OVERSIGHT HEARING ON
529 COLLEGE SAVINGS PLANS

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

SEPTEMBER 30, 2004

Testimony of the
MUNICIPAL SECURITIES RULEMAKING BOARD
Ernesto A. Lanza
Senior Associate General Counsel

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Before the

Subcommittee on Financial Management, the Budget, and International Security,
Committee on Governmental Affairs,
United States Senate

September 30, 2004

Chairman Fitzgerald, Ranking Member Akaka and Members of the Subcommittee:

My name is Ernesto Lanza. I am Senior Associate General Counsel of the Municipal Securities Rulemaking Board. I greatly appreciate the opportunity to testify before the Subcommittee on behalf of the MSRB concerning the 529 college savings plan market and the MSRB's role in this market. This oversight hearing seeks to examine concerns that have been expressed about the levels of fees and commissions; the quality of plan disclosure, including the ability of investors to make meaningful comparisons among plans; varying state tax treatment; and questionable broker-dealer sales practices. I will seek to address each of these areas, although most of my testimony today will concentrate on those areas subject to MSRB's statutory jurisdiction.

I. BACKGROUND ON THE MSRB'S STRUCTURE, AUTHORITY AND RULES

A. MSRB Structure

The MSRB is a self-regulatory organization ("SRO") established by Congress in the Securities Acts Amendments of 1975 to write rules with respect to transactions in municipal securities effected by brokers, dealers and municipal securities dealers (collectively, "broker-

dealers"). The MSRB stands as a unique SRO for a variety of reasons. The MSRB was the first specifically established by Congress. Also unique is the fact that the legislation, now codified in section 15B of the Securities Exchange Act ("Exchange Act"), dictates that the MSRB governing board shall be composed of members who are equally divided among public members (individuals not associated with any broker-dealer), individuals who are associated with and representative of banks that deal in municipal securities ("bank dealers"), and individuals who are associated with and representative of securities firms.[1] At least one public member serving on the Board must represent investors and at least one must represent issuers of municipal securities. Further, unlike most other securities regulatory bodies, the MSRB was created as a sector-specific regulator, regulating broker-dealer transactions solely in securities issued by state and local governments.

Members of the MSRB governing board meet periodically throughout the year to make policy decisions, approve rulemaking and review developments in the municipal securities market. Day-to-day operations of the MSRB are handled by a full-time professional staff. The operations of the MSRB are funded through assessments made on broker-dealers for initial fees, annual fees, fees for underwritings and transaction fees.[2]

There are over 2,400 broker-dealers registered with the MSRB to engage in municipal securities activities. These broker-dealers range from large securities firms with nationwide

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1 Under MSRB Rule A-3, the MSRB governing board is composed of 15 membership positions, with five positions each for public, bank dealer and securities firm members.

2 These fees are set forth in MSRB Rules A-12 through A-14. At the request of staff of the Securities and Exchange Commission, the MSRB has exempted broker-dealers that market 529 college savings plans from the underwriting and transaction fees.

presence to small local shops. A significant number of these broker-dealers effect 529 college savings plan transactions.

B. MSRB Authority

Section 15B(b)(2) of the Exchange Act sets forth certain specific areas for MSRB rulemaking and also directs the MSRB generally to adopt broker-dealer rules designed to:

> prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling and processing information with respect to and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

Like other SROs, the MSRB must file its proposed rule changes with the Securities and Exchange Commission ("SEC") for approval prior to effectiveness.

Although the MSRB was created to write rules that govern broker-dealer conduct in the municipal securities market, the Exchange Act directs that inspection of broker-dealers for compliance with, and the enforcement of, MSRB rules be carried out by other agencies. For securities firms, the NASD and the SEC perform these functions. For bank dealers, the appropriate federal banking authorities, in coordination with the SEC, have this responsibility.[3]

[3] These federal banking authorities consist of the Federal Deposit Insurance Corporation, the U.S. Treasury Department's Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System, depending upon the specific bank dealer.

The use of existing enforcement authorities for inspection and enforcement of MSRB rules was designed to provide for an efficient use of resources. The MSRB works cooperatively with these enforcement agencies and maintains frequent communication to ensure both that: (1) the MSRB's rules and priorities are understood by examining officials; and (2) general trends and developments in the market discovered by field personnel are made known to the MSRB.

