be problematic because college attendance could be up to 18 years in the future.

As noted in Regulatory Notice 19-04, the Tax and Education Act of 2017 changed this time horizon landscape by adding that expenses for K-12 education could be used from these 529 accounts. However, it is up to each state to adopt the federal change for K-12 expenses for state tax purposes. This has led to patchwork of laws—some states took no action, other states had special tax treatment factors, while others will likely pass legislation in the future.[14] Firms will likely need to keep up with state laws to determine whether a shorter time horizon may be used if the 529 plan is intended to be used for K-12 expenses. As 529 plans are municipal securities, the MSRB, through EMMA (https://emma.msrb.org/search/plan529.aspx), has an excellent resource to keep up with changes.

12. See "additional penalty" language in Section E of SCSD Release. https://www.sec.gov/enforce/announcement/scsd-initiative.
13. FAQ 3. https://www.finra.org/rules-guidance/guidance/faqs/529-plan-share-class-initiative.
14. https://www.edchoice.org/wp-content/uploads/2018/02/529-Expansion-Memo-FINAL-v2.pdf.

Similarly, a good number of 529 plan managers have changed the structure of their C share class offerings, which ultimately benefits clients, and assists broker-dealers in determining appropriate share classes, based on changing investment horizon needs. These funds automatically convert to

A shares after being held for a certain number of years, which is usually the estimated break-even for C shares vs. A shares.

The table below depicts some of the larger state 529 plans, along with conversion features of its C share class funds at the time this article was written:

State/Plan Manager	Conversion Terms
Iowa: I Advisor 529 Plan Voya Investment Management	Automatically convert to a class A shares after 6 years and 1 month if purchased after March 2013.
New York: NY 529 Advisor JP Morgan	Class C Units automatically convert to Class A Units after a 7-year hold period.
Rhode Island: Collegebound 529 Invesco	For Class C Units purchased before July 8, 2016, the Units will convert to Class A on July 18, 2019. For Class C Units purchased after July 8, 2016, the Units will convert to Class A Units after five years from purchase.
South Carolina: Future Scholar Columbia Management	Automatically convert to A shares on the 5th anniversary of the investment into C shares.
Virginia: College America 529 American Funds	Effective December 1, 2017 all C shares automatically convert to A shares after 10 years.
Wisconsin: Tomorrow's Scholar Voya Investment Management	Automatically convert to a class A share in year seven.

Regulation BI

The Care Obligation of Reg. BI adds costs as a specific factor that must be considered in addressing whether a retail recommendation is in the best interest of the customer. The Adopting Release guidance indicates that reasonably available alternatives should be considered.[15] One of the existing and common examples cited in the Adopting Release is mutual fund share classes.[16] The FINRA 529 Share Class Expense Analyzer[17] easily allows representatives to determine the cost of a recommendation; every 529 plan has an A share alternative that is reasonably available. (Conversely, A shares may be more costly for transactions where the beneficiaries are nearing college age.) Many firms have used the lessons of the Initiative and have enhanced proposed Reg. BI policies regarding 529 plan C share purchases by prohibiting or eliminating them for plan funds that have not instituted automatic conversions, as discussed above.

Conclusion

FINRA took a new approach in resolving common examination findings when it announced the Initiative. Rather than following the SEC's carrot-and-stick approach from the Share Class Selection Disclosure Initiative, FINRA offered firms a somewhat different "deal." If firms self-report and participate in the Initiative, and if FINRA agrees there are violations, the firms will likely be sanctioned through a Letter of Acceptance, with a censure, a finding of violations, and an order to pay remediation. However, there will not be any fine. On the other hand, if firms choose not to participate, and FINRA finds violations during an exam, FINRA will impose the same sanctions that it would have imposed prior to the existence of the Initiative. FINRA did, however, provide firms with important information about how to analyze share classes, costs and time horizons. FINRA's remediation approach has allowed for discussion and flexibility in trying to reach a fair result for customers. Broker-dealers may want to take advantage of the opportunity to explore various remediation methodologies, as well as institute sustainable supervisory processes regarding 529 plan recommendations going forward. ■

15. Adopting Release at 278.
16. Id. at 284
17. https://tools.finra.org/529_calculator/main.