

MEMO# 19351

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NASD SANCTIONS BROKER-DEALER FOR LACK OF SUPERVISORY PROCEDURES RELATING TO 529 PLAN SUITABILITY

©2005 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. [19351] November 9, 2005 TO: 529 PLAN ADVISORY COMMITTEE No. 30-05 529 PLAN MEMBERS No. 18-05 RE: NASD SANCTIONS BROKER-DEALER FOR LACK OF SUPERVISORY PROCEDURES RELATING TO 529 PLAN SUITABILITY The NASD recently settled an enforcement proceeding with one of its members in which the NASD found that the member failed to establish and maintain supervisory systems and procedures that were reasonably designed to achieve compliance with suitability obligations relating to the sale of 529 plans.¹ The facts of this case are briefly summarized below. SUMMARY OF FACTS According to the AWC, from May 2001 through the end of 2004, the member sold over \$1.1 billion of 529 college savings plans to over 138,000 customer accounts. When the member began selling a state's 529 plan in May 2001, it issued a bulletin introducing the products to its registered representatives. The bulletin, however, did not contain adequate procedures relating to the sale of 529 plans. Instead, it stated that registered representatives needed to adhere to compliance requirements regarding suitability, disclosures, and documentation, without providing effective guidance on these requirements as they relate to 529 plans. In June 2002, the member issued another bulletin requiring its registered representatives to disclose that out-of-state purchasers of the 529 plan might "wish to consider your own state's college savings plan. Your state's plan may offer state income tax benefits or other benefits that you might want to evaluate with your tax advisory."² While the member's bulletin provided a link to a comparison tool that allowed its representatives to perform a side-by-side comparison¹ See In Re American Express Financial Advisors, Inc., NASD Letter of Acceptance, Waiver and Consent (October 2005) (the "AWC"). The AWC contains no allegation that any of the 529 plan sales affected by the member violated MSRB Rule G-19, which governs the suitability of recommended transactions. ² The member's June 2002 bulletin was issued in response to a May 2002 notice issued by the MSRB. As noted in the AWC, the MSRB's notice discussed the duties of a municipal securities dealer under the MSRB's fair dealing rule, Rule G-17. According to the MSRB's notice, effective July 15, 2002, MSRB Rule G-17 requires a municipal securities dealer selling an out-of-state 529 plan to an investor "to disclose that, depending upon the laws of the customer's home state, favorable state tax treatment for investing in a Section 529 college savings plan may be limited to investments made in a Section 529 college savings plan offered by the customer's home state."² of the plan offered for sale by the member and two other 529 plans and to view state income tax benefits for each plan, the member did not require its representatives to

use the comparison tool. Prior to October 2003, the member only offered one state's 529 plan for sale. Thirty-two percent of its sales (\$200 million) were to customers who lived in twenty-four states that offered state tax deductions for residents who invested in their states' 529 plans. In October 2003, the member began selling seven other states' plans and issued another bulletin that established some procedures relating to 529 plan sales. This bulletin advised the member's representative to consider the existence of state income tax benefits when recommending 529 plans and required representatives to both document the rationale for their recommendation of an out-of-state plan and recommend that clients consider consulting a tax advisor to determine the most appropriate plan from a tax perspective. It also required supervisors to confirm that the representative had disclosed the existence of an in-state plan when selling a 529 plan and to document their review of sales in an internal system. According to the AWC, those procedures were inadequate because they "did not provide any criteria or guidance for [the member's] registered representatives to use in making suitability determinations in recommending 529 plans." It also did not contain any guidance, procedures, or standards regarding sales of 529 plans to residents of the five states (i.e., New Mexico, South Carolina, Illinois, Colorado, and West Virginia) that offer unlimited tax deductions for investments in 529 plans by their residents.

FINDINGS AND SANCTIONS Based upon the foregoing facts, the NASD found that the member did not have adequate procedures:

- To guide registered representatives concerning the factors to consider in determining whether a 529 plan was suitable;
- For supervisors to use when reviewing 529 plan sales;
- To require that documentation be created or maintained regarding suitability determinations for the sale of 529 plans; and
- Requiring that registered representatives document reasons why an out-of-state plan was suitable notwithstanding the lost state income tax benefit.

According to the AWC, the above inadequacies in the member's procedures constituted a violation of Municipal Securities Rulemaking Board Rule G-27, relating to supervision. Based on the member's violation, it was censured, fined \$500,000, and required to pay \$750,000 in remediation. The remediation amount will be used to compensate certain customers who purchased an out-of-state 529 plan from the member when the member was not in compliance with Rule G-27.

Tamara K. Salmon Senior Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 19351, or call the ICI Library at (202) 326-8304 and request the attachment for memo 19351.