While Section 15B of the Exchange Act provides the MSRB with broad authority to write rules governing the activities of broker-dealers in the municipal securities market, it does not provide the MSRB with authority to write rules governing the activities of other market participants, such as state and local governmental issuers, independent financial advisors, trustees, attorneys, derivatives firms, and others active in the municipal securities market. Municipal securities also are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933 (the "Securities Act") and are exempt from the registration and reporting requirements of the Exchange Act.

In adopting Section 15B of the Exchange Act, Congress provided in subsection (d) specific provisions that restrict the MSRB and the SEC from regulating the disclosure practices of state and local governmental issuers in certain ways. Paragraph (1) of subsection (d) prohibits both the MSRB and the SEC from writing rules that directly or indirectly (*i.e.*, through broker-dealer regulation) impose a presale-filing requirement for issues of municipal securities. Paragraph (2) of subsection (d) prohibits the MSRB (but not the SEC) from adopting rules that directly or indirectly require issuers to produce documents or information for delivery to customers or to the MSRB. Paragraph (2), however, specifically allows the MSRB to adopt requirements relating to such disclosure documents or information as might be available from "a

source other than such issuer." The provisions of subsection (d) commonly are known as the "Tower Amendment."

The extent of and limitations to the MSRB's statutory authority reflect the Congressional determination in 1975 to provide for investor protection through regulation of broker-dealer activities while maintaining the general exemption from the federal securities laws for state and local governments. This approach differs from the more comprehensive approach generally taken by Congress with respect to the federal securities laws. In the mutual fund market, for example, regulation under the Investment Company Act of 1940 (the "Investment Company Act") and the other federal securities laws of all parties involved in the market results in an interlocking system of regulation applicable to broker-dealers, issuers, investment managers and others. In contrast, MSRB rules recognize that state and local governmental issuers, as largely unregulated entities, may act in their best judgment in widely divergent manners. In mandating what broker-dealers must do under our rules, the MSRB cannot rely on the assumption that issuers or their agents will structure their securities, provide disclosure to the marketplace, or seek to market their securities in any particular manner. Thus, although the 529 college savings plan market bears considerable similarities to the mutual fund market, the differences in the fundamental legal obligations of issuers and others in the two markets – and basic limitations on the MSRB's authority – can have an appreciable impact on the ability to impose identical broker-dealer requirements on the two markets.

C. MSRB Rules Overview

The MSRB has adopted a substantial body of rules that regulate broker-dealer conduct in the municipal securities market. These rules address all of the subjects enumerated in Section

15B of the Exchange Act by Congress for MSRB action, including recordkeeping, clearance and settlement, the establishment of separately identifiable departments within bank dealers, quotations, professional qualifications of persons in the industry and arbitration of disputes.[4] The MSRB also adopted a number of rules in furtherance of the broad purposes of ensuring the protection of investors and the public interest. Among the most important of these are the MSRB's primary customer protection measures—Rule G-17 (fair dealing), Rule G-19 (suitability), and Rules G-18 and G-30 (fair commissions and transaction prices). These rules require broker-dealers to observe the highest professional standards in their activities and relationships with customers. The application of these rules in the 529 college savings plan market is discussed below.

In addition, the MSRB adopted Rule G-37 on political contributions in an effort to remove the real or perceived conflict of interest created when officials of state or local governmental issuers receive political contributions from broker-dealers and then award municipal securities business to such broker-dealers in a practice that came to be known in the debt markets as "pay-to-play." In general, Rule G-37 prohibits broker-dealers from engaging in municipal securities business with issuers if certain political contributions have been made to officials of such issuers; prohibits broker-dealers and their municipal finance professionals from soliciting or bundling contributions for officials of issuers with which the broker-dealer engages in business; and requires broker-dealers to publicly disclose certain political contributions to

[4] The MSRB's arbitration program was established in 1978. Because of the small number of cases filed with the MSRB and the agreement of NASD to handle arbitration cases relating to municipal securities transactions brought by customers involving bank dealers as well as existing NASD broker-dealer members, the MSRB discontinued its arbitration program in 1998.

allow public scrutiny. The rule also requires broker-dealers to publicly disclose certain contributions to state and local political parties to ensure that such contributions do not represent attempts to make indirect contributions to issuer officials in contravention of Rule G-37.

Further, the MSRB adopted Rule G-38 relating to the use by broker-dealers of consultants to solicit municipal securities business from issuers on the broker-dealers' behalf. This rule is intended to deter and detect attempts by broker-dealers to avoid the limitations placed on broker-dealers by Rule G-37 through their outside consultants, as well as to require full disclosure to issuers and the public of relationships which could otherwise pose potential conflicts-of-interests or could result in potentially improper conduct by consultants. The rule currently requires a broker-dealer who uses consultants to disclose to each issuer information on consulting arrangements relating to such issuer, and to publicly disclose reports of all consultants used by the broker-dealer, amounts paid to such consultants, and certain political contribution information from the consultants.

