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SEC Approves MSRB's Interpretation of Customer Protection Obligations Applicable to Sales of Out-of-State 529 Plans

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20125] June 21, 2006 TO: 529 PLAN ADVISORY COMMITTEE No. 11-06 529 PLAN MEMBERS No. 10-06 RE: SEC APPROVES MSRB'S INTERPRETATION OF CUSTOMER PROTECTION OBLIGATIONS APPLICABLE TO SALES OF OUT-OF-STATE 529 PLANS The Municipal Securities Rulemaking Board has published its interpretation regarding the impact of MSRB Rule G-17 on the fair practice and disclosure obligations that municipal securities dealers owe to their customers in connection with transactions in 529 plan securities.¹ This Interpretation, which was recently approved by the SEC without modification² and which is briefly described below, is effective as of August 7, 2006. REQUIRED DISCLOSURES FOR SALES OF OUT-OF-STATE 529 PLANS Pursuant to the Interpretation, MSRB Rule G-17 requires dealers selling out-of-state 529 college savings plans to disclose to the customer, at or prior to the time of the trade, that: □ Depending on the laws of the home state of the customer or designated beneficiary, favorable state tax treatment or other benefits offered by such home state may be available only if the customer invests in the home state's 529 plan; □ State-based benefits should be one of many appropriately weighted factors to be considered in making an investment decision; 1 See SEC Approves Interpretive Notice on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans, MSRB Notice 2006-16 (June 15, 2006) (the "Interpretation"), which is available at: <http://www.msrb.org/msrb1/whatsnew/2006-16.asp>. The text of the Interpretation can be found in MSRB Files Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans, MSRB Notice 2006-07 (March 31, 2006), which is available at: <http://www.msrb.org/msrb1/archive/2006/2006-07.asp>. 2 The Institute filed a letter with the SEC supporting adoption of the Interpretation. See Institute Memorandum to 529 Plan Advisory Committee No. 8-06 and to 529 Plan Members No. 6-06 [No. 19995], dated May 2, 2006. 2 □ The customer should consult with his or her financial, tax, or other adviser about how such state-based benefits would apply to the customer's specific circumstances; and □ The customer may wish to consult his or her home state or any other 529 college savings plan to learn more about their features. These disclosure obligations may be met through the issuer's program disclosure document, provided that the customer receives the disclosure timely and it appears in the document in a manner that is reasonably likely to be noted by an investor. According to the Interpretation, the later requirement should be

satisfied if the required disclosure is in close proximity to and presented with equal prominence to (1) the principal presentation of substantive information on other federal or state tax-related matters, and (2) each other presentation of information on state-tax related matters. If the issuer's disclosure document does not satisfy this standard, the Interpretation provides that the disclosure obligation may be fulfilled by including the disclosure in the document in another manner so long as such disclosure is reasonably likely to be noted by an investor. Otherwise, the dealer is obligated to disclose such information separately to the customer no later than the time of the trade. According to the Interpretation, if the dealer provides information to an out-of-state customer about the state tax or other benefits available through the customer's home state, Rule G-17 requires the dealer to ensure that the information is not false or misleading. Dealers should make sure that any information they provide to customers, whether pursuant to an affirmative disclosure obligation or in response to questions from the customer, is correct and not misleading. The disclosure a dealer is required to provide in connection with the sale of an out-of-state plan is in addition to any obligation the dealer has under Rule G-17 to disclose to its customers, at or prior to the time of trade, all material facts known by dealers about the 529 college savings plan interests it is selling to its customer. This disclosure is also in addition to the dealer's duty to disclose all material facts about the 529 college savings plan that are reasonably accessible to the market. **SUITABILITY** The Interpretation reminds dealers that providing the required disclosures in connection with the sale of out-of-state plans does not relieve them from their suitability duties. These duties include the dealer's obligation to consider the customer's financial status, tax status, and investment objectives in connection with recommended transactions. The Interpretation emphasizes that any dealer recommending a transaction must actively analyze information about the customer and the security and must consider appropriately weighted factors that are relevant to the customer's particular situation. It also reminds dealers of their obligation to have and enforce written supervisory procedures that are reasonably designed to ensure compliance with their suitability obligations in connection with each recommended transaction. In connection with the dealer's suitability requirements, the MSRB believes that it is crucial for dealers to remain cognizant of the fact that 529 college savings plans are designed for a particular purpose and the purpose generally should match the customer's investment objective. Also, because an investor generally is required to designate a specific beneficiary for the plan, the MSRB believes that information about that designed beneficiary generally would be relevant in weighing the investment objectives of the customer as part of a suitability analysis. **OTHER SALES PRACTICE PRINCIPLES** The Interpretation also reminds dealers that, based upon the particular facts and circumstances, the following may violate Rule G-17's requirement that dealers deal fairly with all persons and not engage in any dishonest or unfair practice: □ Engaging in transactions primarily designed to increase commission revenues in a manner that is unfair to customers; □ Recommending an unsuitable share class; □ Engaging in churning or recommending rollovers year after year; □ Consistently recommending that, of the various 529 plans offered by the dealer, customers invest in the one that offers the dealer the highest compensation; □ Recommending transactions in amounts designed to avoid commission discounts; □ Engaging in marketing activities that result in a customer being treated unfairly; and □ Acting in a manner that is reasonably likely to induce another dealer or its associated persons to violate Rule G-17 or other MSRB customer protection rules. Tamara K. Salmon Senior Associate Counsel