Testimony

of

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Committee on Government Affairs
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Hearing to Review
529 College Savings Plans

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Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to submit this written statement for the record.

NASD

NASD is the world's preeminent private sector securities regulator, established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—more than 5,200 securities firms that operate more than 97,000 branch offices and employ more than 664,000 registered representatives.

Our rules comprehensively regulate every aspect of the brokerage business. Our market integrity and investor protection responsibilities include examination, rule writing, professional training, licensing and registration, dispute resolution, and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules, and the federal securities laws—and we discipline those who fail to comply. Last year, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (827) from the securities industry than in any previous year. NASD monitors all trading on the NASDAQ Stock Market—more than 70 million orders, quotes and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors, more than half of whom are unaffiliated with the securities industry.

529 College Savings Plans

NASD recognizes that there are few things in life more essential than a good education. Helping parents save and invest for their children's higher education is an important public policy goal and important to the future of our country. U.S. government statistics show a clear correlation between education and earning levels and indicate that the fastest growing jobs require some education beyond high school. Paying for college in this era of rising tuition costs is increasingly challenging and makes saving for college all the more important.

529 college savings plans ("529 plans") are financial products designed to help parents and others save and invest for higher education.[1] The plans offer families the opportunity to obtain tax-free growth and distribution of the money they save and invest for college costs. They are named after the section of the tax code that gave them their special tax-advantaged status.

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[1] For purposes of this Testimony, the terms "529 plan" and "college savings plan" are intended to refer to college savings plans established under Section 529(b)(A)(ii) of the Internal Revenue Code of 1986 as "qualified tuition programs." The terms are not intended to include pre-paid tuition plans or local government pools.

These plans clearly play an increasingly important role in enabling parents to save for college. Industry statistics show that more than $40 billion is now invested in 529 plans and some estimate that this number will double by the end of 2006. Approximately eight percent of families with children under 18 own a 529 savings plan.

529 plans are sold in two ways. The first is "direct-sold," in which an investor buys an interest in the college saving plan directly from the state that sponsors the plan or from the plan's program manager, with no sales person involved. The second is "advisor-sold," in which investors buy an interest in a college saving plan through an investment adviser, brokerage firm, or bank, generally paying a sales load or fee.

Regulation of 529 Plans

In 1999, the SEC staff determined that interests in 529 plans are municipal securities for purposes of the federal securities laws.[2] This means that the plans are not required to be registered as investment companies under the Investment Company Act of 1940, and the interests in such plans are not required to be registered as securities under the Securities Act of 1933 or the Securities Exchange Act of 1934. Of course, 529 plans are subject to the laws of the states that issue such plans.

As municipal securities, interests in 529 plans fall under the regulatory regime of the Municipal Securities Rulemaking Board ("MSRB"). Brokerage firms that sell 529 plans must register as municipal securities brokers or dealers. In addition, individual representatives and supervisors that sell or oversee the sale of interests in 529 plans must either be qualified generally to sell or supervise the sale of municipal securities, or must pass special qualification exams that are geared toward 529 plans. Recent rules proposed by the MSRB would impose advertising and non-cash compensation standards on the sale of 529 plans that are similar to those standards that already apply to the sale of mutual funds under NASD rules.

NASD does not regulate the state issuers of 529 plans. We do, however, enforce MSRB rules when the securities firms we regulate sell 529 plans. In addition, we apply our own advertising rules to the marketing of the underlying investments. In March 2003, NASD issued a Notice to Members informing securities firms that 529 plan sales materials that refer to or describe the underlying investment company options available through such plans must comply with SEC and NASD advertising rules.[3] This means that, in addition to meeting the content standards of the rules that govern mutual fund advertising, NASD registered broker-dealers must file 529 plan sales material with NASD for review within 10 days of its first use.

In 2003, we reviewed over 2,000 sales pieces concerning 529 plans through our filing program. NASD staff focuses particularly on issues involving fair and balanced

[2] Municipal Securities Rulemaking Board, SEC No-Action Letter (Feb. 26, 1999).

[3] NASD Notice to Members 03-17 (March 2003).

disclosure of the risks as well as the potential rewards of investing in 529 plans, prominent disclosure of sales charges and other fees, and an accurate depiction of the tax consequences of investing in these products. Through this process, we have identified and required members to correct problematic sales material.