The impact of Rules G-37 and G-38 on maintaining the integrity of the municipal securities market has been very positive. The rules have gone a long way towards severing the real or perceived connection between political contributions and the awarding of municipal securities business to broker-dealers.

II. BACKGROUND ON THE 529 COLLEGE SAVINGS PLAN MARKET

Section 529 of the Internal Revenue Code provides for the establishment, on a federally tax-advantaged basis, of two varieties of "qualified tuition programs." So-called 529 college savings plans, established and maintained by states under clause (b)(1)(A)(ii) of Section 529,

allow an individual to make contributions to an account established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. These 529 college savings plans should be distinguished from prepaid tuition plans established under clause (b)(1)(A)(i) of Section 529, which are not subject to MSRB regulation.[5]

In a common model for 529 college savings plans, individuals purchase interests, units or shares (collectively, "shares") in a trust established by the state or its instrumentality and trust assets are invested according to stated investment objectives. The state typically engages an investment management firm to manage the investment of trust assets. In most cases, the trust assets are invested in mutual funds offered by one or more fund families. In addition, most states engage broker-dealers to serve as primary distributors for the shares in their 529 college savings plans. The primary distributor typically is an affiliated broker-dealer of the investment management firm. In many cases, primary distributors enter into selling arrangements with other broker-dealers to serve as selling broker-dealers to provide further distribution channels to customers. This structure (either with or without the selling broker-dealer distribution channel) often closely resembles the distribution patterns normally seen in the mutual fund industry.

Many states also market their 529 college savings plans directly to investors using state personnel. In some states, investments may only be made through state personnel; in others, investments may only be made through broker-dealers; and in others, investments may be made

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[5] Prepaid tuition plans may be established by states and eligible educational institutions to allow individuals to purchase tuition credits on behalf of designated beneficiaries covering specific portions of the costs of future higher education. The MSRB has not undertaken to engage in any rulemaking with respect to such plans since it is the MSRB's understanding that broker-dealers rarely are involved in the marketing of prepaid tuition plans and it is unclear whether the credits acquired under such plans would be considered securities for purposes of the federal securities laws.

through either. Of those states where investments may be made through either state personnel or a broker-dealer, some offer the same underlying investments through both channels and others offer different underlying investments through the different channels. In some states that maintain both direct and broker-dealer channels, the direct channel through state personnel may be limited solely to investors who are residents of such states. Several unique marketing programs have developed in connection with 529 college savings plans, including workplace marketing programs where an employer offers a 529 college savings plan as a payroll reduction or other option to its employees (often with reduced fees) and affinity rebate programs that fund 529 college savings plan accounts from funds rebated by participating merchants from whom the investor makes purchases.

In 1998, the MSRB learned that broker-dealers were being engaged by state 529 college savings plans to help them market the plans to the public. In reply to an inquiry from the MSRB, SEC staff advised the MSRB that shares of at least some 529 college savings plans are municipal securities.[6] As municipal securities, such shares are not subject to the Securities Act and the Exchange Act, other than the anti-fraud provisions thereunder and broker-dealer regulation by the MSRB and the SEC. Furthermore, because the issuers of 529 college savings plan shares are state governmental entities, they are also exempt from the Investment Company Act.[7]

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6 *See* Letter dated February 26, 1999 from Catherine McGuire, Chief Counsel, SEC Division of Market Regulation, to Diane G. Klinke, MSRB General Counsel.

7 529 college savings plan shares generally are considered "exempted securities" under Section 3(a)(2) of the Securities Act and "municipal securities" under Section 3(a)(29) of the Exchange Act. Section 2(b) of the Investment Company Act provides that the act does not apply to, among others, a state or any political subdivision of a state, or any agency, authority, or instrumentality of a state.

As a result of these exemptions, a state that operates a 529 college savings plan need not meet the basic requirements set forth in the Investment Company Act that apply to mutual funds. The requirements from which 529 college savings plans are exempted relate to such matters as registration with the SEC, preparation of a prospectus and statement of additional information ("SAI"), daily calculation of net asset value, end of day pricing of fund shares, limitations on "12b-1 plans" and "fund of funds" structures, changes in investment policy, transactions with affiliates and establishment of a board of directors that includes independent directors, among others. The states also are exempt from the registration and prospectus delivery requirements of the Securities Act, as well as from the registration and reporting requirements of the Exchange Act. However, states remain subject to the anti-fraud rules. Further, states that wish to maintain favorable federal tax treatment for their 529 college savings plans must comply with Section 529 of the Internal Revenue Code. In addition, each 529 college savings plan is subject to the requirements of its state's authorizing legislation and other provisions of applicable state law.

