S. Hrg. 108–716

OVERSIGHT HEARING ON SECTION 529 COLLEGE SAVINGS PLANS: HIGH FEES, INADEQUATE DISCLOSURE, DISPARATE STATE TAX TREATMENT, AND QUESTIONABLE BROKER SALES PRACTICES

HEARING

BEFORE THE

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

SEPTEMBER 30, 2004

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

97–046 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON GOVERNMENTAL AFFAIRS

SUSAN M. COLLINS, Maine, *Chairman*

TED STEVENS, Alaska
GEORGE V. VOINOVICH, Ohio
NORM COLEMAN, Minnesota
ARLEN SPECTER, Pennsylvania
ROBERT F. BENNETT, Utah
PETER G. FITZGERALD, Illinois
JOHN E. SUNUNU, New Hampshire
RICHARD C. SHELBY, Alabama

JOSEPH I. LIEBERMAN, Connecticut
CARL LEVIN, Michigan
DANIEL K. AKAKA, Hawaii
RICHARD J. DURBIN, Illinois
THOMAS R. CARPER, Delaware
MARK DAYTON, Minnesota
FRANK LAUTENBERG, New Jersey
MARK PRYOR, Arkansas

MICHAEL D. BOPP, *Staff Director and Chief Counsel*
JOYCE A. RECHTSCHAFFEN, *Minority Staff Director and Counsel*
AMY B. NEWHOUSE, *Chief Clerk*

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

PETER G. FITZGERALD, Illinois, *Chairman*

TED STEVENS, Alaska
GEORGE V. VOINOVICH, Ohio
ARLEN SPECTER, Pennsylvania
ROBERT F. BENNETT, Utah
JOHN E. SUNUNU, New Hampshire
RICHARD C. SHELBY, Alabama

DANIEL K. AKAKA, Hawaii
CARL LEVIN, Michigan
THOMAS R. CARPER, Delaware
MARK DAYTON, Minnesota
FRANK LAUTENBERG, New Jersey
MARK PRYOR, Arkansas

MICHAEL J. RUSSELL, *Staff Director*
RICHARD J. KESSLER, *Minority Staff Director*
NANCI E. LANGLEY, *Minority Deputy Staff Director*
TARA E. BAIRD, *Chief Clerk*

CONTENTS

WITNESSES

THURSDAY, SEPTEMBER 30, 2004

ALPHABETICAL LIST OF WITNESSES

APPENDIX

OVERSIGHT HEARING ON SECTION 529 COLLEGE SAVINGS PLANS: HIGH FEES, INADEQUATE DISCLOSURE, DISPARATE STATE TAX TREATMENT, AND QUESTIONABLE BROKER SALES PRACTICES

THURSDAY, SEPTEMBER 30, 2004

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MANAGEMENT,
THE BUDGET, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:30 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

Present: Senators Fitzgerald, Lautenberg, Carper, and Pryor.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. This hearing will come to order. I would like to begin by welcoming all of our witnesses who are present today, and by thanking them for taking time out of their schedules to be here.

Today, we are conducting an oversight hearing on Section 529 College Savings Plans, State-sponsored investments that are designed to encourage families to save money for their children's college education. Section 529 refers to the Internal Revenue Code section that authorizes and confers special tax treatment on these entities, and it shouldn't be confused with IRS Section 527, which confers special tax treatment on those political groups that are now so controversial in the current Presidential campaign.

Section 529 College Savings Plans are instrumentalities of the various State Governments. The States usually organize the plans as trusts which, in turn, typically invest the plan assets in mutual funds managed by third party asset managers.

Today's hearing will build on two previous hearings in which this Subcommittee examined mutual fund management and governance, mutual fund fees, and the adequacy of fee disclosures.

Because they typically invest their assets in mutual funds, all of the same problems that are prevalent with mutual funds—high fees, inadequate disclosure, and questionable brokerage sales practices—are also prevalent with Section 529 College Savings Plans. But as problematic as ordinary mutual funds may be, many Section 529 plans are even more problematic. That is because the State Governments which run Section 529 plans are exempt from most

of the Federal securities laws, including the Investment Company Act of 1940. Indeed, the Securities and Exchange Commission does not have jurisdiction over the State Governments which run the college savings plans.

Section 529 plans are also more problematic than ordinary mutual funds, at least in my judgment, because they carry an extra layer of fees. With an ordinary mutual fund investment, the consumer may pay a fee to a broker who steers him or her into a mutual fund and then pay ongoing management fees to the fund manager. With a Section 529 plan, the consumer may not only have to pay a brokerage fee and ongoing fees to the fund manager, but in addition will almost certainly have to pay one-time and ongoing fees to the State Government that sets up the plan.

In other words, with Section 529 plans, the State Governments interpose themselves as additional middlemen and take additional fees from investors. State fees associated with Section 529 plans can include enrollment fees, application fees, account maintenance fees, program management fees, administrative fees, and asset-based fees.

As our earlier hearings pointed out, fees charged to mutual fund investors when they are stated as a percentage of the assets sound *de minimis* and trivial, but small differences in fees add up to very large differences in investment returns over time. Just as investors are free to experience the miracle of compounding returns, so, too, they are free to experience the tyranny of compounding costs.

We had a chart in an earlier hearing that showed one percentage point of fees over 40 years of investing will cut someone's retirement nest egg by 45 percent, and that math has all been worked out and it actually is true. You have to recognize that those fees compound over time, and each year there is money that is not in your account that you are no longer earning a return on.

Given the additional fees that college savings plans charge over and above ordinary mutual funds, it is probably safe to say that no one would invest in Section 529 plans if they weren't tax advantaged. In fact, the tax advantages are probably the only reason to invest in Section 529 plans.

It is, then, a fair question whether the additional fees which States charge to Section 529 plan investors carry any benefit. I am going to be asking questions about that today. Clearly, Congress could devise a means of authorizing Section 529 plans that would eliminate the dead weight fees that the State Governments charge. State bureaucrats might not like it, but the millions of American families which have Section 529 accounts would be a lot better off. There are now about 6.8 million Section 529 accounts holding about $54 billion in total assets as of the middle of this year.

Few things in life are more important to parents than the education of their children, and few things in life are more expensive than a college education. Over the last 10 years, the cost of attending college has increased a whopping 40 percent. According to the College Board, the average cost of a 4-year post-secondary education is currently $42,544 for State universities and $107,416 for private colleges and universities. The price tag for higher education is expected to continue rising, likely outstripping any gains in average household earnings.

The hearing we are holding today will address a number of the vexing issues and concerns which analysts and commentators have raised regarding Section 529 plans. We hope to make saving for college easier for average American families.

Even before the hearing begins, though, I have several suggestions for how we might do that. First, Section 529 plans have a complex cost structure which makes it difficult for investors to compare and select plans in an informed manner. At a minimum, Congress ought to simplify and improve fee disclosures so that families can more easily compare Section 529 plans on an apples-to-apples basis.

Second, in some cases, high fees and commissions are charged not only by the broker and the State, but also some mutual funds, in fact, charge a higher fee to Section 529 plan participants than they do to regular mutual fund investors in the same fund. Some analysts have questioned whether these high fees offset the tax advantages of investing in a Section 529 college savings account, and as we have heard before, small differences in fees can result in enormous differences in returns over time.

This chart was actually prepared from a hypothetical example that the Securities and Exchange Commission included in a memorandum prepared by SEC staff who are studying Section 529 plans for Chairman Donaldson and delivered to House Banking Committee Chairman Oxley.[1] This shows that actually under certain circumstances, you may be better off investing in a fully taxable but low-cost, low-fee ordinary mutual fund than you would be investing in a tax-advantaged college savings plan that charges very high fees.

Theoretically, you may be brought into a Section 529 plan by a broker, and thus pay a 5½ percent sales load for Class A shares, and then have to pay 2 percentage points in aggregate annual fees. Assuming an 8 percent annual return, then after 10 years, you would be worse off than if you had gone into a fully taxable fund that only charged 50 basis points or ½ of 1 percentage point in annual fees and had no load. Even if you paid a 10 percent capital gains tax at the end when you took the money out, you would have $1,625 more on an original $10,000 investment. Again, that example came from the Securities and Exchange Commission.

Another chart, if you could put chart 2 up,[2] this is a comparison of a low-cost Section 529 plan with a high-cost Section 529 plan. The Rhode Island J.P. Morgan Higher Education Plan is a very high-cost plan. It has a 4.75 percent sales load, 135 basis points, or 1.35 percentage point annual expense ratio, and a $25 annual fee. If you invest $10,000 in that Rhode Island fund for 18 years, you will have $7,700 less than if you invest in the Utah Educational Savings Plan Trust. Utah has a Vanguard fund underlying it. Vanguard only charges 10 basis points for their management fee. The State of Utah, however, as you can see, interposes an additional 17 basis points in fees, bringing the total expense ratio up to 27.5 basis points, but that is still way better than being in the

[1] The chart entitled "Value of a $10,000 investment after 10 years," appears in the Appendix on page 164.

[2] The chart entitled "Value of a $10,000 investment after 18 years," appears in the Appendix on page 165.

Rhode Island fund, in which you pay a $25 annual fee. After 18 years, you will have $7,700 more in the Utah fund. You will have $37,000 as opposed to $29,000 for your kid's education.

So the bottom line is that in a high-cost college savings plan, the brokers and fund managers, together with a new actor, the State Governments which set up the plans, in effect can swallow up the tax benefits, leaving the uninformed consumer worse off than if he or she had invested in a fully taxable but low-cost mutual fund.

Now, according to Morningstar, the five worst plans are offered by the States of Wisconsin, Arizona, Wyoming, and Ohio. That is only four States—oh, Arizona has two of the five worst. OK. [Laughter.]

The five best are offered by Utah, which we just saw, Nevada, Virginia, Michigan, and Alaska. Now, some of those may have changed, I understand, since some of these reports have come out. Possibly some of the worst States have improved their plans, and they can certainly set that record straight.

Quite simply, in my judgment, Congress should act to make sure that investors and not State bureaucrats, brokers, or fund managers capture the tax benefits from Section 529 plans. Right now, there are too many middlemen, including State bureaucrats, that are feeding at the Section 529 college savings trough.

Third, several areas of disclosure warrant increased scrutiny of Section 529 plans. These disclosure issues include the level of disclosure required, the type of information disclosed, and the manner in which the information is presented. Under the Investment Company Act, ordinary mutual funds have to provide annual and semiannual disclosure discussing the fund's performance, listing its holdings, and providing the fund's financial statements. Unfortunately, Federal securities laws do not require Section 529 plans to make even these limited disclosures. Congress should, in my judgment, at a minimum, at least provide the minimal disclosures that are now provided by regular mutual funds.

Fourth, while Federal tax advantages are standard for all Section 529 College Savings Plans, State tax treatment varies from State to State, sometimes holding residents captive to a given State's home State plan. Congress, in my judgment, should encourage States to compete amongst themselves and discourage protectionist measures which lock State residents into substandard State funds. Congress could easily make these improvements.

The growth in the college savings plan industry has no doubt resulted in growing pains. While Section 529 plans were created under the Federal tax code for use under State law, no comprehensive regulatory regime was created to oversee this new financial product. Although lacking in enforcement powers, the industry's trade group, the College Savings Plan Network, issued voluntary disclosure principles in May 2004 to help enhance uniformity of fee disclosure across the industry. This morning, we will hear from the College Savings Plan Network about their progress in this effort.

In addition, several agencies are also examining Section 529 plans. They are subject to anti-fraud rules and broker dealer sales practices. Earlier this year, Securities and Exchange Commission Chairman William Donaldson announced the creation of the Chairman's Task Force on College Savings Plans to study the fee disclo-

sure issue in the sale of Section 529 plans. The SEC is expected to report its findings before the end of this year.

Additionally, the NASD, whom we will also hear from this morning, has been investigating alleged misconduct by securities firms in the sales of Section 529 plans. Mary Schapiro is here, chomping at the bit, waiting to go.

Our other witnesses will address statutory and regulatory guidelines for Section 529 plans and those who sell them, discuss investor and consumer concerns regarding these State plans, and make recommendations for change. We will also hear from two witnesses, one from my home State of Illinois and the other from the State of Utah, who will discuss their State's Section 529 plans.

Again, I want to thank our witnesses for being here today. Before I introduce them, I would like to turn to Senator Lautenberg, who has graced us with his presence this morning, and welcome him to make an opening statement.

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Thanks very much, Mr. Chairman. I assume that the audience here noted that neither of the weaker plans was from New Jersey or from the State of Illinois, and the Chairman wasn't sure that I was going to be here, so that the truth is obvious.

Mr. Chairman and all of our guests here today, this is an important hearing. The economy is in the doldrums. Real family incomes are declining while costs for tuition continue to rise and that makes college more and more unaffordable for many Americans. And yet post-secondary education has never been more important for people entering the workforce. According to the Department of Labor, college graduates earn nearly twice as much as workers who have only a high school diploma.

Because of these circumstances, the Section 529 College Savings Plans are crucial. But the problems that are there need attention, as we will see today, and those problems can and must be fixed.

The problems that we need to address include the following: First, because Section 529 plans are run by States, they are only loosely regulated by the Securities and Exchange Commission. Section 529 plans are not subject to most of the securities laws, and as a result, we are seeing problems that parallel the ones in recent mutual fund scandals.

Also, too many layers of investment management are involved, as we have heard from our Chairman. As a result, investors are paying such high fees that in some instances, those fees actually cancel the benefits that these tax savings plans have.

We need to look at ways that Section 529 plans are regulated and administered to make them more investor and beneficiary friendly. Section 529 plans are complex. Tax rules vary from State to State. Many of the plans do not have understandable or meaningful disclosures.

Mr. Chairman, I know firsthand how important a college education is and I know how it can be out of reach for the ordinary person. When I returned from Europe at the end of World War II, the only way I could afford to go to Columbia University—which was a dream of mine—was on the GI Bill, and I want to improve

Section 529 plans because I want to make sure that everyone who wants to go to college and is willing to do the work can go to college. An educated person is an incomparable asset for our country, far more valuable than some of our natural resources. No matter how precious the other assets are, we have got to focus on this one. We have got to do whatever we can to seed, grow, and harvest an educated society and we intend to do that.

Mr. Chairman, I commend you for holding this hearing and I want to apologize because I have another function to go to. I would ask that the record be kept open so that any questions for our distinguished guests can be submitted in writing.

Senator FITZGERALD. Absolutely, and thank you for being here. I have to say, even though you are a member of the other party, I think that we are probably better off—small investors certainly are better off—now that you have returned to the Senate after a brief retirement.

Senator LAUTENBERG. That is very kind.

Senator FITZGERALD. I am retiring now on January 2, so you may have to pick up——

Senator LAUTENBERG. Think about it a couple of years and see how you feel.

Senator FITZGERALD. You may have to pick up a couple of these issues, and you might be able to eliminate some of these fees after I am gone.

Senator LAUTENBERG. You have an advantage, Mr. Chairman, having come from a business background. I really believe that.

Senator FITZGERALD. Yes.

Senator LAUTENBERG. This is not to discourage or dissent with any opinions about our attorneys and other professionals. We have doctors and lawyers. We almost have an Indian Chief, and he is about to retire, unfortunately. But the fact of the matter is that a business background, Mr. Chairman, I think is invaluable. So we may as well gloat while we can and thank all of you.

Senator FITZGERALD. Well, thank you. I just want to add that since we did those hearings on the high fees before, several mutual funds have announced they are lowering their fees. Fidelity has lowered them down to 10 basis points on their index funds. So even though we didn't pass legislation yet, I think the focus on those high fees has helped. Thank you very much, Senator Lautenberg.

I would like to now introduce our witnesses. Our first witness is Steven T. Miller, who serves as Commissioner of the Tax Exempt and Government Entities Division of the Internal Revenue Service. Mr. Miller's division oversees the administration of tax laws relating to employee plans, tax-exempt organizations, and government entities. Before joining his current division in June 2004, Mr. Miller served as the Director of Exempt Organizations within the IRS.

We would also like to welcome back our second witness, Mary L. Schapiro. She appeared first before this Subcommittee in November 2003 on the mutual fund trading practices and abuses. Ms. Schapiro currently serves as Vice Chairman and President of Regulatory Policy and Oversight at NASD. Prior to assuming her duties at NASD, Ms. Schapiro was appointed the Chairman of the Commodity Futures Trading Commission in 1994 by President Clinton. Before that position, she served as a Commissioner of the Securi-

ties and Exchange Commission from 1988 to 1993, when she was appointed Acting Chairman of the SEC. So she has been Commissioner and Acting Chairman of the SEC and Chairman of the Commodity Futures Trading Commission—a very impressive background.

I would also like to welcome Ernesto A. Lanza, who is the Senior Associate General Counsel of the Municipal Securities Rulemaking Board, the MSRB. The MSRB is a self-regulatory organization established by Congress to develop rules regulating securities firms and banks involved in underwriting, trading, and selling municipal securities. Mr. Lanza joined MSRB in 1997 after practicing law as a public finance attorney.

I would like to thank all of you for being here. In the interest of time, it is usually best if you can just introduce your written statements into the record and we will make them a part of the permanent record of the Committee. We ask, as best as possible, if you could summarize your remarks within 5 minutes. I won't be too tough on that, but in order to keep the hearing going, we would like to stick to that 5 minutes.

Mr. Miller, I thank you for being here and you may proceed.

TESTIMONY OF STEVEN T. MILLER,[1] COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION, INTERNAL REVENUE SERVICE

Mr. MILLER. Thank you, Mr. Chairman, for the opportunity, and I would ask that my written testimony be entered into the record.

Thank you for inviting us today. My division, as you mentioned, is responsible for ensuring that Section 529 programs meet the exemption requirements under the Code. I will divide my remarks into two parts, first, a general overview of the tax rules, and second, how the Service interacts with Section 529 programs.

As you mentioned, Section 529 of the Internal Revenue Code exempts qualified tuition programs provided they meet certain requirements. The first requirement is that the program has to be established and maintained by a State, an agency or instrumentality of the State, or by one or more post-secondary institutions. Thus, the plan either needs to be a State-run program or a program established or maintained by private colleges or universities.

Second, the operation of the program is limited to one of two designs. State programs may be either pre-paid or a savings program. Those programs established by eligible private colleges and universities may offer only the pre-paid design. Under pre-paid design, the person purchases actually credits or certificates for qualified education expenses. Under a savings plan maintained by a State, a person contributes to an account that is established for the purpose of meeting a designated beneficiary's education expenses. The balance in the account can go up or down depending on what the investment does over time.

When we talk about qualified higher education expenses defined in Section 529, we are talking about tuition, fees, supplies and equipment required for either enrollment or attendance at an eligi-

[1] The prepared statement of Mr. Miller appears in the Appendix on page 51.

ble educational institution. Certain room and board expenses are also included in that.

The third requirement is that the individual must be designated at the time that you make the contribution to the plan.

Other requirements include the fact that only cash can be contributed to these plans, and that there is a separate accounting with respect to each beneficiary in the plan. With respect to college and university programs, those programs must employ a trust instrument, and an interest in the program may not be used as security for a loan.

The Code has one final requirement that I will mention. The ability to select and change investments in a program is limited under Section 529. Contributors and beneficiaries may not direct the investment of earnings or contributions. That does not mean, however, that a program violates the requirement if selection is permitted among various broad-based investment strategies that are designed exclusively for the program.

Turning to rules relating to contributions under Section 529, there is a limitation on the amount that can be contributed. Those amounts are limited to amounts that are necessary to provide for a beneficiary's qualified expenses. There is no statutory dollar limitation, but proposed rules in the area indicate that 5 years' worth of expenses can be funded through one of these accounts.

Contributions are not deductible for Federal income tax purposes, and as you mentioned, whether a State deduction is available quickly depends on the State law.

Let me move to tax rules on distributions quickly. Distributions are not taxed if they are used to pay qualified expenses. The earnings component might be subject to income tax if it is not used for those expenses and will be subject to a 10 percent additional tax, as well, in many instances.

There are also special estate and gift tax rules that we briefly discuss in the written testimony.

That is a quick outline of some of the tax rules. Let me talk very quickly about how the IRS administers the section.

State programs are not required to come to us for a ruling that they are a Section 529 plan. In contrast, private colleges and university plans must come in to the IRS to be approved as a Section 529 plan. Coming in, they will request a private letter ruling. I think it is important to note that Section 529 doesn't require plans to follow a prototype, so that all plans that come in are different and there are discussions with our staff concerning whether they meet the requirements before we can confirm status.

In terms of reporting, a program generally has no requirement to file a tax or information return regarding its operations with the IRS. This is consistent with our treatment of other State Governmental entities. If there is unrelated business income tax due, then we do require a Form 990–T. In terms of reporting to the participants, a program is required to provide an annual account statement showing the total account balance, the contributions to the account, earnings, and any distributions. A plan is also required to issue a Form 1099–Q for each designated beneficiary who has actually received a distribution, and also where there is a transfer between plans, a 1099–Q will occur, as well.

I see my time has run out and so has my testimony, Mr. Chairman, so I am willing to take any questions. Thank you.

Senator FITZGERALD. Thank you, Mr. Miller. Ms. Schapiro.

TESTIMONY OF MARY L. SCHAPIRO,[1] VICE CHAIRMAN AND PRESIDENT, REGULATORY POLICY AND OVERSIGHT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Ms. SCHAPIRO. Thank you very much, Mr. Chairman. It is a pleasure to be back before this Committee. We are very grateful to have this opportunity to talk about Section 529 College Savings Plans. We also have a longer statement that we would like to submit, with your permission, for the record.

NASD is the world's largest private sector regulator of financial services. We regulate every broker dealer in the United States, about 5,200 of them, that do business with the public. Last year, we brought more than 1,400 enforcement actions and barred or suspended more than 850 individuals from the securities industry, and I am sorry to say these are both record numbers.

Our interest in scrutinizing Section 529 sales stems in part from their having become hugely popular. Every State offers at least one Section 529 plan and there are now about 80 available. Our investor protection duty compels us to examine sales practices of all investment products and most particularly those that generate a high level of investor enthusiasm.

This morning, I would like to briefly cover three topics. First is our investigative efforts regarding Section 529 plans. The second is the need for standardized disclosure among plans. And finally, our efforts to help educate investors about them.

By way of background, Mr. Chairman, NASD does not regulate the State issuers of Section 529 plans nor do we directly regulate mutual funds that are offered as investment choices in Section 529 plans. As you pointed out, Congress has authorized the MSRB to regulate sales of Section 529 plans. We enforce the MSRB's rules.

In 2003, we began hearing allegations of inappropriate recommendations of brokers selling Section 529 plans. We undertook a review of six firms, chosen based on the number of customer complaints and the sales volumes of particular plans. We wanted to learn about the suitability of the recommendations investors were getting and about the procedures firms had for ensuring the efficacy of those recommendations. Since last year, we have expanded our review to include 12 additional firms in order to have a more comprehensive and representative sample of the firms we regulate.

We were surprised to discover that in some cases, more than 95 percent of the dollar value of Section 529's sold came from sales to customers who are not residents of the States in whose plans they invested. Selling an investor an out-of-state plan is not necessarily a problem. It may be that the underlying investment companies offered by the in-state plan could provide inferior portfolio management or a relatively limited array of investment choices. As you point out, the fees associated with the in-state plan could be very high. And, of course, some States don't provide a tax deduction or

[1] The prepared statement of Ms. Schapiro appears in the Appendix on page 56.

other benefit. Consequently, another State's plan might be a perfectly suitable recommendation.

But since half the States offer State tax deductions for residents investing in their plans, and some are quite significant, the fact that out-of-state sales exceeded 95 percent in some cases led us to wonder if broker dealers were doing suitability analyses before making recommendations and whether they were giving their customers all the information they needed before deciding which plan to buy, in-state or out-of-state.

Our sales practice investigations have also included reviews of advertising and marketing materials. In a number of cases, we have required firms to significantly revise advertising to be more balanced, to disclose risks as well as potential rewards, and to disclose more prominently the fees and tax implications of Section 529 investing. And finally, we are reviewing suitability, breakpoint, and supervisory issues, as well.

Most importantly, however, retail investors have been ill served by the lack of uniform disclosure among Section 529 plans. Such disclosure would allow easy comparison in making investment choices. The lack of transparency concerning fees and expenses, disparate State tax policies and rates, share classes, and other features of Section 529 plans have led to significant investor confusion. We strongly support a uniform disclosure regime for Section 529 plans.

With this lack of uniformity in mind, NASD has increased its effort to educate investors about Section 529's. We have two tools on our website to help investors in this area. Our booklet, "Smart Saving for College," details all of the features of Section 529 College Savings Plans as well as other college savings vehicles, including Coverdell Education Savings Accounts, prepaid tuition plans, custodial accounts, and even U.S. Savings Bonds.

We also offer an online Section 529 expense analyzer which can calculate for investors how fees and expenses affect their returns. The analyzer explains the many different Section 529 plan fees and provide guidance on where to find them in the Section 529 disclosure documents. It also provides prompts that help investors to make the best possible comparison between plans.

We recently issued an investor alert, advising investors to be aware of certain facts, including that contribution limits and State tax treatment vary from State to State, that investment options vary broadly, from high-risk stock funds in some plans to more conservative short-term bond funds in others, and that there are wide disparities among fees and expenses from plan to plan.

More positively, I would note, as you did, that several States have been working to make their Section 529 plans clearer and more attractive to investors by lowering enrollment and management fees and expanding investment options.

In closing, Mr. Chairman, NASD is committed to protecting investors by ensuring that they have all the information they need to make informed investment choices and that the brokers they work with adhere to just and equitable principles of dealing. We will, as appropriate, continue to broaden both our educational and regulatory and investigative efforts with regard to Section 529 College Savings Plans.

Thank you again, and I am happy to answer any questions that you might have.

Senator FITZGERALD. Thank you, Ms. Schapiro. Mr. Lanza.

TESTIMONY OF ERNESTO A. LANZA,[1] SENIOR ASSOCIATE GENERAL COUNSEL, MUNICIPAL SECURITIES RULEMAKING BOARD

Mr. LANZA. Yes. Thank you, Mr. Chairman, Members of the Subcommittee. My name is Ernesto Lanza, Senior Associate General Counsel of the Municipal Securities Rulemaking Board. I appreciate this opportunity to testify today. I ask that our written statement be admitted into the record. Thank you.

The MSRB is a self-regulatory organization established by Congress to write rules covering the municipal securities activities of brokers. Because shares in Section 529 plans are municipal securities, our rules apply to brokers in this market.

Congress sought to protect investors in municipal securities through MSRB regulation of broker activities while exempting State and local governments from Federal securities laws. MSRB rules, therefore, must recognize that unregulated State and local governments may act in their best judgment in widely divergent ways. Further, we are prohibited by statute from using broker regulation to indirectly require issuers to produce disclosure materials for customers. In contrast, Congress provided for interlocking mutual fund regulation covering all parties so that mutual fund broker rules fit hand-in-glove with issuer rules.

Within this statutory landscape, the MSRB has adopted a comprehensive set of broker rules in the Section 529 plan market. Our primary customer protection measures which establish standards of fair practice and professionalism require that brokers deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice.

When a broker recommends that a customer invest in a specific Section 529 plan, the broker needs to first conclude that this investment is suitable for the customer. The broker can't steer customers toward a particular share class just to increase his commissions, and the broker can't steer customers away from available break-point discounts. Brokerage firms can't conduct sales contests or use incentives that may cause individual brokers to act unfairly toward customers. These marketing rules will soon be strengthened by a pending proposal banning most forms of non-cash sales incentives.

Unlike in the mutual fund market, the MSRB is legally prohibited from setting broker fees. However, our fair commission rule should effectively keep Section 529 broker charges at a level consistent with if not lower than broker charges for the comparable investment in the mutual fund market.

Full and timely disclosure is central to investor protection and to the health of the Section 529 plan market. We require brokers to disclose to their customers at the point of sale the material facts about that investment. Also, a broker that markets an out-of-state Section 529 plan must let the customer know that he or she may

[1] The prepared statement of Mr. Lanza appears in the Appendix on page 65.

lose out on a State tax break by not investing in-state. Then, by no later than settlement, the broker must deliver the Section 529 plan's program disclosure document to the customer.

On Section 529 plan advertisements, we provided extensive guidance on a number of specific items of disclosure and we are moving towards comprehensive standards that will greatly improve the quality and comparability of performance data in advertisements.

Because of the political environment in which State and local governments operate, the MSRB also has unique conflict of interest rules. These rules, G–37, dealing with political contributions, and G–38, on outside consultants, apply equally to the Section 529 plan market.

The MSRB strongly encourages vigorous enforcement of these rules by the SEC, NASD, and the bank regulators. These are the agencies that enforce our rules. It is worth noting, however, that our broker rules do not apply when State personnel market their own Section 529 plans directly to investors.

Now, turning to the other topics for this hearing, the MSRB has long been an advocate for the best possible disclosure practices in the Section 529 plan market. The needs of investors dictate that disclosure be based on six basic characteristics: Comprehensiveness, understandability, comparability, universality, accessibility, and timeliness.

The MSRB applauds the College Savings Plan Network's first steps at addressing the need for such disclosure through its draft voluntary disclosure principles. Meaningful success in this area will require the ongoing commitments of the issuer community.

In cases where Section 529 program costs exceed those of comparable mutual fund investments, this can often be attributed to the extra layering involved in plan structures, either from fund of funds structures with expenses incurred at two levels, or from costs incurred for State agency public policy initiatives for in-state or lower-income residents, such as subsidized fees, matching grants, or scholarships. In our view, these activities are within the purview of the States. We strongly believe, however, that all material program expenses must be fully disclosed to investors.

Finally, on variation of State tax treatment, we have been at the forefront of ensuring that brokers inform their customers of the possible loss of State tax benefit for out-of-state investments. The MSRB believes that any State tax benefit is one of many appropriately weighted factors that can influence a customer's investment decision but should not necessarily always be the controlling factor.

The MSRB takes no position on States providing or withholding State tax benefits based on their own public policy determinations. We believe that comprehensive and easily accessible centralized disclosure of State tax treatment would enhance the market and provide investors with the tools needed to make meaningful investment choices.

Thank you for inviting me to testify this morning. I will be happy to take questions.

Senator FITZGERALD. Thank you. I thank all of you very much. I appreciate your being here.

We have been joined by Senator Pryor from Arkansas. Senator Pryor is welcome to make an opening statement if he wishes to, or ask questions.

Senator PRYOR. I really don't have an opening statement. I was just down on the floor a few moments ago doing the intelligence issue, which I know most of the Committee Members are very interested in that because that has come to our Committee, so I don't have any opening statement, but you go ahead and ask questions.

Senator FITZGERALD. Well, thank you.

I wanted to start with Ms. Schapiro and ask you about the NASD's investigations. You began your investigations of the sales of Section 529 College Savings Plans because you heard of numerous customer complaints, as I understand it. What types of complaints were you getting, and is it the complaints that were to such an extent that it caused you to begin the investigation?

Ms. SCHAPIRO. Thank you, Mr. Chairman. We received several customer complaints. They related largely to investor confusion about State tax deductibility issues, quite honestly, but also about some of the fees that are associated with investing in Section 529 plans.

What really spurred our interest in this area, though, as I said, is the tremendous growth in assets invested in Section 529 plans and whether when a product becomes very popular very quickly, broker dealers have in place adequate supervisory and compliance procedures to ensure that the product is being sold appropriately.

Senator FITZGERALD. Now, did you get people complaining that after they were in the plan for a while, they realized that they weren't getting a tax benefit because maybe they had invested in an out-of-state plan?

Ms. SCHAPIRO. Yes, that kind of question, and a number of the complaints were not received by us directly but were reported on in the press as well as received at some of the brokerage firms where investors had sent complaints.

Senator FITZGERALD. So then you follow up on them. Now, during NASD's investigation of 20 securities firms, it was discovered that 18 firms had made sales of out-of-state Section 529 plans which accounted for 84 percent or more of total sales and the other two firms had percentages of 69 percent and 37 percent. These figures are pretty astounding.

What criteria are you using to evaluate any possible violations of MSRB rules? Mr. Lanza has testified that the MSRB rules require the brokers to explain the possible loss of tax benefits by going out of State. Is that what you are looking for, to see if the brokers explained to consumers that they might lose tax benefits?

Ms. SCHAPIRO. Yes. We want to ensure that they fully explain to investors—first of all, that they did the suitability analysis, that they determined that the Section 529 plan, if they recommended a particular one, was, in fact, suitable for investors, including the underlying investments of that Section 529 plan, a stock fund versus a bond fund, for example. And then secondarily, whether they explained the presence of a State tax benefit that might exist for the investor who chose to buy their home State's plan if, in fact, there was one. About half the States don't give any State tax deduction for the contributions, but about half do.

So we also focused our second round of inquiries on firms that were selling particularly to residents of States where there was an in-state tax benefit to see if they were doing a better job of disclosing that information.

Senator FITZGERALD. Have you had any settlements yet with brokerage firms?

Ms. SCHAPIRO. No. We are still in the information gathering part of this investigation. We are looking at their sales literature to understand whether they are accurately and adequately disclosing risks. We look at the training materials to see whether firms are adequately training brokers to make all the explanations and disclosures that they need to make. We are looking at the offering memoranda, the dealer agreements between the plans and the dealers, as well as customer complaints, and then the transaction data, which allowed us to come up with the chart that is in the written testimony that demonstrates the very high percentage of out-of-state sales.[1]

Senator FITZGERALD. Would you have any recommendations at this point based on what you found so far?

