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Comment Letter on Section 529 Plan Rules, September 2001

September 27, 2001

Ernesto A. Lanza, Esquire
Senior Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

Re: Proposed Rule Revisions

Dear Mr. Lanza:

The Investment Company Institute[1] appreciates the opportunity to comment on the Notice relating to municipal fund securities that was recently issued by the Municipal Securities Rulemaking Board (MSRB).[2] In addition to providing temporary relief from the qualification requirements for certain municipal securities principals, the MSRB's Notice seeks to provide guidance and clarify existing standards on various issues relating to municipal fund securities, particularly securities issued by Section 529 college savings plans.[3]

The Institute is pleased that the MSRB has recognized—both in the amendments adopted earlier this year[4] and in this Notice—that municipal fund securities are fundamentally different from traditional municipal debt securities. In particular, contributions by individuals to Section 529 plans are typically invested in one or more registered investment companies. Thus, from the perspective of the investor, interests in Section 529 plans are very similar to investments in mutual funds,[5] albeit with certain limitations and differences in tax treatment. Indeed, as the Notice states, issuers of municipal fund securities would be required to register under the Investment Company Act of 1940 but for the exception set forth in Section 2(b) of that Act. Moreover, as the Notice also recognizes, many dealers in the Section 529 plan market are not dealers in traditional municipal securities, but rather have experience in dealing investment company securities or variable contracts.

For these reasons, we recommend that the MSRB, where possible, seek to incorporate in its rules regulatory standards applicable to the sale of investment company securities. While the Notice does so to some extent, we believe that additional steps could be taken in this regard. By doing so, the MSRB will help assure that participants in the Section 529 plan market are not unduly burdened by being forced to comply with disparate or inconsistent regulations. It will also help ensure that persons holding Section 529 plan securities benefit from the strong investor protections that have well served consumers who invest directly in mutual funds.

Our specific comments are set forth below. They cover: the proposed temporary exception for certain small dealers in Section 529 plan securities; the amount of commissions and fees charged in connection with Section 529 transactions; required confirmation disclosure of fees and other charges; additional disclosure considerations; and the capacity (agency/principal) of the dealer.

I. Exception for Certain Small Dealers

The Notice states that the MSRB has filed with the SEC a proposed rule change that would temporarily permit certain dealers whose municipal securities activities are limited to municipal fund securities to satisfy the obligation to have a municipal securities principal by designating an investment company/variable contract limited principal (Series 26) to act as a municipal securities limited principal.[6] The Institute supports this relief but recommends that it be expanded to extend to general securities principals (Series 24). As the Notice indicates, many dealers in Section 529 plan securities do not otherwise deal in municipal securities, but rather have concentrated in the sale of investment company securities and/or variable contracts. (For the reasons discussed above, this is not surprising.) As such, the principals of these firms typically have qualified with either the Series 26 or Series 24 principal examination.[7] Extending to Series 24 principals the relief provided by the MSRB to Series 26 principals is consistent with the MSRB's objective—i.e., to assist smaller dealers in fulfilling their regulatory obligations while avoiding a situation in which such dealers are forced to suspend their activities in the Section 529 plan market, thereby depriving investors of the benefits of having a broad array of dealers offering college savings programs. And, because of the similarity of Section 529 plan securities to investment

company products, the presence of a principal who is qualified to supervise the offer and sale of such products will ensure that investor protection standards are not in any way compromised.

II. The Amount of Commissions and Fees

MSRB Rule G-30, relating to prices and commissions in agency transactions, prohibits dealers from selling municipal securities to a customer for a commission or service charge "in excess of a fair and reasonable amount." According to the MSRB's Notice, the MSRB has received inquiries about whether the sales charge schedule set out in Rule 2830 of the National Association of Securities Dealers (NASD) applies to the level of commissions and fees that dealers may charge in connection with sales of municipal fund securities. For the reasons discussed below, the Institute strongly encourages the MSRB to utilize the schedule set forth in NASD Rule 2830 to determine what constitutes a fair and reasonable commission or service charge in connection with the offer or sale of a Section 529 plan security.