In addition to the exemptions provided under the federal securities laws for the governmental issuers of shares of 529 college savings plans, broker-dealers that market the 529 college savings plans (including primary distributors, selling broker-dealers, wholesalers and broker-dealers acting in other capacities) are not subject to the Investment Company Act but are regulated by MSRB rules and certain rules of the SEC, including but not limited to Exchange Act Rules 10b-5 and 15c2-12. It is important to note, however, that states that market their 529 college savings plans directly to investors through state personnel without using broker-dealers are not subject to MSRB rules.

III. MSRB REGULATION OF BROKER-DEALER ACTIVITIES RELATING TO 529 COLLEGE SAVINGS PLANS

This hearing has been convened to examine four general areas of concern identified by the Subcommittee: high fees and commissions; lack of disclosure and comparability among plans; inconsistent state tax treatment; and questionable broker-dealer sales practices. As noted above, the MSRB has primary regulatory responsibility with respect to broker-dealer activities relating to 529 college savings plans and therefore I will first address the sales practice issue and other matters subject to the MSRB's jurisdiction, then return to discuss the other remaining issues. MSRB rules and interpretations relating to broker-dealer activities in the 529 college savings plan market are available at www.msrb.org/msrb1/mfs.

In a short period of time, the MSRB has undertaken broad-ranging rulemaking and interpretive action on over a dozen of its rules to amend provisions previously oriented solely toward debt securities into rules applicable to securities that are much like mutual fund shares. The MSRB monitors this market closely and has been adopting rule changes, issuing interpretive guidance, conducting educational outreach and speaking to the 529 college savings plan community on a frequent and regular basis. The MSRB believes that it has, within the reach of its statutory jurisdiction, put into place strong and effective rules – soon to be further strengthened by some important pending proposals discussed below – to protect investors and the public interest. The MSRB strongly encourages vigorous enforcement by the SEC, NASD and the bank regulatory agencies of the MSRB's rules in connection with broker-dealers' 529 college savings plan activities.

The following is a brief overview of key MSRB broker-dealer rules for the 529 college savings plan market.

A. Basic Fair Practice Requirement

MSRB Rule G-17, on fair dealing, lays down the basic precept that broker-dealers must deal fairly with all persons and must not engage in any deceptive, dishonest or unfair practice. This seemingly simple rule actually touches on nearly every activity of broker-dealers, either as a general ethical standard that backstops specific requirements established by other MSRB rules, or by creating its own specific requirements through MSRB interpretation. At the rule's core is a basic anti-fraud standard applicable specifically to all broker-dealer activities in municipal securities that parallels the anti-fraud provisions established under the Securities Act and Exchange Act. Situations where the rule's general terms have subsequently been interpreted to carry specific obligations for broker-dealers are identified below.

B. Suitability of Recommended Transactions

MSRB Rule G-19, on suitability of recommendations and transactions, requires a broker-dealer that recommends to a customer an investment in a 529 college savings plan to have reasonable grounds for believing that the recommendation is suitable, based on information available about the investment and information on the customer's financial status, tax status, investment objectives and other relevant information. The MSRB has stated that broker-dealers must be cognizant that 529 college savings plans are designed for a particular purpose and that this purpose should match the customer's investment objective. For example, broker-dealers should bear in mind the potential tax consequences of a customer making an investment in a 529 college savings plan where the broker-dealer understands that the customer's investment objective may not involve using such funds for qualified higher education expenses. Furthermore, the MSRB has stated that information regarding the age of the 529 college savings

plan account's designated beneficiary and the number of years until funds will be needed to pay qualified higher education expenses are relevant factors to consider.

The MSRB also has provided guidance where a 529 college savings plan may offer more than one share class, such as A, B and C shares with different sales load structures. Broker-dealers must consider the appropriate share class for a particular customer, and the MSRB has stated that a customer's investment objective – particularly, the number of years until withdrawals are expected to be made – can be a significant factor in determining which share class would be suitable for the particular customer.