For example, we reviewed a television commercial that discussed the rising cost of a private college education and focused on a small child holding a check for $250,000. The advertisement stated that 529 college savings plans have "powerful savings benefits" and implied that investing in a 529 plan will yield enough money to cover the cost of a private college education. Since there is no assurance that an investment in a 529 plan will achieve this goal, and the $250,000 check is promissory in nature, we prohibited the broker-dealer from using the advertisement.

Similarly, we corrected sales material that misrepresented the tax treatment of investments in 529 plans. We reviewed a print advertisement that included the headline "Pay for college TAX-FREE!" The headline implied that college costs would be covered, and that there would be no tax implication throughout the investment process – even if the plan were offered to an out-of-state resident. We required the firm to make substantial revisions to this advertisement before using it. We will continue to review sales material for 529 plans to prevent these kinds of misleading advertising campaigns.

Complicated Choices for Investors Creates Need for Standardized Disclosure

NASD supports standardized disclosure of fees and expenses among 529 plans. This standardized disclosure would clarify the costs associated with an investment in a 529 plan, and would facilitate an investor's ability to compare the costs of different plans. We also recommend clear and concise disclosure concerning the forms of compensation paid to dealers for the sale of 529 plans.

Last month NASD recommended to the MSRB and SEC that every SEC and NASD sales practice standard that applies to the distribution of mutual funds to retail investors also should apply to the sale of mutual funds through 529 plans, and these standards should be supplemented by additional sales practice requirements to address the unique characteristics of 529 plans. The reason for these recommendations is that 529 plans present all of the potential suitability, disclosure and other sales practice issues as do mutual funds. In fact, these products from an investor’s point of view look very much like mutual funds. NASD has worked closely with the SEC in developing what we believe is highly-effective disclosure to investors when they buy mutual funds. We shouldn’t reinvent the wheel for 529 plans. It would be a disservice to investors to hold 529 plans to a lower standard of transparency and clarity than mutual funds. Plus, their very benefits, such as in-state tax deductions and fee reductions, present additional disclosure and other sales practice issues, further confusing investors.

The number and variations of 529 plans complicate the choices for investors and the sales process for those selling the plans. First, while federal tax advantages are standard to all college savings plans, state tax treatment of 529 plans varies from state to state and can be an important consideration for investors in deciding which plan to select. In 25 states and the District of Columbia, investors receive a tax deduction or tax credit if they reside in the state sponsoring the 529 plan.

Deductions vary from state to state. For example, Colorado currently allows residents to deduct the entire amount of their contribution to their in-state plan for each beneficiary, up to the maximum contribution limit. Rhode Island, on the other hand, allows only a $1000 deduction in total for joint filers and $500 for single filers.

States Offering Tax Deductions or Credits to In-State Investors

Colorado	Michigan	Oregon
District of Columbia	Mississippi	Rhode Island
Georgia	Missouri	South Carolina
Idaho	Montana	Utah
Illinois	Nebraska	Vermont
Iowa	New Mexico	Virginia
Kansas	New York	West Virginia
Louisiana	Ohio	Wisconsin
Maryland	Oklahoma	

The variations in fees the plans charge can also be confusing to investors. All 529 plans charge fees and expenses and investors have to look carefully to compare them. These costs not only vary among 529 plans but also can vary within a single 529 plan. Fees may include: enrollment charges, annual maintenance fees, sales loads, deferred sales charges paid when investors withdraw their money, administration and management fees and underlying fund expenses.

Advisor-sold plans often cost more than direct-sold plans. Typically, these additional costs take the form of front-end sales loads or other fees associated with share classes, and annual distribution fees, including service fees that compensate the financial professional, who provides guidance in selecting a plan.

Another complicating factor can be the plans' share classes. Some broker-sold college savings plans, like some mutual funds, have different share classes. Often referred to as Class A, B, or C shares, each class has different fees and expenses.

College Savings Plan Share Class Costs Comparison Chart

	Class A	Class B	Class C
Front-End Load	Initial sales charge. Can be reduced or eliminated by breakpoint discounts.	None.	None.
Contingent Deferred Sales Charge (CDSC)	None.	Declines over several years.	Typically, lower CDSC than Class B that is eliminated after one year.
12b-1 Fees	Typically, lower than Class B and C shares.	Typically, higher than Class A shares.	Typically, higher than Class A shares.
Converts to Class A Shares	N/A.	Convert to Class A shares after several years, thereafter reducing expenses.	No. Annual expenses remain at Class C level.