NASD Rule 2830 governs the level of commissions and fees a dealer may charge in connection with investment company securities. The rule imposes limits on all types of sales charges—front-end loads, back-end loads, and asset-based sales charges. By contrast, the MSRB's analogous rule governing sales charges, MSRB Rule G-30 does not specify the maximum amounts for commissions or service charges. The MSRB states in the Notice that NASD Rule 2830 does "provide some relevant information in determining whether a dealer selling municipal fund securities is charging a commission or other fee that is fair and reasonable," but goes on to state that "the NASD schedule is by no means dispositive nor is it the principal factor in determining compliance with Rule G-30."[8]

The Institute believes it would be preferable for the MSRB to expressly incorporate the standards of NASD Rule 2830 for the purpose of limiting sales charges for Section 529 plan securities. Alternatively, the MSRB should issue an interpretation of Rule G-30 to deem "fair and reasonable commission or service charges" as used in the rule to mean sales charges that would be in compliance with the amounts set forth in NASD Rule 2830. Such an approach would ensure that the sale of investment company securities is subject to uniform limits on sales charges, irrespective of whether or not such securities are offered through Section 529 plans. It also would provide more specificity to the MSRB's general standard in Rule G-30 against charging a commission or service charge "in excess of a fair and reasonable amount."[9]

III. Required Confirmation Disclosure of Fees and Other Charges

MSRB Rules G-15 and G-32 set forth certain obligations of dealers to disclose fees and other charges received in connection with municipal securities transactions. Rule G-15 requires disclosure on the transaction confirmation of specified information relating to fees, remuneration, and any deferred commissions or other charges. Rule G-32 requires that a dealer disclose to the customer, no later than settlement, any underwriting spread and the amount of any fee received by the dealer as agent for the issuer in the distribution of the securities. The Institute recommends that the MSRB interpret these rules to permit alternative means for delivery of the required disclosure.

The requirements of Rules G-15 and G-32 were developed to ensure that purchasers of traditional municipal securities would be provided material information concerning the fees, expenses, and any third-party remuneration incurred in connection with the transaction. Disclosure of the fees and expenses enables the investor to know the cost of the investment; disclosure of any third-party remuneration enables the investor to assess any potential conflicts of interest that the dealer may have. In their intent and purpose, Rules G-15 and G-32 are very similar to Rule 10b-10 under the Securities Exchange Act of 1934, which requires every broker or dealer to issue a confirmation in connection with a transaction involving any security other than U.S. Savings Bonds or municipal securities, and which sets forth the contents of the confirmation. As with Rules G-15 and G-32, Rule 10b-10 requires disclosure of the amount and sources of remuneration received or to be received in connection with the transaction. In the case of mutual funds, however, the SEC takes the position that, if the required information is contained in a prospectus, Rule 10b-10 does not require the broker-dealer to repeat it in a confirmation.[10]

For the reasons discussed below, and consistent with the SEC's position, we urge the MSRB to interpret Rules G-15 and G-32 to permit alternative means for delivery of the required confirmation disclosures.

The SEC's position is based on the fact that mutual fund prospectuses contain extensive disclosure regarding sales charges and other fees. Consequently, disclosure in a confirmation statement would be, at best, redundant. The same rationale applies in the case of Section 529 plan securities. Indeed, typically the offering documents for these securities closely resemble mutual fund prospectuses and, thus, include detailed information about all fees and expenses. This is not necessarily the case for offering documents provided to investors in connection with offerings of traditional municipal securities. For example, the voluntary guidelines issued by the Government Financial Officers Association (GFOA), which detail the information that should be included in the offering documents for traditional municipal securities, do not address information relating to the fees incurred by an investor in connection with a purchase or sale of such securities, nor do they address any third-party remuneration. Thus, it is not surprising that neither

MSRB Rule G-15 nor MSRB Rule G-32 contains an exception similar to Rule 10b-10; these MSRB rules contain the only specific requirements to disclose fees and remuneration in connection with the offer or sale of traditional municipal securities.

To the extent that, with respect to disclosure concerning fees (as well as other matters), Section 529 plan offering documents follow the format of fund prospectuses rather than offering documents for traditional municipal securities, the MSRB should follow the approach of the SEC in Rule 10b-10 and permit disclosure of fees and other remuneration that would otherwise be required to be made in confirmation statements to be included in the official statement. As with the SEC's position, this approach would recognize that no public purpose is served by requiring duplicative disclosure of this information. Moreover, it would ensure that, to the extent the information is not included in the disclosure document, the investor, as with a traditional municipal security, would be assured of receiving it on the confirmation.

Unless the MSRB adopts this interpretive position for Rules G-15 and G-32, program managers for Section 529 plans will have to completely redesign their confirmations to include the information required by these rules. This would not be in the best interest of investors. First, it may not be feasible to provide investors with meaningful disclosure of the required information, due to the space constraints of the confirmation. Second, redesigning the confirmation would involve costs that likely would be passed through to investors. For these reasons, and especially given that such disclosure in the confirmation would merely be repetitive of disclosure already provided to the investor in more detail in the offering document., there would appear to be no benefit to the investor by requiring inclusion of this information in the confirmation.