Broker-dealers also are prohibited from recommending transactions to customers that are excessive in size or frequency. For example, where the broker-dealer knows that a customer is investing in a 529 college savings plan with the intention of qualifying for the federal tax benefit, such broker-dealer may violate Rule G-19 if it were to recommend roll-overs from one 529 college savings plan to another with such frequency as to lose the federal tax benefit. Even where the frequency does not imperil the federal tax benefit, roll-overs recommended year after year by a broker-dealer could, depending upon the facts and circumstances (including consideration of legitimate investment and other purposes), be viewed as illegal churning. Similarly, where a broker-dealer recommends investments in one or more plans for a single beneficiary in amounts that far exceed the amount that could reasonably be used to pay such beneficiary's qualified higher education expenses, a violation of Rule G-19 could result.[8]

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[8] The MSRB understands that investors may change designated beneficiaries and therefore amounts in excess of what a single beneficiary could use ultimately might be fully expended by additional beneficiaries. The MSRB expresses no view as to the

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B. Sales Incentives, Breakpoint Sales and Other Marketing Practices

The MSRB has established some basic tenets with respect to the use of sales contests and incentives, and is in the process of amending its rules to establish rigorous guidelines for the use of non-cash compensation as an incentive for increased sales. Under the MSRB's broad fair practice dictates, the MSRB has stated that any broker-dealer engaging in marketing activities that result in a customer being treated unfairly, or otherwise engaging in deceptive, dishonest or unfair practices in connection with such marketing activities, would violate Rule G-17. Further, a broker-dealer may violate Rule G-17 if it acts in a manner that is reasonably likely to induce another broker-dealer to itself violate Rule G-17 or any other MSRB customer protection rule, such as the MSRB's suitability or fair pricing and commission rules.

In particular, broker-dealers must ensure that they do not engage in transactions primarily designed to increase commission revenues in a manner that is unfair to customers. Thus, in addition to being a potential suitability violation of Rule G-19, recommending a particular share class to a customer that is not suitable for that customer, or engaging in churning, may also constitute a violation of Rule G-17 if the recommendation was made for the purpose of generating higher commission revenues. Further, recommending transactions to customers in amounts designed to avoid commission discounts (*i.e.*, sales below breakpoints where the customer would be entitled to lower commission charges) or otherwise inhibiting or withholding the benefits of such breakpoints may also violate Rule G-17.

(. . . continued)

applicability of federal tax law to any particular plan of investment and does not interpret its rules to prohibit transactions in furtherance of legitimate tax planning objectives, so long as any recommended transaction is suitable.

In June 2004, the MSRB proposed for comment an extensive set of draft amendments to its gifts and gratuities rule in furtherance of the MSRB's goal of reducing potential conflicts of interest and strengthening the arm's length, merit-based environment in the municipal securities market. The proposal would prohibit broker-dealers from accepting or making payments of non-cash compensation in connection with an offering of municipal securities, with strictly limited exceptions. The commentators are generally supportive of the proposal. The MSRB expects to consider industry comments and take final action on the proposal at its November board meeting.

C. Commissions and Fees

MSRB Rule G-30(b), on prices and commissions in agency transactions, prohibits broker-dealers from selling municipal securities to a customer for a commission or service charge in excess of a fair and reasonable amount. In assessing the fairness and reasonableness of the charge, the rule provides for considering a number of relevant factors, including the expense of executing the order, the value of services provided, and the amount of any other compensation received by the broker-dealer from others (such as the state plan or the primary distributor).

Both the MSRB and NASD are subject to statutory provisions that effectively prohibit each to adopt rules that "impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by" the broker-dealers subject to their respective jurisdiction.[9] However, Section 22(b)(1) of the Investment Company Act expressly exempts NASD from this prohibition with regard to the establishment by NASD of limitations on sales loads for mutual fund sales. Pursuant to this authority, NASD has established its Rule 2830, which sets forth

[9] *See* Exchange Act Section 15B(b)(2)(C) with respect to the MSRB and Exchange Act Section 15A(b)(6) with respect to NASD.

sales charge levels to which member firms must conform in order to ensure that such sales charges are not deemed excessive. Lacking a similar exemption, the MSRB is constrained from effectively imposing a specific schedule of sales charges for 529 college savings plans similar to the schedule created by NASD with respect to mutual fund sales.

