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FINRA Launches First-Ever Self-Reporting Initiative on 529 Plan Share Class Recommendations.

FINRA announced on January 28, 2019, the launch of a new initiative encouraging broker-dealers that offer 529 plans to self-report potential supervisory violations involving share class recommendations to customers (529 Plan Initiative).¹ Under the 529 Plan Initiative, in exchange for a firm's assessment of its supervision of 529 plan share class recommendations, self-reporting and remediation of potential violations, and preparation of a restitution plan for harmed customers, FINRA's Department of Enforcement will recommend a settlement that includes restitution and a censure but no fine.² Broker-dealers that wish to participate in the 529 Plan Initiative must notify FINRA in writing by **April 1** and must submit to FINRA information regarding their systems and procedures for supervising 529 plans (discussed below) by **May 3**.

Investment in 529 Plans

529 plans are tax-advantaged municipal securities that allow individuals to save for a designated beneficiary's future educational expenses. They are typically sold in different share classes, which carry different fees and other costs. While 529 plans have traditionally been used to save for higher education, amendments to the Internal Revenue Code that became effective in 2018 expanded the permitted use of 529 plans to certain kindergarten, elementary school and secondary school (i.e., high school) expenses. Because 529 plan share classes have different fee structures, the financial impact to the customer will depend in part on the class of share purchased and the number of years the customer expects the assets to be invested. For example, Class A shares generally impose a front-end sales charge but have lower annual fees, whereas Class C shares impose no front-end sales charge but have higher annual fees. As a result, a customer who plans to invest in a 529 plan for a period of several years may pay significantly more in fees if invested in Class C shares rather than Class A shares.³

Purpose and Scope of the 529 Plan Initiative

Broker-dealers must have systems and procedures to supervise registered representatives' share class recommendations to customers and ensure they are consistent with those customers' investment goals. However, FINRA's examination of some firms identified supervisory gaps with respect to 529 plans.⁴ The 529 Plan Initiative is intended to encourage firms to review their systems and procedures governing 529 plan share class recommendations and to self-report and remediate identified gaps. The initiative appears to be modeled after the SEC's 2018 Share Class Selection Disclosure Initiative, under which the SEC offered favorable settlement terms to investment advisers that self-reported potential violations of securities laws relating to their failure to make certain disclosures concerning mutual fund share class selection.⁵

Firms that offer 529 plans should assess their supervisory systems and procedures and evaluate areas including

- training regarding the costs and benefits of different 529 plan share classes

- understanding and assessing the different costs of share classes for individual transactions
- receiving or reviewing data reflecting 529 plan share classes sold
- reviewing share class information, including potential breakpoint discounts or sales charge waivers in determining the suitability of 529 plan recommendations
- the potential impact of any identified supervisory failures (by either conducting a customer-specific analysis or using a statistical approach to identify customers who received 529 plan share class recommendations that were unsuitable)

Regardless of whether it elects to participate in the 529 Plan Initiative, FINRA encouraged any firm that engages in 529 plan activity to conduct this review — including a firm that is confident that it has established, and is enforcing, 529 plan supervisory systems and procedures. In a video released in connection with the launch of the 529 Plan Initiative, FINRA Executive Vice President of Enforcement Susan Schroeder emphasized that FINRA’s review of firms’ 529 plan supervision will not be limited to firms that elect to participate in the initiative.⁶ To the extent violations are identified at a firm that elects not to participate, FINRA will recommend sanctions greater than what would be recommended under the initiative.⁷

How to Participate

The deadline for broker-dealers participating in the 529 Plan Initiative to submit the results of their assessments to FINRA is May 3. Some broker-dealers have already begun the assessment process and indicated their intention to participate. Given the volume of data FINRA is requiring from participants, firms that timely notify FINRA of their intention to participate but anticipate they will not be able to meet the May 3 submission deadline may request an extension.⁸

Sidley Perspective

The 529 Plan Initiative is the most recent effort by FINRA to address broker-dealer compliance obligations and is consistent with FINRA’s ongoing focus on obligations related to suitability determinations.⁹ Participating firms should anticipate certain challenges in assessing their supervisory systems and procedures and preparing their submissions to FINRA. For example, many firms that participated in the SEC’s ongoing Share Class Selection Disclosure Initiative have found collecting the required data to be challenging and burdensome.

Moreover, as is the case with all suitability reviews, determination of suitability is often a nuanced, fact-dependent process involving numerous considerations. For example, the appropriateness of a share class may vary depending on the availability of breakpoints based on the customer’s holdings of mutual funds managed by the 529 plan sponsor. Certain features of 529 plans also may create particular supervision and monitoring challenges including, but not limited to, the availability of information related to beneficiaries¹⁰ and the manner in which 529 plan transaction information is tracked internally.

Broker-dealers that offer 529 plans should consult legal counsel to discuss undertaking a self-assessment of their 529 plan supervisory systems and procedures and the benefits and drawbacks of participating in the 529 Plan Initiative.

1 See FINRA Regulatory Notice 19-04 (Jan. 28, 2019), available [here](#).

2 Broker-dealers that have already been contacted by FINRA’s Department of Enforcement as of January 28, 2019, regarding potential violations involving 529 plan share classes are not eligible to

participate in the 529 Plan Initiative. See *id.*, n. 12. The 529 Plan Initiative also does not apply to individuals, and FINRA has stated that it provides no assurance that an individual associated with the broker-dealer who sold 529 plans in violation of federal securities laws and regulations or self-regulatory organization rules would be offered similar terms. See FINRA Regulatory Notice 19-04.

3 Importantly, FINRA acknowledges that a recommendation of a higher-expense class share is not per se unsuitable but must be reviewed in light of the customer's particular facts and circumstances. See FINRA Regulatory Notice 19-04, n. 13. Nevertheless, the 2018 amendments to the Internal Revenue Code expanding the permitted use of 529 plans further complicates this analysis.

4 FINRA Executive Vice President of Enforcement Susan Schroeder noted that FINRA's review found supervisory "blind spots" within some firms. See A Few Minutes with FINRA - 529 Plan Share Class Initiative (January 28, 2019), available [here](#).

5 See Announcement, Share Class Selection Disclosure Initiative, SEC Division of Enforcement (Feb. 12, 2018), available [here](#).

6 Additionally, broker-dealers that elect not to participate in the 529 Plan Initiative are still subject to the self-reporting obligations under FINRA Rule 4530.

7 See A Few Minutes with FINRA - 529 Plan Share Class Initiative (stating that FINRA's examination program will continue to review firms that offer 529 plans for share class recommendation and supervisory violations).

8 FINRA Regulatory Notice 19-04, n. 15.

9 See, for example, FINRA 2019 Risk Monitoring and Examination Priorities Letter, at 3 (Jan. 17, 2019), available [here](#).

10 Because 529 plans are municipal securities, they are subject to the oversight of the Municipal Securities Rulemaking Board, which has stated that since investors purchase 529 plans for a beneficiary, registered representatives should also consider information known about the beneficiary in evaluating the investment objectives of the customer in order to recommend a share class that is tailored to the customer's particular circumstances and needs. See FINRA Regulatory Notice 19-04.

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