Bond Case Briefs

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Frequently Asked Questions Regarding the 529 Plan Share Class Initiative.

FINRA is providing these Frequently Asked Questions about its 529 Plan Share Class Initiative (the "Initiative") in response to a number of inquiries it has received from firms and trade associations. In order to allow firms sufficient time to consider the additional information provided here and to provide firms more time to review their supervisory systems and procedures with respect to 529 plan sales, FINRA is extending the due dates set forth in Regulatory Notice 19-04. **New due dates**: Participating firms must provide FINRA Enforcement notice of their self-report by **April 30, 2019**, and then must confirm their eligibility by submitting the additional information specified in Regulatory Notice 19-04 by **May 31, 2019**.

1. Is FINRA asking firms to review all of their 529 plan sales and to identify unsuitable transactions?

No. Firms that choose to participate in the Initiative should review how they have supervised sales of 529 plan shares since January 2013. Firms should assess for such matters as: whether their procedures require that appropriate supervisory personnel review share class suitability and obtain the information necessary to do so; whether they actually conducted reviews for share class suitability; and whether the firm provided training to its registered representatives so that they could make suitable recommendations. For example, FINRA has observed firms that: were unable to review 529 plan transactions for suitability because they failed to keep records of those transactions1 or failed to capture information relevant to the suitability determination, such as the age of the beneficiary and the number of years until the funds are needed for the beneficiary's qualified education expenses; failed to have a process or procedures in place to review 529 transactions for suitability; or failed to provide training or guidance to registered representatives regarding 529 share classes and the factors to consider, such as beneficiary age. These are the types of issues that firms participating in the Initiative might review.

If a firm reviews its supervisory systems and procedures and concludes that they were reasonably designed and implemented, that is the end of the assessment. There is nothing more to do. A firm might choose to test some transactions according to risk-based criteria as part of its review concerning the reasonableness of its supervision, but that is not required. **FINRA is encouraging firms to undertake a qualitative review, not a quantitative analysis.**

If, however, a firm discovers that there was a weakness in its systems, procedures or training, so that the firm concludes that it may not have had a supervisory system reasonably designed to achieve compliance with its suitability obligations, then the firm should self-report to take advantage of the Initiative. FINRA will then discuss with the firm how the firm has responded or plans to respond to the issue, including different ways to assess impact on customers. Assessing customer impact is likely to require firms to review transactions, but FINRA would work with firms to identify an appropriate, risk-based way to analyze transactions.

2. Do all firms have to conduct this assessment? Is my firm required to participate?

No. This is a voluntary program.

3. Will a firm that chooses not to participate incur a penalty or an increased sanction should FINRA find violations in this area post-Initiative?

There is no penalty for choosing not to participate. If FINRA later determines that a firm that did not participate in the Initiative failed to reasonably supervise 529 plan sales, it will evaluate that matter in the ordinary course based on the facts and circumstances presented. The firm would not be eligible for an automatic fine waiver. However, FINRA will not increase the sanctions that it otherwise would have imposed solely because the firm did not participate in the Initiative.

4. What concerns prompted FINRA to create this Initiative?

In several ongoing examinations and investigations, FINRA found deficiencies in firms' supervision of 529 plan recommendations. For example, FINRA found that firms did not:

- keep records of 529 plan transactions and were therefore unable to review those transactions for suitability;
- capture information relevant to the suitability determination, including the age of the beneficiary and the number of years until the funds are needed to pay for the beneficiary's qualified education expenses;
- have a process or procedures in place to review 529 transactions for suitability; or
- provide training or guidance to registered representatives regarding 529 share classes and the factors to consider, such as beneficiary age.

FINRA has also observed some firms that have reasonably designed supervisory systems for 529 plan recommendations, so this has not been a uniform issue across the industry. However, given the number of firms that have had issues, FINRA determined that many member firms could quickly address weaknesses in their supervision and return money to harmed customers if FINRA were to identify this compliance issue promptly, offer firms the opportunity to voluntarily report potential supervisory deficiencies, and work collaboratively with firms to fix any supervisory deficiencies and remediate affected customers.

5. What is the benefit of participating in the Initiative?

A firm that participates in the Initiative will avoid any fine that FINRA might otherwise impose in an Enforcement action concerning the firm's failure to supervise the suitability of 529 plan share class recommendations. In addition, a firm that participates in this Initiative will have the benefit of a discussion with FINRA about the steps it plans to take to remediate its supervisory failures and pay restitution to customers. FINRA believes dialogue is an important part of this process, and is centralizing and coordinating its responses to best provide consistent feedback to participants in the Initiative. FINRA staff working on this Initiative may be able to provide the firm with guidance or observations to help the firm achieve compliance and make harmed customers whole in a manner that is fair and efficient. As a result of information that FINRA learns through these discussions, it may also identify additional information or guidance that would be helpful for the industry.