Nonetheless, the MSRB has stated that the charges permitted by NASD under its Rule 2830 for mutual fund sales may be a significant factor in determining whether a broker-dealer selling shares of 529 college savings plans is charging a commission or other fee that is fair and reasonable under MSRB rules. For example, charges for 529 college savings plan transactions in excess of those permitted for comparable mutual fund shares under NASD Rule 2830 may not, depending upon the facts and circumstances, meet the fair and reasonable standard under MSRB Rule G-30(b). Further, a sales charge for a 529 college savings plan transaction meeting the NASD scale for a sale of a substantially identical mutual fund generally would comply with MSRB Rule G-30(b).

However, the NASD schedule is not dispositive nor is it always the principal factor in determining compliance with MSRB Rule G-30 since all relevant factors must be given due weight in determining whether a sales charge is fair and reasonable. A broker-dealer may not exclusively rely on the fact that its charges fall within the NASD schedule, particularly where sales charge levels in the marketplace for similar 529 college savings plans sold by other broker-dealers providing similar levels of services are generally substantially lower than those charged by such broker-dealer, taking into account any other compensation.

D. Disclosure

(1) **SEC Rule 15c2-12**. As noted previously, the Tower Amendment specifically prohibits the MSRB and SEC from requiring any state or local governmental issuer, directly or indirectly through broker-dealer regulation, to produce any pre-sale disclosure document. The MSRB (but not the SEC) is further prohibited from requiring an issuer, directly or indirectly through a broker-dealer or otherwise, to furnish any disclosure document to the MSRB or to any investor unless such document has otherwise become publicly available.

Through its somewhat broader rulemaking authority under the Tower Amendment, the SEC has adopted its Rule 15c2-12, under which the underwriter for most primary offerings of municipal securities (including the primary distributor for a 529 college savings plan) is obligated, among other things, to contract with the issuer to receive copies of the final official statement (*i.e.*, the issuer's program disclosure document) after final agreement with the issuer to offer the securities. Rule 15c2-12 has very limited content requirements for the official statement, in contrast to the detailed prospectus and SAI content requirements set forth in Form N-1A for mutual fund offerings.

(2) **MSRB Point-of-Sale Disclosure Requirement & SEC Proposal**. In all transactions with customers, broker-dealers must provide certain basic disclosures under MSRB rules. The MSRB has interpreted its Rule G-17 to require a broker-dealer to disclose to its customer at or prior to the time of trade all material facts about the transaction known by the broker-dealer, as well as material facts about the 529 college savings plan interest that are

reasonably accessible to the market.[10] The 529 college savings plan's program disclosure document typically serves as the primary source for the information that the broker-dealer is obligated to disclose to its customer at the point-of-sale under Rule G-17. The MSRB believes that a state plan's program disclosure document that seeks to qualify as an official statement under SEC Rule 15c2-12 and to comply with the anti-fraud provisions of SEC Rule 10b-5 would need to provide disclosure of any material fees or other charges imposed in connection with the plan. However, if the program disclosure document fails to include any such material information that is known to the broker-dealer or otherwise reasonably accessible to the market, the broker-dealer is obligated to separately disclose such information to the customer at the point-of-sale.

Rule G-17 also obligates a broker-dealer that sells shares in an out-of-state 529 college savings plan to a customer to disclose at the time of trade that, depending on the laws of the customer's home state, favorable state tax treatment for investing in a 529 college savings plan may be limited to investments made in a 529 college savings plan offered by the customer's home state.[11] In June 2004, the MSRB proposed to expand this requirement to include reference to other state benefits that may be offered by 529 college savings plans to state residents.

These two point-of-sale disclosures are required to be made by broker-dealers to customers in every 529 college savings plan transaction, regardless of whether the broker-dealer has made a recommendation to the customer. Earlier this year, the SEC proposed new Rule

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10 *See* MSRB Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, March 20, 2002.

11 *See* MSRB Interpretive Notice – Application of Fair Practice and Advertising Rules to Municipal Fund Securities, May 14, 2002 (the "MSRB Fair Practice Notice").

15c2-3 that would create a point-of-sale disclosure requirement with respect to certain sales charges for mutual fund and 529 college savings plan transactions. The MSRB submitted a comment letter to the SEC supportive of its proposal and suggesting certain modifications that would make the proposal more suitable for 529 college savings plan transactions. If the SEC adopts the proposed rule, the disclosures provided for under that rule would serve as a significant supplement to the existing MSRB point-of-sale disclosures.

(3) **Delivery of Program Disclosure Document**. In every transaction with a customer, the broker-dealer is obligated under MSRB Rule G-32 to deliver to the customer by transaction settlement a copy of the 529 college savings plan's program disclosure document.[12] This requirement is designed to ensure that broker-dealers' customers who invest in 529 college savings plans receive the most complete and authoritative information available regarding their investments.

