Drinker Biddle

Client Alert

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FINRA's 529 Plan Share Class Initiative to Self-Report

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On January 28, 2019, FINRA released its Regulatory Notice 19-04 announcing its 529 plan self-reporting initiative. FINRA Notice Summary explained that "FINRA's 529 Plan Share Class Initiative Encourages Firms to Self-Report Potential Violations."

To qualify for this initiative, firms must self-report by providing written notification to FINRA Enforcement by 12:00 a.m. E.T. on April 1, 2019. The firm must then provide FINRA with all required information by May 3, 2019. The qualifying reporting period is January 2013 through June 2018.

FINRA seeks to address its finding that "some firms have failed to reasonably supervise brokers' recommendations of multi-share class products." Specifically, FINRA believes there have been "suitability violations related to brokers recommending 529 plan share classes that were inconsistent with the accounts' investment objectives and were, therefore, unsuitable for the investors .

FINRA's goal in this initiative is to encourage firms to:

1. promptly remedy potential supervisory and suitability violations related to recommendations as to share classes for 529 plans;
2. quickly and efficiently return money to harmed investors; and
3. voluntarily report past lapses to FINRA's Department of Enforcement ("Enforcement") with a detailed remediation plan.

To encourage this self-reporting, Enforcement "will recommend that FINRA accept favorable settlement terms for reporting firms." Specifically, should a firm self-report and timely provide the information requested and Enforcement determines to recommend a formal enforcement proceeding against that firm, FINRA would recommend "a settlement that includes restitution for the impact on affected customers and a censure, but no fine. Recommended settlements also will include either an acknowledgement that the firm has voluntarily taken corrective actions or undertakings to do so. Enforcement anticipates that settlements entered into pursuant to this 529 Initiative will include charges under MSRB Rule G-27 (Supervision). Settlements under this rule **would not result in a firm's "statutory disqualification"** as that term is defined in Section 3(a)(39) of the Securities Exchange Act of 1934."

Because 529 plans are municipal securities, they are governed by, among other things, the Municipal Securities Rulemaking Board (MSRB) Rule G-19 (Suitability of Recommendations and Transactions) and Rule G-27 (Supervision) which requires a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations, and MSRB rules. Therefore, in concert with other rules, such as FINRA Rule 2111, brokers must have a reasonable basis for their recommendations in light of the investor investment profile and firms must have systems in place to ensure such suitable recommendations. Specifically, in articulating its concern, FINRA mentions that different share classes have different fee structures and suitability is dependent upon "the age of the beneficiary and the number of years until the funds will be needed to pay qualified education expenses of the beneficiary."

A January 2018 amendment to the federal tax code now permits 529 plans for tuition for grades K-12, subject to certain limitations. FINRA believes these changes underscore the importance of recommending the appropriate share class to an investor in light of that investor's goals for the funds.

> FINRA is concerned that because of the unique features of 529 plans, some member firms may not provide adequate supervision. For example, 529 plan transactional data, including account asset levels, may not be available in the systems that firms use to monitor other types of transactions. This initiative is intended to encourage firms to assess their supervisory systems and procedures governing 529 plan share-class recommendations, to identify and remediate any defects, and to compensate any investors harmed by supervisory failures.

FINRA is explicit in what it expects firms to do as part of this initiative.

> Firms are encouraged to review their supervisory systems and procedures governing 529 plan share-class recommendations and self-report to FINRA areas where their supervision may not have been reasonable. Potential areas of concern include the failure to:
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> - provide training regarding the costs and benefits of different 529 plan share classes;
> - understand and assess the different costs of share classes for individual transactions;
> - receive or review data reflecting 529 plan share classes sold; and
> - review share-class information, including potential breakpoint discounts or sales charge waivers, when reviewing the suitability of 529 plan recommendations.
>
> Firms that identify and self-report issues with 529 plan share-class supervision should also assess and self-report the potential impact of such supervisory failures.

FINRA suggests that the potential impact analysis can be achieved by either undertaking customer-specific analysis or using a statistical approach.

Drinker Biddle has had significant experience with the SEC's similar initiative – the SCSDI. Given that experience, we believe that in light of the very short window in which firms can self-report, this is the time for our Broker-Dealer clients to undertake with counsel a client-privileged assessment of your supervisory systems relating to 529 plans for the potential areas of concern articulated by FINRA. Consultation with competent counsel can assist you in understanding: a) this initiative and the consequences of reporting or not; b) what would be a violation under FINRA's thinking (for example, when is a C share better than an A share; how much flexibility is there, etc.); and c) what Written Supervisory Provisions and supervision are expected going forward.

The Drinker Biddle Best Interest Compliance Team is available to assist you with general issues relating to FINRA RN 19-04 or an analysis and/or reporting pursuant to that Notice.

Best Interest Compliance Team

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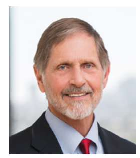

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