The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

August 3, 2005

ICI Comments on MSRB Proposal Regarding Sale of Out-of-State 529 College Savings Plans, August 2005

July 29, 2005

Ernesto A. Lanza, Esquire
Senior Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

Re: MSRB Notice 2005-28 Relating to Draft Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans

Dear Mr. Lanza:

The Investment Company Institute[1] appreciates the opportunity to express its concerns with the MSRB's proposed guidance regarding the obligations of municipal securities dealers in connection with selling out-of-state 529 college savings plans ("529 plans").[2]

The Institute strongly supports efforts to provide potential purchasers of 529 plans with ample information to make informed investment decisions. With respect to the purchase of out-of-state plans, informing investors, through prominent disclosure, that they may be forgoing home-state tax benefits is sufficient.[3] The MSRB's proposed interpretive guidance would go well beyond this, however, and impose on dealers[4] selling out-of-state 529 plans burdensome requirements that do not apply to sales of any other investment product, including in-state 529 plans. We are concerned that, if the proposed guidance is adopted, either many dealers will cease selling out-of-state 529 plans or the costs to investors associated with such plans will increase. Neither of these outcomes is in the best interests of investors. For these reasons, and as discussed below, the Institute recommends that the MSRB refrain from pursuing this proposal further.

The interpretive guidance imposes a series of unique, unprecedented and unreasonable obligations on dealers that sell out-of-state 529 plans. First, it requires a dealer to affirmatively seek information from the customer in all transactions involving the offer or sale of out-of-state 529 plans, including unsolicited transactions.[5] To our knowledge, no such sweeping duty of inquiry applies to dealers or broker-dealers in any other context.

Instead, MSRB and NASD rules require dealers and broker-dealers, respectively, to inquire about a customer's financial status, tax status, and investment objectives only when recommending a security to that customer.6

Second, the guidance requires a dealer to be familiar with securities that are not the subject of the particular transaction, and that the dealer may not even offer. This obligation is inconsistent with the MSRB's longstanding interpretation of MSRB Rule G-17, which requires a dealer to disclose material information solely about the transaction being effected for the customer.7 It also will require every dealer selling an out-of-state 529 plan to be knowledgeable about every state's laws governing such plans and the plans themselves. Not only is this requirement patently unreasonable, but also it discriminates inappropriately against dealers selling out-of-state 529 plans compared to dealers and broker-dealers selling other securities products.

For example, in the municipal securities market, preferential tax treatment often is limited to residents of the state that issued the security. Yet, the MSRB has never proposed to require dealers selling municipal securities to be knowledgeable about each state's tax treatment of such securities before selling state municipal bonds to an out-of-state investor.

Third, if a dealer recommends an out-of-state 529 plan to a customer, the guidance requires the dealer to conduct a "comparative analysis" between the recommended security and any 529 plan offered by the customer's home state to ensure that the 529 plan sold to the customer is the most suitable security for the customer. A dealer that has conducted the required comparative analysis may sell a less suitable out-of-state 529 plan to the customer provided the dealer (1) maintains records of the customer's direction to buy the less suitable security, (2) has a principal promptly review and approve the transaction, and (3) confirms such direction at least annuallyif the customer makes periodic investments in the 529 plan.8

Again, this onerous requirement is completely unprecedented. In no other instance is a dealer or broker-dealer selling a security to a customer required to determine whether it is the "most suitable" security for the customer.

The comparative analysis requirement also raises a host of practical issues. For example, if the customer or beneficiary is in the military or otherwise likely to relocate his or her residence on a regular basis, it is not clear which residence would be relevant for the comparative analysis. Also, in this situation, it is not clear whether a comparative analysis made by the dealer could continue to be used if the customer or beneficiary moves to a new state. If not, and the new comparative analysis of the customer's or beneficiary's home state indicates that the new home state's plan is more suitable than the existing plan, it is not clear whether the dealer would be required to recommend that the customer open a new account, thereby perhaps forfeiting any breakpoint or rights of accumulation advantages that result from having a single account. It is not clear whether the new comparative analysis must take issues such as these into account in order for the dealer to satisfy its obligations under Rule G-19. Because each state's 529 plan has unique features, benefits, tax treatment, etc., it is not clear which particular plan features the dealer must consider in its comparative analysis.

Moreover, before conducting such analysis, a dealer would have to consider what liability it has under state or federal securities laws for disclosures it makes to a customer about a product that the dealer does not sell but that it must include in its comparative analysis. A dealer also would have to consider whether the tax analysis included in the comparative

analysis may be construed as providing tax advice – which may be beyond the purview of the dealer's expertise. If the customer's home state 529 plan is only sold via a competing dealer, dealers likely would be concerned with having to contact a competing dealer to obtain the information necessary to conduct the comparative analysis.

This requirement might also impede the ability to effect a transaction requested by the customer inasmuch as, before the dealer can execute the trade, it must gather sufficient information about other 529 plans to enable it to conduct the comparative analysis. Dealers also would be concerned with how current the comparative analysis must be. For example, if the dealer's analysis is a month, six months, or one year old, will it be considered current? Moreover, in the event the customer purchases the out-of-state 529 plan through a periodic investment plan, the dealer would need to consider how often its analysis must be updated after the initial transaction.

Also, a dealer that sells a customer an out-of-state plan after conducting a comparative analysis would be concerned with whether Rule G-19 would require the dealer to notify the customer who purchases such plan of any subsequent changes to the customer's home state plan that might alter the comparative analysis. If so, the dealer would have to consider the consequences for itself and the customer if the revised comparative analysis indicates another state's security may be more suitable for the customer.