IV. Additional Disclosure Considerations

The MSRB's Notice raises two issues in connection with additional disclosure considerations. The first relates to fees and charges received by other parties to a transaction (e.g., administrative fees of the issuer or investment adviser payable from trust assets or directly from the customer). According to the Notice, while such disclosure is not explicitly required, the rules may implicitly require it and it is likely already provided in an issuer's official statement. The Institute understands that such information is routinely included in the disclosure documents issued in connection with Section 529 plan securities. As a result, we do not believe there is any need for additional regulation in this area.

The second issue raised in the Notice relates to advertisements used in connection with sales of municipal fund securities. According to the MSRB's notice, such advertising must be in compliance with MSRB Rule G-21, which prohibits publishing an advertisement that a dealer knows or has reason to know is materially false or misleading. The Notice goes on to discuss that rule's requirements concerning use of historical yield numbers and disclosure of fees and other charges.[11]

The Institute concurs with the MSRB's views on advertisements. We would encourage the MSRB, however, to give further consideration to this subject. Consistent with the views expressed above, we believe that, in the case of Section 529 plan securities, the MSRB should incorporate applicable standards for mutual fund advertisements, such as those set forth in Rule 482 under the Securities Act of 1933 and NASD Rule 2210. In particular, we recommend that the MSRB confirm that any advertisement for Section 529 plan securities that is in compliance with the rules of the SEC and the NASD will not be deemed materially false or misleading for purposes of Rule G-21.

V. Capacity of Dealers

The MSRB's Notice raises the following miscellaneous issues relating to the capacity of dealers: whether transactions in Section 529 plans are made on an agency or principal basis; in a multi-tiered distribution system, which dealers have customer protection obligations under the MSRB's rules; and whether "inter-dealer" trades are conducted in municipal fund securities and, if so, whether any relief is necessary from the provisions of MSRB Rules G-14, which requires the reporting of such transactions, and from Rule G-12, relating to confirmation of such transactions. Each of these issues is discussed briefly below.

A. Agency v. Principal Transactions

To our knowledge, all transactions effected between the issuer of the Section 529 securities and the investor are conducted on an agency basis. Indeed, based upon the structure of these programs, Section 529 securities likely could not be traded on a principal basis because of restrictions in the program regarding eligibility of investors and transferability of interests in the programs.[12]

B. Customer Protection Obligations

The MSRB's Notice questions which dealer—i.e., the primary distributor or each intermediary dealer—is (or should be) responsible for complying with the customer protection obligations under the MSRB's rules. The Institute recommends that the obligation for complying with the MSRB's various customer protection rules (e.g., the suitability requirements of Rule G-19) be the responsibility of the dealer that interacts directly with the prospective investor. It is this dealer that is in the best position to obtain the information

necessary to evaluate the suitability of the investment for the investor. We note that, like NASD Rule 2310, MSRB Rule G-19 only requires a suitability determination in connection with a recommendation to purchase or sell a security. In most, if not all, transactions involving the sale of Section 529 plans, any such recommendation would come from the dealer that interacts directly with the customer (or its representative) and is in a position to determine the suitability of such security for the investor. Accordingly, we recommend that the MSRB impose customer protection obligations only on the dealer interacting with the investor at the point of sale. We note that this recommendation is consistent with the manner in which the NASD would treat a similar situation involving the sale of securities in a multi-tiered distribution system.

C. Inter-Dealer Trades

The MSRB's Notice inquires whether inter-dealer trades involving Section 529 securities should be provided relief from Rule G-14, relating to transaction reporting procedures,[13] and Rule G-12, relating to the confirmation of inter-dealer transactions that are ineligible for automated trade comparison through a registered clearing agency. Interests in a Section 529 plan are not like traditional equity or debt securities that may be freely traded.[14] Indeed, we are not aware of any inter-dealer trades occurring in such securities. For these reasons, there would not seem to be any need to provide them relief from the provisions in MSRB Rules G-14 and G-12 relating to inter-dealer trades. However, if the MSRB were to clarify in these rules that they do not apply to transactions in municipal fund securities, the Institute would support such an amendment.[15]

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The Institute appreciates the opportunity to share these comments with you in response to the MSRB's Notice. Overall, the Institute encourages the MSRB, to the extent appropriate, to consider imposing on Section 529 programs regulatory requirements that are more suited to investment company products. We submit that such requirements have served investors well and are consistent with the MSRB's mission to protect investors and ensure the integrity of the municipal securities industry. In addition, allowing Section 529 plans to comply with such regulatory requirements as an alternative to the MSRB's municipal security rules will eliminate unnecessary costs and burdens that would result from a company that is used to being regulated in the conduct of its business as a mutual fund from having to reconfigure the portion of its business dedicated to Section 529 plans to resemble an issuer of traditional municipal securities.