6. Can a firm participate in the Initiative and not face formal disciplinary action?

Yes. It is possible that, as a result of participating in the Initiative, a firm could receive a cautionary action, or FINRA could close the matter with no action. As with every case, FINRA will consider a number of factors in making this determination, such as the impact of the misconduct, the scope, the timeframe and the cause of the supervisory failure.

7. Does FINRA take the position that certain 529 plan share classes are per se unsuitable? For example, does FINRA believe that Class C shares are inappropriate for 529 plans because 529 plans are long-term investments?

MSRB rules and guidance do not take the position that there is a *per se* inappropriate share class.2 The obligation to recommend a suitable share class under MSRB rules requires a case-by-case analysis, and there may be circumstances in which a recommendation to purchase Class C shares is suitable in light of the customer's facts and circumstances. This underscores how important it is for representatives to know each customer's unique needs and understand the impact of 529 share classes, and for firms to train representatives and supervise their recommendations of 529 plan share classes.

8. Is FINRA establishing a new rule about the suitability of 529 plan share classes through the Initiative?

No. A representative's obligation to recommend a suitable share class when recommending a 529 plan transaction is well established, as is a firm's obligation to supervise such recommendations.3 This Initiative does not change that, nor does it mandate that a broker or a firm recommend a specific share class under certain circumstances. Rather, the Initiative encourages firms to review information about a potential risk – the risk that their supervision may not be reasonable – and work with FINRA to address any deficiencies efficiently and promptly. In return for this effort, FINRA would waive the fine it might otherwise impose.

9. Does FINRA expect firms' supervision of 529 plan share classes to be perfect? Can a firm determine that it has a reasonable supervisory system even if it identifies one or two isolated transactions that might be problematic?

FINRA and MSRB rules require that a firm establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable laws and regulations, including suitability rules. In addition, firms are required to establish, maintain and enforce written supervisory procedures that are reasonably designed to achieve compliance with those rules. The Initiative encourages firms to qualitatively assess whether their supervisory systems and procedures were **reasonably designed** and enforced. As described in question 1 above, FINRA is not asking firms to review all of their 529 transactions in order to participate in the Initiative. If, however, a firm knows of a specific unsuitable transaction, it should reasonably respond to such a "red flag" in the normal course of its supervision of its registered representative.

10. What if a firm identifies a potential supervisory deficiency related to its sale of 529 plan shares but determines that there was no resulting customer harm; should the firm still self-report?

FINRA would encourage the firm to participate in the Initiative under those circumstances. After self-reporting, the firm can discuss with FINRA how it has changed its supervisory system to address the problem, and FINRA may be able to provide the firm with additional guidance or observations to help the firm achieve compliance. While that is a clear benefit of self-reporting, some firms may be concerned that the self-report would also trigger a formal Enforcement action. But not all self-reports will necessarily result in formal disciplinary action. (See question 6 above.) Under these circumstances, FINRA would consider the lack of customer harm when determining an appropriate outcome and may, based on the facts and circumstances, determine that the matter should be resolved informally or with no further action.

11. If firms identify concerns about the reasonableness of their 529 plan supervisory

systems that are unrelated to the share class recommended, should firms self-report these concerns?

This Initiative only encompasses potential deficiencies with respect to firms' supervision of 529 plan share class recommendations. Firms are encouraged to immediately correct any additional supervisory deficiencies detected during their self-evaluation and to report those deficiencies under FINRA Rule 4530 if required by that rule. See Reg. Notice 19-04, fn. 14.

12. If a firm identifies a potential issue in its supervision but has not concluded that its overall supervision was unreasonable, can it participate in the Initiative?

Yes. FINRA encourages firms to self-report potential supervisory issues, so that FINRA staff and the firm can discuss the potential issue and whether it requires remediation. If it does require remediation, the firm will be eligible for a fine waiver if applicable. If it does not, no additional steps will be necessary.

13. If FINRA examiners previously reviewed a firm's supervision of 529 plan sales and did not recommend formal action, should the firm still conduct this self-assessment?

Firms are **not required** to participate in the Initiative; it is voluntary. A firm might consider a previous exam, or a previous internal audit or other analysis, and decide that based on the information the firm has, it will not perform any additional review. There is no penalty for that decision.