These are just some of the many issues that would need to be resolved before the guidance could be implemented. The number and scope of these issues exacerbate our concern that the proposed guidance will be unworkable.

Also, the guidance places inordinate focus on state benefits associated with an in-state plan, while ignoring the fact that there are myriad reasons why an investor might choose to purchase an out-of-state plan, even in the absence of such home state benefits. Based on the foregoing, the Institute is concerned that the proposed guidance will adversely affect investors.

By applying disproportionately burdensome requirements to sales of out-of-state 529 plans, the guidance will discourage dealers from offering these securities. As a result, investors wishing to invest in 529 plans may have to do so directly with state issuers. Unlike dealers, however, that are subject to the MSRB's regulatory requirements and jurisdiction, state issuers are not subject to any disclosure, suitability, or other regulatory requirements, apart from the general antifraud provisions of the federal securities laws. Nor are states subject to the MSRB's jurisdiction.

Further, to the extent some dealers choose to continue offering 529 plans, the proposed requirements will increase their costs. It is likely that at least some of the additional cost will be passed through to investors.

The costs and burdens that the proposed guidance entails, in addition to being discriminatory, are unwarranted. The Notice provides no evidence of abuses in the offer or sale of out-of-state 529 plans to support the proposed onerous requirements. Nor does it explain why existing requirements – including disclosure that the customer's home state may only offer favorable tax treatment for investing in a plan offered by that state and suitability requirements – are insufficient to address potential abuses. 9 And, it provides no policy basis for singling out the offer and sale of out-of-state 529 plans and subjecting dealers to higher standards for this product than for any other.

The Institute continues to believe, as we recommended to the MSRB in 2002, that alerting customers, through prominent disclosure, of the potential loss of state tax advantages is sufficient to enable them to make an informed decision regarding the purchase of an out-of-state 529 plan. For this reason, and to avoid the adverse unintended consequences outlined above, we strongly urge the MSRB to withdraw the proposed guidance.

* * *

The Institute appreciates the opportunity to explain its significant concerns with the proposed interpretive guidance. If you have any questions concerning these comments or would like additional information regarding the proposed impact of the MSRB's proposal on dealers and the 529 plan market, please do not hesitate to contact the undersigned at (202) 326-5825.

Sincerely,

Tamara K. Salmon
Senior Associate Counsel

Attachment

cc: Ghassan Hitti
Assistant General Counsel

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. More information is available about the Institute at the end of this letter.

2 See MSRB Notice 2005-28, Request for Comments on Draft Interpretive Guidance on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans (May 19, 2005) (the "Notice").

3 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Diane G. Klink, Esquire, General Counsel, MSRB, dated April 1, 2002, in which the Institute recommended that the MSRB require municipal securities dealers to provide concise and understandable written disclosure to all customers alerting them that the customer's home state may only offer favorable tax treatment for investing in a plan offered by that state. The MSRB subsequently adopted such a requirement. See Application of Fair Practice and Advertising Rules to Municipal Securities, MSRB (May 14, 2002).

4 As used in this letter, the term "dealer" refers to those persons that are municipal securities dealers subject to the MSRB's jurisdiction; the term "broker-dealer" refers to those persons, such as full-service broker-dealers, that are subject to the NASD's jurisdiction under the Securities Exchange Act of 1934.

5 If, through this proposed inquiry, the dealer determines that the customer is not a resident of the state whose plan is being offered to the customer, the Notice would require the dealer to inquire whether realizing state-based benefits is an important factor in the customer's investment decision. If it is, the dealer would then be required "to disclose material information available from established industry sources about state-based benefits offered by the home state of the customer or designated beneficiary for investing in the home-state plan" and whether such benefits are available to a customer who purchases an

out-of-state plan. Notice at p. 10. The dealer also would have to suggest that the customer consult with his or her financial, tax, or other adviser to learn more about the home state's plan and inform the customer that he or she may want to contact the home state plan to learn more about any state-based benefits or limitations.

6 See MSRB Rule G-19 and NASD Rule 2310.

7 See, e.g., Rule G-17 Interpretive Letters – MSRB Interpretations of March 4, 1986 and May 13, 1993, which state that "the Board has interpreted Rule G-17 to require that a dealer must disclose, at or before the sale of municipal securities to a customer, all material facts concerning the transaction, including a complete description of the security, and must not omit any material facts that would render other statements misleading." (Emphasis added).

8 According to the Notice, for those dealers that determine that the customer's home state plan is more suitable than any of the 529 plans offered by the dealer, the dealer "may wish to contact the 529 plan or its primary distributor (if any) to gain such authorization and to sell the home state 529 plan interest to the customer. The MSRB recognizes that this . . . option may not always be available." We believe that it will rarely, if ever, be available, thereby resulting in the dealer having to refer its customer elsewhere to purchase the securities.

9 To our knowledge, and notwithstanding the fact that the NASD as the enforcer of the MSRB's rules has been looking at this issue for some time, there have been no enforcement proceedings commenced against dealers or broker-dealers that have alleged sale practices abuses or fraud in connection with the sale of out-of-state 529 plans (e.g., sales of unsuitable securities or omissions of material facts) to customers. Given this, we question the basis for the proposed interpretive guidance to address alleged – but unsubstantiated – abuses in connection with the sale of these plans.
