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Client Alert Commentary

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FINRA Launches New Self-Reporting Initiative for 529 Savings Plan Violations

The new initiative promises standard settlements for qualifying self-reported violations.

On January 28, 2019, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 19-04 announcing its 529 Plan Share Class Initiative (Initiative) to encourage member firms to self-report potential rules violations involving 529 plan recommendations. The Initiative follows the model of prior self-reporting initiatives undertaken by the Securities and Exchange Commission (SEC), including the 2014 Municipalities Continuing Disclosure Cooperation Initiative and the 2018 Share Class Selection Disclosure Initiative, and is the latest step in furtherance of FINRA360, a program that aims to increase the organization's efficiency and transparency. In announcing the Initiative, FINRA noted its concern that members' supervisory functions had a blind spot on 529 plans. The Initiative aims to remedy that blind spot by offering settlements of restitution and censure but no fine for qualifying self-reported violations.

Background on 529 Plan Supervision

529 plans are tax-advantaged savings plans designed to encourage savings for educational purposes that are typically sponsored by state governments. 529 plan shares are municipal securities and thus are governed by Municipal Securities Rulemaking Board (MSRB) rules. Chief among these are MSRB Rules G-19 and G-27, which require firms and brokers offering 529 plans to have a reasonable basis to believe that a recommended transaction is suitable in light of an investor's investment profile and to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations, respectively. The MSRB rules dovetail with FINRA rules, which, among other things, require members to have a reasonable basis to believe a recommended transaction is suitable for the customer (Rule 2111) and self-report violations of specified laws, rules, regulations, and standards of conduct (Rule 4530).

FINRA is charged with examining plans for violations and enforcing the rules of the MSRB, and its primary focus on 529 plan supervision concerns the recommendation of share classes within a 529 plan. In announcing the Initiative, FINRA drew special focus to the distinction between Class A shares, which typically impose an up-front sales charge and lower annual fees, and Class C shares, which typically dispense with an up-front sales charge in exchange for higher annual fees. Though FINRA has resisted providing bright-line guidance on share class suitability, it has emphasized the MSRB's statements that the age of the intended beneficiary and the number of years until the funds will be needed are critical factors in assessing share class suitability. FINRA has drawn attention to the January 2018 amendment to the federal tax code permitting use of 529 plans for certain K-12 educational costs, which adds a potentially complicating wrinkle to the suitability assessment. In addition, the ease with which investors can change beneficiaries under 529 plans complicates the suitability analysis. In many cases, firms may need to make a judgment call regarding suitability if guidance is not clear.

Breaking Down the 529 Plan Share Class Initiative

To take advantage of the Initiative, firms[1] must self-report by providing written notice to FINRA Enforcement by 12:00 a.m. ET on April 1, 2019. Notification can be made either by email to 529Initiative@finra.org or by mail to 529 Plan Initiative, FINRA, Department of Enforcement, Brookfield Place, 200 Liberty Street, New York, New York 10281.

Firms must then confirm their eligibility by submitting the following information for the reporting period of January 2013–June 2018 by May 3, 2019[2]:

- A list of the 529 plans sold by the firm, including the 529 plan name and the dates the firm offered each 529 plan
- The total aggregate principal amount invested in each 529 plan sold by the firm during the disclosure period
- A description of the firm's supervisory systems and procedures relating to 529 plan sales during the disclosure period
- A description of the changes to the firm's supervisory systems and procedures that the firm has implemented or will implement in order to strengthen compliance with its supervisory obligations; to the extent the firm identifies changes that have not yet been implemented, the firm should identify the individual supervisor at the firm who is responsible for the implementation
- The firm's assessment of potential impact on customers of supervision weaknesses, including a description of the firm's methodology for assessing impact on customers and a description of the firm's proposal to make restitution payments to harmed customers[3]
- Any other information the firm believes would assist FINRA Enforcement in understanding the firm's assessment of an account's expected investment horizon, the suitability of the firm's recommendations, or the reasonableness of the firm's supervisory system regarding share class recommendations

If a firm meets the requirements of the Initiative and FINRA recommends a formal enforcement action, it will further recommend FINRA accept a standard settlement of restitution and censure, but no fine. FINRA anticipates that settlements pursuant to the Initiative will include charges under MSRB Rule G-27d, and has confirmed that such settlements will not result in a firm's statutory disqualification under Securities Exchange Act Section 3(a)(39).

FINRA has clarified that, for firms choosing not to self-report, enforcement against violations likely will result in a recommendation of sanctions beyond those in the standardized settlement terms.

Key Considerations in the Self-Reporting Decision

If the SEC's approach in the Municipalities and Share Class Disclosure Initiatives are indicative of FINRA's intended approach regarding its 529 Plan Share Class Initiative, firms should expect increased scrutiny on 529 plan recommendations in examinations now and in years to come. Thus, firms would be wise to use the Initiative as an opportunity for a meaningful review of past and current recommendation practices. Doing this homework now will help firms determine whether self-reporting through the Initiative is the right course of action.

The Initiative presents a number of benefits to a firm considering self-reporting. Principally, it lowers the cost of self-reporting by removing the specter of a penalty. It will also likely reduce the negative publicity associated with a violation, since self-reporting firms are likely to be seen as one of many taking proactive measures. Moreover, firms should keep in mind that self-reporting does not automatically trigger restitution and censure, but may result in a cautionary letter or declination. Thus, for firms with knowledge of 529 supervisory issues, those whose 529 plans comprise a significant portion of their business (on which FINRA is likely to focus in an examination), or for firms currently subject to a FINRA examination that are concerned about potential 529 issues (firms under examination are still eligible to participate in the Initiative), the Initiative may be a useful and relatively inexpensive approach for moving forward from past violations. Firms that know they have a self-reporting obligation under FINRA Rule 4530 concerning 529 plan supervision should likewise take advantage of the Initiative.

Self-reporting, however, is not without its costs. First and foremost, to take advantage of the Initiative, firms must commit to provide customer restitution for the full reporting period. For firms with large 529 plan businesses, these costs may be significant, and the restitution analysis itself may be time- and resource-consuming. Moreover, self-reporting to FINRA may not immunize firms from enforcement by other regulatory agencies or from private litigation. For example, the SEC Enforcement Division investigated many firms that self-reported and settled with FINRA in 2015-2016 regarding share class selection issues involving retirement shares. Firms must consider whether the expected costs from self-reporting are more tolerable than the probability of an adverse enforcement action imposing penalties.

In assessing these options and in considering a review of 529 plan supervisory controls and recommendations, firms should keep in mind that the best reviews are done in coordination with experienced outside counsel, to ensure the review is privileged and to help determine whether self-reporting is the best course of action.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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Endnotes

1 The Initiative only covers member firms and not individuals. Individual registered representatives should expect greater scrutiny both from their firms and possibly from FINRA.

2 Firms may request an extension of the May 3, 2019 deadline by emailing 529Initiative@finra.org at least two days before the deadline.

3 Regarding the calculation of potential impact on customers, FINRA has advised that firms may choose to calculate impact on a customer by customer basis or by undertaking a statistical analysis based on beneficiary demographics, for example by reviewing share classes recommended to investors for beneficiaries within a given age range.