But there may be reasons that the firm decides that a new review could still be helpful. It may be, for example, that FINRA's review was limited to a particular aspect of the firm's supervision, or FINRA's consideration of 529 plan supervision might have been part of a larger, thematic review of the firm's supervisory system and therefore wasn't focused on 529 plan supervision. Alternatively, it may be that the firm's process for supervising 529 plans has changed or that the firm's sale of 529 plan shares has grown exponentially, but the firm failed to adjust its supervisory system accordingly. If the firm self-reports those issues as part of the Initiative, it will avoid any fine that might otherwise have resulted.

14. If a firm participates in the Initiative, must it also file a report pursuant to FINRA Rule 4530?

Not necessarily. Rule 4530 requires a firm to self-report if it concludes, or reasonably should conclude, that it violated the securities laws if the conduct has widespread or potential widespread impact to the firm, its customers or the markets, or if conduct arises from a material failure of the firm's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts. In contrast, firms can participate in the Initiative when their conduct does not meet the criteria set forth in Rule 4530.

15. Should firms document their self-assessment under the Initiative?

Firms do not have to document their review. Indeed, as noted, firms may choose not to conduct any review at all. If, however, a firm chooses to conduct a review, it is a good practice to document that review, and may assist the firm in responding to questions from FINRA in any future exams and investigations.

16. Regulatory Notice 19-04 advises firms to provide certain information regarding their 529 plan share class supervision for the period January 2013 through June 2018 (the "disclosure period"). When calculating customer harm, should firms use that same period?

As a first step, firms choosing to participate in the Initiative need only determine whether there was a potential supervisory violation; they need not calculate customer harm. After the self-reporting due date of April 30, FINRA will confer with self-reporting firms on an acceptable methodology and period for calculating restitution. Our focus will be on the firm's customers who paid more in fees than they would have if they purchased a different share class during that relevant time period.

17. Why did FINRA select a 5 1/2 year time-period (from January 2013 through June 2018) for this Initiative? What should firms who improved their supervisory system during the disclosure period do with respect to this Initiative?

FINRA sought to select a period that is fair for investors who might have been affected by any supervisory failures, but not so broad that reviewing the supervisory system becomes onerous. To the extent that a firm conducts a review and determines that its 529 plan supervision may not have been reasonably designed and implemented at any point before or during the disclosure period, we encourage that firm to self-report pursuant to the Initiative so that FINRA and the firm can have a dialogue about the firm's remediation, whether there was customer impact, and, if so, how to address it.

18. Can a firm receive an extension of the April 30 self-reporting deadline?

Yes. Firms that cannot complete their supervisory review before the new April 30 deadline may request an extension by emailing 529Initiative@finra.org. Firms may also request an extension of time to provide FINRA the additional information due by May 31, 2019.

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1. Some matters concerning 529 supervisory failures may also include related violations of securities laws and rules, such as failure to retain required books and records. Where such violations are considered to be integrally related to the firm's supervisory failures, FINRA Enforcement would recommend including such violations in a no-fine settlement pursuant to the Initiative.

2. See, e.g., MSRB Rules G-19, on suitability of recommendations and transactions and G-17, on conduct of municipal securities and municipal advisory activities; MSRB Interpretation on Customer Obligations Related to Marketing of 529 College Savings Plans (Aug 7, 2006).

3. FINRA and the MSRB repeatedly have stated that firms and their representatives must select a share class tailored to the customer's investment profile, both in the context of mutual fund shares generally and with respect to 529 plan shares in particular. See, e.g., NASD Regulatory & Compliance Alert (Summer 2000); MSRB Interpretation on Customer Obligations Related to Marketing of 529 College Savings Plans (Aug. 2006); and MSRB Fair Practice Notice, Application of Fair Practice and Advertising Rules to Municipal Fund Securities (May 2002). In particular, the MSRB has stated that information known about the designated beneficiary generally would be relevant in weighing the investment objectives of the customer, including information regarding the age of the beneficiary and the number of years until the funds will be needed to pay qualified education expenses of the beneficiary. See MSRB Interpretation on Customer Obligations Related to Marketing of 529 College Savings Plans (Aug 7, 2006). For more than a decade, FINRA and the SEC have brought enforcement actions against broker-dealers who failed to reasonably supervise representatives' sales of 529 plan shares. See, e.g., In re 1st Global Capital Corp., SEC Rel. No. 34-54754 (Nov. 15, 2006); MetLife Securities, Inc., AWC No. EAF0401020003 (Nov. 6, 2006); and American Express Financial Advisors Inc., AWC No. EAF0400340002 (Sept. 20, 2005).