Ms. SCHAPIRO. Well, I would say that we strongly recommend that there be uniform disclosure of fees, expenses and tax issues with respect to Section 529 plans. It strikes us as incongruous that there is very detailed, specific and formatted disclosure for mutual funds, but investors who are basically investing in mutual funds but do so through the Section 529 program are not getting anywhere near that kind of uniformity of disclosure. Without uniform disclosure, you don't have comparability and you put investors——

Senator FITZGERALD. It is not just that there is not uniform disclosure, there really doesn't have to be any disclosure. There is no mandate that they disclose the fee, really, is there?

Ms. SCHAPIRO. We cannot require, nor can the MSRB require the issuers, the States, to disclose particular information.

Senator FITZGERALD. Congress could, though.

Ms. SCHAPIRO. Yes, that is right.

Senator FITZGERALD. Congress has said that the States are exempt from our securities regulations except for maybe in a couple areas, but they are certainly exempt from the Investment Company Act, which imposes certain requirements such as having a semi-annual statement that mutual funds have to give. I thought those disclosures were inadequate, and I wanted to beef them up. But, in fact, in the case of Section 529 College Savings Plans, the States don't even have to give those minimal disclosures that mutual funds give.

Mr. Miller, you mentioned in your testimony, you went through the IRS requirements and you said there is no requirement that the fees be disclosed. Is that correct?

Mr. MILLER. There is a requirement to give an annual account statement that shows contributions, earnings, and any distributions, but I am unaware of anything that would indicate that.

Senator FITZGERALD. And Congress dictated that law, right? I mean, we drafted that law and you are just enforcing that.

---

[1] The chart entitled "Growth in Section 529 Plans 1996–2004," appears in the Appendix on page 166.

Mr. MILLER. I believe so. We have rules out in terms of——

I think we probably could go beyond that, Mr. Chairman.

Senator FITZGERALD. Well, could the IRS go beyond the rules that are out there and require a disclosure of the fees?

Mr. MILLER. The disclosure on the fees—I think the answer probably is yes. The problem, Mr. Chairman, is it would be too late in the plan by that point because the account balance information is once you are in the plan. There is no requirement under the code for disclosure prior to entry into the plan. So the timing would sort of miss, I believe.

Senator FITZGERALD. OK, but could you draft a rule pursuant to Section 529 that required, say, from now on, that every plan participant would receive an annual or at least semi-annual statement that included the fee, not just an account statement that tells you how much money you have at the end of the year, but showed you the fee? Could the IRS——

Mr. MILLER. I would have to check on that, but I believe the answer is that we could.

Senator FITZGERALD. I would encourage you to look at that. We don't have to wait around for Congress to get to revising the statute. If you have that authority, take that up with people because we are dealing with a vehicle that was supposed to encourage people to save for college, and there are tax advantages here, but it looks like high fees are gobbling up a lot of the tax benefits. The SEC isn't a player here. There is no one to regulate these programs except possibly the IRS. I know it is not your usual area, but you are the only ones who potentially have any authority. So I would encourage you to take that up with the Commissioner.

Mr. Lanza, would you have any recommendations you would want to add here? I know that the MSRB has proposed an extensive set of draft amendments to its advertising rules that would improve the quality and comparability of performance data. If adopted, these rules would only apply to broker dealers. Since the rules would not apply to the States which also sell the plans directly, how can we ensure consistent dissemination of information?

Mr. LANZA. Right. I should start off by saying that we, in fact, are a broker dealer organization and therefore our mission is to regulate broker dealers, and so we typically have not opined as to what it is that issuers should or should not be required to do. We clearly have stated that disclosure is fundamental to——

Senator FITZGERALD. Could you require the broker dealers to disclose what the State plans——

Mr. LANZA. Well, we do require at the time of trade that broker dealers provide disclosure to the customer of all material information about the program so that if there is a material fee, expense or cost, that is covered by our disclosure obligation. But again, it only applies to broker-sold plans. It would not apply to non-broker-sold plans.

Senator FITZGERALD. Right. So if somebody buys it directly from the State, there is nothing you can do about it.

Mr. LANZA. That is correct.

Senator FITZGERALD. So they are likely to get more information if they go through a broker. However, they are also likely to pay a load.

Mr. LANZA. There is a trade-off, but certainly the States are making an effort, it seems, to try to create uniform disclosure and we are hopeful that effort will work.

Senator FITZGERALD. Would any of you have any recommendations for Congress on what we might be able—I mean, there is nothing any of you can really do about this because you don't have any powers over the State Governments that are administering these plans. Does it make sense to you that we have this additional layer of fees interposed by State Governments? Why couldn't Congress just design Section 529 plans that would allow you to go directly to Fidelity or Vanguard or any one of the mutual fund companies and open a Section 529 plan and not pay a fee to a State Government? Do any of you want to venture forth on that?

Ms. SCHAPIRO. I probably shouldn't, but I will. That is something that clearly should be considered and an option that the Congress ought to consider very carefully. There is a tremendous amount of confusion because of the different way the plans are administered and the different, particularly tax issues associated with the contributions at the State level. But I also think that if we could have very clear, very concise disclosure for investors about fees and expenses on one page, so that they could not only see what happens with their in-state plan, but compare across plans within their State and across all the States and then make an informed investment decision, that would be a tremendous step forward. The comparability from our perspective, whether it is mutual funds you are talking about, variable annuity sales, or Section 529 plan sales, it is absolutely critical for investors to be informed of choices.

Senator FITZGERALD. Do any of you see any reason why college savings plans need to be run by State Governments? Is there something I am missing here? All I see is an additional layer of fees. Do any of you see any benefit to having the State Governments be involved? I suppose the one benefit is the tax benefit. If they are not running them, they are probably not going to give you a State tax benefit, right?

Mr. LANZA. I would let the States speak for themselves, but it is a policy question between the Federal and State Government as to where things should lie. Some States provide certain benefits that they believe are beneficial to their residents and others may not. Again, it is a policy decision, at least from the MSRB's view, between the States and the Federal Government.

Senator FITZGERALD. Well, the Federal Government could simply make them all tax-exempt, Federal and State tax-exempt, and that would be the end of it, and you could go and just buy them directly online and not pay an additional layer of fees. Am I missing something here? Can you think of a benefit that having an additional middleman, in addition to the brokers and in addition to the fund managers, having the State Governments get in there and get their paws on a fee? Can you articulate a benefit we get by setting it up this way?

Mr. MILLER. The only thing I would mention, Mr. Chairman, is that the history of these plans is that they grew out of the States, and so in the 1980's and 1990's, that is how these things were created out of State plans, and when the Congress acted in 1996, that is what was in front of it at that time——

Senator FITZGERALD. Were there any State plans prior to 1996, or was it in 1996 the State Treasurers Association came to Washington——

Mr. MILLER. No. There were, in fact, plans in the 1980's and 1990's that States had set up and their tax treatment was a point of discussion and contention, to some extent. That was clarified in 1996. So that gives some background as to why we are where we are today.

Senator FITZGERALD. So it was just clarified in 1996. It arguably may have been—they may have been tax advantaged before 1996?

Mr. MILLER. There would be a court case that indicated that that was the case. We lose a court case against Michigan's Education Trust.

Senator FITZGERALD. Oh, I see. OK. So in 1996, we made the internal build-up in the accounts tax advantaged by Federal statute, and then in 2001——

Mr. MILLER. Distribution side.

Senator FITZGERALD [continuing]. We made distributions from the plan, and then the funds have really grown since that time, is that correct? Making the distributions tax-exempt when used for educational purposes, that has caused additional quick growth.

Mr. MILLER. We are not tracking that at the Service. Inferentially, that would seem right, but I would look to other people to answer that question.

Ms. SCHAPIRO. I would agree with Mr. Lanza. It is really a question of where the authority ought to lie, with the Federal Government or the State Governments. I will say that it would provide a tremendous simplification for the brokerage industry to have some uniformity here with respect to the tax treatment across all the States and would help with sales practice issues, quite honestly.

Senator FITZGERALD. It is really tough for the brokers, too. They may make a mistake, because you have to know the tax laws in all 50 States, then, in order to be able to fully educate your customers, right?

Ms. SCHAPIRO. MSRB rules don't require them to specifically analyze the different tax treatments of every State. They do have to give general disclosures—such as "there may be an in-state tax benefit versus going out of State." But nonetheless, good brokers really do want to be able to explain what the impact on the value of an investment is of a tax benefit at the State level as well as the impact of expenses——

Senator FITZGERALD. So the broker's only obligation is to say to the customer, if you go out of State, you might lose a tax benefit. I don't know, but you will have to look this up. He doesn't have to tell you, I am recommending this plan and——

Mr. LANZA. That is a baseline obligation. If you are marketing an out-of-state plan, the duty is to let the customers know that they may be missing out on an in-state benefit.

Senator FITZGERALD. That is a pretty minimal requirement. I would think a lot of brokers are going to want to know a lot more than that. Say if you are a broker in my State of Illinois and somebody is going to go out of State, you are going to want to know what happens to your Illinois customers as far as their taxes are concerned. So maybe from the standpoint of your rules, they don't

have a duty of going further, but I would think a lot of diligent brokers out there would be forced to study the tax laws very carefully here. That seems to me it imposes an additional enormous obligation on them.

Ms. SCHAPIRO. I think that is absolutely right. Brokers really do want to be able to give that information to their customers. In addition, brokerage firms are working very hard to increase the number of States plans that they sell so that they can have within their menu of investment options one that is an in-state plan for as many of their customers as they can. That creates a lot of administrative burden on the firms.

Senator FITZGERALD. Thank you all for your testimony. I appreciate it.

Senator Pryor, do you have any questions you would like to ask?

OPENING STATEMENT OF SENATOR PRYOR

Senator PRYOR. Let me just say, Mr. Chairman, I think you have done a great job of quizzing the panel and defining some very important issues here. I think I share your concerns about the confusing nature and some of the details of this policy that we have on the books today.

I would say this, and I think everybody pretty much in the room and probably in the Congress would agree that I think as a matter of national policy, it is a good thing for us to get more people to go to college. I think that we should find ways here in the Congress, whether it is through our tax code or whatever, but we need to find ways—if it is creative, so be it—but find ways to incentivize people to go to college.

I think, really, if you look at the Section 529's, that is probably the original intent of this, is to allow investors, allow people to look at their options and have this as a viable option for them to really give them a tax incentive, an advantage, if you will, in sending their children to college. So that concept is totally acceptable to me. In fact, I think it is something that we need to keep on the books.

But at the same time, some of the ways this program is implemented, whether it was intentional or unintentional, I don't know and we can't speak for all of that, but I do think it is time for us to revisit this. Mr. Chairman, I appreciate your leadership on this because I think you have really laid out the issues and helped us define the issues so that we can proceed on this and hopefully have some positive restructuring of the Section 529 program.

So let me just make a couple observations, but really ask a few questions, and that is in looking at the Section 529 savings plans, I think it is confusing. As I understand it, there are at least, or about, six possible fees that could apply, and depending on what you are doing and what your circumstances are, you may get one or a combination of those fees. My impression is that there is just not a very good system in place to disclose all of this to the investor. Is that fair? Ms. Schapiro, I don't want to pick on you, but is that a fair statement?

Ms. SCHAPIRO. That is a fair statement.

Senator PRYOR. I guess my first question is, why don't we just adopt—I know you all can't do it, but why doesn't Congress just adopt a uniform fee, just a flat or very easy to understand formula,

just a uniform fee that would apply to this? Do you all see any problem with just a uniform fee in some way? Does that create a problem?

Mr. LANZA. It would be a different approach than currently exists elsewhere in the marketplace, but I see no legal problem.

Senator PRYOR. All right. Well, let us talk about that. What currently exists in the marketplace today?

Mr. LANZA. Typically, for example, the MSRB—and again, our jurisdiction is limited to broker dealers—we are statutorily prohibited from setting fees. The Congress's determination at the time that we were created, and I believe it also applies in general to the NASD, was that market forces should be left to operate. So we certainly don't have any kind of mandate to create any kind of fixed fees.

Senator PRYOR. OK. I see these as a little bit different, like the Chairman said, because the State has a role in this, but anyway, that is good.

Ms. SCHAPIRO. There actually is, under NASD rules with respect to mutual funds, an 8.5 percent cap on sales charges in funds where there are no 12b–1 fees or services assessed. Otherwise, it is a 6.25 percent cap. But generally, fee caps and limits and the dictation of fees has not been done by the government or by the Congress but rather set in the marketplace. Critical to the marketplace functioning with respect to the competition among fees is disclosure that investors can understand so that they can make informed choices about whether they want to pay particular fees or not——

Senator PRYOR. Right.

Ms. SCHAPIRO [continuing]. And so that they can understand what the impact of multiple levels of fees are on their investment's return over time.

Senator PRYOR. Right. As I understand, the SEC has mandated the so-called "plain English" rule so that investors, when they read materials, etc., most investors, at least, can understand it or at least come closer to understanding it than if it is just filled with legalese. I think the National Association of State Treasurers and the College Savings Plan Network have come up with what may be considered their version of this. It is kind of voluntary disclosure principles, guidelines, etc.

These are voluntary disclosure principle guidelines. Do you know how many are complying with these voluntary disclosures? Do we have a sense of what everybody is doing out there?

Mr. LANZA. I don't have a figure. I understand that some States have begun to implement it. Others are, I believe, waiting for the SEC Chairman's task force report. But again, I am not the person to speak to that.

Senator PRYOR. I guess what is puzzling to me about this is, and maybe it is because of my Attorney General background where we did a lot of consumer protection work, but it is just puzzling to me where the States would not want their consumers to have full knowledge and a clear understanding of what they are getting themselves into. I am puzzled by that. I know that you can't speak for them or speak to that.

Let me ask you just one last question. Is it your opinion that the States and the investment community are doing enough to allow parents and students to make intelligent investment decisions, or do you think that we need to review and revise what we have on the books today?

Mr. LANZA. Clearly, we believe disclosure can be improved. I mentioned the six characteristics that we think disclosure needs to bring in, which is that it be understandable, comprehensive, comparable, universal, accessible, and timely. All the information that anyone needs needs to be available in a timely manner and in a simple manner and in a way that they can compare one State versus the other.

Again, we are hopeful that the CSPN disclosure principles will get them there. It is not an easy process. It will take a lot of work and real vigilance.

I will mention that MSRB also regulates broker dealers in the municipal bond area, which has clearly had a longer history, and over time, disclosure practices have improved in that market, as well, even though there is no mandatory set of requirements for disclosure. So certainly it is possible. I just can't predict where it will go.

Ms. SCHAPIRO. I think improving disclosure is key, too. We have developed a one-page disclosure document that would lay out for investors what fees they pay to buy and own a Section 529 plan and then, out of those fees and expenses that they pay, what is paid to the brokerage firm and to the broker for selling that plan. I don't know if it is perfect, but it is that kind of point-of-sale, simple, one-page disclosure that allows for comparability across different plans that I think would be the greatest service we could provide investors in this area.

Mr. MILLER. That is not really a tax issue for our side of it.

Senator PRYOR. Thank you very much, Mr. Chairman.

Senator FITZGERALD. Senator Carper from Delaware has joined us. You are free to ask any questions or we can bring up the second panel.

Senator CARPER. Let me just ask a question of each of the witnesses, if I could. Thank you for being here. I apologize for not being here to hear your testimony, but I would just ask that you briefly give me a take-away or two, what you would have us take away from this hearing.

Steve Miller, you are about the third Steve Miller we have had testify in this Congress.

Mr. MILLER. There are a lot of us.

Senator CARPER. I always ask the same thing, like what have you been doing since your recording career sort of leveled off——[Laughter.]

But you still look young. You look great.

Mr. MILLER. Thank you. [Laughter.]

What we testified on, Senator, were the basic requirements for exemption for a qualified tuition program under Section 529. There is nothing explicit in that that really deals with the disclosure area to prospective customers, and I think that is a take-away.

Senator CARPER. All right, thanks. Ms. Schapiro.

Ms. SCHAPIRO. I sound a bit like a broken record, but I would say that the key take-away from our perspective would be the need for uniform disclosure concerning fees, expenses, tax treatment, and all the other unique features of Section 529 plans that go well beyond the underlying mutual fund investment, things like the rollover options and designation of beneficiaries and so forth.

Senator CARPER. Thank you. Mr. Lanza.

Mr. LANZA. I spoke to the broker dealer obligations to customers and I think, as Ms. Schapiro said, we believe disclosure really is the key in this marketplace because it is complex and there are lots of features and the best thing for investors as well as the broker dealers who market to investors is to be able to understand the marketplace and understand all the key features. So we urge the issuer community to really work on quality, comparable, timely, and comprehensive disclosure.

Senator CARPER. I don't know if any of you have children of your own, but some of you may, but if you are giving advice to people who have children, about to have children, someday have children, what they might want to keep in mind as they prepare for their children's education as it relates to the Section 529's. What would you have them keep in mind?

Ms. SCHAPIRO. I do have children. I have two daughters, both of whom have Section 529 plans. I also serve on the board of a college, and so I see from that perspective what tremendous burdens are placed on families who are trying to pay for a particular private school education, but even today, public school education. My advice would be to start saving day one. The day the child is born, open a Section 529 plan. Look for one with the lowest possible fees and expenses, with a good reputation on the part of the mutual fund complex that underlies the Section 529 plan, and make regular contributions to it, watching the investment very carefully, of course, so that if there are issues that arise over time, you can make the appropriate changes.

Senator CARPER. Good. Thank you. What college?

Ms. SCHAPIRO. Franklin and Marshall in Lancaster, Pennsylvania.

Senator CARPER. We know where that is in Delaware.

Ms. SCHAPIRO. That is right. [Laughter.]

Senator CARPER. Gentlemen.

Mr. MILLER. I think that the most likely take-away on that is that you really do need to do your homework because the plans are very different, and that is really what we would suggest, as well.

Senator CARPER. All right.

Mr. LANZA. I don't think anyone in their right mind would want to take financial advice from me, but we have college savings plans as well for our children. We think they are very helpful. We were very careful in our selection, making sure they met with our——

Senator CARPER. What did you consider when you were making those selections?

Mr. LANZA. Well, it is a matter of personal choice. I tend to go for the low-cost indexed type of funds. Others have other views towards the mutual fund industry in general. Some like more actively managed. In my case, it is more of an index fund, so I went in that direction.

Senator CARPER. All right.

Mr. LANZA. But it is a matter of what your personal investing style is.

Senator CARPER. How old are your children?

Mr. LANZA. One is 11. The other one is six.

Senator CARPER. Ms. Schapiro.

Ms. SCHAPIRO. Eight and ten.

Senator CARPER. Eight and ten, all right. Mr. Miller.

Mr. MILLER. Five years old.

Senator CARPER. Five years old, OK. Fourteen and sixteen, and we have a plan for each of our boys, too. Thank you very much.

Senator FITZGERALD. Thank you to this panel of witnesses. I did want to tell Senator Pryor there definitely are huge variations in fees. I am going to have my staff try and get you something that has been worked up by Morningstar. We are going to hear from a Morningstar witness. You might want to take a look at the fees they charge in Arkansas, too. I won't state those publicly, but you might want to take that up with your Treasurer back home.

All of you, you have been great. We appreciate your time. Thank you so much for coming here.

Now, I would like to welcome our witnesses for panel two. Our first witness on this panel is the Hon. Michael A. Ablowich, who is the Treasurer for the State of New Hampshire. Treasurer Ablowich began his 2-year term in January 2003 and is responsible for cash management and investment of more than $300 million daily, banking relationships, debt management, and trust fund management. Treasurer Ablowich also is statutorily appointed to a number of State committees, including the New Hampshire Municipal Bond Bank and the New Hampshire College Tuition Savings Plan Advisory Commission.

Our second witness is Jacqueline T. Williams, who serves as the Executive Director of the Ohio Tuition Trust Authority. The Ohio General Assembly created the Tuition Trust Authority in 1989 to promote savings for higher education. Prior to her current role, Ms. Williams held leadership roles as Chief Administrative Officer for the Ohio Bureau of Workers' Compensation and the Director of Consumer Services for the Ohio Consumers Council.

Our third witness is from my home State of Illinois. Martin M. Noven serves as Deputy Chief of Staff to Illinois State Treasurer Judy Baar Topinka. Mr. Noven joined the Treasurer's Office in 1993 and his responsibilities include supervision of all legal, legislative, and policy matters, including program creation and new initiatives. Mr. Noven is responsible for the implementation and supervision of Bright Start, the college savings program established by Treasurer Topinka.

Our next witness is Richard O. Davis. Mr. Davis is the Deputy Executive Director for Finance and Administration for the Utah Higher Education Assistance Authority. The Authority is a subsidiary organization of the Utah State Board of Regents that oversees the operation of the State's student loan secondary market activities, guarantor operations, and the Utah Educational Savings Plan trust.

Our fifth witness is Dan McNeela, who is a senior analyst at Morningstar, an independent investment research firm. Mr. Mc-

Neela has researched mutual funds for Morningstar since October of 2000 and is the firm's lead editorial analyst covering Section 529 College Savings Plans.

Our final witness is Mercer Bullard, whom we welcome back before this Subcommittee. Mr. Bullard also testified at our mutual fund hearings in November 2003. Mr. Bullard is the founder of Fund Democracy, a nonprofit membership organization that serves as an advocate and information source for mutual fund shareholders and their advisors. Mr. Bullard also is an assistant professor of law at the University of Mississippi, where he teaches in the areas of securities and banking regulation, corporate finance, and contracts. I know one of my staff members was keeping abreast of the conference you held on mutual fund ownership down in Mississippi, and you have been a great advocate for investors. We thank you for being here.

To the best of your ability, please try to summarize your remarks within 5 minutes. We will take your full written statements for the record, and we will make them part of the record. Thank you all for being here.

I would like to begin with Treasurer Ablowich from New Hampshire. I went to Dartmouth College in Hanover, New Hampshire, so I have some connection to your State. Welcome.

TESTIMONY OF HON. MICHAEL A. ABLOWICH,[1] TREASURER, STATE OF NEW HAMPSHIRE, ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS

Mr. ABLOWICH. Thank you very much, Mr. Chairman and Members of the Subcommittee. My name is Michael Ablowich. I am the Treasurer of the State of New Hampshire and trustee of both the UNIQUE College Investing Plan and the Fidelity Advisor Section 529 Plan, both of which are sponsored by our State. I would like to have my written testimony entered into the record of this Subcommittee, please, Mr. Chairman.

Senator FITZGERALD. Without objection.

Mr. ABLOWICH. I am also a member of New Hampshire's College Tuition Savings Plan Advisory Commission and a member of the College Savings Plan Network, which is an affiliate of the National Association of State Treasurers. CSPN coordinates State college savings efforts by harnessing the collective resources of States to improve industry practices and develop self-regulating policies.

It is my sincere pleasure to be here today to speak with you about Section 529 College Savings Plans, the State of New Hampshire's perspective, and philosophy regarding these plans and how States are making them successful.

The States have been working with Congress for over a decade to increase access to college by helping families overcome one of the greatest barriers to college, the ever-increasing cost of higher education for their children.

New Hampshire's story is really no different in this case. We began our Section 529 plans in 1998 and since then, residents in New Hampshire and other States have responded to these plans with excitement and enthusiasm. More than $3.3 billion has been

[1] The prepared statement of Mr. Ablowich appears in the Appendix on page 90.

invested in more than 330,000 accounts in our two programs combined. That high level of response is even more amazing when you consider that we started these plans a couple years before one of the most challenging financial markets in history.

Investors clearly understand the need for higher education and the principle of saving early and regularly in a tax advantaged account. Of course, while periodic investing strategies do not guarantee a profit or protect against loss in a declining market, investing in a Federal income tax-free vehicle like a Section 529 plan may be one of the simplest and best ways for families to start saving for college.

Our Section 529 plan is built on the foundation of putting investors and beneficiaries first. We make every program decision with the interests of our investors in the forefront, and while we maintain an outstanding relationship with our private sector partner, our first priority is always to our investors, the plan participants. That is why New Hampshire currently has two Section 529 plans to choose from, each offering investors a different method of deciding on which investment options are best for them.

The UNIQUE College Investing Plan is sold directly to investors and the Fidelity Advisor Section 529 Plan is marketed to investors through intermediaries, like financial planners or brokers. Both plans give investors a wide range of college savings options to satisfy their college savings goals. Our retail UNIQUE plan is designed with smaller investors in mind, but these investors, they can get started with as little as $50 and $50 monthly contributions, or for a one-time contribution of $1,000. It is our goal to offer solid investment choices to attract a wide range of investors with varying risk tolerances and investment philosophies.

Everyone talks about the amount of money saved in Section 529 plans, and it is substantial, but I believe the more important statistic is the number of accounts. I really don't care whether people are saving $50 or $50,000 as long as they save. I am also not concerned whether they save in one of our two Section 529 plans or in another plan or, frankly, in their name in a traditional bank savings account or some other method. The important thing is that parents are making plans for one of the most important investments in their lives, their children's education.

In New Hampshire, we have worked to develop college savings awareness to ensure that every resident, regardless of income, understands and has easy access to the Section 529 plan and other college financing options. We have also made this decision simpler for our residents by allowing them to receive favorable State tax interest and dividends tax treatment regardless of the plan they participate in.

The States have a legitimate vested interest in making college more affordable and accessible to their citizens. In New Hampshire, the Treasurer's Office is responsible for our Section 529 plans, as is the case in most States. We have been entrusted with looking after the hard-earned dollars of families who are saving for their children and grandchildren's education.

Our Advisory Commission meets regularly to review plan operations, the performance of securities markets, and performance in each of the portfolios and investment options available to our inves-

tors. We have worked hard to ensure that our Section 529 plans, whether bought directly or through financial advisors, offer competitive fees that are fully disclosed to all investors.

We also spend much time reviewing the performance of each portfolio to ensure that investors are earning competitive returns net of fees compared to the appropriate benchmarks. This allows me and our commission to exercise full and effective control over the program as well as oversee our private sector program manager. Every significant decision made regarding the plan, whether investment-related or administrative, is analyzed and approved by the commission. The roles of the Treasurer and the Advisory Commission and the terms of the contract with Fidelity Investments, our plan administrator, have been approved consistent with the process used for all State contracts.

After listening to the customer concerns regarding disclosure and transparency, the National Association of State Treasurers and the College Savings Plan Network have undertaken an effort to create voluntary disclosure principles. These principles were adopted in draft form with input from our private sector partners this May at the Network's annual meeting. The National Association of State Treasurers has also adopted the principles at its annual conference earlier this year.

The goal of the principles is to provide a framework for disclosure so that investors can easily understand his or her own State's plans compared to other Section 529 plans on an apples-to-apples basis.

Senator FITZGERALD. You have got to wind it up.

Mr. ABLOWICH. Can I have 2 more minutes, Mr. Chairman?

Senator FITZGERALD. We will give you time in the question and answer segment. We have got to give everyone an opportunity. We want to stay to that 5 minutes, so please watch these lights. We will come back to you.

Mr. ABLOWICH. Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you very much, Treasurer. Ms. Williams.

TESTIMONY OF JACQUELINE T. WILLIAMS,[1] EXECUTIVE DIRECTOR, COLLEGE ADVANTAGE SAVINGS PLAN, OHIO TUITION TRUST AUTHORITY, ON BEHALF OF THE COLLEGE SAVINGS PLAN NETWORK

Ms. WILLIAMS. Thank you, Mr. Chairman and Subcommittee Members. I am Jackie Williams, Executive Director of the Ohio Tuition Trust Authority and I appreciate the opportunity to share one State's perspective on Section 529 plans and hopefully clear up some misperceptions and highlight the enormous value these plans provide to America's families.

Our agency is an independent State agency governed by an 11-member board comprised of business, education, and elected leaders in our State. In 1989, Ohio was one of the first States in the country to offer a Section 529 qualified tuition program. The General Assembly created the plan to make higher education more affordable and accessible for all Ohio citizens. Since inception, our

[1] The prepared statement of Ms. Williams appears in the Appendix on page 103.

State provided tax-exempt earnings to encourage early savers. Only 11 States have fewer college graduates than Ohio, and a recent report by our governor indicates that our economic future depends on increasing participation in higher education.

The Tuition Trust first offered a unit-based prepaid plan designed to keep pace with tuition inflation at Ohio's public universities. The plan enjoyed wide acceptance and market success. Long before I became an employee of the plan, I financed the education of my two sons through the guaranteed program.

In 1994, the Ohio General Assembly and Ohio voters approved a constitutional amendment putting the State's full faith and credit backing behind the plan if it could not meet future obligations.

In 1996, Ohio's plan fell under guidelines established by Congress establishing qualified State tuition programs and adding Section 529 to the Internal Revenue Code. These changes have encouraged more States to offer college savings plans and expanded their ability to offer new investment choices and tax incentives. Legislation to take advantage of the Federal changes was approved unanimously by the Ohio General Assembly in 1999, and this also created new investment options and added a $2,000 annual State tax deduction on contributions.

Launched in the Fall of 2000, College Advantage included the original prepaid plan and the new actively managed investments. We were one of the first States to offer both a director-sold and an advisor-sold program. We found that many savers wanted investment advice from financial professionals and were willing to pay to receive it and that there were also do-it-yourself investors who wanted to make their own investment decisions and wanted a broad range of low-cost options. With product enhancements and improved distribution, we have over 266,000 beneficiaries in Ohio alone.

The Federal Tax Act of 2001 permitted a tax exemption on earnings on funds when they were used for qualified higher education expenses. When that law took effect in June 2001, there were a million-and-a-half U.S. children with Section 529 accounts valued at $9.5 billion. Three years later, Section 529 plans have become the preferred college savings vehicle, with 6.8 million accounts valued at over $54 billion. Unfortunately, unless extended by Congress, the Federal law will expire after December 2010.

For 15 years, our organization has worked very hard to educate people to determine what kinds of products and features to offer, how best to inform and educate, and how to distribute products to a broad cross-section of the public. Each investment manager is selected through a rigorous competitive process subject to State procurement laws.

We currently work with two investment firms, Putnam Investments, which provides actively managed investment products, and the Vanguard Group, which provides passively managed index funds. Recently, we selected an Ohio bank to develop a Section 529 banking product. Our goal is to make investment vehicles available to savers at every level of income, education, and investment experience.

We encourage families to save through flexible contribution methods, such as electronic funds transfer, payroll deduction, and

online investing. Participants pay no application or service fees. Ohio residents pay no annual account fees. And account fees are waived for non-residents who are participating in systematic investing. A College Advantage account can be opened for as little as $15.

And while expense ratios vary by investment, our direct-sold plan offers some of the industry's lowest fees and our advisor-sold fees are about average for advisor-sold actively managed funds. Obviously, enhancing disclosure of fees and performance is a very high priority of ours and we fully support CSPN's direction on this.

Earlier this year, we took a leadership position and disclosed all of our fees on a single page in our opening statement. I would just like to say that there are a number of organizations that rate Section 529 programs, and I think in many cases they have done a disservice to the people who read their reviews and have not shed light on these plans. Frankly, much of their information has a very long shelf life, and these plans are dynamic ones which can change the day after these articles are written. For example, the Rhode Island J.P. Morgan fund no longer exists. So clearly, it is in the best interests of States, as well, to make sure that our information is out there and that the organizations reporting on them are using accurate, timely information. Thank you very much.

Senator FITZGERALD. Thank you, Ms. Williams. Mr. Noven, welcome.

TESTIMONY OF MARTIN M. NOVEN,[1] DEPUTY CHIEF OF STAFF, ON BEHALF OF JUDY BAAR TOPINKA, STATE TREASURER, STATE OF ILLINOIS

Mr. NOVEN. Thank you. Good morning, Chairman Fitzgerald and Members of the Subcommittee. I would like to enter my written comments into the record, as well.

Senator FITZGERALD. Without objection.

Mr. NOVEN. Thank you. We appreciate the opportunity to present this testimony. I personally appreciate your inviting me to testify on behalf of Treasurer Topinka. She feels very strongly about a number of the issues that you are discussing and appreciates the opportunity to share her views on the matter.

When these State Section 529 programs were set up, they were set up so that there would be someone looking out for the interests of consumers. They were set up by States so they would have a product to offer their investors in-state and their consumers in-state that would be protected by someone who was looking out for their interests so they could feel comfortable that they weren't paying high fees, that they weren't getting false information.

In that spirit, Treasurer Topinka created the Bright Start College Savings Program. It wasn't an easy program to start. Legislatively, we had a difficult time getting authority. We were actually forced by the banking industry to include some unique provisions in our law that made it more difficult to have a successful program. For example, all contributions and applications have to go through Illinois banks to participate in the Illinois plan, and banks even have the option, although very few actually—it is a negligible

[1] The prepared statement of Mr. Noven appears in the Appendix on page 107.

amount have actually taken advantage of it—to have some deposits on hand as part of the investments that are in the participants' portfolio.

So we worked very hard to get a plan together. We were glad that despite the fact that we had a hard time getting people to respond to the RFP and some of the responses that we did get had inflated fees because of our unique requirements, we were able to negotiate a contract with Smith Barney that gave us one of the lowest-cost programs in the Nation. It gave a tremendous amount of control to the Treasurer to protect consumers. And also, with their affiliation with Citibank, they were able to comply with our enabling legislation.

We are extremely pleased with the success of the Bright Start program. We have more than 100,000 accounts that have been opened. Our performance places us among the top in the Nation. We have done all of this without engaging in the problems that you have mentioned: The high fees and commissions, the questionable sales practices, the inadequate disclosure. We feel very strongly that all of these are important things that we need to consider. We applaud the efforts of the Federal regulatory agencies that are looking at some of these issues. We think it is important.