If you have any questions concerning our comments or request additional information, please contact the undersigned at 202/326-5815 or Tami Reed at 202/326-5825.

Sincerely,

Craig S. Tyle
General Counsel

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,638 open-end investment companies ("mutual funds"), 498 closed-end investment companies and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.909 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] See "Municipal Fund Securities – Qualification of Municipal Securities Principals and Application of MSRB Rules to Fees, Disclosure, and Other Market Practices," MSRB (July 5, 2001) (the "Notice").

[3] While the term "municipal fund security" as defined in MSRB Rule D-12 includes both local government investment pools and Section 529 college savings plans, the MSRB's current proposal seems to be solely directed to issues relating to the Section 529 plans. The Institute's comments are similarly directed to such plans and not to issues that may relate to local government investment pools.

[4] See "Municipal Fund Securities – Rule Changes Approved by the Securities and Exchange Commission," MSRB Reports, Vol. 21, No. 1 (May 2001).

[5] In the case of Section 529 plans sponsored by several states, investments in each investment option are allocated among several mutual funds. In these cases, the investment is similar to holding shares in a "fund of funds."

[6] In addition to the short-term relief provided by the MSRB from the examination requirements, we recommend that the MSRB give consideration to developing a new qualification examination that is tailored to municipal fund securities. This approach would recognize the fact that municipal fund securities are dissimilar from traditional municipal securities and would obviate the need to pass a qualification examination designed for traditional municipal securities.

[7] Under the rules of the NASD, while a Series 26 principal may only supervise a member's investment company/variable contract product business, a Series 24 principal may supervise these areas as well as the member's general securities business.

[8] See Notice at p. 3.

[9] This recommendation would also eliminate the need for the MSRB to develop an entirely new schedule of acceptable commissions for a product that is substantively similar to mutual funds.

[10] See SEC Release No. 34-13508 (May 5, 1977) at footnote 41. See also Investment Company Institute (pub. Avail. April 18, 1979). Under this no-action letter, a confirmation of a transaction in a mutual fund shares is not required to include information relating to the sales load or other charges in connection with the transaction provided that the customer had received, at or before the completion of the transaction, a current prospectus that discloses the precise amount of the sales load or other charges or a formula that would enable the customer to calculate the precise amount of those fees. However, if a broker-dealer received remuneration that was not disclosed in the prospectus, that remuneration would be required to be separately disclosed on a confirmation.

[11] See Notice at p. 4.

[12] The attractiveness of Section 529 as education savings plans to investors is largely a function of their treatment under state and Federal tax laws. Section 529 of the Internal Revenue Code places strict requirements on the designated beneficiaries to these accounts and the transfer of an established account from one beneficiary to another. Pursuant to Section 529(e)(1)(A) and (C), in order for a education savings plan to be treated as a "qualified tuition plan" for purposes of taking advantage of the tax treatment in Section 529, a designated beneficiary must be designated "at the commencement of participation in the . . . program" or the interest in the program must have been purchased by a state or local Government or a Section 501(c)(3) organization as part of a scholarship program offered by such purchaser. Pursuant to Section 529(e)(3)(A), to obtain favorable tax treatment of distributions, a designated beneficiary who is not a special needs beneficiary must use such distributions to pay for tuition, fees, books, supplies and equipment for the enrollment or attendance of the designated beneficiary at an eligible educational institution. These provisions would seem to preclude the ability of dealers to hold ownership interests in these plans or trade them on a principal basis.

[13] In the January 2001 amendments to its rules, the MSRB amended Rule G-14(b)(iii)(B) to expressly provide an exemption for municipal fund securities from the customer transaction reporting requirements of the rule. The Institute recommends that the MSRB's rule continue to retain this exemption in its current form.

[14] See footnote 12, above.

[15] If the MSRB determines such revisions are necessary, revisions similar to those made by the MSRB in January 2001 to Rule G-14(b)(iii)(B) for customer transaction reporting could be made to address other provisions in Rule G-14 and provisions in Rule G-12 relating to inter-dealer trades.