NASD Review of Sales Practices

Because of the complexities of these instruments, NASD has been reviewing the sales practices used by broker-dealers to market these plans. Late last summer we selected six firms, based on the number of customer complaints and the sales volume of particular plans to see how their plans were being sold and to whom. We were troubled to discover that more than 90 percent of the sales by some of those firms were to out-of-state residents, despite the fact that about half of the states give a state tax deduction to their citizens for contributions to the home state's 529 plan.

MSRB Rule G-19 requires that a broker-dealer "have reasonable grounds . . . for believing that the recommendation is suitable." NASD understands that under the MSRB's interpretation of G-19, a sale of an out-of-state plan can be suitable. For example, the underlying investment companies offered by the in-state plan could provide inferior portfolio management, or a relatively limited array of investment choices. The fees associated with the in-state plan could be very high. And, of course, in some states the in-state plan may not even provide a state tax deduction or other benefit. A broker must consider a variety of factors, in addition to the possible availability of in-state benefits, before making the recommendation.

We received information from the six firms in September 2003. The data revealed that most of the six firms sold over 95 percent of the dollar value of 529 plan investments to non-residents of the state that sponsored the plan. As a result of this finding, NASD sent follow-up letters to the initial six firms and initial letters to twelve additional firms at the end of March 2004.

NASD chose the twelve additional firms with an eye to broadening the character of the firms under review to include small broker-dealers, mid-size firms, bank-affiliated broker-dealers, and insurance affiliates. We also broadened the selection criteria to include firms that offered a number of 529 plans rather than just one in order to determine if this had an impact on the sales practices and the in-state/out-of-state statistics. Our March 2004 inquiries focused on sales of out-of-state plans to residents of 26 jurisdictions that appear to have the greatest tax incentives to use in-state plans.

Preliminary Sweep Findings

During the review period, the firms sold approximately $2.1 billion worth of 529 plans. The most striking finding in the sales data is that regardless of the number of 529 plans sold, the vast majority of sales were made to residents outside of the state that sponsored the 529 plan.

Firm	No. of Plans	Total 529 Plan Sales	In-State as Percentage of Total	Out-of-State as Percentage of Total
A	12	$240,922,374	5.17%	94.83%
B	11	$1,693,450	2.16%	97.84%
C	11	$1,606,522	30.46%	69.54%
D	9	$57,139,900	8.36%	91.64%
E	8	$85,236,657	1.46%	98.54%
F	7	$519,701	0.00%	100.00%
G	5	$461,094,775	14.92%	85.08%
H	4	$103,094,340	1.30%	98.70%
I	3	$7,120,458	0.01%	99.99%
J	3	$73,659,053	15.33%	84.67%
K	3	$570,071,987	62.85%	37.15%
L	2	$57,368,904	1.06%	98.94%
M	1	$393,407,837	1.49%	98.51%
N	1	$60,190,000	2.26%	97.74%
O	1	$9,405,380	3.02%	96.98%
P	1	$23,519,436	13.98%	86.02%

As our investigations continue, NASD will keep working with the other regulatory authorities to help ensure that interests in 529 plans and the underlying investments are marketed and sold in a manner that protects investors.