When the largest programs in the Nation, the ones that are growing the fastest and being sold most aggressively and have the most consumer assets, are the ones that are least consumer-friendly and are the ones that charge consumers the highest fees so they have the least amount of assets to grow, like you mentioned on the charts that you have, we have got a real problem here and we are glad that it is being looked at.

We have been fighting that battle in Illinois, as well, where two dollars is being invested out of State in these high-priced broker-sold plans for every dollar that is being invested in-state. The performance of these plans has not been better than Bright Start. The broker fees are higher in these plans. These citizens are paying higher fees and not getting the tax benefits in Illinois. That has caused some concern in Illinois, and instead of the brokerage community dealing with this conflict by changing their selling practices, they have come after us with a fleet of lobbyists in Springfield, trying to force us to extend those benefits to encourage Illinoisans to go to plans that are not in their best interests as a consumer. Those are the concerns we have.

We have tried to extend our State tax benefits to any other State plan that will agree to adequate disclosure and the industry killed the bill. We tried to extend it to any plans that had reasonable sales charges. The industry killed that bill. We offered—it was a legislative proposal, it didn't get to the bill form—if other States would treat Illinois residents as well as they treated their own and not charge extra fees and commissions to help pad their State treasury, extend the tax benefits to them, and the industry rejected that proposal.

So we have been working very hard on this issue. On a state-by-state level, we fear that States are competing with each other for assets as opposed to looking out for consumers, as was the original intention of this bill. We very much welcome the chance to address these issues.

Senator FITZGERALD. Thank you very much, Mr. Noven. Mr. Davis.

TESTIMONY OF RICHARD O. DAVIS,[1] DEPUTY EXECUTIVE DIRECTOR FOR FINANCE AND ADMINISTRATION, UTAH HIGHER EDUCATION ASSISTANCE AUTHORITY

Mr. DAVIS. Thank you, Mr. Chairman. Mr. Chairman, Members of the Subcommittee, my name is Richard Davis, Deputy Executive Director for Finance and Administration for the Utah Higher Education Assistance Authority, which is a subsidiary board of the Utah State Board of Regents. We manage the Utah Section 529 plan as part of our role to provide financial and informational assistance to Utah residents.

The Utah plan was set up in 1996 as a State agency and is governed by a 17-member Board of Directors comprised of members from both private and the public sector. In response to the burden of increasing costs of education, the Board of Directors was charged with creating a safe, simple, and low-cost college savings program. The Board made a conscientious decision to create a plan that charges the lowest fees possible. To maintain these lower costs, the Board has chosen to offer its plan, manage it internally, and market it directly to investors. For example, a Utah account with a balance of $10,000 will pay, on average, between $50 and $60 of fees per year, depending on the investment options.

A Utah savings account may be established with no enrollment fees and an initial deposit as low as $25 per family. Once this account has been created, there are no deposit requirements and the account holder may choose a payment schedule that meets their specific needs.

We have ten investment options utilizing nine Vanguard mutual funds and the Utah Public Treasurer's Investment Fund, which mirrors the attributes of a money market account. We have four static investment options where the allocation of funds remains the same throughout the entire time the account is open and five different age-based options, all of which provide portfolios that change the allocation of funds to become more conservative as the beneficiary approaches college enrollment.

Residents of Utah also benefit from a State tax deduction of up to $1,470 currently, or $2,940 on a joint return.

As a confirmation of the value of this decision to offer a low-cost college savings plan, Utah has been consistently rated by various investment research organizations and financial magazines and other third parties as among the top five Section 529 plans in the Nation. Although we only market within the State of Utah, 80 percent of our participants are non-Utah residents, out of State.

We recently began a new pilot program which provides matching funds for low-income families in Utah. We provide a matching incentive of up to $300 per year for 4 years for families with incomes up to 200 percent of the Federal poverty level.

As a member of the College Savings Plan Network, Utah supports the effort to create a voluntary disclosure system among the various plans. We are currently working towards developing and

[1] The prepared statement of Mr. Davis appears in the Appendix on page 112.

refining our own offering materials to meet the objectives of the disclosure principles and plan to provide materials that will help consumers make more informed and objective comparisons of fees and expenses.

Mr. Chairman, Section 529 plans in general and Utah in particular have proven to be very successful among families as they plan for their children's education. Congress set out to create a simple and easy-to-understand process to assist participants save money for college. We believe this goal is being accomplished every day through the continued growth in these plans.

Thank you, Mr. Chairman and Members of the Subcommittee. I appreciate the opportunity to speak here and would be pleased to address any questions.

Senator FITZGERALD. Mr. Davis, thank you very much. Mr. McNeela.

TESTIMONY OF DANIEL McNEELA,[1] CFA, SENIOR ANALYST, MORNINGSTAR, INC

Mr. MCNEELA. Thank you. I ask for my written testimony to be entered into the record.

Senator FITZGERALD. Without objection.

Mr. MCNEELA. Thank you for the opportunity to appear before this distinguished Subcommittee. My name is Dan McNeela. I am a senior analyst with Morningstar, Inc. My testimony focuses on the shortcomings of Section 529 plans and the steps that can be taken to ensure that the generous Federal tax breaks are not squandered.

Some of our greatest concerns relate to the host of costs investors pay to participate in a Section 529 plan. Investors face enrollment fees, account maintenance fees, administrative fees, management fees, and in many cases, broker fees. Some of those costs are dollar-based while others vary depending on the amount of assets an investor has in the plan. Most Section 529's exacerbate this problem by burying this important cost information in the back of a 100-page-long program disclosure document. At its worst, the complexity of the cost structure and the reluctance to make this information easily accessible and understandable amount to deceit on the part of Section 529 providers.

When all the costs are added together, too many Section 529 plans appear to be prohibitively expensive. One reason these plans cost so much is that several groups have lined up to collect fees. With States, fund companies, brokers, third-party administrators all putting their fingers in the pie, it is no wonder that investors can end up with a knuckle sandwich.

With several plans having investment options whose costs approach or exceed 2 percent of assets, investors' ability to capture needed investment gains is significantly impaired. States offering Section 529 plans need to provide more disclosure on how fees are used and how investment managers are chosen. Only by opening up these decisions to public scrutiny can citizens feel comfortable that the plans are being operated for their benefit.

[1] The prepared statement of Mr. McNeela appears in the Appendix on page 114.

The final area in need of improved disclosure is performance evaluation. To grasp how well a plan is performing, investors need to see the performance of relevant benchmarks alongside the plan's returns. If this is done properly, plans saddled with poorly performing funds and high cost structures will have few places to hide. As a supplement to those numbers, plans should provide investors with a written commentary explaining why the investment options did better or worse than their benchmarks.

This distinguished Subcommittee must decide what, if anything, must be done on a Federal level to assure that Section 529 plans reach their full potential. Toward that end, I submit the following recommendations.

First, bring uniformity to standards for disclosure and transparency by appointing the SEC to set the regulatory environment. With the SEC in charge, all plans will be required to comply with the same set of rules. That measure will increase investor confidence, make comparisons between plans easier, and allow for alignment with rules and protections already being enforced as they relate to mutual funds.

Second, ensure that the Section 529 marketplace is competitive by granting the Federal tax break only to plans that promote fair competition through the adoption of the following standards. First would be State tax laws on contributions and withdrawals should be applied uniformly to all Section 529 plans with no special status afforded to a State's own plan. Twenty-six States offer a deduction or tax credit on contributions, but typically that benefit is not bestowed on those who find an out-of-state plan more compelling. Four States grant tax-free withdrawals for citizens who opt for the home State plan, but require beneficiaries to pay State tax on qualified withdrawals from out-of-state plans, and Illinois and Mississippi residents who choose an out-of-state plan give up both benefits.

Also, we think it is important to require uniform access to Section 529 plans. Some States have seen fit to create two distinct plans, one geared to in-state residents while the other is for out-of-state residents. This two-tiered system can impact the range and quality of the underlying investment options.

Third, we would require uniform fee schedules regardless of residency. In addition to restricting access, some States have created a special low-cost share class that is available only to its residents. Out-of-state investors can't buy the lower-cost shares and usually must pay a sales load and higher ongoing expenses to access the plan. Certain plans also waive annual maintenance fees only for in-state residents.

States protect themselves from competing plans and favor their residents over out-of-state investors because they have little motivation to act otherwise. Only the Federal Government is in position to set appropriate ground rules that will promote fair competition and ensure freedom of choice for investors. By ensuring a competitive marketplace, the Federal Government will guarantee that tax benefits has bestowed upon Section 529 plans are not squandered.

I thank you for your time and I will take any questions.

Senator FITZGERALD. That was excellent. Thank you very much. Mr. Bullard.

TESTIMONY OF MERCER E. BULLARD,[1] PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC

Mr. BULLARD. Thank you, Chairman Fitzgerald and members of the Subcommittee, again for inviting me to appear today. It is an honor and a privilege to speak on this very important issue and I would like my written testimony to be added to the record.

Senator FITZGERALD. Without objection.

Mr. BULLARD. Today, I am going to deal with the four issues that were listed in the title of this hearing: High fees, fee disclosure, questionable sales practices, and disparate State tax benefits.

High fees and fee disclosure are actually closely related. Seventy years of Federal securities regulation have taught us that effective fee disclosure can promote price competition and mitigate high fees.

There is no coincidence that since the adoption of the mutual fund expense ratio and fee table, for example, mutual fund assets have increased substantially as investors have been drawn to the product's transparency and accessibility. Mutual fund fee disclosure rules have led investors to migrate to lower-cost funds, and these rules, these mandatory rules, have thereby created wealth by reducing costs. Effective fee disclosure rules have provided Americans with more money to finance their children's education and their retirement.

Effective fee disclosure did not come about voluntarily. It came about only as a result of SEC rulemaking. Low-cost providers have a strong incentive to provide fee transparency, but high-cost providers have an equally strong incentive to obscure their fees. Effective fee disclosure should be standardized, transparent, understandable, and comprehensive, but most of all, it must be mandatory. Only when the high fees charged by high-cost providers are required to be disclosed will the markets be able to operate efficiently to bring down fees.

Sponsors of Section 529 plans have flatly rejected this model for fee disclosure. Fees for many Section 529 plans are extremely obscure. Section 529 plan sponsors argue that fee disclosure should be voluntary and left to the markets. The disclosure principles, for example, proposed by the College Savings Plan Network strongly emphasize that "the guidelines are not intended to suggest that alternative disclosure practices may not be acceptable or a comprehensive list of disclosure matters that must be addressed in connection with Section 529 plans in order to fulfill their responsibility of State issuers to their account owners."

As long as obscure fee disclosure is an acceptable alternative to transparent fee disclosure Section 529 plan fee disclosure will not promote price competition and thereby reduce fees. Section 529 plan sponsors that charge high fees have a strong disincentive to provide standardized disclosure that will only put them at a disadvantage to their low-cost competitive. It is essential that Section 529 plan fee disclosure be mandatory.

Congress should also consider addressing high fees by limiting certain fees. Mutual fund sales charges are already subject to

[1] The prepared statement of Mr. Bullard appears in the Appendix on page 123.

NASD rules that limit the amount of sales charges that can be imposed. Section 529 plans should be subject to the same limits.

Limiting sales charges would also reduce high fees while addressing another issue, the issue of questionable sales practices. By bringing sales charges in Section 529 plans into line with mutual fund sales charges, the extra incentive to push inappropriate Section 529 plans over mutual funds would be removed. But this step is not enough. Brokers will still have economic incentives to sell inferior Section 529 plans that pay higher sales compensation, as indicated by Mary Schapiro's testimony earlier this morning. Brokers may receive higher compensation for selling one Section 529 plan than another plan, even though the services provided to the broker's client are the same. The situation exists because we allow investment products to pay brokers to push the product, the functional equivalent of a bribe.

What is even more troubling is that such differential compensation is not required to be disclosed to the investors. Investors should be made aware of the dollar amount of brokers' incentives to recommend one product over another, whether or not it is in the best interests of the client. In addition, Congress should begin to unravel the regulatory structure that effectively requires that sales compensation depend on which product the broker sells rather than the quality of the services the broker provides.

The last issue, disparate State tax treatment, arises from States granting State tax benefits with respect to contributions to in-state plans while denying these benefits for contributions to out-of-state plans. This is not surprising, as Congress has essentially authorized the States to engage in the business of developing and selling financial products and it should be expected that they, like any other enterprise, will seek to gain advantages over their competitors, such as by limiting State tax benefits to their own investment products. This practice distorts market incentives, however, as it may cause an investor to choose an inferior State Section 529 plan that offers a State tax break over a superior out-of-state plan that does not. Congress should consider requiring that States afford equal tax treatment on all Section 529 plans.

This disparate State tax treatment issue is really a part of a broader problem with Section 529 plans. Governments are good at funding public projects, and providing tax breaks for their citizens' education fits squarely within that role. Developing, managing, and marketing financial services products is not something that we should expect governments to do as well as markets. Congress should expect issues like a disparate State tax treatment issue to arise and become increasingly problematic.

By asking State Governments to invest in the infrastructure needed to support Section 529 plans, Congress created a vested governmental interest in their continued growth, regardless of whether the markets continue to believe that Section 529 plans provide an efficient way to save for education. This was illustrated during a recent House subcommittee meeting in June where a State Representative noted that lifetime savings accounts would threaten the viability of Section 529 plans. Congress needs to be especially vigilant in protecting against the distortions in the finan-

cial services marketplace that governmental sponsorship of private enterprise invariably creates.

Thank you again for the opportunity to appear here today. I would be happy to take questions.

Senator FITZGERALD. Thank you.

We are going to have some good basis for questions between this side of the panel and that side of the panel based on all that testimony.

I want to start out asking Mr. McNeela and Mr. Bullard, you both basically seem to go in the same direction I went in my opening statement where I was questioning what benefit we get by allowing the States to run these plans and just charge an extra fee. Is there any benefit that you can see to having the States run these plans? Why can't people go to a mutual fund provider and open a Section 529 plan and cut out this additional layer of fees?

Mr. BULLARD. That is precisely what Congress decided to do with 403(b)s, 401(k), IRAs, Roth IRAs, and Coverdell accounts. The entire list of accounts that have been created for tax-deferred purposes have done that and done it very well. There is absolutely no reason why States should be in the business of creating and developing and marketing these products, thereby essentially putting them in competition with industry.

Senator FITZGERALD. And do all the States charge an additional fee for their services? Mr. McNeela, would you know? Are there any States that don't charge an additional fee?

Mr. MCNEELA. I am not aware of any States that don't charge fees. I know Utah does have a money market option that they provide at no cost to investors, but outside of that, I am not aware of any other State that doesn't charge fees.

Senator FITZGERALD. If I could refer to this chart that I put up earlier [1] and I showed how much better somebody would do if they were in the Utah plan as opposed to the Rhode Island plan, which Ms. Williams pointed out no longer exists, and that is a good thing, but Utah, as I understand it, you are ranked as one of the best year in and year out by Morningstar. Mr. McNeela will confirm that Utah has one of the best plans. They use Vanguard as your underlying fund provider.

My understanding, your total expense ratio is 27.5 basis points. Only 10 basis points of that is Vanguard, am I correct, and another 17 basis points is charged by the State of Utah? Is that correct, Mr. Davis?

Mr. DAVIS. Mr. Chairman, the Vanguard fees can range, depending on the option selected, up to 42 basis points. That is the highest.

Senator FITZGERALD. So you are not just allowing people to invest in index funds? Vanguard's index funds are very low. You have some that have expense ratios as high as 43 basis points at Vanguard?

Mr. DAVIS. Yes, sir.

Senator FITZGERALD. Are they not index funds?

Mr. DAVIS. They are index funds, but not just——

[1] The chart entitled "Value of a $10,000 investment after 18 years," appears in the Appendix on page 165.

Senator FITZGERALD. International index?

Mr. DAVIS. Yes.

Senator FITZGERALD. OK. But is it true that you impose an additional cost on—the State of Utah charges an additional fee on top of whatever Vanguard charges, right?

Mr. DAVIS. That is correct.

Senator FITZGERALD. And how much is that?

Mr. DAVIS. That is $5 per $1,000 of account, up to $25 max.

Mr. MCNEELA. But I believe there is also an administrative fee that is added on, and largely those expenses are to pay for customer service calls, administration of the plan in terms of servicing and sending out the account statements, unless I am missing something, because the Vanguard would just be providing the investment management expertise of the index funds and administering the accounts would be the responsibility of Utah and there would be costs associated with that.

Mr. DAVIS. That comes out of the $25.

Mr. BULLARD. Chairman, just to add to the issue of the extra layer of fees, that layer of fees will exist no matter what economic or regulatory structure is used because the way these work is just like 403(b)s, 401(k)s, and all those other types of investments. All the investments are pooled by some kind of intermediary who keeps track of the accounts. What actually goes into the mutual fund is one large account. So there will inevitably be those costs. And in 401(k)s, employers typically pick them up——

Senator FITZGERALD. Wait a second——

Mr. BULLARD [continuing]. IRAs, you pay an account fee.

Senator FITZGERALD. OK——

Mr. BULLARD. So there is a parallel in all of the privately offered similar——

Senator FITZGERALD. Well, 401(k)s, yes, but I know some of them have expense ratios, total expense ratios as low as 10 basis points, for example. But what would prevent someone from going to—if Congress authorized individuals to open Section 529 plans directly at mutual fund complexes, what would prevent somebody from going into, say, a Vanguard and getting an index fund-based account that had a total expense ratio of 17 or 18 basis points?

Mr. BULLARD. And that is exactly what would happen, but there will be people who live in a market channel where they are going to use an intermediary for whatever investment they make and——

Senator FITZGERALD. They might——

Mr. BULLARD [continuing]. They will get high-cost Section 529 plans——

Senator FITZGERALD. There will be some who go, but now, with the current set-up, you have consumers paying brokerage commissions, loads. You have them paying management fees to the fund complexes. And then you have them paying a fee to the State Governments. I am just trying to figure out what benefit the State Governments bring for their additional fees. Now I will let the Treasurer defend this.

Ms. WILLIAMS. Mr. Chairman.

Senator FITZGERALD. Yes.

Ms. WILLIAMS. Can I just make one statement? First of all, if an individual were to go to a mutual fund company and attempt to

open a mutual fund, there is no mutual fund that I am aware of that you could get into for a $15 minimum. Mutual fund companies typically have very high minimums in order to come into many of those funds, and I think the States look at it from the perspective that we are trying to make these programs available to residents of every income level and that is why we establish very low points of entry for people who come into these plans. So I think that many people who are now able to have very small Section 529 accounts would never be able to go into a mutual fund because they simply do not have the initial investment amount that would allow them the opportunity to get into the fund.

One thing I would like to correct that Mr. McNeela mentioned, you do not have to be an Ohio resident to participate in our low-cost options, and I would be happy to provide him with a copy of our offering statement.

Senator FITZGERALD. Mr. Noven.

Mr. NOVEN. I do think there is an importance in having someone that is overseeing what is being done in this area for people who are saving for college that is actually looking out for the consumer. In the State of Illinois, we have been able to add value in a number of ways. One, we have been able to get institutional share classes for investors that they wouldn't get on the street. For 99 basis points in Illinois, that is an all-in fee. There is no account maintenance fees or set-up fees or annual fees, or any other types of additional——

Senator FITZGERALD. Of that 99 basis points, how much is paid to Smith Barney and how much does the State of Illinois retain?

Mr. NOVEN. Smith Barney provides us 5 basis points to administer the program. We have a unique statute that the Treasurer drafted intentionally that any monies that we bring in with the 5 basis points that is above what is needed to actually pay for the expenses of administering the Bright Start program, anything extra, in excess of that, is refunded as a dividend to participants or will reduce the fee of the program. So it is not a money-maker for the State of Illinois.

Senator FITZGERALD. So is your net fee lower than the 99 basis points?

Mr. NOVEN. It will be in the future unless we issue dividends. One way or the other, now that we have had a successful program——

Senator FITZGERALD. OK, but of that 99 basis points, how much—is Smith Barney keeping all but 5 basis points of that?

Mr. NOVEN. Well, out of the 94 basis points that are remaining, all the internal fund management fees are paid out of that. A broker commission is paid out of that, so it is not charged to consumers if a financial advisor sells the product and——

Senator FITZGERALD. It is not possible for a consumer to pay a load——

Mr. NOVEN. No.

Senator FITZGERALD [continuing]. Going in——

Mr. NOVEN. No. Smith Barney pays the load out of their fee because we didn't want consumers that use financial advisors to be treated less well than——

Senator FITZGERALD. Are all the Smith Barney funds that you allow Bright Start participants, are they all index funds?

Mr. NOVEN. No, they are actively managed funds. We actually have some non-Smith Barney funds. We have a lot of control to switch funds and make sure that consumers have funds that are performing and are doing well. We recently put in—actually, now it is probably a year and a half ago—we substituted an MFS fund that on the street would cost a consumer 180 basis points just in the fund management fees, not talking about a sales load or any other added fees, if they bought it on the street. They can get that as part of the 99 basis points through our program. So we have been able to negotiate some benefits for——

Senator FITZGERALD. Why would you allow—I mean, 88 percent of mutual funds, actively managed mutual funds, underperform the market, and they underperform the market almost by the exact amount of their fees. The markets returned, on average, a little bit under 12 percent over the last 20 years, and the average mutual funds returned about 2 percentage points, which is exactly their fees. I mean, why would you even encourage residents to go into an actively managed fund if they are just going to pay higher fees?

Mr. NOVEN. There certainly is the age-old debate as to whether you are wiser to invest in an actively managed product or an indexed product. I think everyone would agree, if you are not looking out for your investments, if you are not an informed consumer, if you don't have a State entity looking out for you and making sure those funds are performing with enough extra benefit to justify the fees, then you would be better off to invest in index funds. We are not a passive investor as the State Treasurer of Illinois——

Senator FITZGERALD. If I invested in a Bright Start index fund, will I pay less than the 99 basis points?

Mr. NOVEN. Well, we don't have an index fund that is currently offered, although we are looking at——

Senator FITZGERALD. There are no index funds that are offered?

Mr. NOVEN. In Bright Start? No, there aren't. We are looking to expand our offerings. I don't want to go down that road, but the Treasurer is——

Senator FITZGERALD. Fidelity's index funds charge 10 basis points now. They have lowered their fees to 10 basis points.

Mr. NOVEN. We have had a fortunate run, Senator, but we are lucky to have outperformed the index, our benchmarks and outperformed what an index fund would have done. Of course, you never know how it is going to look over time, but so far, we have been successful and we are committed to trying to give the best investment product we can to consumers.

Senator FITZGERALD. Mr. Ablowich.

Mr. ABLOWICH. I guess, Mr. Chairman, one of the comments I would make is with regards to active management. While I think that your chart is an accurate mathematical calculation of the value of fees net of expenses and a return, I think one of the other things that we would emphasize in our plan is that we use 100 percent actively managed funds. We also use, which a lot of plans do, so-called age-based portfolios, so that when you first start out investing for your child—and I have a 10½-year-old son that I participate in our plan for. When I opened the account for him when

he was younger, it is much more—it is more heavily weighted in equities and over time it shifts more towards fixed income and cash.

So in your example, let us assume you have a constant 8 percent compounded annual return. But what we think customers are concerned about is not necessarily seeing a straight line up at 8 percent, but as the markets go up and down, capture the up side, but also, when your child is ready to go to college, make sure those dollars are there. You may not be willing to accept the volatility when your child is a junior in high school or a senior in high school when you are waiting to pay tuition perhaps in 1½ or 2 years from now.

Senator FITZGERALD. Your New Hampshire Fidelity Advisor, the sheet that I have, suggests that it has a maximum expense ratio of 130 basis points. Is that right?

Mr. ABLOWICH. That would be for the advisor-sold product, that is right, Mr. Chairman. Again, two products, one advisor-sold, broker-sold plan. There are some people who like working with a broker. The broker will give them that personal advice with regards to the unique plan, or assuming a Fidelity advisor——

Senator FITZGERALD. That includes Fidelity's fee and whatever you take?

Mr. ABLOWICH. Correct.

Senator FITZGERALD. How much do you retain of that 130 basis points?

Mr. ABLOWICH. In the 130 basis points you are looking at there, I am assuming that includes not only the underlying fee on all the mutual funds, but also 30 basis points that is split between the State and Fidelity investments, and there is probably in that number, as well, a trail for the broker that sold the advisor-sold product. Which is standard mutual fund pricing.

Senator FITZGERALD Our Federal mutual fund, the Thrift Savings Plan, would any of you care to guess what we pay in expense ratios——

Mr. BULLARD. I was in it, and it ranges between about 5 and 8 basis points.

Senator FITZGERALD. Yes. It is going to be like 5 basis points for our total expense ratio. It is all index funds. We are lower than any of the private sector index funds out there but you get much lower expenses by going into low-cost index funds. I am just having trouble understanding, other than the tax advantages of having a Section 529 plan, it seems to me if the fees are so high in so many of these, so much higher than just index funds that anybody can go to, why would anybody be in the Section 529 plans but for the tax advantages?

Mr. ABLOWICH. I think one of the issues to consider, Mr. Chairman, is the issue of the active management and an age-based portfolio, that you can't have that security over time. You may be willing to take more risk at the beginning, but for some investors, they are not willing to sit down every year and constantly review their portfolio to make sure they have the right amount of risk given the investment horizon that they are looking for.

So part of that cost, we believe, also goes to help an active management so that over time, you become more conservative, and

again, limit that risk at the end of the period when they are ready to pay for tuition.

Mr. BULLARD. Those lifestyle funds are also available in the private marketplace. There is nothing unique about Section 529 plans that provides you can only get them there. In fact, if Section 529 plans were run like IRAs, you would have exactly the same funds being offered privately.

Mr. MCNEELA. Right. And Utah, primarily using index funds, has age-based options, as well, that get more conservative as the child moves up to college age. So the bulk of that asset allocation decision can be handled easily in the framework of an index fund. The only potential for active management to surpass that is if they made a market call saying that the stock market was highly valued and pulled below to a low level of stocks relative to bonds to kind of mitigate some volatility. But it is questionable about how much benefit there is to that effort.

Mr. BULLARD. If I could just put a face on Mr. Noven's point about protecting the residents of Illinois from high-priced products, Mississippi has a $20,000 deduction for contributions to its plan, but this year, I plan on investing in the Utah plan because I would give back all of that tax deduction in a matter of years because Mississippi's products are more expensive. I wonder how Mr. Noven explains to his constituents why those who choose lower-cost investments—and that would be easy to do at 99 basis points—why they are deprived of the Illinois State tax benefit if they go outside to get a better product than what Illinois is providing, not to mention the fact that Mary Schapiro's testimony shows that your argument is simply failing. We have got 95 percent of these brokers, whether or not the State tax benefit is available somewhere else, going somewhere else.

So the plan isn't working. It deprives people of choice. And it ends up—and it has ended up for me costing me more money because I won't be able to use the Mississippi State tax benefit.

Senator FITZGERALD. If I can defend Mr. Noven, that may not be his responsibility. That is probably our State legislature that enacted the tax laws that penalize you if you go out of State, is that correct?

Mr. NOVEN. What we did in Illinois is we sought to get the tax benefits to our residents when 35 States offered tax benefits to their own residents and it was primarily a state-by-state program. We sought to give those same benefits to our residents that other States got in their home States.

What we have recently tried to do is promote legislation that would give the tax deduction to plans that were low-cost plans. We don't think that the State should, as a government, provide a tax incentive for people to make bad financial decisions by going to the fastest-growing, highest-cost programs in the Nation.

The industry hired lobbyists to kill the bill that would have extended these benefits to other low-cost programs because they don't want the other low-cost programs to get traction. It is truly a consumer issue.

We agree with you. I agree with what these folks are saying, other than 99 basis points being high because that is an all-in fee. That is not one of five different fees that is being charged. And if

you look relative to other programs, it is one of the lowest cost in the Nation.

Senator FITZGERALD. Do you agree with Mr. Bullard's comment earlier that Congress should act to limit the States' abilities to offer the tax benefits only to their own benefits?

Ms. WILLIAMS. Mr. Chairman, can I just say that, coming from a State where we do offer a tax deduction, we feel that it is the State's exclusive prerogative to decide whether they are going to offer a tax deduction and to whom to offer it. Frankly, very few States would be willing to extend a tax benefit to plans over which they exercise no fiduciary oversight.

The other thing is that States lose tax revenues by providing deductions.

Senator FITZGERALD. We require you to give tax benefits for 401(k)s, don't we?

Ms. WILLIAMS. Well, that, I don't know. I can't address the 401(k). I do know that with a Section 529 plan, in Ohio, you can only get the State tax deduction on contributions if you participate in our plan. However, on withdrawal of the funds, the withdrawals are State tax-free and the State allows that consideration for any plan.

So I think the key is for States to provide effective product offerings so that they can be competitive, but I think that States are going to——

Senator FITZGERALD. But they are enacting protectionist legislation protecting——

Ms. WILLIAMS. Well, we certainly aren't——

Senator FITZGERALD [continuing]. Their own State's program from competition.

Ms. WILLIAMS. We certainly aren't, and I think that if these programs, particularly in a time of difficult State budgets, if our State were required to extend State tax benefits to any plan operating in the country, what would end up happening is that the State would withdraw the tax deduction for all plans, which I really think is what some in the industry want. If they can't provide a competitive product and be competitive without the State tax benefit, then perhaps they shouldn't offer a plan. But I think that the State has the prerogative to offer a State tax deduction only for their own plan if they want.

Senator FITZGERALD. Mr. Bullard.

Mr. BULLARD. So what you are telling Ohio residents is, we will give you a State benefit. We really want you to be able to afford college. But we will only give you the State tax benefit if you buy my product.

Ms. WILLIAMS. That is exactly what we are telling Ohio residents, but we have told any Ohio resident that there are a wide variety of options available and we ask that they be very well educated. It is in our benefit as a State in the final analysis if every single child in our State has a Section 529 plan, whether it is ours or another State's, because that means that there are resources available for that child to attend college, and hopefully they will stay in our State and contribute to the economy in our State. So we try to be competitive by offering a very wide variety of product offerings, and by the way, we do happen to have a tax deduction.

Senator FITZGERALD. Mr. Noven, when you mentioned you would like the money to be invested in-state, with Illinois, you appointed Smith Barney as your agent as trustee and they are not based in Illinois. They are part of Citibank and they are based in New York. So the money isn't invested in Illinois, is it?

Mr. NOVEN. Yes, but I don't believe I made that statement. If I did, I didn't mean to state that. Also, to the previous question, if Congress——

Senator FITZGERALD. There is no real benefit when a lot of the States say, we want to keep this invested in-state. The money is really not invested in-state unless you are in New York or Massachusetts or maybe California or Philadelphia, where Vanguard is. In most States, it is not an issue. The money is not going to be invested in-state even if the plan is sponsored by a State.

Mr. NOVEN. We are not talking about those assets actually being invested physically in-state. There are two things about having assets in Bright Start that are important to Illinois consumers. One, we believe it is a tested program. We are looking out for consumers and they are not being charged excessive commissions and fees. They are getting adequate disclosure. The Treasurer is not seeking to get any assets of any individuals in the State if they would do better in their home State because of tax benefits. We are running a consumer-friendly program that we feel good about, so we feel good about having our consumers in it.

Also, there are economies of scale when it comes to college savings programs. We have 100,000 Illinois families that are invested in Bright Start and if Bright Start is raided by out-of-state programs that are entering into this broker bidding war to get brokers to "sell mine, sell mine," then Illinois residents are hurt, and 100,000 Illinois families will be hurt because our program will not be able to be viable unless we compete by paying brokers high fees, and we don't want to enter into that bidding war. We want to have a nice even playing field. We would welcome Congress taking control of some of these issues.

Senator FITZGERALD. How do consumers in Illinois benefit from having to go through the State of Illinois to invest in a college savings plan? And I would ask you that and also Ms. Williams. I mean, why do we need to have the State Governments involved in college savings programs at all?

Mr. NOVEN. If Illinois——

Senator FITZGERALD. Shouldn't you just be able to go online on Vanguard and open your own college savings account and just pay Vanguard's fee and not a fee to the States?

Mr. NOVEN. If Illinois consumers went directly to buy all the funds that are part of Bright Start currently, they would pay higher fees overall than if we hadn't put this program together, we wouldn't have negotiated institutional share classes that were lower using the economies of scale. We are bringing a billion dollars to a vendor. We are able to use, in the same way that we do with our Illinois Funds Investment Program in Illinois that I am sure you are familiar with——

Senator FITZGERALD. States haven't negotiated low fees. Some of them have negotiated awful fees.

Mr. NOVEN. Right.

Senator FITZGERALD. The Rhode Island J.P. Morgan Higher Education Fund, 4.75 percent sales load, 135 basis points annual expense ratio, annual fees. You get clobbered in some of them.

Mr. NOVEN. We agree, and those are the programs that we are unwilling to provide our tax benefits to and give consumers an incentive to join, because those are the types of programs that are not a good deal for Illinois consumers.

Senator FITZGERALD. But will you provide your tax benefit——

Mr. NOVEN. To Utah? Absolutely. We tried to. We tried multiple pieces of legislation that would have given the tax benefit to people who invest in Utah. It is a wonderful program. It has got good fees. People should——

Senator FITZGERALD. The legislature defeated it?