MSRB Rule G-36 requires primary distributors for 529 college savings plans, as well as other underwriters of municipal debt securities, to send copies of the program disclosure document or other official statement to the MSRB for inclusion in its Municipal Securities Information Library (MSIL) system. The collection of documents assembled by the MSRB in the MSIL system is made available to the marketplace as a resource.

(4) **Confirmation Disclosure of Sales Charges**. The MSRB's transaction confirmation rule, Rule G-15, requires that information regarding commissions and other

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[12] In the case of certain classes of repeat purchasers who have already received the program disclosure document, the broker-dealer generally is permitted to promptly send any amendments or supplements to the program disclosure document as they become available for purposes of subsequent investments in the 529 college savings plan.

transaction-based charges be provided to customers. Earlier this year, the SEC proposed its new Rule 15c2-2 that would create a standardized confirmation disclosure requirement with respect to transactions in mutual funds and 529 college savings plans. The confirmation requirement would provide for significantly more detailed information of the broker-dealer's commissions, sales charges and other payments that may be material to the investor. The MSRB submitted a comment letter to the SEC supportive of its proposal and suggesting certain modifications that would make the proposal more suitable for 529 college savings plan transactions.

E. Advertising

MSRB Rule G-21 provides that any broker-dealer advertisement must not be materially false or misleading. By interpretation, the MSRB has provided that a broker-dealer's 529 college savings plan advertisement that would be in compliance with NASD Rule 2210 relating to mutual fund advertisements also would be in compliance with Rule G-21. Similarly, an advertisement that would be in compliance with the SEC's Rules 156 and 482 under the Securities Act also would be in compliance with Rule G-21. The MSRB has also provided interpretive guidance on the use of historical yields, the inclusion of information about the nature of the issuer and the securities, the capacity of the broker-dealer and other relevant parties, tax consequences for investing in the advertised 529 college savings plan, and information about underlying investments (*e.g.*, mutual funds held by the 529 college savings plan).

In June 2004, the MSRB proposed for comment an extensive set of draft amendments to its advertising rule that would (i) require that performance data included in 529 college savings plan advertisements generally be calculated and displayed, together with related legends and disclosures, in the manner required under SEC Rule 482 for mutual fund advertisements; (ii)

require that all 529 college savings plan advertisements include general disclosure language based in part on a similar requirement in SEC Rule 482, with additional language relating to benefits available solely to state residents; and (iii) incorporate into the rule language the MSRB's previously enunciated interpretive standards. The MSRB believes, and the commentators generally agree, that the proposed amendments will substantially improve the quality and comparability of performance data, allowing investors to compare 529 college savings plans against one another and against mutual funds and other forms of investments. The MSRB expects to consider industry comments and to take final action on this proposal at its November board meeting.

F. Political Contributions and Consultants

As noted above, MSRB Rule G-37 is designed to sever the relationship between political contributions to state or local governmental officials and the awarding of business to broker-dealers by such governmental entities, thereby seeking to eliminate pay-to-play as a significant problem in the municipal securities market. In addition, MSRB Rule G-38 relating to the use of outside consultants to obtain business for broker-dealers is designed to limit the ability of broker-dealers to circumvent the restrictions of Rule G-37 and to reduce the incidence of other types of conflicts of interest or questionable practices on the part of consultants. Both of these rules apply to broker-dealers active in the 529 college savings plan market.

IV. DISCLOSURE PRACTICES IN THE 529 COLLEGE SAVINGS PLAN MARKET

The MSRB has long been an advocate for the best possible disclosure practices by the 529 college savings plan community. The MSRB believes that investor protection concerns

dictate that disclosure in this market be based on six basic characteristics: comprehensiveness, understandability, comparability, universality, timeliness, and accessibility. The MSRB applauds the College Savings Plan Network's first steps at addressing the need for such disclosure through publication of its draft voluntary disclosure principles in May 2004. Although the MSRB understands that some states have begun implementing the principles, it is too early to conclude whether the principles will successfully address the existing concerns over disclosure.

Achieving the goal of quality disclosure that meets the needs of investors will require a commitment on the part of CSPN and the issuer community to continuously monitor practices, to work proactively to raise the standards of those state plans that lag behind, to revise the basic standards for disclosure as circumstances dictate or as the opportunity arises, and to create a disclosure infrastructure that would make comprehensive and comparable information on any state plan easily accessible to all investors. The MSRB believes that the success of CSPN's effort will be strongly dependent upon whether it can achieve universal compliance by all state plans and whether the state plans will view the principles as a baseline on which to add further and better disclosure rather than as a target that need not be surpassed. In addition, the MSRB believes that substantial uniformity in how different states disclose comparable elements of their plans is important.