Investor Education

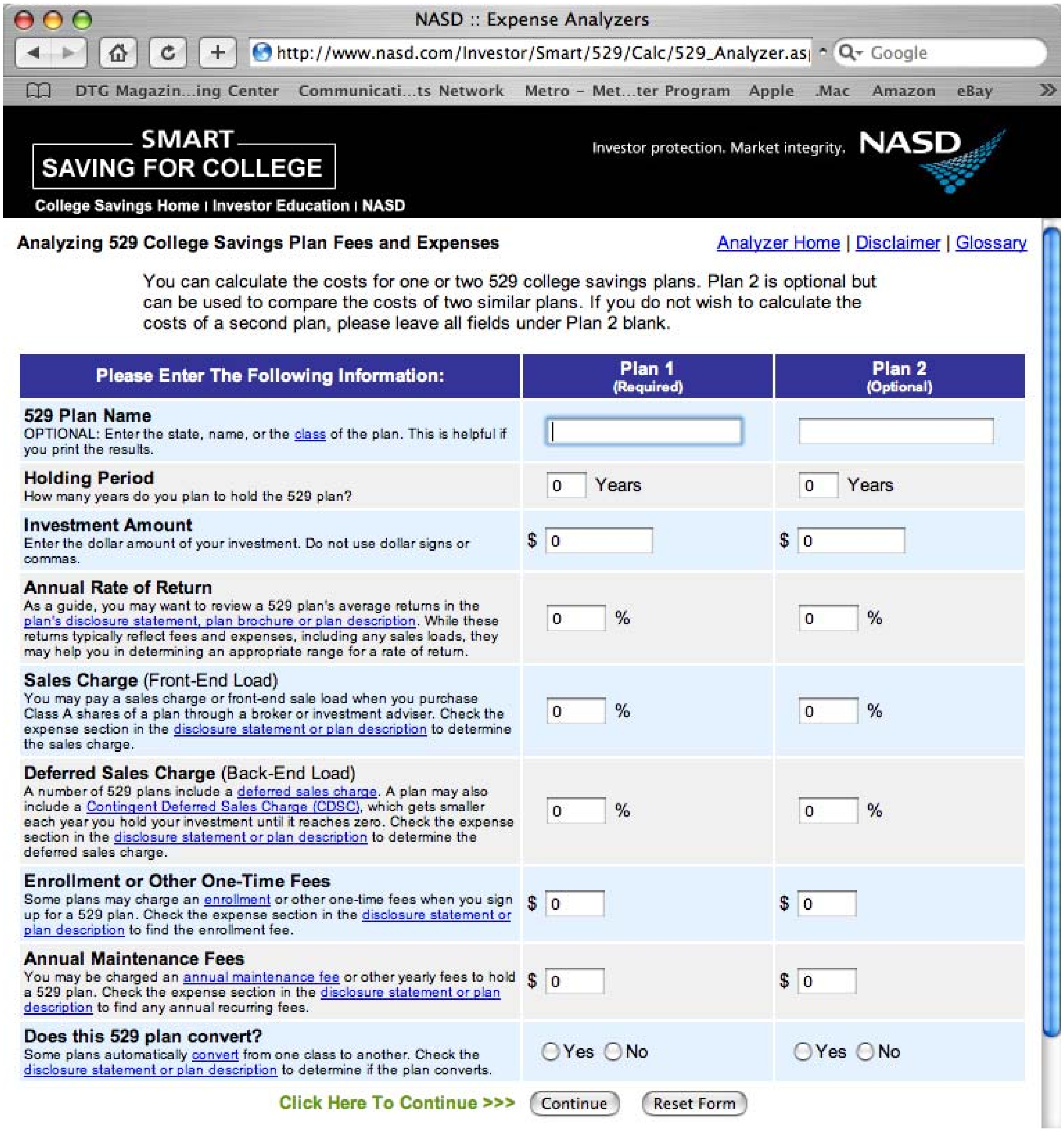
529 college-savings plans can be confusing to both brokers and investors. Not only do broker-dealers need to be better informed and better equipped to explain to customers the complexities of these plans, but customers need to do their homework as well. Matching a client with a 529 can be a complicated task and it does not help either brokers or investors that there is no standardized disclosure among the plans.

The NASD Web site provides guidance for both investors and broker-dealers who navigate these waters. See http://www.nasd.com/. For example, we recently issued an Investor Alert to help educate investors on 529 plans before they buy. It stresses that since no two plans are alike, investors need to be aware of these four factors:

- Contribution limits vary by state.
- State tax advantages vary from state to state and may depend on whether you are a resident of the state sponsoring the plan.
- Investment options vary greatly — from high-risk stock funds, to funds that contain a mix of stocks and bonds, to conservative investments that contain money market or short-term bond funds. Most plans offer age- or enrollment-based investments that grow more conservatively over time, as the beneficiary gets closer to using the proceeds to pay for college expenses. Many plans also offer static investments where assets are typically invested in a set allocation of one or more mutual funds.
- Fees and expenses vary greatly, even among plans offered within the same state.

NASD has two tools on its Web site to help investors in this area. Our booklet, *Smart Saving for College,* details all of the features of 529 college savings plans, as well as other vehicles for college savings, including Coverdell Education Saving Accounts, prepaid tuition plans, custodial accounts, and even U.S. Savings Bonds. The booklet answers almost every question imaginable about 529 plans.

NASD has also developed a tool to help investors compare how fees and expenses can impact returns. The analyzer (below) is designed to work with most college savings plans. It explains the various fees and provides guidance about where to find them in 529 disclosure documents. It also provides prompts that help ensure the best possible comparison between plans.



Conclusion

As NASD continues its investigations into the sales practices of broker-dealers relating to 529 plans, we will enforce NASD and MSRB rules with a full range of disciplinary options—including fines, restitution to customers, and the potential for suspension or expulsion from the industry. NASD will continue to work with other regulators for better fee disclosures and other tools to protect investors and maintain investor confidence as families strive to save for college.