Mr. NOVEN. Yes. Well, the brokerage industry defeated it because they want to sell that plan over there that is on your chart and they don't want to——

Senator FITZGERALD. Has anybody seen patterns of the brokerage industry coming in trying to—Mr. Bullard, would you——

Mr. BULLARD. I mean, that is exactly what I would expect them to do. But, in fact, whether or not you provide your in-state tax benefit to those out-of-state plans, the brokers are going to sell the out-of-state product and so that theory is not succeeding. All you are really accomplishing is the people in Illinois who want to buy a better plan, that is, the Utah plan, are unable to do that and get the same State tax benefit that those who invest in your high-cost plan, your 99 basis point plan, get.

Mr. NOVEN. Some day, I would like to sit down with you and talk about fees and show you what our fees are so we can all talk from the same——

Mr. BULLARD. The best thing that a State——

Mr. NOVEN [continuing]. But I would like to say, as a fiduciary, as State Treasurer, we feel an obligation not to provide a financial incentive to make it easier for brokers to put people in a plan that is not in their best interest and I think the Treasury has an obligation to do that as a policy maker.

Mr. ABLOWICH. Mr. Chairman, one thought I had for you is that when we are talking about broker-sold programs in the Section 529 area, the pricing is really not that much different than broker pricing for any other mutual fund product. I know that your Subcommittee has worked, discussed this issue of the mutual fund industry and fees and governance and oversight and transparency. The National Association of State Treasurers and CSPN has a long history of supporting thoughtful efforts in this area.

To the extent that those efforts are successful and costs come down and transparencies improve, all of those benefits are ultimately passed on, as well, to Section 529 investors, as well. I think that is important to mention, because this pricing that you are talking about exists today not just in Section 529, but in retirement plans and so on.

The other thing I would offer is that we heard from the NASD that they are investigating and gathering information about questionable broker practices. At this point, we don't have any specific instances of where brokers are making unsuitable, or not taking into account the suitability of investors. But to the extent that

there are those documented cases, I welcome—and I know all of my colleagues do—getting that information so that we can work with our plan administrators.

And then also when I go back to Concord, I can walk upstairs to see our State Securities Regulator and ask him or her, is this something that we should be—what are you doing in this area? Here is something you should be aware of, as well, because those State Securities Regulators are typically on the front line of working with those individual investors. So that is another important point I wanted to bring up for your information.

Ms. WILLIAMS. Mr. Chairman, can I just say that I think one of the things that the States do, long before the savings plans were offered, we worked to offer a prepaid plan. We have a full-service organization. We have marketing representatives who live in various regions of our State who work with very small organizations. Increasingly over the years, we have decreased the average age of enrollment in our plan to 5 years of age. We work with over 2,000 employers in our State to offer payroll deduction because we believe that small investors should have access to these investments, as well.

Unfortunately, with the high minimum entry in most of these mutual funds, the average consumer would never have the opportunity to participate in these mutual funds were it not for the fact that we allow them to get in with as little as $15. That has been the fact since we first started our savings program and we are going to continue to require that people be able to get in with as little as $15 and can save as little as $15 a month if they want to do it in a systematic way. They could not do that if they were enrolling directly with a mutual fund company.

Senator FITZGERALD. What about the disclosures, or the lack of disclosures, in the Section 529 area? We have had repeated testimony that the State Governments as trustees of these plans are exempt from the Investment Company Act of 1940 and don't even have to make the minimal disclosures that ordinary mutual funds have to make. How do the Treasurers feel about that, Mr. Noven.

Mr. NOVEN. Go ahead, Mr. Ablowich.

Mr. ABLOWICH. I think that the disclosure principles we put together are certainly a very important first step. They are not going to be perfect. That is why we have asked the NASD—well, we haven't asked the NASD—the Securities and Exchange Commission and the MSRB to comment on what was prepared to get their feedback. Even before we received their feedback, around 30 States have already started adopting these principles and incorporating them into their disclosure documents.

Senator FITZGERALD. Do these principles require a dollars and cents disclosure, or are all the expenses stated in percentage terms?

Mr. ABLOWICH. They are used in dollars and cents disclosure, Mr. Chairman.

Senator FITZGERALD. They are? OK. That is good. Mr. Bullard.

Mr. BULLARD. They provide for dollar disclosure of dollar fees. They do not require a dollar disclosure of individualized costs and expenses that you are paying. They include an example that is

similar to the mutual fund example on a hypothetical investment, but not individualized cost disclosure.

Senator FITZGERALD. Mr. Noven, did you have something to——

Mr. NOVEN. I was going to say, we support the work that the College Savings Plan Network is doing on these disclosure requirements but we think they need to be mandatory. We think they need to go further. The Treasurer feels especially strong about disclosing the fact that there may be tax benefits that a resident may be giving up, so that people know that. We have that notification in our glossy brochure, not on page 85 of a program disclosure statement. We feel very strongly about disclosure. We think it is a great first step. We should go even further.

Senator FITZGERALD. I would like to let Mr. McNeela have a chance to talk for a second.

Mr. MCNEELA. Just from my perspective, it is hard for investors to have confidence that they are getting all the information they need when the disclosure requirements are voluntary and the fund company or the plans can choose to follow some of the requirements that are recommended but ignore others at their discretion. It makes very little sense to me to allow that situation to exist.

Senator FITZGERALD. You have prepared a chart that is available on the Morningstar website,[1] apparently, that discloses the fees for Section 529 plans, and you have the program manager's fees on the left and then the expense ratio on the right. Are the program manager fees the fees paid to the State Governments? Do they include the expense ratio charged by the underlying fund manager?

Mr. MCNEELA. The program manager fees typically do not include underlying fund fees, but they can include broker compensation in the form of 12b–1 fees.

Senator FITZGERALD. OK. Where it says the Alaska John Hancock Fund charges a maximum program manager fee of 165 basis points, is that in addition to the maximum expense ratio of 130 basis points?

Mr. MCNEELA. Yes, it is.

Senator FITZGERALD. It is? So we are up to, like, 3 percentage points in total fees on that fund?

Mr. MCNEELA. It is not always appropriate to add maximums and maximums together because sometimes they will give you a discount on one or the other, but yes, that sounds possible that total expenses could be well in excess of 2 percent if a B or C Class share was sold which had large 12b–1 fees, administrative fees, and underlying fund fees, as well.

Senator FITZGERALD. Now, on the Illinois Bright Start plan, they list a program administration fee at 99 basis points, but then they say an additional 65 basis points is paid in expenses?

Mr. NOVEN. That is incorrect. That is an error in the chart.

Mr. MCNEELA. And that was my qualification—I am sorry, if I could just talk to that for one minute—where Illinois has a flat fee of 99 basis points regardless of——

Senator FITZGERALD. And that includes the expense ratio——

[1] The "529 Plan Information" chart from the Morningstar website appears in the Appendix on page 167.

Mr. MCNEELA. But they also make an effort to break out the costs for underlying fund fees and administrative fees and those vary depending on the investment options, but the total always comes out to 99 basis points.

Senator FITZGERALD. So even if you invest in a lower-cost fund, you will still pay 99 basis points?

Mr. NOVEN. You are paying 99 basis points to invest in a fund that is usually 180 basis points on the street, but you are also paying 99 basis points to invest in a fund that may be 65 basis points on the street because there are the extra administrative fees that are charged by the vendor to comply with the IRS regulations.

Senator FITZGERALD. But it is always 99 basis points and no other charges?

Mr. NOVEN. Right, and we thought that was the best way to disclose fees to consumers, to not have a $30 account maintenance fee that is paid every year. If you have a small balance, that is a huge percentage. So all those other little expenses that consumers may not be aware of that they are going to get socked with going forward——

Senator FITZGERALD. Now, you disclose the 99 basis points. Do you disclose it in dollars and cents? Do you explain the impact of the fees paid by consumers over time? Do you show them how much their savings erode over 18 years of investing by paying those fees?

Mr. NOVEN. We certainly incorporate that into the discussion, and we are very interested in——

Senator FITZGERALD. And if I am in Bright Start, do I get an annual account statement?

Mr. NOVEN. And monthly statements and regular reporting.

Senator FITZGERALD. And monthly statements?

Mr. NOVEN. Yes. And we will be glad to give you copies of what we do. We are very proud of the way we do it and how we disclose information. We would be glad to share it with you.

Senator FITZGERALD. That would be very expensive to send monthly statements.

Mr. NOVEN. We have a vendor that is required to do that.

Senator FITZGERALD. Solomon Smith Barney is required to do that, but that adds to their whole—they probably charge you more.

Mr. NOVEN. Well, we believe we negotiated a good contract.

Senator FITZGERALD. All right. Ms. Williams.

Ms. WILLIAMS. I would just say that I think that a lot of States have made a lot of progress in this matter. In fact, we do have one page in our document that shows what all the program fees and expenses are.

I appreciate Morningstar and other organizations who are looking at these matters, but I guess my concern is how frequently is the data updated to reflect changes in State programs? I know that in June, Mr. McNeela and I had a conversation regarding where they get their information in order to be able to display it and how often it is updated. So I think it is a good thing and I think that will put pressure on States to make sure their information is accurate. I just want to make sure that the information is reflected accurately and is up to date.

It is in the best interest of the State to make sure that they adhere to these disclosure guidelines and, in fact, that they go beyond the voluntary disclosure guidelines, because clearly, as it becomes easier to compare plans, their plans are going to suffer by comparison if they have made it very difficult for people to be able to find the information they need to make a valid comparison.

So my only request would be that information is timely and up to date and accurate, because many times, articles have been written, comparisons have been made, and information is simply not accurate, and that has accrued to the detriment not only of the State programs, but also consumers who are trying to make valid comparisons and who often find themselves paralyzed into doing nothing regarding savings. All the while, college expenses continue to escalate.

Senator FITZGERALD. You don't want to ever offer a bad plan because it will stay with you forever, hang out there on the Internet and people will see it, even if you have withdrawn a bad plan.

Ms. WILLIAMS. That is right.

Senator FITZGERALD. So maybe the lesson is never to offer a bad plan. But listen, all of you have been terrific. I posed some tough questions—Mr. Davis, do you have something to add here?

Mr. DAVIS. One comment, Mr. Chairman. As I sat here between crossfire on my left and right, I thought about your question, what do States add, and I think it is important for you to know that there are a fair number of middle- and low-income people in our State who have not been served and are not currently served by the free market of the Smith Barneys and the Fidelities of our Nation who are now saving. We are working on that and we are seeing a tremendous support of that. The fact that we have put together a fairly decent program cost-wise which has drawn a fair number of out-of-state investors, we are seeing much more progress in the State, which the intent of the Board was to accomplish. And so that is where our success comes from.

Senator FITZGERALD. Do all of your States competitively bid out your asset management?

Ms. WILLIAMS. We certainly do, yes.

Mr. NOVEN. Yes.

Mr. ABLOWICH. Yes. For the record, yes.

Mr. DAVIS. We manage internally.

Senator FITZGERALD. You manage—well, you have Vanguard, though. How did you select Vanguard?

Mr. DAVIS. The State Treasurer has dealt with them, among others——

Senator FITZGERALD. Is there a bidding process or a request for proposal or how did they do that?

Mr. DAVIS. We piggybacked on the State Treasurer's contract initially and have stayed there.

Senator FITZGERALD. OK. In Illinois, I understand you are about to rebid?

Mr. NOVEN. We are bidding an advisor-sold plan. We are concerned that consumers that work through financial advisors are not being offered a low-cost, low-commission, quality program that would suit their needs. We are concerned that most of the broker-

age commissions that are being paid—everyone has risen up to the 5.75 percent, all trying to jockey for position——

Senator FITZGERALD. What percentage of your participants pay a brokerage commission?

Mr. NOVEN. Well, none of our participants pay a brokerage commission——

Senator FITZGERALD. They can't.

Mr. NOVEN. They cannot. Smith Barney absorbs that.

Senator FITZGERALD. OK.

Mr. NOVEN. But a lot of folks that go to brokers that do not want to sell the Smith Barney product, they do want to have a product to sell consumers in Illinois, their consumers that work with them, and if we could find a consumer-friendly advisor-sold plan, we think we would be providing a real service to Illinois consumers. So we are looking at that, as well.

Senator FITZGERALD. So most people are still going to their brokers to figure out where to get one of these, and they don't realize that their broker is going to get paid a fee out of their savings in order to steer them into a plan.

Mr. NOVEN. A very large fee, right.

Senator FITZGERALD. Yes, but now, will that change as the SEC is now going to require a statement at a point of sale?

Mr. BULLARD. As currently proposed, it wouldn't include any reference to the State tax advantages. But it is simply unrealistic to think that a broker is going to give up any compensation at all in order to recommend an Illinois product. I mean, it is just not going to happen and it is not realistic to think that has any kind of deterrent effect.

Mr. NOVEN. We actually have a lot of selling agreements with a lot of folks and there are—while I share his skepticism about brokers, there are a lot of brokers who are doing the right thing, using a low-cost college savings program as a way to build trust with the client and make money off of other products. We actually think that is the right way to go. We are not going to be competing with the most expensive plans in the Nation because they will follow the money, but there are a core group of brokers that we believe will do the right thing——

Senator FITZGERALD. Vanguard is the second largest mutual fund in the country. It has done that largely by having the lowest cost. When John Bogle was the Chairman, the company never advertised. It is much younger than Fidelity, which goes back to the 1940's. Bogle founded Vanguard in the 1970's, and it grew to the second largest just on word of mouth, because of having the lowest fees.

So if your fund is really a good deal and it is going to get high rankings from Morningstar, consumers will figure that out, won't they? Even without brokers and without paying loads, you will have money migrate to your fund.

Mr. NOVEN. If consumers would figure it out on their own—I think brokers talk them out of that when they go into their office frequently. If consumers would figure it out on their own, the largest programs in the Nation right now would not be the ones that charge consumers the most money. We don't think the system is working, which is why we are excited about——

Senator FITZGERALD. What is the largest right now in the country?

Mr. NOVEN. I think Virginia is the largest one. I think they have got something like 7——

Senator FITZGERALD. But that is a pretty good plan, at least according to Morningstar, isn't it?

Mr. MCNEELA. It is a broker-sold plan, but it is a quality plan with terrific investment choices and flexibility.

Senator FITZGERALD. Who is the underlying manager?

Mr. MCNEELA. The American Funds.

Senator FITZGERALD. OK. And Nevada also has a top plan, doesn't it?

Mr. MCNEELA. Right. Nevada primarily uses Vanguard, at least for one of their plans.

Mr. BULLARD. Mr. Noven's point really just tells us that most people buy through intermediaries, so logically, the plans that use intermediaries are going to be the largest.

Senator FITZGERALD. OK.

Ms. WILLIAMS. Mr. Chairman, about half of our State residents have purchased directly from our agency and the other half have used financial intermediaries.

Senator FITZGERALD. Maybe we should just cap what kind of a load or commission can be paid to the brokers.

Mr. BULLARD. Well, the first step would be to apply expressly to brokers of Section 529 plans the NASD limits——

Senator FITZGERALD. Which are?

Mr. BULLARD [continuing]. Which MSRB cannot legally do.

Senator FITZGERALD. Right. So there is no limit now.

Mr. BULLARD. Well, the MSRB can impose a fair and reasonableness standard, but they can't expressly state that we always consider that to be the NASD limit. So there are going to be cases where——

Senator FITZGERALD. If a fee is paid, if a load is paid to a broker, say a 6 percent load, is that disclosed to a Section 529 purchaser?

Mr. BULLARD. Not in dollars, but, of course, that is also true for mutual funds and the SEC proposal will, one way or another, address that in both contexts.

Senator FITZGERALD. And require a dollar——

Mr. BULLARD. Both for Section 529 plans and for mutual funds.

Senator FITZGERALD. OK. But right now, there is technically no limit on the load?

Mr. BULLARD. Technically, no limit other than the MSRB's fair and reasonable standard.

Senator FITZGERALD. Unbelievable.

Mr. NOVEN. We tried that in Illinois. We tried to provide a tax benefit to any State that would agree to charge a load that was under a certain cap. It was a 4 percent cap, and we thought that was a reasonable amount of compensation for a financial intermediary. That is what brought all the brokers out of the woodwork and that is why there is a fleet of lobbyists working on the issue in Illinois. You should see how full our conference room was after we tried that in Springfield. It is a hard issue to tackle.

Senator FITZGERALD. OK. All right. Well, thank you all. You have been great——

Mr. BULLARD. Chairman, if I could just take a second——

Senator FITZGERALD. Yes.

Mr. BULLARD. I don't know if I will be back here by the end of the year, but I wanted to thank you for your leadership on financial services issues, especially over the last 12 months or so, and hope that you will continue the battle—either rejoin the Illinois Senate race or continue the battle outside of your tenure here in the Senate.

Senator FITZGERALD. I am hoping somebody takes up the issue after I am gone, and my last day is January 2, but I certainly appreciate the help you supplied, Mr. Bullard. You were a great witness a year ago at this time, and I do think our hearings on high fees led to some of the fund complexes lowering their fees, as we have seen. That will, over time, result in a lot more money for savers.

I want to thank all the witnesses today. I would like to mention that Senator Akaka, the Subcommittee's Ranking Democratic Member, wanted to be here but was unable to attend. He will submit a statement for the record.

[The prepared statement of Senator Akaka follows:]

PREPARED STATEMENT OF SENATOR AKAKA

Thank you, Senator Fitzgerald for your continued leadership in helping Americans understand more fully the opportunities and risks available to them as investors. As a father and grandfather, I know the considerable burden facing young people and their families when it comes to financing college educations. As a former educator, I believe that investing in an education is one of the most important investment an individual can make.

In response to rapidly escalating college tuition costs, Congress amended the Tax Code in 1996 to create tax-advantaged programs to help families save for college. These programs are called 529 plans after the section in the Tax Code. One of the programs is a college savings plan. These plans offer investors the opportunity to contribute to a trust fund and accrue tax-free interest if funds are withdrawn solely to pay for education expenses of a selected beneficiary. Qualified 529 college savings plans are sponsored by states which may directly administer their plans or select companies to manage the funds.

These state-sponsored savings plans offer families and individuals the ability to save for education expenses at any accredited public or private educational institution, including colleges, universities, law or medical schools, and most community colleges. Earnings accumulate on a tax-deferred basis and distributions used for qualifying education costs are tax-free. Non-qualifying distributions are subject to a ten percent federal tax penalty and possible state tax liabilities. As with other investment vehicles, investors pay assorted fees to cover account costs, and the plans provide no guarantee of a specific rate of return.

Recently, the true costs of 529 college savings plans have generated substantial attention. Many individuals have questioned the basis of plan fees and whether these fees diminish the tax benefits of the plans. Moreover, because the plans are not governed by federal investment or securities laws, there is inconsistent oversight and lack of transparency associated with these plans which has further elevated public concern. This situation is similar to the problems the Subcommittee examined in the mutual fund industry.

I firmly believe that transparency and accountability must be a priority of the investment industry. Brokers and investment employees should disclose the costs and terms of the products they sell and provide a potential investor with the information needed to make informed decisions. An accurate assessment and picture of investment costs and returns should remain paramount.

Because 529 college saving plans are state-sponsored and not regulated under federal securities laws, the Security Exchange Commission (SEC) cannot require the same registration and reporting requirements that exist for mutual funds. However, six months ago SEC Chairman William Donaldson formed the Chairman's Task Force on College Savings Plan to examine the structure and sale of the plans, and I look forward to this review.

There are questions to be asked: Should federal securities laws govern some aspects of 529 plans because investors now face inconsistent disclosure policies that may result in unforeseen fees? How do states select plan managers, and how are fees and costs to investors allocated?

Moreover, as long as investors in a college savings plan may opt to purchase a plan offered by a state where he or she does not reside, consumers must be able to compare different state plans in order to make informed investment decisions. Due to the complex nature of these plans and the lack of meaningful disclosures, I believe there should be strong financial literacy and investor education programs. Such programs are necessary so that investors may choose the plan that best meets their financial situation and savings goals. Furthermore, promoting transparency will undoubtedly enhance the financial benefits of these plans and the educational opportunities they put within reach of plan recipients.

I look forward to working with Senator Fitzgerald and our colleagues to help investors better understand 529 college savings plans. I also wish to thank today's witnesses for sharing with us their concerns and recommendations.

Senator FITZGERALD. The record will remain open for 1 week, until next Thursday, October 7.

With that, this hearing is adjourned. Thank you all very much.

[Whereupon, at 1:05 p.m., the Subcommittee was adjourned.]

APPENDIX

Testimony of Steven T. Miller
Commissioner, Tax Exempt and Government Entities Division
Internal Revenue Service
before the
Senate Committee on Governmental Affairs
Subcommittee on Financial Management, the Budget, and International Security
September 30, 2004

Thank you Mr. Chairman for the opportunity to testify regarding Qualified Tuition Programs ("Programs") described under section 529 of the Internal Revenue Code. Today I will divide my remarks into two parts, first outlining the tax rules relating to these Programs and secondly, explaining how we at the Internal Revenue Service interact with the Programs.

Tax Rules Relating to Qualified Tuition Programs

Legislative Enactment

During the late 1980s and early 1990s, certain states formed prepaid tuition and college savings Programs. There was uncertainty about their treatment for federal income tax purposes. In 1996, Congress took action to clarify the tax rules, enacting section 529 of the Internal Revenue Code as part of the Small Business Job Protection Act. Section 529 was then amended by the Taxpayer Relief Act of 1997 to, among other things, provide special estate and gift rules for these Programs. The Service and Treasury issued proposed regulations providing further guidance on the operation of section 529 in August, 1998.

The statute was again amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) to accomplish three changes. First, the amendments made the earnings portion of a distribution nontaxable if the distribution is used for qualified higher education expenses. Second, the amendments allowed private Programs to be established under section 529. Third, the amendments changed the requirement for imposition of a more than de minimis penalty on withdrawals not used for qualified higher education expenses into a ten percent additional Federal tax on earnings. The Military Family Tax Relief Act of 2003 further amended the rules affecting the taxation of distributions.

The provision that provides that earnings withdrawn from section 529 savings to pay for qualified higher education expenses are free from federal tax is scheduled to lapse at the end of 2010 unless renewed by Congress. The Administration has proposed permanently extending this provision.

The Service has issued additional guidance in the form of Notices 2001-55 and 2001-81, and has a pending project to complete work on implementing regulations.

Legal Requirements to be a Section 529 Program

Section 529 of the Internal Revenue Code exempts "qualified tuition programs" from federal income tax. To be described in section 529, a Program must meet a number of requirements.

Established and Maintained. The Program must be established and maintained by a State, or agency or instrumentality of a State, or by one or more eligible educational institutions (i.e., post-secondary institutions that are described in section 481 of the Higher Education Act of 1965 and are eligible to participate in federal financial aid programs under Title IV of such Act). Thus, the Program may either be a State Program or a Program established and maintained by eligible private colleges and universities.

Pre-Paid or Savings Programs Allowed. State Programs may be either prepaid or savings Programs. Programs established by eligible private colleges and universities must be prepaid Programs. Under a prepaid Program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the designated beneficiary to a waiver or payment of qualified higher education expenses. Under a savings Program maintained by a State, a person makes contributions to an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. The balance may go up or down over time depending on how the account is invested.

Named Beneficiary and Certain Trust Requirements. A specified individual must be designated as the beneficiary at the commencement of participation in a Program. There is an exception to this rule in the case where a State or local government or a tax-exempt organization purchases an interest in a Program as part of a scholarship program. In addition, Programs established and maintained by eligible educational institutions must also hold contributions in a qualified trust for the exclusive benefit of designated beneficiaries.

Limitation on type of Contribution. Contributions to a Program account can be made only in cash.

Separate Account Rule. A separate accounting is to be made for each designated beneficiary.

Limitation on Ability to Direct Investment. Contributors and beneficiaries are not allowed to direct the investment of contributions or earnings. A Program does not violate this requirement if a participant is permitted to select among

different broad-based investment strategies designed exclusively for the Program. The Service has taken the position in guidance that this selection is permitted at the time contributions are made to the account, upon a change in beneficiary, and once per calendar year.

No Transfers of Interest. An interest in a Program account may not be used as security for a loan.

Limitations on Amount that can be Contributed. The statute provides that a Program must have adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. In the case of a State Program, such safeguards require the consideration of all accounts, both savings and prepaid, maintained within the same State for such beneficiary.
There is no statutory dollar limitation. A safe harbor was provided in the proposed regulations (Federal Register, Vol. 63, No. 163, August 24, 1998) permitting contributions until the account balance reaches the amount necessary to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the Program.

Treatment of Contributions

Contributions to a Program account are not deductible for federal income tax purposes. Whether or not a deduction is available on a contributor's state income tax return depends upon state law. State law varies but a full or partial deduction may be permitted on some State income tax returns for amounts contributed to a State Program.

Special estate and gift tax rules apply to contributions to a Program account as well as to changes in the designated beneficiary of the account. For gift tax purposes, a special statutory election permits a contribution that would have exceeded the annual gift tax exclusion amount to be treated as if made ratably over 5 years, beginning in the year the contribution is made. For example, since the annual exclusion amount for 2004 is $11,000, an individual may contribute $55,000 in 2004 to a Program account on behalf of a designated beneficiary without incurring any gift tax liability.

Treatment of Distributions

As stated, earnings on contributions to Program accounts grow tax-free. Distributions from Program accounts are not taxed to the beneficiary if the distribution is used to pay qualified higher education expenses of the beneficiary. As indicated earlier, this tax free treatment was provided under EGTRRA and expires after December 31, 2010. Distributions that are made on account of the death or disability of the beneficiary, or the receipt of a scholarship by the

beneficiary, or made on account of the attendance of the beneficiary at a United States Armed Forces or Merchant Marine Academy (to the extent the distribution does not exceed the amount of the scholarship or costs of the advanced education) are subject to federal income tax to the extent they represent earnings on contributions. Earnings on all other non-qualified distributions are subject to federal income tax and an additional 10-percent tax of the amount included in income. In all cases, the portion of a distribution that represents a returned contribution (i.e., basis) is not taxed as income.

The statute permits the designated beneficiary of an account to be changed to certain family members without triggering federal income tax. The statute also permits certain distributed amounts to be transferred within 60 days to another Program account for the benefit of the same beneficiary or a family member without triggering federal income tax.

Special estate and gift tax rules apply to distributions from a Program account as well as to changes in the designated beneficiary of a Program account. The Administration has proposed modifications to the statute in the transfer tax area.

Definition of Qualified Higher Education Expenses

Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution. Certain room and board expenses are also included.

Administrative Treatment of Section 529 Programs by the Internal Revenue Service

Section 529 Rulings Program

State Programs are not required to receive a determination or ruling in order to operate as a section 529 Program. Nevertheless, many state Programs have requested rulings that they meet the requirements of section 529. Even more States have come in to talk to the Service regarding their planned Programs in order to ensure compliance with section 529.

Programs established and maintained by eligible private colleges and universities must receive a ruling or determination that the Program meets these requirements before they are entitled to operate as a qualified section 529 Program.

There is no application form for a ruling under section 529. Programs seeking recognition of status request a private letter ruling from the Exempt Organizations Technical Office in Washington, DC. The focus of attention at the Service is whether the Program's terms meet the requirements of section 529(b). Because

of the wide variety of practices among the various state Programs (section 529 does not require Programs to follow a particular prototype), each request presents unique issues, and we may inform a Program that we cannot issue a ruling that it qualifies as a Program under section 529 until after the Program changes certain aspects of its operations.

Private letter rulings issued under section 529 are available for public inspection under section 6110 of the Code. They are released to the public upon request but without identifying information.

Reporting to the Service, Contributors and Beneficiaries

Reporting to the Service by a Program on its Operations

A Program is not required to file an annual information return (Form 990) with the Service regarding its operations. Affiliates of governmental units generally are exempt from the Form 990 filing requirements applicable to most tax exempt organizations. However, if a Program has unrelated business income, it is required to file a Form 990-T (Exempt Organization Business Income Tax Return). Even if the Programs were required to file Form 990, the Service could not disclose the returns to the public. The disclosure requirements that apply to Forms 990 filed by other tax-exempt entities would not apply to returns filed by section 529 Programs.

Reporting of Contributions and Distributions

A Program is required to provide an annual statement for each account showing the total account balance, the investment in the account (i.e., contributions), earnings, and distributions from the account. In the case of a prepaid program, the total account balance may be shown as credits or units of benefits instead of fair market value.

A Program must also report on Form 1099-Q (Payments from Qualified Education Programs) the earnings portion of any distribution made during the year together with other information such as the name, address and TIN of the person receiving the distribution. A Form 1099-Q is also issued when money is transferred between different Program accounts.

Testimony

of

Mary L. Schapiro

NASD Vice Chairman and President
Regulatory Policy and Oversight

Before the

United States Senate

Committee on Government Affairs
Subcommittee on Financial Management, The Budget,
and International Security

Hearing to Review
529 College Savings Plans

September 30, 2004

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.

[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.

NASD :: Expense Analyzers

http://www.nasd.com/Investor/Smart/529/Calc/529_Analyzer.asp

SMART SAVING FOR COLLEGE

Investor protection. Market integrity. NASD

College Savings Home | Investor Education | NASD

Analyzing 529 College Savings Plan Fees and Expenses

Analyzer Home | Disclaimer | Glossary

You can calculate the costs for one or two 529 college savings plans. Plan 2 is optional but can be used to compare the costs of two similar plans. If you do not wish to calculate the costs of a second plan, please leave all fields under Plan 2 blank.

Please Enter The Following Information:	Plan 1 (Required)	Plan 2 (Optional)
529 Plan Name OPTIONAL: Enter the state, name, or the class of the plan. This is helpful if you print the results.		
Holding Period How many years do you plan to hold the 529 plan?	0 Years	0 Years
Investment Amount Enter the dollar amount of your investment. Do not use dollar signs or commas.	$ 0	$ 0
Annual Rate of Return As a guide, you may want to review a 529 plan's average returns in the plan's disclosure statement, plan brochure or plan description. While these returns typically reflect fees and expenses, including any sales loads, they may help you in determining an appropriate range for a rate of return.	0 %	0 %
Sales Charge (Front-End Load) You may pay a sales charge or front-end sale load when you purchase Class A shares of a plan through a broker or investment adviser. Check the expense section in the disclosure statement or plan description to determine the sales charge.	0 %	0 %
Deferred Sales Charge (Back-End Load) A number of 529 plans include a deferred sales charge. A plan may also include a Contingent Deferred Sales Charge (CDSC), which gets smaller each year you hold your investment until it reaches zero. Check the expense section in the disclosure statement or plan description to determine the deferred sales charge.	0 %	0 %
Enrollment or Other One-Time Fees Some plans may charge an enrollment or other one-time fees when you sign up for a 529 plan. Check the expense section in the disclosure statement or plan description to find the enrollment fee.	$ 0	$ 0
Annual Maintenance Fees You may be charged an annual maintenance fee or other yearly fees to hold a 529 plan. Check the expense section in the disclosure statement or plan description to find any annual recurring fees.	$ 0	$ 0
Does this 529 plan convert? Some plans automatically convert from one class to another. Check the disclosure statement or plan description to determine if the plan converts.	○Yes ○No	○Yes ○No

Click Here To Continue >>> Continue Reset Form

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.

Testimony of Ernesto A. Lanza
Senior Associate General Counsel
Municipal Securities Rulemaking Board

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

---

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

---

[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]

---

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]

---

[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

(continued . . .)

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

---

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

---

[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.

* * * * *

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.

Testimony of

New Hampshire State Treasurer Michael Ablowich

regarding

Section 529 College Savings Plans

before the

United States Senate Committee on Governmental Affairs

Subcommittee on Financial Management, the Budget, and International Security

September 30, 2004

Mr. Chairman and Members of the Committee, my name is Mike Ablowich. I am the Treasurer of the State of New Hampshire, trustee of the UNIQUE College Investing Plan, the Fidelity Advisor 529 Plan, both of which are sponsored by our state. I am also a member of New Hampshire's College Tuition Savings Plan Advisory Commission, and a member of the College Savings Plans Network (CSPN), which is an affiliate of the National Association of State Treasurers. CSPN coordinates states' college savings efforts by harnessing the collective resources of the states to improve industry practices and develop self-regulating policies.

It is my sincere pleasure to be here today to speak with you about 529 college savings plans, the State of New Hampshire's perspective and philosophy regarding these plans, and how states are making them successful.

The states have been working with Congress for over a decade to increase access to college by helping families overcome one of the greatest barriers to college – the ever-increasing cost of sending a child to college. This successful partnership culminated in the enactment of the tax exemption for qualified distributions from the plans in the Economic Growth and Tax Relief

Reconciliation Act of 2001. Since 2001, these plans have grown tremendously, and we appreciate Congress' vision and leadership in enhancing the ability of the states to build the college savings plans, which in turn makes higher education more affordable and accessible to families. You should know that our shared vision is being realized every day as 529 plans in all 50 states continue to help families achieve the dream of a college education. Families in record numbers are putting their hard-earned dollars in 529 plans, and that commitment is paying off. More than 400,000 students nationwide already have used their 529 resources to pay for college, and nearly seven million more are waiting to use their accounts when they go to college.

New Hampshire's story is no different.

We began offering 529 plans in 1998, and since then, residents in New Hampshire and other states have responded to 529 plans with excitement and enthusiasm. More than $3.3 billion has been invested in our two programs combined. That high level of response is even more amazing when you consider that we started these plans a couple years before one of the most challenging financial markets in history. Investors clearly understand the need for higher education and the need to save early and regularly in a tax advantaged account. Of course, while periodic investing strategies do not guarantee a profit or protect against a loss in a declining market, investing in a federal income tax-free vehicle, like a 529 plan may be one of the simplest and best ways for families to start saving for college.