V. LEVEL OF FEES AND COMMISSIONS

As noted previously, the MSRB is prohibited from establishing fixed commission scales for broker-dealers. However, the MSRB has put into place requirements that should effectively

maintain broker-dealer charges for 529 college savings plan sales at a level consistent with, if not lower than, the sales loads and commissions received in connection with mutual fund sales.

The MSRB believes that, to the extent that some 529 college savings plans entail total fees and expenses that exceed comparable mutual fund investments, much of this difference can be attributed to the extra "layering" that is often involved in the structuring of the state plans. One type of layering that retail investors in mutual funds have not typically seen arises from the "fund of funds" structure that is much more common in the 529 college savings plan market than in the non-tax advantaged mutual fund market. This layered structure often results in investment management and/or other asset-based or transaction expenses being incurred at the underlying fund level as well as at the top-level fund.

Another form of layering of expenses results from the creation of infrastructures for states to undertake their obligation under Section 529 of the Internal Revenue Code to "establish and maintain" the 529 college savings plan. From what the MSRB understands, the size and expense of this infrastructure varies greatly from state to state, with some states simply adding this administrative and oversight function as an additional duty to existing agencies and others creating new agencies that may be dedicated solely to the 529 college savings plan. Furthermore, the MSRB understands that some states may seek to pursue various public policy objectives within the framework of the 529 college savings plan structure that are not strictly limited to providing a vehicle for investment. For example, in some cases revenues earned from fees on some investors' 529 college savings plan accounts (*e.g.*, out-of-state investors, etc.) may be used to help subsidize the costs of other investors (*e.g.*, in-state investors, lower income investors, etc.) or to provide other benefits (*e.g.*, matching grants, in-state scholarships, etc.). In

our view, the use of these funds and the extra expenses resulting from such use are matters of public policy to be determined in the first instance by the states and the federal government. The MSRB strongly believes, however, that these expenses must be disclosed in a full and timely manner. The MSRB believes that investors are best served by being informed of not just the level of such expenses but the purposes for which they are used, since an investor might otherwise believe that the added expense is being used in some manner to improve investment performance rather than for other purposes that do not provide a direct benefit to the investor.

VI. TAX ISSUES

With respect to state tax treatment of investments in 529 college savings plans, the MSRB has been at the forefront of ensuring that broker-dealers are obligated to inform their customers of the possible loss of a state tax benefit if they choose to invest in an out-of-state 529 college savings plan. There is no question that having different tax treatment of 529 college savings plan investments from state to state makes it much more difficult to fully understand the marketplace in general and the merits of a specific investment in particular. However, the MSRB takes no position on the merits of any state's determination to provide or withhold a state tax benefit based on its own public policy determination. Rather, the MSRB believes that providing for comprehensive and easily accessible centralized disclosure of the state tax implications would greatly enhance the integrity of the market and provide investors with the tools needed to make meaningful investment choices.

The MSRB observes that there can be, in some circumstances, a potential for over-emphasizing the importance of a particular state's beneficial state tax treatment of an investment in its 529 college savings plan. For example, some states may offer tax benefits that ultimately

are relatively small in value compared to the financial impact that a marginally higher expense figure may have. The MSRB believes that any state tax benefits offered with respect to a particular 529 college savings plan should be considered as one of many appropriately weighted factors that have an ultimate influence on a customer's investment decision.

The MSRB would like to make one additional observation relating to the federal tax treatment of 529 college savings plan investments. Without reaching the merits of whether the sunset provision of the Economic Growth and Tax Reconciliation Act of 2001, as it applies to Section 529, should be permitted to take effect, the MSRB observes that the uncertainty created by the approaching sunset of the current tax treatment is becoming an increasingly important matter for disclosure to investors and could, as the sunset date nears, result in significant inefficiencies in that market. It is worth noting that, in the tax-exempt bond market, the threat that a single bond issue may be declared taxable can have a disruptive effect on the market for that issue as well as for other similar issues. In the case of 529 college savings plans, the potential for a significant shift in tax treatment for the entire market could have more far-reaching ramifications.

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Again, I thank you for this opportunity to appear before your Subcommittee. The MSRB will continue to monitor the 529 college savings plan market as it further evolves. We will remain vigilant and will not hesitate to modify our rules as circumstances dictate.