Our 529 program is built on the foundation of putting the investors and beneficiaries first. We make every program decision with the interests of our investors placed first. And while we

maintain outstanding relationships with our private-sector partners, our first priority is always to our investors, the plan participants. That is why New Hampshire currently has two 529 college savings plans to choose from. Each offering investors a different method of deciding on which investment options are best for them. We sponsor the UNIQUE College Investing Plan which is sold directly to investors and the Fidelity Advisor 529 Plan which is marketed to investors through intermediaries like financial planners. Both plans give investors a wide range of 529 college savings options to satisfy their college savings goals. Our retail UNIQUE Plan is designed with smaller investors in mind. For these investors they can get started with as little as $50 with $50 monthly contributions, or for a one-time contribution of $1,000. It is our goal to offer solid investment choices to attract a wide range of investors with varying risk tolerances and investment philosophies.

We believe our approach is working, with over 332,000 accounts opened since we opened and new investors joining daily.

The Public Policy Behind 529

The states long recognized the need to foster saving for college, which is economically more sound than borrowing, both for families and for institutions of higher education. Beginning in the late 1980s, the states established tuition savings programs to encourage families to save for college, leading the way in meeting the needs of families to save for college by developing innovative plans to reach families of every income level and in every community. The mission of the state college savings plans, whose existence predates the passage of Section 529 of the

Internal Revenue Code, has always been to increase access to higher education by offering families a simple, safe, affordable and dedicated way to save for college tuition. In 1996, Congress recognized the need to develop supportive federal policies to encourage and empower more Americans to save for college. Today, 529 plans are shining examples of how good public policy can enhance the futures of many Americans. My passion and my interest in the 529 program is the same as yours — to foster a savings ethic and help all families save for a college education.

So what is the challenge that families face to send their children to college? The frequent headline in newspapers across the country says it all: "Cost of college rising again." While families continue to take advantage of the 529 plans, they see the cost of college rising steadily every year. Families are doing financial back-flips to meet this rising cost. Many are forced to rely heavily on debt to meet their needs. According to the College Board's *Trends in College Pricing 2003*, average annual tuition and fees at a public four-year college in current dollars has increased from $617 to $4,694 since 1976, an increase of 761 percent.

Despite the rising cost, the value of a college education is enormous. To give you an example, median annual earnings for full-time workers with bachelor's degrees are about 60 percent higher than earnings for those with only a high school diploma. Over a lifetime, this gap exceeds one million dollars in earning potential. Further, more and more jobs require technical training and post high-school education.

That is why Congress and the states long have recognized the need to foster a college savings ethic. Today, states design 529 plans to specifically promote future access to higher education for children of all economic means. These plans provide a unique savings opportunity for two-year, four-year, or graduate schools, vocational or technical schools, or any accredited educational institution, and the invested dollars can be used any time in your life.

Everyone talks about the amount of money saved in 529 plans, and it is substantial, but I believe the more important statistic is the number of accounts. I don't care whether people are saving $50 or $50,000, as long as they save. I also am not concerned whether they save in one of our two 529 plans or in another plan, in their name in a traditional savings account or some other method. The important thing is that parents are making plans for one of the most important investments in their lives, their child's education. In New Hampshire, we have worked to develop college savings awareness to ensure that every resident, regardless of income, understands and has easy access to the 529 program and other college financing options.

State Oversight

The states have a legitimate, vested interest in making college more affordable and more accessible for their citizens.

State implementation and oversight of 529 plans has been critical in the growth and success of these programs. We have found that the states' strong role in the administration of these programs add credibility and therefore encourages new investors who otherwise might not have

considered such a vehicle for their college savings needs Each of us who administer such plans is accessible to talk with customers at any time. In fact, when was the last time the head of a mutual fund company went to a local youth sports event and had a fellow parent come up to them and ask them questions about how their investment account was performing for their child. This has happened to me. My neighbors who participate in our 529 plan know where to find me if they have questions or concerns. For this reason I and my colleagues from the other 50 states take our oversight responsibility very seriously.

States have become very innovative in their approaches to attract college savers, using everything from state tax incentives, scholarship programs, matching grant programs, low-cost mutual funds, easy contribution and withdrawal features, online enrollment and account access, and low investment minimums.

In New Hampshire, the Treasurer's office is responsible for our 529 plans, as is the case for many state treasurers around the country. We have been entrusted with looking after the hard-earned dollars of families who are saving for their children's and grandchildren's futures. Our Advisory Commission meets regularly to review plan operations, the performance of the securities markets and performance of each of the portfolios and investment options available to our investors. We have worked hard to ensure that our 529 plans, whether bought directly or through a financial advisor, offer competitive fees that are fully disclosed to all investors. We also spend much time reviewing the performance of each portfolio to insure that investors are earning competitive returns net of fees compared to the appropriate benchmarks. This allows me, and our Commission, to exercise full and effective control over the program as well as

oversee our private-sector program manager. Every significant decision made regarding the program, whether investment-related or administrative, is analyzed and approved by the Commission.

The roles of the Treasurer and the Advisory Commission and the terms of the contract with Fidelity Investments, our plan administrator, have been approved consistent with the process used for all state contracts. This contract, as with all state contracts, was approved as to form and substance by the state Attorney General's office and approved by the Governor and the Governor's Executive Council, again consistent with the process for all state contracts. This level of state oversight of the 529 plans provides an essential layer of protection and accountability for the participants. Our program is governed by state law and administrative rules, ethical standards, and open public records and meetings laws. In addition, both our plans are audited every year by an independent auditor selected not by our Commission or our plan administrator but by the office of director of state audits, who works for the legislative branch of our government. These audited financial statements are then accepted by the legislature in the same manner as any other financial or performance audit contracted for by the state. Each participant in our plans recieves a copy of the annual report, which contains the audited financial statements for each plan and each portfolio within the plan.

I have mentioned some of the oversight activities we perform in New Hampshire to make sure our 529 is the best available option for our state's residents. I would like to now describe to you briefly two important initiatives CSPN is very proud of.

First, in reaction to the recent emphasis on disclosure and transparency, the College Savings Plans Network has undertaken an effort to create voluntary disclosure principles. These principles were adopted in draft form this May at the Network's annual meeting. The National Association of State Treasurers also adopted the principles at its annual conference earlier this year. The goal of the principles is to provide a framework for disclosure so that an investor can easily understand his or her own state plan as well as compare Section 529 plans on an apples-to-apples basis. The principles establish a framework for disclosure, including general matters such as how frequently offering materials are to be updated. More specifically, the principles specify information that should be prominently stated, such as the lack of any state guarantee, the need to consider state tax treatment and other benefits, and the availability of other state 529 programs. The principles also provide tables and charts to provide clear, concise and consistent descriptions of fees, expenses and investment performance. Fees will continue to vary among these plans, as fees differ among all types of investment options. Consumers do not expect to pay the same fees for a completely passive large-cap index fund as they do for an actively managed international equity fund. Nor do they expect to pay the same for a direct-sold investment as they do for a broker-sold product. But the intent of the disclosure guidelines is to make comparing the same types of plans easier. Another initiative of the Network is to continue improving its website

To date, 21 states have begun implementing the principles. More states will implement the principles as they revise their offering materials. Additionally, CSPN is enhancing its' web site to include the disclosure principles as part of each state's information presented on the Network's web site.

Second, we have worked extensively over the past 5 years, in anticipation of the reauthorization of the Higher Education Act to make the impact of 529 plans more rational when it comes to determining a family's eligibility for financial aid. We have been working with many legislators in the House and Senate to make sure that the financial aid rules do not unfairly penalize those families that choose to save in a prepaid tuition program compared to the other options they have for college savings and are hopeful that these changes will be incorporated into the next version of the Higher Education Act.

We are very proud of the voluntary disclosure principles and our efforts to simplify for people the interaction between saving and financial aid. Both are examples of how states can come together on issues of importance to their residents and work together to develop effective solutions to what can be complex issues.

I hope that we can have a dialogue with your committee about the positive aspects of college savings plans. Many improvements have been made over the past ten years as federal and state laws have evolved and state and federal regulators have become more knowledgeable about these investment plans. States continue to improve these plans, as economic and market conditions evolve. These improvements are consistent with the oversight role of the states.

Unfortunately I think the title of your hearing today does a disservice to these many improvements. I know that this committee has spent time discussing the issue of mutual fund fees and expenses and whether those fees and expenses encourage portfolio managers to work in the best interests of investors. You should know that the National Association of State

Treasurers has a long history of supporting thoughtful changes in the mutual fund and investment industry. CSPN and NAST looks forward to the results of the deliberative work of legislators and regulators to examine mutual fund pricing. After all the majority of college savings plans are essentially mutual fund products and the benefits of any industry wide efforts to improve the disclosure of fees and expenses will be passed on to all mutual fund investors of all types including 529 plan investors.

In discussing claims of "disparate tax treatment," it is important to remember that the college savings programs are STATE programs. Many were started before section 529 of the Internal Revenue Code was enacted. Moreover, section 529 requires that these programs be "created and maintained" by a state. The enactment of section 529 has added essential benefits to the states' college savings plans by providing substantial federal tax advantages. The enactment and subsequent amendments have largely been responsible for the tremendous growth in these programs over the last few years. Nevertheless, these programs fundamentally remain state programs. They further the states' public policy of making higher education more accessible and affordable for their citizens. If section 529 were to disappear, state statutes would require us to operate and maintain these programs regardless of the federal income tax benefits.

The state tax treatment of these programs should remain the prerogative of the states. In keeping with the federal/state structure of our nation, each state has created its own program aimed at meeting the needs of its citizenry. In doing so, most of the 43 states with income taxes provide state tax incentives to their residents who choose to save for college through their own state's plan. Approximately 35 of those 43 states provide that their residents will not be subject to state

income tax on any earnings gained through the program when the account is used for qualified education expenses. Many states (26) have provided their residents an additional incentive to save for college by giving a state income tax deduction for at least some of the contribution made into their state's college savings plan.

While providing incentives to save through its college savings program, most states' laws simply do not address the state tax treatment of out-of-state section 529 plans. As a result, in most states taxation of an out-of-state section 529 account owned by a state resident is governed by the state's revenue code generally applicable to similar investments such as out-of state municipal securities or mutual funds.

As of January 1, 2002, however, federal law – the amendments making 529 plan earnings used for qualified expenses exempt from federal income tax -- has had an indirect affect on many states' treatment of out-of-state 529 plans owned by state residents. By state law, many states (34, including D.C.) have chosen to adopt the federal law regarding taxable income. These "conformity" states mirror the federal income tax treatment of section 529 plans. That is, when used for qualified higher education purposes, income from any section 529 plan is not subject to that state's income tax. Of course, if the federal income tax exemption for section 529 plans were to sunset, as scheduled on December 31, 2010, these conformity states would, once again, subject residents' earnings on out-of-state 529 plans to state income tax. The strongest step Congress could take to safeguard these plans would be to repeal the sunset provision and make the favorable federal tax treatment permanent.

On the last point raised in the title of today's hearing, questionable broker sales practices. Although we are aware of the current investigation of broker sales practice by the NASD, I am not aware of any publicized **specific** examples of questionable broker sales practices. In fact, I and my colleagues in the College Savings Plan Network would welcome **specific, detailed** information regarding allegations that brokers are not performing sufficient due diligence for their clients or failing to provide suitable disclosures for the purpose of properly recommending to their clients a college savings plan. If such specific examples exist releasing that information and making it public would be welcome. At this point there are only rumors and innuendo contained in newspaper and magazine articles concerning this issue. If there are in fact inappropriate sales practices I speak for all state plan administrators when I ask for this information to be shared with us so we can properly address this issue with our plan administrators and if appropriate, state securities regulators who are frequently on the front line of protecting individual investors. In fact, our fiduciary responsibilities to program participants and beneficiaries would demand that we act on any such specific allegations of questionable sales practices.

Conclusion

Creating greater access to higher education and encouraging savings over borrowing is sound public policy. 529 plans are designed to improve access to higher education and, through the states' administration of the plans, do in fact improve access. The state 529 plans provide opportunities for investment and savings by low- and middle-income investors, support investor education, and reduce the need for financial aid and loans. In the longer term, the plans provide

our states and nation a better-educated workforce, and help individuals to secure higher-paying jobs. And Section 529 is working: Citizens are investing in these plans in great numbers because they trust that the states are administering them in the best interest of the participants. The public policy goals of the Section 529 qualified tuition programs are foremost in the administrative efforts of the states, and the states are in a unique position to further those goals.

I hope that this hearing is the beginning of a dialogue between NAST, CSPN and your committee to protect and preserve one of the best ways for parents to save for one of the most important investments in their lives, the education of their children. You have my commitment to work with you and the other states to continue to improve the 529 plans and make them the best way for American families to save for a college education. Thank you for the opportunity to be here today. I am happy to answer any questions.

CollegeAdvantage™
A 529 Savings Plan

Written Testimony of

Jacqueline T. Williams
Executive Director
Ohio Tuition Trust Authority

Before the

Subcommittee on Financial Management,
the Budget, and International Security

September 30, 2004

"Oversight Hearing on Section 529 College Savings Plans"

Written Testimony of Jacqueline Williams, Executive Director
Ohio Tuition Trust Authority
September 30, 2004

Mr. Chairman and Committee Members, I'm Jackie Williams, Executive Director of the Ohio Tuition Trust Authority and a member of the Executive Committee of CSPN. (College Savings Plans Network)

I'd like to share one state's perspective on 529 college savings plans. I also hope to correct certain misconceptions highlight the enormous value the plans provide to America's families.

The Ohio Tuition Trust Authority is an independent state agency governed by an 11-member Board comprised of business, higher education and elected leaders.

In 1989, Ohio was one of the first states to offer a 529 qualified tuition plan. The Ohio General Assembly created the Trust to help make higher education more affordable and accessible for all Ohio citizens. Since inception the state provided tax-exempt earnings to encourage early savings.

Only 11 states have fewer residents with bachelor's degrees than Ohio. A recent Governor's Commission Report concludes that the state's economic future depends on increasing participation in higher education.

The goal of the Trust is to offer affordable, accessible, tax-advantaged investment products. The Trust first offered a unit-based prepaid tuition plan designed to keep pace with tuition inflation at Ohio's public universities. The plan enjoyed wide acceptance and market success.

In 1994, the Ohio General Assembly backed and Ohio voters approved a constitutional amendment putting the state's full faith and credit backing behind the plan if it could not meet future obligations.

Ohio's plan fell under 1996 Congressional guidelines establishing "qualified state tuition programs" and adding section 529 to the IRC. Federal changes encouraged more states to offer college savings plans by expanding their ability to offer new investment choices and tax incentives. Today, all 50 states have 529 plans.

Legislation to take advantage of the federal changes was introduced in 1999 and received the unanimous support of the Ohio General Assembly, which approved creating new investment options and adding a $2,000 annual state tax deduction on contributions.

Launched in the fall of 2000, CollegeAdvantage included the original prepaid plan and new actively managed investments.

As the first state to offer both a direct and advisor sold program, we recognized that many savers want investment advice from financial professionals are willing to pay for that advice. There are also "do-it-yourself investors" who want to make their own investment decisions and who want a broad range of low cost options.

With product enhancements and improved distribution, CollegeAdvantage has grown to over 266,000 beneficiaries in Ohio alone. Another factor in the growth of 529 plans was enactment of the 2001 federal tax act. (Economic Growth and Tax Relief Reconciliation Act)

The Act permitted a tax exemption on earnings on funds used for qualified higher education expenses. When the law took effect in June 2001, 1.5 million U.S. children had 529 accounts valued at $9.5 billion. Three years later, 529 plans have become the preferred college savings vehicle with 6.8 million accounts valued at over $54 billion. Unfortunately, unless extended by Congress, the law will expire after December 2010.

For 15 years, the Trust has worked to improve our plan. We routinely conduct market research and communicate with the public to determine what products and features to offer, how to inform and educate, and how to distribute products to a broad cross-section of people.

Each investment manager is selected through a rigorous, competitive process, subject to state procurement laws. Putnam Investments provides actively managed investment products; the Vanguard Group provides passively managed index funds. We recently began working with an Ohio bank to develop 529 banking products. Our goal is to make investment vehicles available to savers at every level of income, education and investment experience.

Families are able to save through flexible contribution methods such as electronic fund transfers (EFT), payroll deduction and online investing. Participants pay no application or service fees. Ohio residents pay no annual account fees and account fees are waived for non-residents saving through systematic investing. A CollegeAdvantage account can be opened with as little as $15.

While total expense ratios vary by investment, our direct-sold plan offers some of the industry's lowest fees with some as low as .35%. Our advisor-sold fees are generally average for advisor-sold, actively managed options.

Enhancing disclosure of fees and performance is a high priority. We fully support standardizing critical expense, investment performance and legal information. Early this year, along with our investment managers, we updated all offering materials to simplify program information. These enhancements are setting an industry standard for disclosure and transparency.

Ohio's program is unique. To date, over 25,000 students have attended college using our plan. While we agree that disclosure should be standardized across the 529 industry, states created these plans and they must be able to shape their plans to meet the unique needs of their constituents.

It is the state's exclusive prerogative to determine whether and to whom to extend state tax benefits. Frankly, few states would be willing to extend a state tax benefit to plans for which it exercises no fiduciary oversight.

Standardizing disclosure will help investors and should also help financial journalists and others who report on, monitor and evaluate 529 plans. In an effort to examine 529 plans, too often comparisons are generic, overly simplistic and lack in-depth analysis of each program's unique features.

These plans are dynamic and constantly changing. Unfortunately, plan ratings provide snapshots and snapshots can change the next day. Stale information can have a long shelf life and provides a shaky foundation for good decision-making.

Valid comparisons should be made by evaluating key variables and investment strategies such as whether plans are sold direct or through advisors and whether investments are actively or passively managed. Comparisons should be based on accurate, adequate and timely data.

To do less is a disservice to the plans and to consumers who are often paralyzed into doing nothing while college costs continue to escalate. Clearly, there is much the states can do to improve disclosure. Indeed, CSPN and NAST are committed to this goal.

Our success is critical if we are to encourage greater participation in higher education. These plans support the aspirations of millions of young people and their families. We take our responsibility to them seriously.

Mr. Chairman and Committee Members, thank you for your time and attention. I would be happy to answer any questions.

TESTIMONY OF MARTIN M. NOVEN, DEPUTY CHIEF OF STAFF,
ON BEHALF OF
THE HONORABLE JUDY BAAR TOPINKA, ILLINOIS STATE TREASURER

Oversight Hearing on Section 529 College Savings Plans: High Fees, Inadequate Disclosure, Disparate State Tax Treatment and Questionable Broker Sales Practices

September 30, 2004

Dear Chairman Fitzgerald and Members of the Committee:

I appreciate the opportunity to offer testimony on behalf of Illinois State Treasurer Judy Baar Topinka regarding the issues surrounding what are commonly referred to as 529 college savings plans. The importance of helping families save for college cannot be overstated. However, Treasurer Topinka is concerned that a number of developments in the industry may be causing more harm to these families than good. The Treasurer established Bright Start, the Illinois college savings program, to help Illinois families save for college with a program that was monitored by the State of Illinois to ensure that consumers' best interests were being taken care of. While a number of other states have taken a similar approach, we are concerned that some states have let the competition for assets interfere with the interests of consumers. To more fully explain our concerns, I would like to describe how our office established Bright Start and our specific concerns about current industry practices.

In 1999, Treasurer Topinka sought the authority to establish a college savings plan for Illinois citizens to enable them to take advantage of the tax benefits provided in Section 529 of the Internal Revenue Code. At that time, 529 plans were administered by each state primarily as a service to each state's residents. In accordance with the original intention of the Internal Revenue Service, we were committed to developing a program

that was administered and monitored by the State of Illinois for its residents as opposed to by a financial services firm focused primarily on asset-based revenues.

The banking industry in Illinois fought the enabling legislation based on concerns that the program would result in a loss of retail deposits in Illinois banks. The industry forced a compromise that required that all applications and contributions to the plan be made through Illinois financial institutions and that the institutions would be entitled to hold a portion of each participant's assets as a deposit. As a result of the unique requirements of our enabling legislation, it was more difficult for us to find a vendor than in the states without similar restrictions. Many bidders either refused to respond to our request for proposals or offered inflated price schedules as a result of the unique requirements.

We were very pleased when we were ultimately able to negotiate an agreement with Salomon Smith Barney that provided one of the lowest cost programs in the nation to participants and that provided our office with unprecedented control over the administration of the program. Salomon Smith Barney was able to use its affiliation with Citigroup to assure full compliance with our enabling legislation.

In March of 2000, Treasurer Topinka launched the Bright Start program. Since that time we have been very pleased with its success. We are servicing more than 100,000 accounts, the performance of the program places it among the most successful programs in the nation, and we obtained tax benefits in 2001 and 2002 for participants in

Bright Start that were similar to the tax benefits offered by 35 other states for their own programs. We have realized this success without engaging in the anti-consumer behavior of some other state programs including charging high fees and commissions, encouraging questionable broker sales practices, and providing inadequate disclosure to consumers.

Treasurer Topinka is concerned that an increasing number of states permit their vendors to charge high fees and commissions to consumers seeking to save for college in an effort to grow assets. States should be focused on the interests of consumers as opposed to competing with each other for assets. Bright Start marketing material prominently encourages citizens of other states to first consider their home state's program before investing in Bright Start. The majority of states have tax incentives that are exclusive to the states' own programs. Treasurer Topinka does not want a single participant to join Bright Start if that participant would be better served in their home state. While many states share the Treasurer's consumer focus, we are concerned with the states that seem to have lost that focus in the interests of growing their programs.

We applaud the efforts of the federal regulatory agencies that are investigating the questionable broker sales practices. The programs being sold most aggressively nationwide are those programs with the highest sales loads. The fact that the largest programs in the nation are among the most costly to consumers suggests that a number of states are not doing an adequate job of policing their vendors.

Treasurer Topinka believes that additional disclosure requirements must be established and must be mandatory. Voluntary disclosure standards do not go far enough. All consumers of 529 college savings plans must be fully advised of all of the costs charged by a program prior to investing in the program and must also be made aware of the benefits of investing in the program administered in the state in which they reside.

Similarly, the state programs that charge reasonable fees and commissions, have avoided high broker commissions, and adequately inform consumers about the benefits of investing in the consumers' home state must be protected. There are two main reasons why Bright Start has remained successful. First, the Treasurer has used her marketing resources to enable consumers to learn about the program without having to compensate a financial intermediary. Second, Illinois is among the majority of states that provide exclusive tax benefits to participants in the programs administered by the State. The Treasurer will continue to use the resources that she has available to notify Illinois citizens of the availability of Bright Start, however, the focus of the efforts will necessarily be more heavily focused on consumer awareness and protection in the future. We have estimated that for every dollar that is invested by Illinois consumers in Bright Start or another consumer focused program, two dollars is being invested through financial intermediaries out-of-state in one of the most expensive programs in the nation despite the fact that the participants are being forced to sacrifice the in-state tax advantages.

The brokerage industry, in recognition of this conflict, has sought an extension of the Illinois tax benefits to out-of-state plans. The negotiations have been unsuccessful because the Treasurer has refused to make it easier for brokers to sell overpriced 529 plans to Illinois consumers, and the brokerage industry is unwilling to include any consumer protection measures. The industry defeated legislation promoted by Treasurer Topinka that would extend the tax benefits to the programs with less than the highest sales loads. The industry has also rejected an alternative proposal that would require reasonable fee disclosure as well as the extension of the tax benefits. The industry even rejected a proposal that would extend Illinois tax benefits to programs as long as the programs treated Illinois residents similarly to its own residents.

Treasurer Topinka's concerns about consumers that invest in 529 programs through financial intermediaries have prompted the Treasurer to investigate launching a consumer focused advisor-sold program in the State of Illinois. The Treasurer has put out a request for proposals seeking a vendor willing to work with the office to create a multi-manager product with quality investments, reasonable fees and commission, and thorough disclosure to consumers.

On Treasurer Topinka's behalf, I would like to commend the Chairman and committee members for considering the important issues surrounding 529 college savings plans. I am available for any questions that you have.

Utah Higher Education Assistance Authority

Utah Student Loan Guarantee Program (LGP)
Utah State Board of Regents Loan Purchase Program (LPP)
Utah Centennial Opportunity Program For Education (UCOPE)
Utah Educational Savings Plan Trust (UESP)

WRITTEN TESTIMONY OF

Richard O. Davis
Deputy Executive Director for Finance and Administration
Utah Higher Education Assistance Authority

Regarding
529 College Savings Plans

Before the
Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security
September 30, 2004

Mr. Chairman and members of the Subcommittee, my name is Richard Davis, Deputy Executive Director for Finance and Administration for the Utah Higher Education Assistance Authority (UHEAA), a subsidiary of the Utah State Board of Regents. UHEAA administers the Utah Educational Savings Plan Trust (UESP) as part of their role to provide financial and informational assistance to Utah residents and students attending postsecondary institutions. The Utah Educational Savings Plan was created by the Utah State Legislature in 1996 to encourage Utah residents to save for the college education of their children and grandchildren. UESP is a state agency created to provide a simple, low-cost vehicle for saving for college while offering both federal and state tax incentives. UESP is governed by a seventeen (17) member Board of Directors, comprised of members from both the private and public sector.

It is my pleasure to be here today to speak with you about college savings plans in general and the State of Utah's approach to the creation of one of the nation's lowest cost programs.

In 2004, a student planning to complete a four-year degree at one of Utah's colleges or universities can anticipate spending $32,000 or more to accomplish their goal. That same degree is estimated to cost more than $80,000 by the year 2024. The average family is unlikely to be able to afford to send their child to college, without taking on substantial debt or limiting their school options. In response to this burden on families, the UESP

(801) 321-7200
(800) 418-8757
TDD (801) 321-7130
Fax (801) 321-7299

Board of Regents Building, The Gateway
60 South 400 West
Salt Lake City, Utah 84101-1284
www.uheaa.org

P.O. Box 45202
Salt Lake City, Utah
84145-0202
uheaa@utahsbr.edu

Board of Directors was charged with creating a safe, simple and low-cost college savings program. UHEAA made the conscious decision to create a 529 savings plan that charges the lowest fees possible. To maintain these lower costs, UHEAA has chosen to offer its plan directly to investors.

A UESP savings account may be established with no enrollment fee and a deposit as low as $25 per family. Once an account has been created, there are no deposit requirements and the account holder may choose a payment schedule that meets their specific needs.

UESP offers nine investment options that utilize Vanguard mutual funds from the Vanguard Group and/or The Utah Public Treasurers Investment Fund (PTIF). One UESP option invests only in the Public Treasurers Investment Fund, and is offered at no fee. UESP offers four static investment options where the allocation of funds remains the same throughout the entire time the account is open. Five different age-based options are also offered, all of which provide portfolios that change the allocation of funds to become more conservative, as the beneficiary approaches college enrollment.

Residents of Utah also realize an additional benefit from establishing a UESP account, which is in the form of a state tax deduction. In 2004, a Utah resident contributing to their UESP account is eligible for a state tax deduction of up to $1,470 for each beneficiary, or up to $2,940 if filing jointly.

In addition to the low fees and the state tax deductions, the federal tax advantages make 529 savings plans even more beneficial to all Utah residents.

As a confirmation of the value of this decision to offer a low-cost college savings plan, UESP has been consistently rated by various investment research organizations, magazines, and other third parties as among the top five Section 529 plans in the nation. Although UESP markets only in Utah, 80% of the plan's participants are out of state residents.

UESP recently began a new pilot program, which provides matching funds for low-income Utahns. UESP will provide a matching incentive of up to $300 per year, for four years, for the first 50 children of Utah families who apply with incomes up to 200% of the federal poverty level.

As a member of the College Savings Plan Network (CSPN), UESP supports the effort to create a voluntary disclosure system among the various plans. UESP is currently working toward developing and refining our offering materials by the beginning of 2005 to meet the objectives of the disclosure principals, and plans to provide materials that will help consumers make more informed and objective comparisons of fees and expenses.

Mr. Chairman, Section 529 plans in general, and UESP in particular, have proven to be very successful among families as they plan for their children's educations. The Congress set out to create a simple and easy to understand process to assist participants save money for college. That goal is being accomplished everyday through the continued growth in 529 plans.

Thank you again Mr. Chairman, and Members of the Subcommittee, for your time and your continued support of state college savings programs. I look forward to working with you and this Committee to provide the best college savings program possible. I would be pleased to address any questions.

Morningstar Testimony to the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security

Subject: 529 College Savings Plans

Hearing Date: September 30, 2004

Testimony of Daniel McNeela, CFA, Senior Analyst, Morningstar, Inc

Thank you for the opportunity to appear before this distinguished Committee. My name is Dan McNeela. I am a senior analyst with Morningstar, Inc., an independent investment research firm that provides data and analysis on mutual funds and other investments. More than 150,000 individual investors and 80,000 financial planners subscribe to our services. In addition, there are more than 2 million registered users of our investment Web site, Morningstar.com.

More than two years ago, we expanded our research to cover 529 savings plans. I currently lead a small team of analysts who review all the 529 plans and write editorial commentaries to help investors make better decisions. Our analysis shows that a well chosen 529 plan can be an attractive investment vehicle. Given the considerable investment flexibility, tax advantages, high contribution limits and diversification afforded to 529 investors, the plans have much to offer.

Today's hearing is important because 529 savings plans are increasingly becoming a valuable tool for parents working to save for their children's education. Our most recent figures show that investors have assets totaling more than $40 billion in 529 savings plans. Studies have shown that after retirement savings, putting money away for college is often parents' top priority.

That said, my testimony focuses on the shortcomings of 529 plans and steps that can be taken to ensure that the generous federal tax breaks are not squandered. Several areas require substantial improvement. All too often, high costs, poor disclosure and an unreasonably complex structure greatly diminish their potential value. We also believe that federal legislators need to remove existing barriers that restrict the choices of investors and decrease competition among 529 plan providers.

Complex Cost Structure

Some of our greatest concerns relate to the host of costs investors pay to participate in a 529 plan. Investors face enrollment fees, account maintenance fees, administrative fees, management fees and, in many cases, broker fees. Some of those costs are dollar based, while others vary depending on the amount of assets an investor has in the plan.

Calculating the specific fees associated with a particular investment option can be a major undertaking. Most plans are set up as funds of mutual funds, whereby a single investment option represents a basket of underlying funds. To arrive at the total expenses

of a single investment option, investors first must prorate the costs of the underlying funds depending on their weighting in the portfolio and add the costs of all those funds together. Any associated administrative fees and broker fees, if applicable, must be added to arrive at a total. Even at that point, dollar-based fees are left unaccounted.

That process is frustrating enough for investors, but most 529 plans exacerbate this problem by burying this important cost information in the back of a 100-page-long program disclosure document. At its worst, the complexity of the cost structure and the reluctance to make the information easily accessible and understandable amount to deceit on the part of 529 providers.

The simplest solution is to require plans to prominently feature cost information on their Web sites and in their literature. Costs should be presented both at the base level, so investors can see what they're paying for; and in aggregate, to allow investors a summary of a plan's expenses. In situations where costs vary depending on the chosen investment option, total costs for each investment option should be clearly outlined. In effect, this summary expense data would serve the same purpose as expense ratios currently provide for mutual funds.

Finally, 529 plans should heed the calls mutual funds are hearing for better cost disclosure by providing cost estimates in dollar terms as well as percentage terms. A projection of total costs in dollar terms based on a $10,000 investment would be enlightening for investors and make comparisons between competing plans much easier.

Exorbitant Fees

Having clear disclosure of costs in both percentage terms and in dollar terms should go a long way toward resolving the other major problem associated with 529 plans. In short, too many 529 plans are prohibitively expensive. One reason plans cost so much is that several groups have lined up to collect fees. With states, fund companies, brokers and third-party administrators all putting their fingers in the pie, it's no wonder that investors can end up with a knuckle sandwich.

Anyone who tells you that costs don't matter is most likely a recipient of those fees in one way or another. The plain truth is that plan costs come out of investors' pockets on a dollar for dollar basis. While the debate between low-cost index funds and more expensive actively-managed options is worthwhile, overcharging for lavish advertising campaigns and bloated administrative expenses is reckless and unfair.

Our recent review of 529 plans turned up several plans with investment options whose costs approach or exceed 2% of assets for class A shares. This figure does not include front-end sales costs, which can be as much as 5.75% of assets or any dollar-based fees. At these levels, investors' ability to capture needed investment gains is significantly impaired. If long-term returns before fees average 6% annually, expenses could consume more than a third of an investor's potential savings.

How Fees Are Used

Although the level of fees and the transparency of fees are important issues, 529 plans also have the responsibility for disclosing how fees are used. This concern focuses on administrative fees, which vary greatly from plan to plan. Tennessee's plan, for example, is cheaper than average because its uses low-cost index funds and lacks a broker sold option. Its cost structure is also simple, because it charges a flat fee of 0.95% regardless of the investment option selected. But Tennessee's administrative costs are unreasonably high. The plan's disclosure documents make no attempt to justify why it costs almost 50% more than nearly identical plans offered by Michigan and Missouri. Tennessee charges as much as 0.88% in administrative fees, without accounting for how that money is being used. By comparison, Utah reports that it has been able to cover its operating costs by charging a mere 0.25% in administrative fees.

States offering 529 plans need to be held accountable for the fees they charge. The first step toward achieving that goal is improved disclosure. We believe that states should show investors how much money they're taking in and where that money ends up. Are fees paying for splashy advertising campaigns or defraying the costs of other projects? Citizens have a basic right to know how their money is being used. The current environment provides few answers to those questions.

Selection of Investment Manager

In a similar vein, residents get precious little information regarding how their states selected fund company partners. States should be forthcoming regarding that selection process, identify the criteria used, show why their choice serves citizens and fully explain the terms of the deal including any benefits the states will receive.

Evaluating Performance

The final area in need of improved disclosure is performance evaluation. Investors currently get information regarding the performance of the various investment options for both short-term and long-term time periods. But to grasp how well their plan is performing, investors need to see the performance of relevant benchmarks alongside the plan's returns. These benchmarks should reflect the asset classes in which the investment options are invested. Because many of the investment options include both stocks and bonds, blended benchmarks, which combine returns from different asset classes, are most appropriate. It is important that this comparison relates to the actual performance of the investment options net of all asset-based fees. If this is done properly, plans saddled with poorly performing funds and high cost structures will have few places to hide.

As a supplement to those numbers, plans should provide investors with a written commentary explaining why the investment options did better or worse than their

benchmarks. This analysis doesn't have to be lengthy or complicated, but it would go a long way toward improving accountability.

Federal Intervention

Given the current state of affairs, this distinguished subcommittee must decide what, if anything, must be done on a federal level to assure that 529 plans reach their full potential. Toward that end, I submit the following recommendations.

1. **Bring uniformity to standards for disclosure and transparency by appointing the SEC to set the regulatory environment.** With the SEC in charge, all plans will be required to comply with the same rules. That measure will increase investor confidence, make comparisons between plans easier and allow for alignment with rules and protections already being enforced as they relate to mutual funds.
2. **Ensure that the 529 marketplace is competitive by granting the federal tax break only to plans that promote fair competition through adoption of the following standards.**
    a. State tax laws on contributions and withdrawals should be applied uniformly to all 529 plans, with no special status afforded to a state's own plan. Twenty-six states offer a deduction or tax credit on contributions, but typically that benefit is not bestowed on those who find an out-of-state plan more compelling. Four states grant tax-free withdrawals for citizens

who opt for the home state plan, but require beneficiaries to pay state tax on qualified withdrawals from out-of-state plans. In Illinois and Mississippi, residents who choose an out-of-state plan give up both benefits.

b. Require uniform access to all 529 plans. Some states have seen fit to create two distinct plans: One is geared to in-state residents, while the other is for out-of-state investors. Often, in-state residents can buy shares directly from the state and save on costs, while out-of-state investors can access the plan only through the more expensive broker-sold channel. But this two-tiered system can also impact the range and quality of the underlying investment options. In Ohio, for example, the state made broad improvements to the plan available to its residents by adding low cost index-based options, but it did not include those enhancements in the plan offered to out-of-state investors.

c. Require uniform fee schedules regardless of residency. In addition to restricting access, certain plans have special fees, which are paid only by out-of state investors. Some states have created a special low-cost share class for its residents. Typically, the special share class allows in-state residents to bypass sales loads and cut ongoing asset-based fees by purchasing shares directly from the state. Out-of-state investors can't buy the lower cost shares and usually must pay a sales load to access the plan even if they aren't using a broker. Certain plans also waive annual maintenance fees for in-state residents.

States protect themselves from competing plans and favor their residents over out-of-state investors because they have little motivation to act otherwise. Only the federal government is in position to set appropriate ground rules that will promote fair competition and assure freedom of choice for investors. By ensuring a competitive marketplace, the federal government will guarantee that the tax benefits it has bestowed upon 529 plans are not squandered.

3. **Make the sunset provisions permanent.** The Economic Growth and Tax Relief Act of 2001 gave 529 plans a significant boost by making qualified withdrawals from 529 savings plans free from federal taxes. The hitch is that the federal tax exemption is set to expire in just over six years, at the end of 2010. Although we recognize the need for fiscal restraint, this uncertainty complicates matters for 529 investors. Saving for college is a long-range goal and investors need to know that they can count on promised tax benefits being there when the tuition bills come due. Each year the tax-exemption is not extended, investors become less certain that the benefits will endure. We therefore encourage you to tackle this issue head-on and make permanent the federal tax-exemption on qualified withdrawals as soon as possible.

Thank you for your time.

Testimony of Mercer E. Bullard

President and Founder
Fund Democracy, Inc.

and

Assistant Professor of Law
University of Mississippi School of Law

before the

Subcommittee on Financial Management, the Budget and
International Security

Committee on Governmental Affairs

United States Senate

on

Section 529 College Savings Plans:
High Fees, Inadequate Disclosure, Disparate State Tax Treatment and
Questionable Broker Sales Practices

September 30, 2004

Executive Summary

It is widely recognized that fees must be transparent and accessible for retail markets to work efficiently, yet fee disclosure for 529 plans is obscure and difficult to understand. Congress should promptly authorize the Securities and Exchange Commission to adopt rules governing the disclosure of 529 plan fees. Rules for 529 plan fee disclosure, at a minimum, should be:

- Standardized, both in the way in which the fees are calculated and the terms used to describe the fees;
- Prominently disclosed relative to other information about the plan;
- Presented both as a percentage of assets and a dollar amount, and on an illustrative and individualized basis;
- Inclusive of a total expense ratio for each investment option that includes all fees incurred in connection with an investment in the plan, to include, among other things, portfolio transaction costs, distribution costs, operating costs and administrative fees, whether charged by the state, plan manager, investment manager, or other person;
- Inclusive of a pie chart that illustrates the components of the total expense ratio according to standardized categories of fees, such as investment management, administrative services, and marketing and distribution;
- Inclusive of information on fees charged by other 529 plans both in a disclosure document and in an easily accessible format on the Internet; and
- Inclusive of separate disclosure of all payments received by intermediaries for executing the transactions in plan interests, both as a dollar amount and percentage of assets, whether or not the payment is made directly by the participant.

Congress also should consider steps to curb questionable sales practices through improved disclosure of, and substantive limits on, compensation paid in connection with sales of 529 plans. Finally, Congress should consider prohibiting states that offer state tax benefits in connection with 529 plan investments from limiting those benefits to in-state plans.

Chairman Fitzgerald, Ranking Member Akaka, members of the Subcommittee, thank you for the opportunity to appear before you to discuss 529 State Tuition Savings Plans. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an Internet web site.

Table of Contents

I. Introduction

As this Subcommittee is aware, 529 plans have become an increasingly popular means for Americans to save for higher education. During 2002 and 2003, assets in 529 plans increased from $2.5 billion to $46 billion, a 1,840% increase.[1] Assets in 529 plans are expected to reach $100 billion by 2006 and $300 billion by 2010.[2] These plans have enjoyed enormous appeal in part because they offer a unique combination of federal and state tax benefits, high contribution limits, matching state contributions, donor control, automatic rebalancing and, in many cases, low costs.

529 plans also have been subject to criticism on the grounds of excessive and inadequately disclosed fees, inconsistent state tax treatment across different plans, and questionable sales practices. This testimony addresses each of these topics separately, with primary focus on the question of fees and fee disclosures, which are addressed in Part II. This testimony also briefly discusses questionable sales practices in Part III and disparate state tax treatment in Part IV.

II. Fees and Fee Disclosure

Some commentators have criticized 529 plans on the ground that the high fees charged by many 529 plans have reduced the potential tax benefits of the plans.[3]

---

[1] See State 529 Plan Program Statistics, Investment Company Institute (reporting date: Dec. 31, 2003) (source: College Savings Plan Network) available at http://www.ici.org/issues/edu/529s_12-03.html (site last visited May 29, 2004); Margaret Clancy and Michael Sherraden, The Potential for Inclusion in 529 Savings Plans: Report on Survey of States, Center for Social Development at 4 (Dec. 2003) available at http://www.collegesavings.org/education/ResearchReport-529savingsplansurvey.pdf (site last visited May 29, 2004).

[2] See Kathy Chu, Investors Bullish On '529' Plans For College Saving, Wall Street Journal (Aug. 26, 2004); see also The Potential for Inclusion, id. at 4.

[3] See, e.g., Austan Goolsbee, The "529" Ripoff, Slate.com (Aug. 23, 2002) ("The long-run potential of [529] plans has been seriously compromised by excessive 'management' fees that states have added to these plans.") available at http://www.slate.com/id/2070062 (site last visited May 29, 2004); Penelope Wang, The Trouble With 529 Plans, Money Magazine (Oct. 7, 2003) ("as revenue-hungry states compete for 529 assets -- more than $20 billion is stashed in these plans -- they're layering on marketing gimmicks, restrictive tax rules, and higher fees. As a result, many 529 plans are beginning to resemble high-priced insurance products rather than 401(k)s.") (quoted in Potential for Inclusion, supra note 1, at 10).

Although no comprehensive study has been conducted to determine whether 529 plan fees are higher than for similar investments, a cursory review suggests that fees charged by 529 plans generally reflect fees charged by tax-deferred investments in mutual funds, with the possible exception that low-cost 529 plans may be more expensive than the lowest-cost tax-deferred accounts.[4] At the high end, 529 plan fees, albeit arguably excessive, do not appear to be outside of the range charged by some mutual fund providers.[5]

Determining whether a particular fee is too high or too low, based solely on the amount of the fee, is a difficult and uncertain exercise. The best arbiter of the fairness of fees is generally the marketplace, and in the absence of evidence that the market for 529 plans is inefficient or unworkable, Congress and regulators should exercise restraint before imposing additional regulatory burdens that are designed to reduce 529 plan fees. In the case of 529 plans, however, the indirect evidence of market failure is substantial.

One of the most important indicia of efficient markets is standardized, transparent disclosure of fees. It is generally accepted that standardized, transparent fee disclosure promotes competition and reduces prices.[6] The disclosure of 529 plan fees, however, is

---

[4] A $10,000 Vanguard IRA invested in a Vanguard index fund can cost as little as 0.18% of net assets annually. This is significantly lower than the fees charged by the Nebraska and Utah 529 plans, for example, which are two plans often cited as having low fees. The fees charged by low-cost 529 plans do not appear to be higher than low-cost variable annuities, however. For example, a Vanguard variable annuity can cost about 0.60% annually.

[5] One article cites, as an extreme example, a 529 plan in which fees consumed more than 10% of plan balances each year for two years. See Brooke A. Masters, College Savings Get Closer Study; With Little Oversight, State-Sponsored 529 Plans Vary in Expenses, Benefits, Washington Post (Apr. 14, 2004). But there are mutual funds whose expense ratios alone exceed 10% annually. According to Morningstar, Inc., for example, the Frontier Equity Fund charges annual fees of 42.36% plus a 4.50% front-end load, the Ameritor Investment Fund charges annual fees of 21.57%, APEX Mid Cap Growth Fund charges annual fees of 9.19% plus a 5.75 front-end load; the Alger Socially Responsible Fund and American Heritage Growth Fund both charge annual fees of 10.00%.

[6] See Opening Statement of Michael G. Oxley, Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Mar. 12, 2003) (inadequate fee disclosure "precludes [investors] from 'comparison shopping,' a strong market influence that would encourage fee-based competition and would likely bring down costs) available at http://financialservices.house.gov/media/pdf/031203ox.pdf (site last visited May 31, 2004); Testimony of Paul G. Haaga, Jr., Chairman, Investment Company Institute and Executive Vice President, Capital

generally incoherent and obscure, and 529 plans would likely be forced to reduce their fees if adequate fee disclosure were provided.[7] The disclosure of 529 plan fees is specifically discussed in Part II.A of this testimony. In addition, as discussed in Part II.B of this testimony, the argument for improved fee disclosure in the context of 529 plans is particularly compelling because a number of special factors applicable to 529 plans may further inhibit competition and result in higher fees. It therefore is imperative that Congress takes steps to ensure that 529 plans are required to provide standardized, transparent, prominent fee disclosure.

Fee disclosure for 529 plans, at a minimum, should be:

- Standardized, both in the way in which the fees are calculated and the terms used to describe the fees;
- Prominently disclosed relative to other information about the plan;
- Presented both as a percentage of assets and a dollar amount, and on an illustrative and individualized basis;
- Inclusive of a total expense ratio for each investment option that includes all fees incurred in connection with an investment in the plan, to include, among other things, portfolio transaction costs, distribution costs, operating costs and administrative fees, whether charged by the state, plan manager, investment manager, or other person;
- Inclusive of a pie chart that illustrates the components of the total expense ratio according to standardized categories of fees, such as investment management, administrative services, and marketing and distribution;

Research and Management Company, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives at 9 (Mar. 12, 2003) ("broad availability of information about mutual fund fees and expenses has helped promote competition in the industry") available at http://financialservices.house.gov/media/pdf/031203ph.pdf (site last visited May 31, 2004).

[7] As an example of the potential competitive benefits of full disclosure, some firms may have decided to reduce their fees in response to reports that Morningstar, Inc. had publicly cited those plans as a being among the worst offered partly because of the fees that they charge. See Karen Damato, NASD Investigates College-Savings Fund Sales, Wall Street Journal (Mar. 19, 2004) (discussing Morningstar, Inc. ratings and apparently contemporaneous fee reductions in certain 529 plans).

- Inclusive of information on fees charged by other 529 plans both in a disclosure document and in an easily accessible format on the Internet; and

- Inclusive of separate disclosure of all payments received by intermediaries for executing the transactions in plan interests, both as a dollar amount and percentage of assets, whether or not the payment is made directly by the participant.

In addition, Congress should ensure that fee disclosure requirements for 529 plans are promulgated and enforced by an independent, objective government entity, as discussed in Part II.D.2 of this testimony. The Securities and Exchange Commission ("Commission" or "SEC") has greater experience and expertise in this area than any other government entity, and it would bring greater independence and objectivity to the creation and enforcement of 529 plan fee disclosure requirements. The states, as the issuers of interests in 529 plans, lack the independence and objectivity to regulate their own plans and to enforce any rules they might devise. Congress should specifically authorize the Commission to establish comprehensive rules governing the 529 plan fee disclosure, and consider expanding this responsibility to all aspects of 529 plans operations.

Before implementing these policies, Congress should pause and first develop the analytical framework within which 529 plans should be regulated. This necessitates identifying exactly what the role of the government should be in regulating these plans. Does the fact that 529 plans are created and sold by states militate for greater or lesser regulatory oversight than in other contexts? Once the nature of the governmental interest has been established, Congress should direct the Commission to collect and analyze information on 529 plans. Finally, the development of policies for 529 plans should consider how unique structural issues relate to regulatory goals. These issues are discussed in Part II.C of this testimony. Part II.D of this testimony sets forth specific recommendations regarding 529 plan fees.

A. Fee Disclosure in 529 Plans

The impact of the cost of investing has long been recognized. As stated by the Commission, "fund fees can have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years."[8] Nonetheless, investors do not necessarily consider fees to be a significant factor when choosing mutual funds.[9] Consequently, "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern" to regulators.[10]

---

[8] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870, at Part I.B (Dec. 18, 2002) available at http://www.sec.gov/rules/proposed/ic-25870.htm (site last visited May 31, 2004); see also Opening Statement of Paul E. Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Mar. 12, 2003) ("A recent story in *USA Today*, for example, determined that for government securities mutual funds, the group with the lowest expense ratios averaged a 41 percent gain over five years while those with the highest expense ratios grew by 34 percent during the same time frame. Small differences in annual fees will ultimately result in major differences in long-term returns.") available at http://financialservices.house.gov/media/pdf/031203ka.pdf (site last visited May 31, 2004).

[9] See Shareholder Reports, id. (citing a joint report of the Commission and the Office of the Comptroller of the Currency that "found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns"); Testimony of Arthur Levitt, Chairman, Securities and Exchange Commission, before the before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, U.S. House of Representatives (Sep. 29, 1998) available at http://www.sec.gov/news/testimony/testarchive/1998/tsty1398.htm (site last visited on May 29, 2004) ("Our own research shows that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns. Another recent study found that 40% of fund investors surveyed incorrectly thought that a fund's annual operating expenses have no effect on the gains they earn." (footnotes omitted) (citing, respectively, Report of the Office of the Comptroller of the Currency/Securities and Exchange Commission Survey of Mutual Fund Investors (1996), and Ruth Simon, We Put Investors to the Test – and, Boy, Did They Ever Flunk, Money Magazine (Mar. 1, 1998)); Shareholder Assessment of Risk Disclosure Methods, Investment Company Institute at 11 (Spring 1996) (survey of 657 shareholders who had purchased a fund in the preceding 5 years found that only 43% cited fees and expanses, and only 27% cited the sales charge or load, as factors they considered before investing) available at http://www.ici.org/shareholders/dec/rpt_riskdiscl.pdf (site last visited May 29, 2004); compare Understanding Shareholders' Use of Information and Advisers, Investment Company Institute at 21 (Spring 1997) (survey of 1,000 recent mutual fund investors found that 76% considered annual fees, and 73% considered sales charges, before investing) available at http://www.ici.org/stats/res/rpt_undstnd_share.pdf (site last visited May 29, 2004).

[10] Levitt Testimony, id. ("The Commission is very concerned, though, that many fund investors are not paying attention to the available information about fees."); Disclosure of Mutual Fund Expense Ratios In Performance Advertising, NASD (Jan. 23, 2004) ("Congress, regulators, and investors increasingly have

The Commission has expressed similar concern regarding the impact and investors' understanding of 529 plan fees. The Commission has estimated, for example, that $10,000 invested in each of the Utah and Rhode Island 529 plans over an 18-year period, assuming the same investment performance for each plan, could leave the Utah investor with a balance that was 20.7% larger than the Rhode Island investor's balance.[11] Chairman Donaldson recently expressed his "concern regarding the ability of parents to understand the operation of [529] plans and the economic implications that high fees may have on families as they save for their children's higher education."[12]

Chairman Donaldson has good reason to be particularly concerned about the ability of investors to make informed decisions about 529 plans. Unlike mutual funds, which provide a useful comparison to 529 plans because their structure and fees closely resemble those of 529 plans, such plans generally are not subject to the federal securities laws. Interests in 529 plans are municipal securities that are exempt from registration under the federal securities laws, and the states that issue these securities are exempt for registration under the federal securities laws as brokers and investment advisers. States are subject to the anti-fraud provisions of the federal securities laws, and it is possible that a failure to disclose fees could be actionable as a violation of those provisions, but

---

expressed concerns over the need for improved disclosure of fund expenses. . . . The focus on fund fees is important because fees can have a dramatic impact on an investor's return.") (proposing to require inclusion of fund expense ratios in fund performance advertisements) available at http://www.nasdr.com/pdf-text/0377ntm.pdf (site last visited May 29, 2004); Testimony of Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives at 2 – 4 (June 18, 2003) ("the degree to which investors understand mutual fund fees and expenses remains a significant source of concern").

[11] See Memorandum from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to William H. Donaldson, Chairman, Securities and Exchange Commission at A-3 (Mar. 2, 2004) ("Nazareth Memorandum") at http://financialservices.house.gov/media/pdf/3-16-04%20529%20lttr%20part%20two_001.pdf (site last visited May 30, 2004).

[12] Letter from William H. Donaldson, Chairman, Securities and Exchange Commission to the Honorable Michael G. Oxley, Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Mar. 12, 2004) ("Donaldson Letter") available at http://financialservices.house.gov/media/pdf/3-16-04%20529%20lttr%20part%20two_001.pdf (site last visited May 30, 2004).

this risk is unlikely to provide a sufficient incentive for states to adequately reform the disclosure of 529 plan fees.

One result of the exemption enjoyed by 529 plans is that they are not subject to fee disclosure requirements that apply to similar investment products. In some cases, 529 plan fees are relatively clear, but in many cases 529 plan fees are difficult to find and understand. After a preliminary review, the Commission concluded that:

> "the wide variations in disclosure among the various state 529 tuition savings plans we reviewed, as well as the absence of significance securities law protections, makes it difficult for investors to fully understand the options that are available to them with respect to these tax-advantaged college savings plans."[13]

If anything, the Commission's preliminary conclusion understates the inadequacy of fee disclosure for many 529 plans. Fee disclosure for 529 plans is often obtuse and buried in long disclosure documents.[14] The information typically presents a multiplicity

---

[13] Nazareth Memorandum at A-2, supra note 11; see also Donaldson Letter, supra note 12, ("the current state of affairs with respect to 529 plans is complicated and likely difficult for parents to understand.").

[14] For example, the Program Description for Maine's NextGen College Investing Plan is 88 pages, fees are not discussed until page 43, and the discussion of fees is extremely difficult to understand. The Program Description is available at: https://www.enroll529.com/pdf/NEXTGEN_100792RR.pdf (site last visited May 27, 2004). Similarly, the Plan Description for Texas's Tomorrow's College Investment Plan is 31 pages and fees are not discussed until page 18 (although the discussion of fees is relatively clear). The Plan Description is available at http://www.enterprise529.com/downloads/529PLANDES_CA5_04.pdf (site last visited May 30, 2004). The Plan Disclosure Document for Alaska's Manulife College Savings Plan is 61 pages, fees are not discussed until page 45, and the discussion of fees is difficult to understand. The Plan Disclosure Document is available at http://www.manulifecollegesavings.com/files/common/pdf/DisclosureDoc.pdf (site last visited May 30, 2004). These examples, as with other examples in this testimony that are derived from actual 529 plans, are not based on a comprehensive review of all 529 plans.

It should also be noted that some 529 plans provide accessible, clear (albeit nonstandardized) fee disclosure. For example, the main page of the web site for the Delaware College Investment Plan provides a table of "Fast Facts," including the following statement regarding the Plan's expenses:

> "Annual maintenance fee of $30 is waived for accounts with automatic bank transfer, direct deposit, or balance over $25,000. Expenses of underlying investments are approximately 0.65% to 0.81% (portfolio weighted average). Annual asset-based program management fee is approximately 0.3%."

The Fast Facts are available at http://www.doe.state.de.us/high-ed/DCIPfacts.htm (site last visited May 28, 2004).

of fees that do not follow standardized terminology and frustrate comparison across different plans. These fees include, among others, program fees, annual fees, enrollment fees, administration fees, investment fees, transfer fees, service fees, and sales charges; they may be charged at the opening of the account, on a periodic basis, or upon the closing of the account; and they may be presented as a percentage of assets, a one-time, flat payment, or a series of payments that depend on a variety of account characteristics, such as the residency of the participant and the value of the account. The complexity and nonstandardized nature of 529 plan fees make it unlikely that an investor who is not already financially sophisticated about fees will be able to make an informed investment decision regarding 529 plans.

Disclosure rules that apply to mutual funds provide a good illustration of how 529 plan fee disclosure could be improved. Mutual funds must include, near the front of the prospectus, standardized information about expenses in an easy-to-read fee table, as well as the estimated dollar amount of expenses on a $10,000 account over 1-, 3-, 5- and 10-year periods. This disclosure enables investors to easily compare mutual fund fees and thereby promotes competition and reduces costs.[15] Although mutual funds that are used as investment vehicles in 529 plans are subject to these disclosure requirements, and plan participants therefore can access that information, the states are not required to provide mutual fund disclosure documents to plan participants.

Even mutual fund disclosure is inadequate in several respects, however, as has been recognized by the Commission in recent rulemaking initiatives[16] and widely discussed in Congress over the last year, including this Subcommittee's hearings in late

---

[15] See Haaga Testimony, supra note 6.

[16] See, e.g., Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341 (Jan. 29, 2004) (proposing point-of-sale and confirmation disclosure for mutual funds) available at http://www.sec.gov/rules/proposed/33-8358.htm (site last visited May 31, 2004); Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Rel. No. 26313 (Dec. 19, 2003) (requesting comment on ways to improve disclosure of mutual fund portfolio transaction costs) available at http://www.sec.gov/rules/concept/33-8349.htm (site last visited May 31, 2004).

2003 and January of this year.[17] For example, the mutual fund expense ratio does not include portfolio transaction costs, which can be a fund's (and a 529 plan's) single largest expense.[18] Furthermore, funds are not required to inform shareholders about the dollar amount of their individual fees[19] or provide them with comparative information about fees charged by other funds.[20]

The College Savings Plans Network, an affiliate of the National Association of State Treasurers, recently issued voluntary disclosure principles ("CSPN Principles") that include guidelines regarding the disclosure of 529 plan fees.[21] The Principles are:

> "not intended to suggest (1) that alternative disclosure practices may not be acceptable, or (2) a comprehensive list of disclosure matters that must be addressed in connection with 529 Plans in order to fulfill the responsibilities of State Issuers to their account owners. . . . These voluntary disclosure principles are also not intended to provide guidance

---

[17] See Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors, Hearing before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, U.S. Senate (Jan. 27, 2004) available at http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=146 (site last visited Sep. 29, 2004) and Mutual Funds: Trading Practices and Abuses that Harm Investors, Hearing before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, U.S. Senate (Nov. 3, 2003) available at http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=124 (site last visited Sep. 29, 2004).

[18] See Opening Statement of Congressman Paul E. Gillmor, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Mar. 12, 2003) (fund portfolio transaction costs "can be very significant and even exceed the amount of the fund's expense ratio; yet, these costs are not clearly presented to consumers") available at http://financialservices.house.gov/media/pdf/031203gi.pdf (site last visited May 31, 2004); Testimony of Mercer Bullard, President and Founder, Fund Democracy, Inc. and Assistant Professor of Law, University of Mississippi School of Law, before the Banking, Housing, and Urban Affairs Committee, U.S. Senate at 11 – 15 (March 23, 2004) available at http://banking.senate.gov/_files/bullard.pdf (site last visited May 31, 2004).

[19] See Bullard Testimony, supra note 18 at 15 – 16.

[20] Id. at 16.

[21] See Letter from Tim Berry, NAST President and Indiana State Treasurer and Diana Cantor, CSPN Chair and Executive Director, Virginia College Savings Plan to William Donaldson, Chairman, U.S. Securities and Exchange Commission (June 4, 2004) (attaching College Savings Plans Network Voluntary Disclosure Principles (May 25, 2004)) available at http://www.collegesavings.org/Draft%20Voluntary%20Disclosure%20Principles%206%204%2004.pdf; see generally Kathy Chu, States Draft Guidelines for 529 Plans, Wall Street Journal (June 15, 2004).

> concerning the disclosure obligations of broker-dealers or investment managers who are involved with Section 529 Plans."[22]

As the CSPN Principles expressly concede, they are strictly aspirational; they do not have the force of law.

The voluntary nature of the CSPN Principles is a fatal flaw because of the inverse correlation between the cost of a plan and the incentive of its state sponsor to comply with the Principles. States that sponsor high cost plans will have a greater incentive not to follow the Principles.[23] It has been suggested that competition will force plans to abide by the Principles,[24] but this flatly contradicts decades of experience regulating investment products similar to 529 plans. In fact, fully transparent cost disclosure by high-cost plans will place them at a competitive disadvantage to other plans with lower costs. Competition has never caused makers of high-cost products, in any line of business, to choose to highlight their cost disadvantage, and there is no reason to believe that high-cost 529 plans will be an exception. To the contrary, high-cost 529 plans -- for which transparent price disclosure is most important to investors -- will be least likely to voluntarily provide such disclosure.

If they were mandatory, the CSPN Principles would still be inadequate in many respects, although it should be noted that some of these inadequacies are characteristic of mutual fund fee disclosure as well. To their credit, the Principles provide disclosure of fees in an easy-to-read table, both as a percentage of assets and in dollars in a separate fee example. But the Principles do not propose that the fee information be prominently displayed in relation to other information, or provide comparative data on fees charged by

---

[22] Id.

[23] See Albert Crenshaw, No Quick Fix for Section 529 Plans, Washington Post (June 6, 2004) ("Diana Cantor emphasized that anything [CSPN] does must leave room for states to tweak the rules for their plans -- which is, of course, where so much of the confusion comes from in the first place").

[24] Judith Burns, Revising College-Savings Plans, Wall Street Journal (July 6, 2004) (quoting Indiana Treasurer Tim Berry: "the market is going to require [conformity to the CSNP Principles] and if you don't provide this consistent disclosure, your program will not be as competitive as others out there").

the average 529 plan other 529 plans. They do not provide investors with disclosure of the actual dollar amount of their expenses, or provide for the disclosure of portfolio transaction costs incurred by the underlying portfolios. Nor do they provide for disclosure of compensation received by brokers relative to other 529 plans.

Finally, the Principles recommend that, to the extent that fee information is contained in a mutual fund prospectus, such information need not be repeated in the 529 plan fee disclosure. This would result in the bifurcation of fee disclosure in two separate documents and make it likely that either investors will not review both documents or be confused if they do. Fee disclosure should be provided in a single, short, easy-to-read document, accompanied by other key factors that investors should consider when evaluating a 529 plan.

B. The Special Importance of Fee Disclosure in the 529 Plan Context

The lack of transparent, prominent, standardized disclosure of 529 plan fees is exacerbated by factors in the 529 plan context that make fee disclosure even more important. In effect, certain governmental entities have been granted an exclusive monopoly to sell a particular tax-deferred investment product in competition with private providers of other tax-deferred investment products. This intrusion of the government into the private sector may distort many functions of the financial services markets, including the setting of fees.[25]

[25] The distorting effect of governmental sponsorship of tax-deferred investment products were illustrated at a recent Congressional hearing on 529 plans. The executive director of the Ohio Tuitions Trust Authority was asked whether Lifetime Savings Accounts ("LSAs") "could be designed in a manner that could coexist with 529 plans without siphoning off their investors." She responded that the creation of LSAs "would be detrimental to 529s." Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives at 33-34 (June 2, 2004) available at http://financialservices.house.gov/media/pdf/108-90.pdf. This exchange illustrates the risk that governmental sponsorship of 529 plans will create a vested, 50-state lobby for a particular investment product, with the potential result of inhibiting the development of products that more effectively serve investors' interests. Markets, not state governments, should decide whether 529 plans, Lifetime Savings Accounts, or other investment options succeed or fail, based on how well they serve investors, and not whether they might successfully compete with state-run enterprises.

For example, investors may lower their guard when evaluating 529 plans on the assumption that a public-minded governmental entity would sell only a high-quality, low-cost investment product. In fact, states' interests may not be aligned with plan participants' interests with respect to negotiating fees and choosing investment options, and investors' trust in states' motivations and interests may be misplaced.[26]

States may have incentives to offer plans that charge high fees. States may charge high fees as a means of increasing their general revenues,[27] or charge higher fees to out-of-state residents as a way to subsidize services provided to in-state participants.[28] Political considerations also may influence the selection of money managers and cause states to be less diligent when negotiating fees. For example, states may favor in-state money managers[29] or managers that have contributed to the election campaigns of state officials.[30] State officials may even use 529 plan assets for self-promotion.[31] The

---

[26] See Closer Study, supra note 5 ("Regulators and industry experts warn that investors should not assume that the government-sponsored nature of these plans means they have consumer interests at heart").

[27] See Restrictions Lessen Benefits of State College Savings Plans, USA Today (Dec. 1, 2003) (states may seek to add new accounts "because they can keep a portion of the investment fees"); Avrum D. Lank, Tax Break is Just One Factor in Choosing a 529 Plan, Milwaukee Journal Sentinel (Dec. 14, 2003) ("'To the extent that [states] can keep assets in their state [plan], they want to do that because fees accrue to the state as well,'" quoting Shannon Zimmerman, college savings plan analysis for Morningstar, Inc.).

[28] See Closer Study, supra note 5 ("state officials acknowledge that they want to attract out-of-state participants and may even charge them more to cut costs for their own residents"); see, e.g., Texas Plan Description, supra note 14 (waiving annual account fee for accounts with Texas owners or beneficiaries); Rhode Island Plan Description, supra note 33 at 11 (same for Rhode Island owners).

[29] For example, the Maryland College Investment Plan is managed by Baltimore-based T. Rowe Price, and Wisconsin's EdVest College Savings Program is managed by Menomonee Falls-based Strong Capital Management, Inc. See Restrictions Lessen Benefits, supra note 27 ("Massachusetts, Maryland, Pennsylvania and Wisconsin have rewarded politically powerful companies based in their states with exclusive contracts to manage" the state's 529 plan); see also Avrum D. Lank, State Seeks New Options for EdVest, Milwaukee Journal Sentinel (Nov. 22, 2003) ("I want to find some way to keep the mutual fund business strong in Wisconsin, I don't want the (Strong) company to be decimated. I want to make certain that whatever liability there is that we don't kill the company." (quoting Wisconsin state treasure Jack C. Voight)); Elliot Blair Smith, Fund Scandal Worries Tuition Plan Investors, USA Today (Nov. 19, 2003) (describing campaign contributions by Richard Strong to Wisconsin politician indirectly responsible for choosing Strong to manage the state's 529 plan).

[30] Such pay-to-play practices have been well-documented. See, e.g., Mercer Bullard, Pay-to-Play in America, TheStreet.com (Apr. 26 - 30, 2001) available at http://www.thestreet.com/funds/mercerbullard/1406251.html (site last visited May 29, 2004). In 1999, the

unavailability of state tax deductions for out-of-state plans may further undermine market efficiency and create incentives to charge higher fees, as discussed further in Part IV of this testimony.

The rules governing 529 plans can limit price competition by making it more costly and burdensome for plan participants to transfer their 529 plan interests, thereby reducing price competition and further elevating the importance of fee disclosure. For example, mutual fund shareholders have the right to receive their pro rata share of the fund's net assets within seven days of a redemption request.[32] In contrast, there is no limit on the amount of time that a state can hold a participant's assets pending a transfer[33] or on the amount of fees charged on the transfer.[34] Accordingly, it is that much more

---

Commission proposed generally to prohibit money managers from accepting compensation from a public client if the money manager had contributed to the campaign of any official who controlled the allocation of management contracts for the client. See Political Contributions by Certain Investment Advisers, Investment Advisers Act Rel. No. 1812 (Aug. 4, 1999) available at http://www.sec.gov/rules/proposed/ia-1812.htm#foot4 (site last visited May 29, 2004). In 1994, the Commission approved a parallel pay-to-play rule that applies to municipal securities underwriting. In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule, Securities Exchange Act Release No. 33868 (Apr. 7, 1994). It appears that this rule applies to sales of interests in 529 plans only when the seller is acting as an underwriter. See 529 – Frequently Asked Questions, NASD, available at http://www.nasd.com/Investor/Choices/College/529_faqs.asp (site last visited May 31, 2004); 529 Savings Plan Workshop, NASD at 16 – 18 (Apr. 3, 2002) (available at http://www.nasdr.com/pdf-text/phone_wkshp_0402.pdf (site last visited May 31, 2004).

[31] See College Savings Get Closer Study, supra note 5 (state treasurer used millions of dollars of 529 plan assets to pay for commercials about the plan that prominently featured the treasurer, who was running for reelection).

[32] As a practical matter, broker regulations and certain SEC staff positions effectively require that sales of fund shares settle in no more than three days. Funds can charge redemption fees, but the SEC staff limits these fees to 2% of the redemption amount and the fee must be paid to the fund.

[33] In addition, mutual funds typically must accept purchases the same business day they are received, whereas there are no limits on states' ability to hold 529 plan contributions pending investment in the plan. For example, the Virginia Education Savings Trust holds participants' contributions for up to 30 days before investing them in the plan. See College Savings Get Closer Study, supra note 5; Nazareth Memorandum, supra note 11, at A-4 (in effect, the "delay in investment [is] an interest-free loan from investors" to the state).

[34] For example, Rhode Island imposes $50 fee on transfers to another state's 529 plan. Rhode Island Program Description at 12 (Oct. 27, 2003) link available at http://www.collegeboundfund.com/ (site last visited May 31, 2004).

important that investors be informed about 529 plan fees before choosing a plan, because it may be difficult or costly to change that decision.

Further, participants in 529 plans have limited control over fees. Mutual funds can raise advisory and 12b-1 fees only with shareholder approval, whereas states generally can raise fees at will without notice to participants,[35] thereby making it more important that investors understand the fees charged before making an investment decision. When a mutual fund that is a 529 plan investment option seeks to raise its fees, the state has the right to vote on the fee increase, but, as noted above, it may not have the same interests to negotiate low fees as plan participants have. In some cases, states have locked themselves into long-term arrangements that may make it difficult for them to change managers or reduce fees.[36]

Finally, federal law gives mutual fund shareholders legal recourse against a fund's directors and manager with respect to excessive fees charged by the manager,[37] which may provide some restraint on fees. Participants in 529 plans, however, have no such rights absent a violation of the antifraud rules under the federal securities laws. Although participants have political recourse against state officials, it is uncertain whether this provides an effective restraint on fund fees.

---

[35] See, e.g., No Quick Fix, supra note 23 (describing Maryland's 25% contract price increase in each of the last two years for its prepaid tuition plan). The Plan Disclosure Document for the Alaska's Manulife College Savings Plan provides that the Trust, "in its sole discretion, will establish or change Fees as it determines to be appropriate. Such Fees may include a program fee, a sales load, an annual Account fee, fees associated with SFAs and other fees and charges to support the purposes and administration of the Trust." Plan Disclosure Document, supra note 14, at 45 – 46. In contrast, Texas state law prohibits the Board from collecting administrative fees in excess of the costs of administering the 529 plan. See Plan Description, supra note 14.

[36] See Nazareth Memorandum, supra note 11, at n. 25 (citing examples of limitations on states' ability to fire 529 plan managers). Whereas Oregon and Utah terminated Strong Capital Management from their 529 plans because of the CEO's wrongful conduct, Wisconsin's plan was bound by an exclusive contract with Strong until 2006. See Avrum D. Lank, EdVest Overseers Add Options to Strong Funds, Milwaukee Journal Sentinel (Dec. 4, 2003). Oregon's contract included an "at-will" provision. See Kathleen Gallagher, Oregon Ousts Strong from College Fund, Milwaukee Journal Sentinel (Nov. 14, 2003).

[37] The Commission also has the authority to sue a fund's directors and manager with respect to fees paid to the manager, but it has never exercised that authority, and that authority therefore cannot be considered to restrain mutual fund fees to any degree. For examples of excessive mutual fund fees, see supra note 5.

Restrictions on 529 plan investment options, participants' limited control over fees and fee increases, the costs and burdens of transferring from one plan to another, states' monopoly on state tax benefits, limited legal recourse against plan sponsors, and the divergence of state and participant interests are some of the special factors that make it especially critical that 529 plan fees be fully disclosed in an understandable, standardized, accessible format.

In addition, permitting states to offer a financial product has effectively added 50 new regulators for tax-deferred mutual fund wrappers, which are subject to too many different regulators and sets of rules as it is.[38] The Commission is responsible for fee disclosure for variable annuities, the Department of Labor is responsible for fee disclosure for employee benefit plans, and banking regulators and the Internal Revenue Service are responsible for fee disclosure for IRAs. Multiple disclosure regimes confuse investors and increase the costs of offering investment products, as each provider must tailor its program to the particular state's requirements. The Subcommittee should take this opportunity to explore ways of rationalizing fee disclosure and other regulatory aspects of various tax-deferred mutual fund wrappers.[39]

Additional regulation of 529 plans probably can mitigate many of the disadvantages of state-sponsored investment products, but Congress should also consider reforms that might more directly address fee disclosure and other problems. The need for additional 529 plan regulation is due, in part, to the fact that they are exempt from the federal securities laws. The municipal exemption under which 529 plans operate was not intended for the offering of retail financial services, and Congress should consider

[38] A substantial percentage of mutual fund assets are invested through these tax deferred wrappers. At the end of 2003, about one-third of mutual fund assets (about $2.7 trillion) were held in retirement plans, primarily in 401(k) accounts and IRAs. See Mutual Fund Fact Book, Investment Company Institute at 86 (May 2004) available at http://www.ici.org/stats/mf/2004_factbook.pdf (site last visited May 31, 2004).

[39] This problem extends beyond tax-deferred investment pools to all types of investment pools, including bank collective investment trusts, funds of funds, folios, mini-accounts, exchange-traded funds, separate accounts, hedge funds, etc., and will worsen as the proliferation of similar investment vehicles subject to different regulations increases the opportunity for and transaction costs of regulatory arbitrage.

amending the exemption to exclude 529 plans or permitting private firms to offer 529 plans outside of state sponsorship.[40]

C. Guidelines for the Regulation of 529 Plan Fees

The inadequacy of 529 plan fee disclosure necessitates prompt Congressional or agency action to ensure that investors in 529 plans can make fully informed investment decisions. Before choosing a particular course of action, however, it is important to (1) establish guidelines regarding the nature of the government's interest in 529 plan fees, and (2) collect and analyze information about fees that are currently charged by 529 plans.

1. The Governmental Interest in 529 Plans

The most important step in developing a framework for 529 plan regulation is to identify the nature of the government's interest in these plans. The government's interest in 529 plans reflects, to a large extent, its interests in financial services and products generally. The government interest in brokerage services, investment advice, mutual funds and other financial services and products is generally based on four principles: (1) promoting the operation of free markets unfettered by government interference, (2) mandating full disclosure to facilitate informed decisionmaking and the efficient allocation of capital, (3) protecting investors against fraud, and (4) imposing targeted, substantive regulation.

[40] As suggested by Professor Goolsbee: "The federal government will forgo billions of dollars in tax revenue to subsidize 529s. The goal of this subsidy was to encourage education, not to have the federal government provide a windfall to states and financial firms in the form of high fees. An easy way to fix the 529 problem would be to bestow the benefits of the 529s on other savings plans. Congress could raise the limit on contributions to Coverdell/Education IRAs or allow penalty-free withdrawals from 401(k) accounts for educational expenses. In these other accounts, people can choose any investment from any provider, without paying extra management fees. It would cost the federal government the same amount as the current 529 system, but the benefits would go to the parents, not the providers." "529" Ripoff, supra note 3.

These government interests are generally applicable to all financial services and products, with some tailoring in individual circumstances. For example, the regulation of securities issuers has generally focused on the first three principles of free markets, full disclosure, and investor protection, with limited substantive regulation. The regulation of brokers and investment advisers has generally entailed a representative mix of all four principles. Mutual fund regulation is characterized by more extensive substantive regulation in many areas, including, in a number of respects, the level and disclosure of fees.[41] Congress has regulated mutual funds more intrusively than in other areas primarily because mutual funds involve the discretionary control over a liquid pool of cash and securities where the potential for abuse is greater than in other securities-related contexts.

The structure of 529 plans is similar to that of mutual funds, and, not coincidentally, states generally have opted for mutual funds as the underlying investment vehicles for plan assets. The regulation of the level and disclosure of 529 plan fees, however, falls well below the standards applicable to mutual funds.[42] Assuming that the governmental interest in 529 plans parallels its interest in mutual funds, Congress should take steps to subject 529 plans to the same level of regulation, and not only with respect to the level and disclosure of fees, but also with respect to governance, affiliated transactions, leverage, and other areas in which mutual funds have been successfully regulated for decades.

But one might argue that the governmental interest in 529 plans is actually quite different. On the one hand, Congress authorized 529 plans to promote a specific "investment objective," that is, to increase or facilitate investment in higher education. Congress therefore may have a greater regulatory interest in ensuring that 529 plans achieve that investment objective. This special government interest is implicit, for

---

[41] See supra, discussion at pages 11 - 12 (regulation of disclosure of mutual fund fees) and infra, discussion at page 30 - 31 (regulation of level of mutual fund fees).

[42] Id.

example, in the question posed by Chairman Oxley to Chairman Donaldson regarding whether 529 plan fees could outstrip the tax benefits of the plan.[43]

In the context of fees, for example, this perspective might argue for more intrusive regulation of the level and disclosure of 529 plan fees for the purpose of maximizing the additional funds available for higher education.[44] Another way of looking at this question would be to consider Congress as having an interest in obtaining the greatest possible return on its investment, its investment being the amount of foregone tax revenues, and accordingly a greater interest in 529 plans' achieving the best possible performance at the lowest possible cost.

On the other hand, 529 plans already are, in a sense, the most intrusively regulated financial product offered in America. The structure and operation of 529 plans are set by their state sponsors. Congress could take the view that the role of the states supports a reduced regulatory role on the assumption that the states generally will set or negotiate fees that are lower than for similar investment products. There is evidence, however, that a number of states offer 529 plans with extremely high expenses, which suggests that some states may provide less effective mechanisms for efficient pricing than the mutual fund marketplace.

---

[43] See Letter from Michael G. Oxley, Chairman, Committee on Financial Services, U.S. House of Representatives, to William H. Donaldson, Chairman, Securities and Exchange Commission at 2 (Feb. 4, 2004) available at http://financialservices.house.gov/media/pdf/3-16-04%20529%20lttr%20part%20two_001.pdf (site last visited May 30, 2004). In July, Chairman Oxley asked Chairman Donaldson to comment on a number of proposals regarding 529 plans, many of which are discussed in this testimony. See Letter from Michael G. Oxley, Chairman, Committee on Financial Services, U.S. House of Representatives, to William H. Donaldson, Chairman, Securities and Exchange Commission (July 15, 2004) available at http://financialservices.house.gov/media/pdf/d2ltr.001.PDF (site last visited Sep. 28, 2004).

[44] This holds for many characteristics of 529 plans. For example, Congress could reasonably decide that the purpose of 529 plans would not be served if a participant could bet his entire investment on a single stock, and accordingly require that 529 plan assets be invested exclusively in diversified pools. This issue echoes the recent debate regarding a proposal by Senator Corzine and others to limit the percentage of an employee's account in a tax-deferred employee benefit plan that may be allocated to his employer's stock. See Ellen Schultz, Should Pension Law Do More to Protect Retirement Savings? Wall Street Journal (Jan. 14, 2002) (proposal by Senators Corzine and Boxer to limit employer's stock to 20% of employee's retirement plan).

The purpose of the foregoing discussion is to frame ways of thinking about the regulation of 529 plan fees and encourage Congress and regulators to resolve the issue of the governmental interest in 529 plans before developing new 529 plan regulations.

The following discussion is based on my view that Congress does have a greater regulatory interest in 529 plan fees than it has in mutual fund fees. In this case, if one also assumes that the regulation of mutual fund fees has generally been successful,[45] then the regulation of 529 plan fees needs a substantial overhaul. At a minimum, Congress should authorize and direct the Commission to establish standardized formats for the prominent disclosure of 529 plan fees, as discussed further in Part II.D of this testimony, that are comparable or superior to the fee disclosure provided by mutual funds.

Indeed, Congress should consider regulation of 529 plan fees that exceeds similar rules for mutual funds. Congress should exercise greater caution here, however, for we lack the historical experience that 16 years of standardized mutual fund fee disclosure has provided. Congress should be particularly careful about addressing concerns that are truly 529 plan concerns, as opposed to concerns that simply reflect problems with the investment products generally.

For example, it may be unprofitable to evaluate the need for regulation based on whether there is a causal relationship between the amount of fees charged by a 529 plan and the amount of additional funds made available for higher education as a result of the plan's tax benefits. It may seem intuitively obvious that, because every dollar that a participant spends on fees is one less dollar that he could spend his child's education, fees directly reduce, and can exceed, the tax benefits provided by 529 plans. But this tradeoff between fees and tax benefits may be nonexistent if the participant would otherwise have invested in a taxable mutual fund that had similar expenses.

[45] There is strong, indirect evidence that mutual fund fee disclosure has been fairly successful (although it could be substantially improved). Over the last decade or so, mutual fund investors generally have migrated toward lower cost fund complexes, thereby suggesting that cost is a factor they consider when making investment decisions.

In response to Chairman Oxley's question about whether fees could outstrip the tax benefit provided by 529 plans, for example, the Commission showed that an investment in a high-cost, load 529 plan that invests in a actively managed fund would leave the participant with a much smaller end-of-period balance than if he had invested in no-load, low-cost index fund in a taxable account.[46] This is not, as the Commission concedes, an "'apples-to-apples' comparison," however, because the participant who buys an actively managed option in a high-cost, load 529 plan probably would not otherwise invest in a low-cost, no-load, index mutual fund in a taxable account, but in a high-cost, load, actively managed mutual fund in a taxable account. Fees charged by high-cost 529 plans, based on a cursory review, simply do not bear out the argument made by some that they exceed what an investor might otherwise pay outside of the plan.[47] While excessive 529 plan fees clearly raise policy concerns, they are not truly ***529 plan*** concerns.

A more relevant question may be whether a 529 plan, after taking into account any additional services it provides (e.g., asset allocation), is more expensive than a similar tax-deferred account.[48] If the answer is "no," then arguably 100% of the tax benefit that Congress intended to bestow on 529 plan participants has been preserved, even where the plan's expenses are very high. In the absence of evidence that participants in 529 plans routinely incur higher expenses than they would otherwise incur

---

[46] Nazareth Memorandum, supra note 11, at A-13. This assumes that the investment option for the model 529 plan used by the Commission, which has annual fees of 2.0%, is an actively managed fund.

[47] Professor Goolsbee uses the example of a 529 plan option that imposes annual fees equal to 1.83% and a 5.75% front-end load (or, without the front-end load, annual fees of 2.54%) to support the statement that "[t]hese fees are unbelievably high, vastly more than you would pay for a normal investment." See "529" Ripoff, supra note 3. In fact, even higher fees are charged by mutual funds outside of 529 plans. See, e.g., supra note 5.

[48] It is also possible that participants in 529 plans might not otherwise invest those assets at all. This might be particularly likely where the interests in the plan have been sold by an intermediary who has convinced the participant that the tax benefits are worth foregoing the benefits of immediate consumption. Even in this case, however, it is difficult to show that fees directly reduce the tax benefits realized from 529 plans. And in any case, it is likely that most 529 plan assets would have been invested in taxable (or other nontaxable) accounts if 529 plans had not been available.

in similar non-529 plan accounts,[49] it is unlikely that 529 plans' tax benefits are reduced or eliminated by fees in any meaningful sense.[50]

2. Current 529 Plan Fees and Fee Disclosure

Once the nature of the governmental interest in 529 plans has been identified, information about 529 plan fees should be collected and analyzed. Legislators and regulators will not be able to formulate effective fee disclosure policies and procedures without a thorough understanding of the amount and kinds of fees charged by 529 plans. The Commission is in the best position to collect and analyze such information regarding 529 plan fees, it has the greatest expertise in this area, and Chairman Donaldson's Task Force on College Savings Plans already has a head start on this work. In the past, the Commission has not been as effective as it should have been in anticipating broad developments in the financial services industry. The Task Force should help remedy this problem by developing not just the empirical basis for further evaluation (and, as appropriate, regulation) of 529 plans, but also an analysis of the role of 529 plans and similar products in the financial services marketplace within the framework of the governmental interests such plans are intended to serve.

---

[49] One reason that fees may be increased is that participants may pay commissions and other distribution fees to intermediaries. Anecdotal evidence suggests, however, that the use of intermediaries in the 529 plan context is no higher than in other contexts. See Nazareth Memorandum, supra note 11 (broker-sold 529 plans account for approximately 75% of all sales of interests in 529 plans) (citing J. Kim, Assets in 529 Plans Jumped 83% to $35B in 2003, Dow Jones Newswire (Feb. 4, 2004) (quoting Whitney Dow, director of education-savings research at Financial Research Corporation)); Mutual Fund Fact Book, supra note 38, at 48 (87% of new sales of mutual fund shares were made through third parties in 2003).

[50] It should be noted that this analysis implicitly rejects the oft-stated view that sales charges are a dead weight expense that by their very nature are excessive. See, e.g., Penelope Wang, The Trouble with 529 Plans: More and More States Are Messing Up a Good Thing with Fees, Commissions and Bum Funds, Money (Oct. 7, 2003). This position confuses what we might like to be true about investors with what we might like to be true about 529 plans. It makes sense to wish that all 529 plans were no-load only in the sense that we might wish that all investors were sufficiently self-directed and informed so as not to need (or have to pay for) investment advice. If one assumes that some investors do need advice, however, then we should wish that all states provided 529 plans that could be used by such investors. The argument that intermediaries should simply recommend no-load 529 plans is a contradiction of terms, for an intermediary is, by definition, a person who is in the business of providing investor services ***for compensation***. In a world in which intermediaries recommended no-load investments, intermediaries would not exist. Thus, the criticism of 529 plans for imposing distribution fees is not so much a criticism of 529 plans as it is of the situation of investors who decide to invest through intermediaries or the practice of tying intermediaries' compensation the product being sold. See Bullard Testimony, supra note 18, at 22.

Toward this end, I recommend that the Subcommittee provide specific guidance to the Commission regarding the scope of the work of the Task Force to ensure that it does not merely collect data, but also places that data in its broader policy context and defines core principles on the basis of which it believes products such as 529 plans should be regulated – even where those products are outside of the SEC's jurisdiction. The Commission often has a tendency to limit its role to that of an interpreter of what the law is and to avoid its equally important role in proposing answers to the hard questions of what the law should be. The Commission's unparalleled expertise and background necessitates that it become more engaged in the process of developing the foundational principles according to which markets should be regulated. The Subcommittee should encourage Chairman Donaldson to steer the Commission's new focus on risk assessment in this direction.

More specifically, the Task Force should not confine its role to identifying and categorizing 529 plan fees and describing the quality and scope of the disclosure of those fees. The Task Force should also consider how 529 plan fees and fee disclosure compare to fees charged by comparable investment vehicles, including mutual funds, Individual Retirement Accounts ("IRAs"), 401(k) plans, variable annuities, and similar investment vehicles. The Commission has expended substantial resources analyzing mutual fund disclosure, for example, but few resources analyzing the actual disclosure provided to end-users of mutual funds where the mutual funds are sold in a tax-deferred wrapper that may or may not be within the SEC's jurisdiction.[51] The Task Force should also consider how the structure of 529 plans affects their operation and fees. The next part of this testimony discusses a number of ways in which the structure of 529 plans raises particular concerns, and the debate about how to regulate 529 plans would benefit from the SEC's analysis of those concerns. Finally, and perhaps most importantly, the Task

[51] For example, in a 1992 study, the SEC staff published an extensive analysis of mutual fund regulatory issues that cut across a variety of investment products, some of which were outside of the SEC's jurisdiction. Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, Securities and Exchange Commission (May 1992).

Force should specifically articulate the general government policy or policies that the Commission and the Task Force understand the regulation of 529 plans should serve.

D. Recommendations for Fee Reform

With respect to the issue of 529 plan fee disclosure, there appears to be widespread agreement that current standards are inadequate, and that 529 plans should be subject to uniform standards for fee disclosure. This leaves the questions of what form such standards should take and who should develop and enforce them?

1. Uniform Standards for 529 Plan Fee Disclosure

Fee disclosure rules for 529 plans should follow certain basic principles. Fees should be prominently disclosed to reflect their importance, and be easy to compare across different plans. This necessitates standardization and disclosure of fees charged by competitors. Fees should be provided as a percentage of assets and in dollars. The former approach permits comparability[52] and prevents high-percentage fees to be hidden in the form of apparently low fixed charges.[53] The latter approach conveys a more tangible sense of the actual cost of the services provided.[54] Fees should be divided into categories, in order that investors may evaluate the uses to which their payments are being put. Finally, 529 plans should provide separate disclosure of the fees received by intermediaries in connection with the purchase and sale of plan interests in order to direct participants' attention to intermediaries' conflicts of interest.

---

[52] See Opening Statement of Chairman Oxley, supra note 6 (affirming importance of investors' being able to engage in "comparison shopping").

[53] For example, the Maryland College Investment Plan charges a one-time $90 enrollment fee and a $30 account fee, which for a minimum account of $250 would equal 48% of assets in the first year and 12% each year thereafter, not including other expenses. Disclosure Statement at 5 & 13 – 14 (November 2003) link available at http://www.collegesavingsmd.org/GT2gettingstarted.cfm (site last visited May 30, 2004).

[54] See Opening Statement of Congressman Gillmor, supra note 18 ("Disclosure of expenses as a percentage of assets allows for better comparison among funds but it does not effectively communicate real costs.)

Based on these principles, uniform standards for 529 plan fee disclosure should meet the following minimum standards. Fee disclosure for 529 plans, at a minimum, should be:

- Standardized, both in the way in which the fees are calculated and the terms used to describe the fees;
- Prominently disclosed relative to other information about the plan;
- Presented both as a percentage of assets and a dollar amount, and on an illustrative and individualized basis;
- Inclusive of a total expense ratio for each investment option that includes all fees incurred in connection with an investment in the plan, to include, among other things, portfolio transaction costs, distribution costs, operating costs and administrative fees, whether charged by the state, plan manager, investment manager, or other person;
- Inclusive of a pie chart that illustrates the components of the total expense ratio according to standardized categories of fees, such as investment management, administrative services, and marketing and distribution;
- Inclusive of information on fees charged by other 529 plans both in a disclosure document and in an easily accessible format on the Internet; and
- Inclusive of separate disclosure of all payments received by intermediaries for executing the transactions in plan interests, both as a dollar amount and percentage of assets, whether or not the payment is made directly by the participant.

As discussed above, the CSPN Principles do not meet these minimum standards ina number of material respects and are not mandatory.[55]

2. Responsibility for Promulgating and Enforcing 529 Plan Fee Disclosure

Congress should assign exclusive responsibility for the regulation of 529 plan fee disclosure to the Commission. The Commission has more experience and expertise regulating fee disclosure than any other governmental entity, and it has more objectivity

[55] See supra text accompanying notes 21 – 24.

and independence than the states. Although the states should play a central role in developing uniform fee disclosure standards, they should not have final decisionmaking authority over the form and content of such disclosure. Nor should states be left to enforce such standards themselves.

The states will not provide the objectivity and independence necessary to develop uniform disclosure standards. For example, the brokerage industry already has expressed its unconditional opposition to the SEC's proposal to require delivery of point-of-sale and confirmation fee disclosure, and it is likely to oppose any similar disclosure standards promulgated by the states.[56] This same industry acts as a partner with the states in the offering of 529 plans. It is unrealistic to believe that, in view of their partnership with the brokerage industry, the states will be as independent and objective as an entity that had no such relationship.

The states' objectivity and independence will also be compromised by the fact that their interests are not necessarily always aligned with the interests of all 529 plan participants.[57] States have incentives to benefit elected officials, state institutions and non-participant state residents to the detriment of plan participants, and to benefit in-state plan participants to the detriment of out-of-state plan participants. The states, as public actors in the private sector, have a conflict of interest that will inevitably color their judgment regarding fee disclosure and other aspects of 529 plan operations.

Regulation of 529 plans by the states has an additional disadvantage of requiring agreement by 50 different entities,[58] and probably a large percentage of their financial

---

[56] See Letter from George R. Kramer, Vice President and Acting General Counsel, Securities Industry Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 12, 2004) (rejecting SEC proposal to require delivery of point-of-sale document and opposing proposal for disclosure of actual dollar amount of commission on confirmation) available at http://www.sec.gov/rules/proposed/s70604/sia041204.pdf (site last visited May 30, 2004).

[57] See supra discussion at pages 15 - 17.

[58] The states were unable to resolve similar problems with state-by-state regulation of mutual fund disclosures, thereby prompting Congress to enact the National Securities Markets Improvements Act of

services partners. There is also the risk that one or more states may refuse to cooperate, thereby undermining the important goal of uniformity, and there is no clear enforcement mechanism to address this potential problem. As noted above, the disclosure principles proposed by the College Savings Plans Network expressly emphasize that they are voluntary and should not be read "to suggest that alternative disclosure practices may not be acceptable."[59] As long as incomplete, nonstandardized fee disclosure is an acceptable alternative to comprehensive, standardized disclosure, fee disclosure will not and cannot be effective.

In contrast with the 50 decisionmakers for 529 plans, the Commission has one, five-member decisionmaking authority that can more efficiently develop rules, issue them for public comment, and move to final adoption in a timely manner, and the Commission can enforce these standards against the states independent of political considerations.[60] To illustrate the limitations of allowing states to regulate their own plans, the states only recently proposed guidelines for 529 plan fee disclosure,[61] and even that step was taken only under the threat of imminent Congressional or regulatory action. The Commission already has taken the initiative in proposing point-of-sale and confirmation disclosure requirements for 529 plans. Interjecting the states into this process risks the promulgation of conflicting standards and ongoing tension between the states and the Commission.

1996, which effectively assigned exclusive authority over the substantive regulation of mutual funds to the Commission.

[59] See supra text accompany note 21.

[60] The Commission has brought numerous enforcement actions against public officials in connection with municipal underwritings. See, e.g., SEC v. Larry K. O'Dell, Civ. Action No. 98-948-CIV-ORL-18A (M.D. Fla.); Litigation Release No. 15858 (August 24, 1998) (settled final order); SEC v. Louis Bethune, Charles L. Howard and John Jackson, Litigation Release No. 15271 (February 28, 1997) (settled final order); SEC v. Louis Bethune, Charles L. Howard and John Jackson, Litigation Release No. 15024 (August 26, 1996) (settled final order); SEC v. Robert L. Citron and Matthew R. Raabe, Litigation Release No. 14913 (May 17, 1996) (settled final orders); SEC v. Robert L. Citron and Matthew R. Raabe, Civ. Action No. SACV 96-74 GLT (C.D. Cal.), Litigation Release No. 14792 (January 24, 1996) (complaint); SEC v. Louis Bethune, Charles L. Howard and John Jackson, Civ. Action No. CV:95-B2509 (N.D. Ala.), Litigation Release No. 14675 (October 2, 1995) (complaint).

[61] See supra note 20.

Although agencies other than the Commission have exercised responsibility for developing fee disclosure requirements for products similar to 529 plans, none has comparable experience and expertise, or a comparable record of success, as the Commission. The Commission currently has responsibility for fee disclosure for mutual funds, which are the predominant investment vehicle in which 529 plan assets are invested, and for variable annuities, which, along with certain employee benefit plans, are the investment products that are most similar to 529 plans. In addition, the Commission already has proposed fee disclosure rules that would address a broad range of 529 plan fee disclosure issues. The SEC's proposed point-of-sale disclosure proposal, with certain key improvements,[62] provides a good starting point for developing a 529 plan disclosure document. Indeed, if Congress grants the Commission jurisdiction over 529 plan fee disclosure, it should consider doing so for other tax-deferred mutual fund wrappers as well.[63]

3. Limits on 529 Plan Fees

The Subcommittee also should consider imposing limits on 529 plan fees. Those who might reject this proposal out of hand -- as contrary to the widespread (and wise) view that the government generally should not set fees -- should hold judgment and consider certain factors that militate for considering limits on fees in the 529 plan context.

---

[62] See Letter from Mercer Bullard, Founder and President, Fund Democracy, Inc. and Assistant Professor of Law, University of Mississippi School of Law, Barbara Roper, Director of Investor Protection, Consumer Federation of America, Kenneth McEldowney, Executive Director, Consumer Action, and Sally Greenberg, Senior Counsel, Consumers Union to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 21, 2004) (recommending, among other things, that point-of sale document be provided a meaningful amount of time before the investment decision is made and include all investment-related costs).

[63] See Protecting Investors, supra note 51, at 151 (recommending that Congress repeal securities law exemption for employee benefit plans in part because "plan participants receive far less information about the investment objectives and policies, performance, investment managers, fees, and expenses of their investment options than do investors who directly purchase securities issued by [mutual funds].")

First, the very concept of a 529 plan depends on the setting of fees by the government because the states set or negotiate all 529 plan fees. The government's role in setting fees is already firmly established in the context of 529 plans.

Second, many do not appreciate that the government already sets fees for investment services and products in a number of contexts. For example, the NASD imposes absolute limits on sales charges on sales of mutual funds and on 12b-1 fees that can be charged by those funds.[64] The Commission effectively prohibits funds from charging redemption fees in excess of 2%. Section 22(d) of the Investment Company Act requires that fund shares be sold only at the price set forth in the prospectus, which effectively fixes the sales charge for any particular fund.

In addition, as discussed above, Congress created 529 plans to achieve a specific social goal: to promote investment in higher education. Congress should consider a more intrusive regulatory approach when an investment product is intended to serve a particular social goal, especially when this purpose is funded by taxpayers in the form of foregone tax revenues. As discussed above, it therefore would be appropriate for Congress to consider limiting 529 plan fees to help achieve this purpose.

There are at least three areas where Congress should consider specific limits on 529 plan fees, as discussed immediately below.

Limits on Distribution Fees.[65] As noted above, the NASD currently limits sales charges and 12b-1 fees. Some 529 plans, within NASD limits,

[64] It appears that these limits may effectively apply to intermediaries selling interests in 529 plans, as the Municipal Securities Rulemaking Board takes the position that sales charges on sales of 529 plan interests that exceed NASD limits on mutual fund sales charges presumptively do not meet the fair and reasonable standard under MSRB rule G-30(b). Rule G-30(b) prohibits dealers from selling municipal securities to a customer for a commission or service charge in excess of a fair and reasonable amount. See Interpretive Notice On Commissions and Other Charges, Advertisements and Official Statements Relating To Municipal Fund Securities, MSRB (Dec. 19, 2001) available at http://www.msrb.org/msrb1/archive/MFSDecNotice.htm#_ftnref1 (site last visited May 31, 2004); Workshop, supra note 25, at 28 – 29.

[65] See also infra text accompanying note 75.

impose front-end sales loads in excess of 5%. This payment reduces an initial $10,000 contribution by $500 or more, thereby substantially reducing the participant's short-term performance.[66] In the 529 plan context, where the investment period as a practical matter is limited to 18 years and is often substantially shorter (depending on the age of the child), participants may have less time over which to spread the impact of a front-end load.

Furthermore, the larger the commission and/or 12b-1 fee, the greater the distortion of the intermediaries' and participants' incentives may be. The greater the distribution payment, the greater the intermediary's incentive to seek a plan with a higher payout and not to recommend a plan that might be better suited for the participant, particularly when the participant's plan offers a state tax deduction only for the in-state plan. The greater the distribution payments, the less freedom the participant has to sell the investment. Locking participants into 529 plans reduces competition and increases costs.

Congress should consider imposing lower limits on 529 plans, such as a 3.00% limit on commissions and a 0.50% limit on 12b-1 and other asset-based distribution fees, that would apply to intermediaries and states alike.

Limits on Purchase and Transfer Fees. For similar reasons, Congress should consider limiting fees charged by 529 plans in connection with initial purchases and transfers. These fees can inhibit competition by making it prohibitively costly for a participant to change plans. For

[66] For example, participants in Arizona's Waddell & Reed InvestEd 529 Plan who buy Class A shares pay a 5.75% front-end load. A $10,000 investment in Class A shares of the highest cost investment option in the Texas Tomorrow's College Investment Plan would incur 7.05% in expenses the first year. See Plan Description, supra note 14, at 18. The expenses include a 4.75% front-end sales charge, a $30 annual account fee, a 0.20% plan manager administrative fee, a 0.25% marketing fee, and up to a 1.75% fee for the underlying investment option. Fees on the investment options range from 0.00% to 1.75%. After May 1, 2005, the plan manager may charge a state administrative fee of 0.10%, thereby increasing the first year's fees to 7.15%.

example, if a plan raises its fees, participants should be able to reject the increase by voting with their feet without having to incur a material fee for doing so. Limits on such fees should be based on the actual administrative cost of processing the purchase or sale.

Mandatory Low-Cost Option. Congress should also consider requiring states that sell 529 plans to offer at least one low-cost option, the fees of which do not exceed a certain amount. For example, Congress could require that each state offer at least one option the annual, total cost of which does not exceed 0.60% of a participant's account in any year. As long as the maximum fee does not exceed the cost of readily available programs, this should not distort the marketplace, while ensuring that every in-state resident has the ability to take advantage of the tax benefits that Congress intended 529 plans to provide without having to pay high fees to enjoy any in-state tax deduction.

III. Questionable Sales Practices

The subcommittee also has expressed concern regarding questionable sales practices in connection with sales of 529 plans. Recent investigations suggest that this concern is justified. The NASD has expanded its investigation of 529 plan sales abuses from 6 to 20 firms.[67] To date, the NASD has found that in some cases more than 90% of the plans sold are out-of-state,[68] and while out-of state plans can sometimes provide greater benefits to investors than their in-state plans, it is highly unlikely that this is the case 90% of the time.[69] A more likely explanation is that brokers may be recommending

[67] See NASD Widens Probe Into 529-Plan Sales, Dow Jones Newswires (Sep. 15, 2004); see also NASD Investigates College-Savings Fund Sales, supra note 7 ("'overwhelming majority'" of plans sold by six securities firms investigated by the NASD were out-of-state, quoting Mary Schapiro, Vice Chairman, NASD); Closer Study, supra note 5 (citing anecdotal evidence that Washington, D.C. "investors are being steered into out-of-state plans that offer neither low fees nor a state tax break").

[68] See NASD Widens Probe, id.

[69] Compare Tom Lauricella and Randall Smith, Morgan Stanley Fund Sales Get Close Look, Wall Street Journal (Apr. 1, 2003) (sales of B shares by Morgan Stanley funds, which provided the highest

plans based on which one pays the highest selling compensation. The NASD's findings that 529 plan marketing materials often tout the plan's benefits but none of the risks is further evidence that sales compensation, not suitability, may often drive the investment advice provided by brokers.[70]

It is important to separate two issues relating to questionable sales practices. The first issue is whether investors are paying too much for investment advice. The second issue is whether the fact that brokers are paid higher sales compensation for selling some 529 plans rather than others ("differential sales compensation") causes investors to make inferior investments. With respect to each of these issues, there are steps that Congress could take to ensure that investors do not pay excessive sales compensation and are protected from self-interested investment advice, as discussed below.

A. The Regulation of Sales Practices

The payment of commissions to compensate brokers for providing investment advice is, of course, not particular to 529 plans. In fact, the percentage of 529 plan investments made through intermediaries appears to roughly parallel the percentage of mutual fund investments made through intermediaries.[71] While some may argue that sales compensation payments are too high, there is no evidence that they are any higher in the 529 plan context than in other contexts.

Nor is there anything inherently questionable about sales compensation.[72] The payment of sales compensation essentially reflects the investor's decision to use -- and

---

compensation to brokers comprised roughly 90% of shares sold); In the Matter of Morgan Stanley DW, Inc., Administrative Proceeding File No. 3-11335 (Nov. 17, 2003) (charging Morgan Stanley with failure to disclose compensation paid in connection with sales of B shares).

[70] See NASD Widens Probe, supra note 67 (quoting NASD vice chairman Mary Schapiro: "We have seen some marketing materials that touted the great benefits . . . with no risk disclosure").

[71] See supra note 49.

[72] See generally supra note 50.

pay for -- an intermediary for financial advice. Sales compensation may even be regarded as necessary to educate investors who are not self-directed about 529 plans.[73] We should not expect brokers to recommend direct-sold 529 plans, that is, plans that do not charge sales compensation, because such plans do not provide a means to compensate brokers for their advisory services. Investors may not be fully aware of the additional cost of investing through an intermediary, but this is a failure of existing disclosure rules and fiduciary standards applicable to brokers. It is not a problem unique to 529 plans.

Nonetheless, disclosure and other problems do indicate that sales compensation in the 529 plan context may be higher than it should be, in the sense that sales compensation may be higher than it would be in a truly efficient market. Sales compensation is poorly disclosed, a problem that the Commission has addressed in a rule that was proposed in January of this year.[74] The rule would require disclosure in documents provided both before and after the client invests in a mutual fund or 529 plan.

This rule, with certain important changes, would improve price transparency and competition, and thereby reduce costs for 529 plans. Industry lobbyists strongly oppose the rule, as they are understandably concerned about how fully informing markets about the prices they charge would affect their profits. The Commission may withstand industry pressure and adopt a good rule, but I continue to believe that Congressional action, such as a bill proposed last year by members of this subcommittee, ultimately will be necessary to ensure that investors know how much they are paying, and how much their brokers are receiving, in sales compensation. Congress should closely monitor the Commission's progress to ensure that it requires useful, transparent disclosure of selling compensation.

---

[73] Sales compensation may provide the needed economic incentive for brokers to educate less affluent Americans about 529 plans who might not otherwise save for their children's higher education. See generally Michael A. Olivas, State College Savings and Prepaid Tuition Plans: A Reappraisal and Review, 32 J. of L. & Educ. 475, 502 (Oct. 2003) (discussing data showing that majority of participants in prepaid college savings plans have high incomes).

[74] See supra note 16.

Congress also should consider whether sales charges on 529 plans should be substantively limited, as they already are for mutual funds. The NASD imposes such limits on the sale of mutual funds, but the Municipal Securities Rulemaking Board ("MSRB"), not the NASD, is responsible for regulating sales of 529 plans. Currently, it is not sufficiently clear whether sales charges on 529 plans are subject to the same substantive limits. MSRB Rule G-30(b) prohibits dealers from selling municipal securities to a customer for a commission or service charge in excess of a fair and reasonable amount, and the MSRB takes the position that sales charges on 529 plans that exceed NASD limits on mutual fund sales charges presumptively do not meet the fair and reasonable standard under MSRB rule G-30(b).[75] But this is not a strict prohibition, and the MSRB has indicated that special circumstances might support sales loads on 529 plans in excess of NASD limits. In view of the close similarity of mutual funds and 529 plans, there is no reasonable basis for permitting 529 plan sales compensation to exceed NASD limits. The MSRB should promulgate rules to this effect.

Finally, Congress should consider whether its special interest in 529 plans warrants imposing lower limits on sales charges than the limits provided under NASD rules. As discussed above, Congress created 529 plans to serve the purpose of promoting affordable higher education, and it is funding this mandate through foregone tax revenues. This heightened policy interest may warrant further restrictions on sales charges imposed on 529 plan sales. For example, as discussed above, Congress might impose a 3.00% limit on commissions and a 0.50% limit on 12b-1 and other asset-based distribution fees, which limits would apply to intermediaries and states alike. There is a risk, however, that brokers may steer clients away from 529 plans and into mutual funds in order to receive a higher commission, even when the 529 plan is the better choice.

B. Differential Sales Compensation and Conflicts of Interest

---

[75] See Interpretive Notice On Commissions and Other Charges, Advertisements and Official Statements Relating To Municipal Fund Securities, MSRB (Dec. 19, 2001) available at http://www.msrb.org/msrb1/archive/MFSDecNotice.htm#_ftnref1 (site last visited May 31, 2004); Workshop, supra note 25, at 28 – 29.

While there is nothing inherently questionable about paying sales charges on 529 plan investments, the payment of differential compensation for different 529 plan investments, especially when that differential compensation is not disclosed, is highly suspect. When different investment products pay brokers different levels of compensation, the payments no longer solely reflect the value of the services provided to the broker's client. The broker generally provides the same services regardless of which 529 plan he advises the investor to purchase, and the payments for that advice should not depend on which product the broker sells. But brokers routinely receive different amounts of compensation for selling different products. This compensation is not adequately disclosed, and even with adequate disclosure, it creates a significant conflict of interest between the broker and his client.[76] This is, again, not a problem unique to 529 plans.

The reason that brokers receive differential compensation is that we allow the maker of the product – the 529 plan provider – to compensate brokers for selling the product, rather than requiring that such compensation be paid by the person to whom the services are actually being provided -- the client. This structure, which for mutual funds is required by the Investment Company Act of 1940 and has been emulated by states that offer load 529 plans, effectively mandates a kind of legalized kickback. Mutual funds -- and now the 529 plans through which they are sold -- pay brokers to incentivize them to sell fund shares and 529 plan interests to their clients, and the funds and plans use the clients' assets to cover this cost, directly through commissions, indirectly through 12b-1 fees, or surreptitiously through revenue sharing arrangements.[77] The broker has a direct

---

[76] See e.g., California v. PA Distributors LLC (Sep. 15, 2004) (charging that fund distributor failed to disclose revenue sharing payments) settlement is available at http://ag.ca.gov/newsalerts/2004/04-105_settlement.pdf (site last visited Sep. 29, 2004); In the Matter of Morgan Stanley DW, Inc., Administrative Proceeding File No. 3-11335 (Nov. 17, 2003) (settling charges that broker failed to disclose revenue sharing payments).

[77] Revenue sharing arrangements are cash payments made by mutual fund managers directly to distributors of fund shares, and there is no meaningful disclosure of these payments by funds or brokers. See generally California v. PA Distributors LLC, id.; In the Matter of Morgan Stanley DW, Inc., id. Another form of hidden sales compensation is the directing of fund brokerage to brokers as compensation for selling fund shares, a practice prohibited by the Commission earlier this month. See Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26591 (Sep. 2, 2004); see generally In the Matter of Massachusetts Financial Services Company, Administrative Proceeding File

incentive to recommend the fund or 529 plan that pays the highest sales compensation, rather than the fund or plan that is the best investment choice.

This structure is questionable because it necessarily leads to greater sales abuses than otherwise would occur. This is not a reflection on the nature of brokers, although one might argue such a compensation structure would attract a higher percentage of malfeasors than other, less conflicted compensation structures. Rather, it is a reflection of how human nature interacts with markets. Market actors inevitably seek out higher profit opportunities for themselves. If the highest-paying, rather than best-performing, 529 plan provides the highest profit opportunity for sellers, then sellers will be more likely to favor the highest-paying 529 plans. Of course, sellers have a parallel interest in recommending the best-performing 529 plan, and, all things being equal, the markets provide strong incentives to recommend that plan. But the direct economic incentive to sell the highest-paying plan will invariably lead to greater sales abuses.

Another structural cause of questionable sales practices is the lower legal standard that the Commission has applied to brokers when they provide investment advice. As brokerage has increasingly become a commodity-like service that cannot support the high profit margins demanded by full-service brokerage firms, these firms have shifted their core service to investment advice. Traditionally, courts hold those who provide investment advice to a fiduciary standard of conduct, in contrast to the lower suitability standard to which sellers of products are held. The Commission has flouted this distinction by exempting brokers who provide investment advice to retail investors from regulation as investment advisers[78] -- while at the same time ironically proposing to regulate hedge fund advisers who provide investment advice only to financially

---

No. 3-11450 (Mar. 31, 2004) (settling charges that fund manager failed to disclose use of fund brokerage to compensate brokers for distributing fund shares).

[78] See Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release. No. 1845 (Nov. 4, 1999); see also Certain Broker-Dealers Deemed Not To Be Investment Advisers: Reopening of Comment Period, Investment Advisers Act Release. No. 2278 (Aug. 18, 2004).

sophisticated investors.[79] The Commission's position directly contradicts an express Congressional mandate in the Investment Advisers Act and will inevitably lead to greater sales abuses in the context of 529 plans and by brokers generally.

The low standard of conduct to which the Commission holds brokers, and the inherent conflict of interest created by differential compensation, provide a fertile field for sales abuses. As a general matter, a broker has no incentive to recommend a higher cost 529 plan or, in the case of an out-of-state plan, a 529 plan that offers fewer tax advantages. But the opportunity to earn higher sales compensation, and the low standard of care to which brokers are held, inevitably conspire to produce self-interested recommendations. These recommendations will often harm investors and directly reduce the amount of money they have available to fund their children's education.

Congress should address the problem of differential compensation, and particularly undisclosed differential compensation, in at least two ways. First, it should require disclosure of differential compensation that shows the dollar amount of the broker's incentive to favor one set of mutual funds or 529 plans over another, if the Commission does not impose this requirement through rulemaking. Second, Congress should begin the process of reevaluating the rules that effectively require differential payments to brokers on sales of mutual funds. Investors and mutual funds would be better served by a system in which sales compensation was based on the services provided to the client, and not the mutual fund's willingness to effectively bribe the broker to sell its shares.

Congress also should act to reverse the Commission's ill-advised position on brokers who provide investment advice. When Congress adopted the Investment Advisers Act, it expressly decided that brokers who provide investment advice should be regulated as investment advisers, unless the advice was "solely incidental" and the broker received no special compensation. The Commission has expressly repealed the special

[79] See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (July 20, 2004).

compensation test and effectively repealed the solely incidental test, and evidence of this abounds in the proliferation of broker advertisements that hype their investment advisory and financial planning services. Congress should enact legislation that prohibits the Commission from exempting brokers who provide investment advice from regulation as investment advisers.

IV. Disparate State Tax Treatment

As mentioned briefly above, the disparate state tax treatment of 529 plans distorts the marketplace for investment products and may create incentives to charge higher fees.[80] Participants in 529 plans typically do not receive any state tax deduction for contributions to out-of-state plans,[81] which may create incentives to pay higher fees. Investors may opt for a higher-cost, in-state plan specifically in order to receive the tax benefits of the in-state plan,[82] or may miss out on the in-state tax benefit offered by a low-cost in-state plan because brokers recommend out-of-state plans that pay higher compensation to the broker.[83]

The disparate state tax treatment of 529 plans has the effect of reducing price competition among 529 plans because in-state plans can exploit their monopoly on in-

[80] See supra pages 15 – 16.

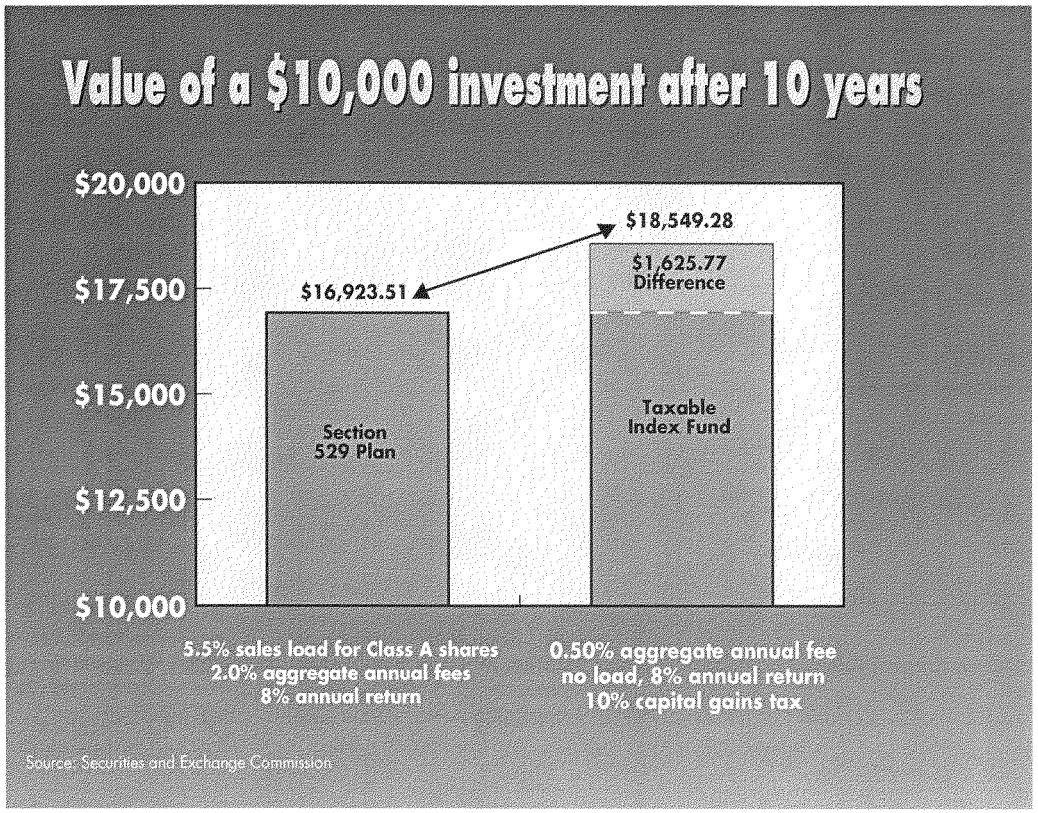
[81] The 529 plans for 24 states and the District of Columbia permit residents to deduct some or all of their contributions to their state's 529 plan from their state tax return. See Tax Break, supra at note 27. A Wisconsin state representative has introduced a bill that would permit residents to deduct some or all of their contributions to any state's 529 plan from their Wisconsin tax return. See Tax Break, id. Some states treat, or are considering treating, all 529 plan distributions equally for state law purposes. See, e.g., 529 College Investing Programs in Maine Now Treated Equally, Finance Authority of Maine (June 23, 2003) (state law treating distributions equally for all 529 plans) link available at http://www.ici.org/issues/edu/arc-leg/03_maine_529_tax.html (site last visited May 29, 2004); Letter from Matthew Fink, President, Investment Company Institute, to Illinois State Representatives Michael J. Madigan and Barbara Flynn Currie (Apr. 24, 2003) available at http://www.ici.org/statements/cmltr/03_maine-illinois_529_com2.html#TopOfPage (site last visited May 29, 2004) (discussing Illinois' considering similar provision for equal treatment of distributions by all 529 plans).

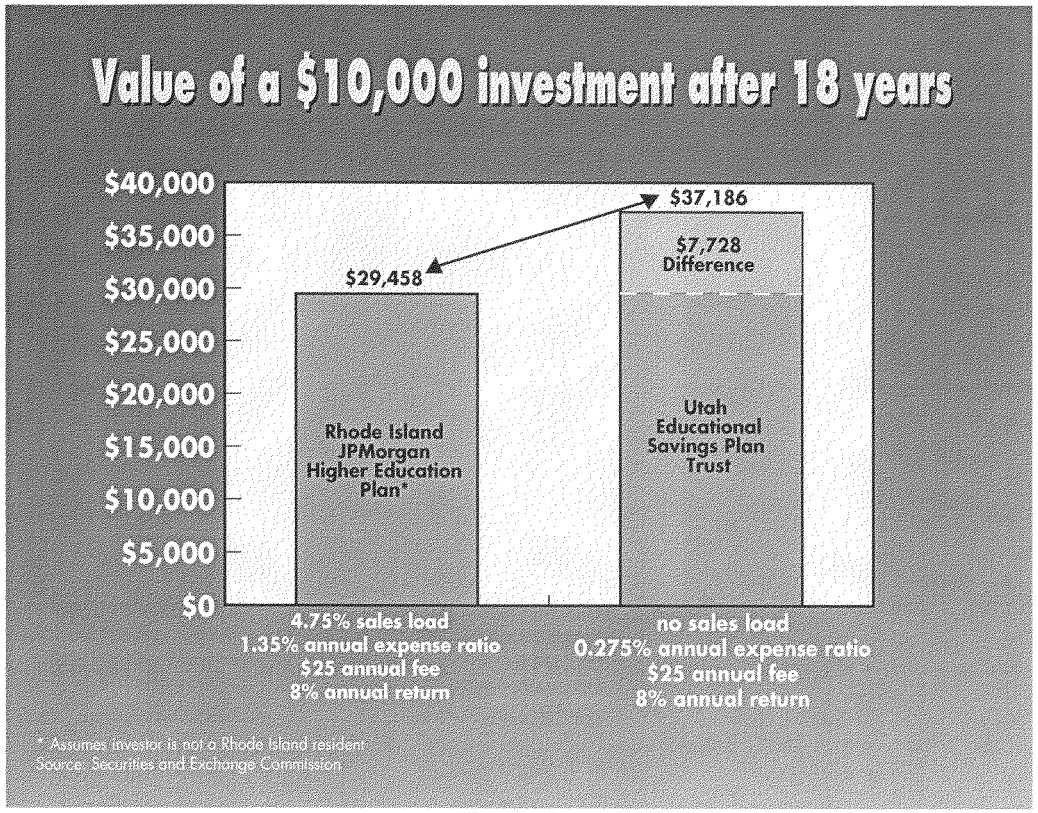
[82] See Tax Break, supra note 27 ("Zimmerman and others are concerned that the various state tax breaks stop some people from making the proper choice of plan").

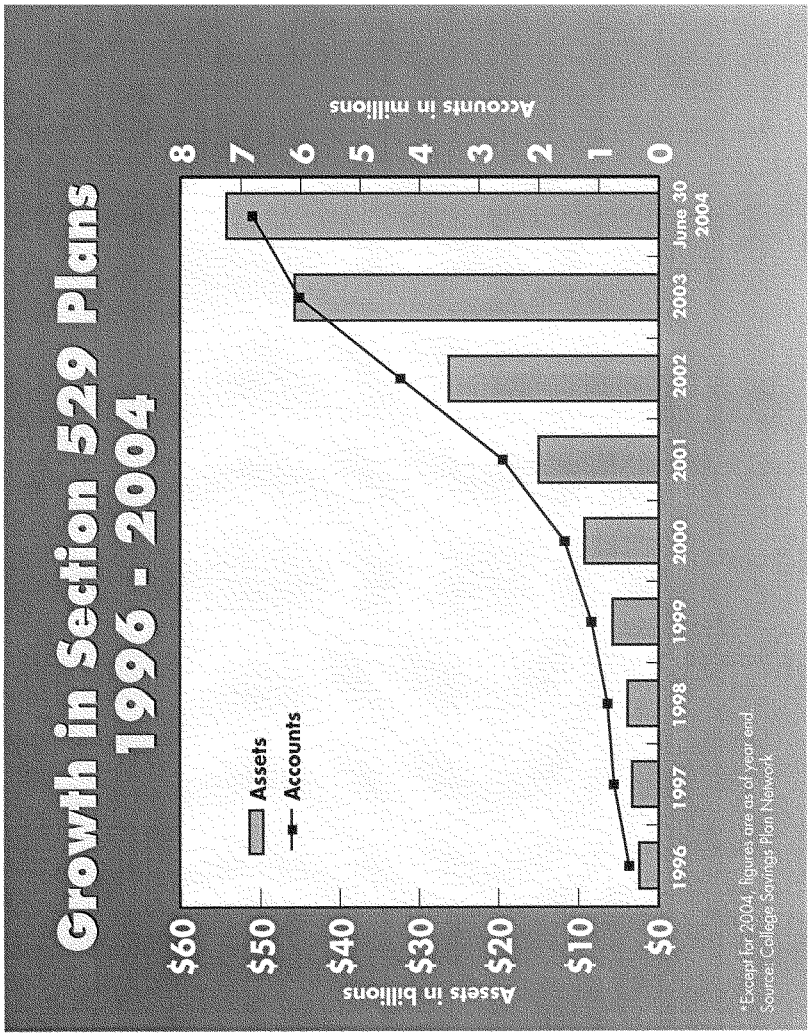
[83] See supra note 67.

state tax benefits to offset their higher fees. This is essentially a kind of bundling, not dissimilar to a private company that has a government-granted monopoly over one product (state tax deductions) to help it sell another, possibly inferior product (the 529 plan).[84] States will inevitably exploit this monopoly to the detriment of investors in 529 plans. Congress should consider mandating that any state tax deductions for 529 plan contributions or distributions be reciprocal across all qualified 529 plans.

[84] See Closer Study, supra note 5 ("'One of the most significant things (the tax breaks) do is to make it necessary for anyone considering a 529 plan to consider their home state plan first,' [said Zimmerman] 'It sweetens the deal.'").


Value of a $10,000 investment after 10 years
$20,000
$17,500
$15,000
$12,500
$10,000
$16,923.51
$18,549.28
$1,625.77
Difference
Section
529 Plan
Taxable
Index Fund
5.5% sales load for Class A shares
2.0% aggregate annual fees
8% annual return
0.50% aggregate annual fee
no load, 8% annual return
10% capital gains tax
Source: Securities and Exchange Commission


Value of a $10,000 investment after 18 years
$40,000
$35,000
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$0
$29,458
$37,186
$7,728
Difference
Rhode Island
JPMorgan
Higher Education
Plan*
Utah
Educational
Savings Plan
Trust
4.75% sales load
1.35% annual expense ratio
$25 annual fee
8% annual return
no sales load
0.275% annual expense ratio
$25 annual fee
8% annual return
* Assumes investor is not a Rhode Island resident
Source: Securities and Exchange Commission


Growth in Section 529 Plans
1996 - 2004
Assets
Accounts
Assets in billions
$60
$50
$40
$30
$20
$10
$0
Accounts in millions
8
7
6
5
4
3
2
1
0
1996
1997
1998
1999
2000
2001
2002
2003
June 30 2004
*Except for 2004, figures are as of year end
Source: College Savings Plan Network

MORNINGSTAR.com

529 Plan Information

View: Fees & Expenses Results: View All

Plan	Prog Mgr % Min	Prog Mgr % Max	Exp Ratio% Min	Exp Ratio% Max	Program Fees $ Enroll	Program Fees $ Annual Maint	Program Fees $ Change Benef	Program Fees $ Non-Qual Withdrawl
AK Manulife College	0.75	1.65	0.55	1.3	---	30	---	---
AK T Rowe Price Coll	0.3	0.3	0.48	0.8	---	30	---	---
AK University Colleg	0	0.3	0.48	0.8	---	30	---	---
AL Higher Education	0	1.1	0.79	1.78	---	10	---	---
AR GIFT College Inve	---	---	---	---	---	25	---	---
AZ CSB Family Colleg	0	0	---	---	---	---	---	---
AZ PF 529 College Sa	0	0	0.95	2.55	10	---	---	---
AZ SM&R Family Colle	0	0	0.5	2.75	10	---	---	---
AZ W&R InvestEd Plan	0.85	0.85	0.92	0.92	10	---	---	---
CA Golden State Scho	0.65	0.8	0.07	0.15	---	---	---	---
CO Scholars Choice C	0.1	0.58	0.51	0.8	---	30	---	---
CO Stable Value Plus	---	---	---	---	20	---	---	---
CT Connecticut Highe	0.64	0.79	0.06	0.15	---	---	---	---
DC 529 College Savin	0.15	0.15	0.62	1.75	25	30	---	---
DE College Investmen	0.3	0.3	0.58	0.86	---	30	---	---
FL College Investmen	---	---	---	---	50	---	---	---
GA Higher Education	0.72	0.85	0.07	0.13	---	---	---	---
HI TuitionEDGE	0.95	0.95	---	---	---	25	---	---
IA College Savings I	0.5	0.6	0.05	0.15	---	---	---	---

IA Principal Coll Sv	---	---	---	---	---	---	---	---
ID College Savings P	0.79	0.93	0.07	0.14	---	---	---	---
IL Bright Start Coll	0.25	0.99	0.51	0.74	30	---	---	---
IN CollegeChoice 529	0.15	0.95	0.35	1.49	---	40	---	---
KS Learning Quest Ed	0.39	0.39	0.52	0.95	---	27	---	---
KS Schwab 529 Colleg	0.39	0.39	0.62	1.14	---	27	---	---
KY Education Savings	0.65	0.73	0.07	0.15	---	---	---	---
LA State Tuition Ass	0	0	---	---	---	---	---	---
MA U.Fund College In	0.3	0.3	0.58	0.83	---	30	---	---
MD College Investmen	---	---	---	---	90	30	---	---
ME NextGen College I	0.6	0.9	0.64	1.65	---	50	---	---
MI Education Savings	0.52	0.65	0.07	0.13	---	---	---	---
MN College Savings P	0.52	0.65	0.07	0.13	---	---	---	---
MO Adv Svg for Tuit	0	0.57	0.08	0.2	---	25	---	---
MO Svg for Tuit Prog	0.51	0.65	0.07	0.14	---	---	---	---
MS Adv Affordable C	0	0.7	0.08	0.2	---	25	---	---
MS Affordable Colleg	0.8	0.93	0.07	0.13	---	---	---	---
MT Family Education	0	0	---	---	---	---	---	---
MT Pacific Funds 529	0	0	0.95	2.55	---	25	---	---
NC National College	---	---	---	---	---	25	---	50
NC Seligman CollegeH	---	---	---	---	---	25	---	---
ND College SAVE	---	---	---	---	---	30	---	---
NE AIM College Savin	0.35	0.9	0.89	1.82	---	25	---	50
NE College Savings P	0	0.6	0	1.06	---	20	---	---
NE TD Waterhouse Col	0.85	0.85	0	1.06	---	30	---	---
NH Fidelity Advisor	0.45	1.3	0.46	1.06	---	30	---	---
NH UNIQUE College In	0.3	0.3	0.58	0.85	---	30	---	---
NJ Better Educationa	---	---	---	---	---	---	---	---

NJ Franklin Templeto	---	---	---	---	---	25	---	---
NM Arrive Education	---	---	---	---	---	25	---	---
NM CollegeSense 529	---	---	---	---	---	25	---	---
NM ScholarsEdge	0.6	1.45	0.63	1.32	---	25	---	---
NM The Education Pla	---	---	---	---	---	30	---	---
NV American Skandia	0	0	1.44	1.9	---	30	---	25
NV Columbia 529 Plan	0.25	0.3	0.59	1.38	---	25	---	---
NV Strong 529 Plan	0.25	0.25	0.6	1	10	10	---	25
NV UPromise College	---	---	---	---	---	---	---	---
NV USAA College Savi	0.3	0.3	1	1	---	15	---	---
NV Vanguard 529 Coll	0.32	0.85	0	0.33	---	20	---	---
NY 529 College Svgs	0.38	0.6	0.08	0.22	---	---	---	---
NY Columbia NY 529 P	0.3	0.3	0.38	1.5	---	25	---	---
OH CollegeAdvantage	0.05	1.35	0.58	1.4	---	25	---	---
OH Putnam CollegeAdv	0	1.35	0.58	1.4	---	25	---	---
OK College Savings P	0.55	0.55	0.07	0.13	---	---	---	---
OR College Savings P	0.1	0.1	0.88	1.15	---	30	---	---
OR MFS 529 Savings P	0.25	0.25	0.7	2.65	---	25	---	---
OR USA CollegeConnec	---	---	---	---	---	30	---	---
PA Tap 529 Investmen	0.35	0.35	0.6	1.29	---	25	---	---
RI CollegeBoundfund	0	1	0.68	2.24	---	25	---	50
RI JP Morgan Higher	0.14	1.32	0.68	1.11	---	25	---	50
SC Future Scholar 52	0.2	1.3	0.35	1.48	---	25	---	---

COMMONWEALTH OF PENNSYLVANIA
OFFICE OF THE TREASURER
HARRISBURG, PA 17120-0018

BARBARA HAFER
TREASURER

October 6, 2004

The Honorable Peter G. Fitzgerald
Chairman, Governmental Affairs Subcommittee on
Financial Management, the Budget, and International Security
Room 445 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Fitzgerald:

Thank you for your leadership in conducting the September 30, 2004 hearings of the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security regarding Section 529 plans. As the Treasurer of Pennsylvania, I administer Pennsylvania's Section 529 Plan – TAP 529. And, I share your desire to make Section 529 plans an even better way for families to save for college. I also applaud your efforts to address the larger issues with mutual funds in general. Reforms in the mutual fund industry will certainly inure to the benefit of Section 529 plans as well. I am writing, however, to respond to some of the questions you and others raised during the hearing. And, I respectfully request that my letter and its attachment be included in the official record of the hearing. I would like to address three major topics discussed at the hearings: The enormous benefits that result from the STATES offering Section 529 plans, the fees that states receive, and the need to preserve the states' right to set their own tax policies.

I. Benefits of States Offering Section 529 Plans.

The states' establishment and maintenance of Section 529 plans bring innumerable benefits to the programs, some of which I will highlight below. But each of those benefits follows from the overarching state public policy driving these programs – their primary, if not sole, purpose: To make higher education affordable and accessible for its citizens of all socio-economic levels – particularly those of lower and middle income groups. I am sure that this is a goal shared by Congress. But it is NOT shared by the private sector investment firms that would be left to offer these programs if the states were not involved. Those investment firms' first obligation, as it must be, is to their own financial success. Without state involvement, Section 529 plans would very likely become plans used more by the wealthy, who have less need for them, than by those of lesser, more moderate means, for whom these programs provide the best hope of a better future.

A. State involvement brings the state's investment expertise and buying-power to each family investing in the program. Most low- and moderate-income families are not sophisticated investors. Few use financial planners. And, to be blunt, many financial planners are not interested in serving these families because they have few discretionary dollars to invest. In creating its Section 529 program, the state has relied on its financial and investment experts that oversee the investments of other state funds. Through the state's establishment and maintenance of its Section 529 program that expertise is brought to each family who invests in the program.

Using its financial experts, Pennsylvania went through an exhaustive process to identify an investment firm with integrity, an investment philosophy that would be compatible with the needs of families of all income levels and investment sophistication, strong investment performance, and a reputation for good customer service. We carefully evaluated and continue to actively monitor the performance of each fund used in the program. We are able to offer lower-cost institutional shares and a stable value fund not normally available to individual investors. Funds typically available only through a broker, with the attendant sales commissions and fees, are available without those charges directly through the program. And, we can adjust the offerings whenever necessary. Few families of even moderate means have the expertise, time, resources, or ability to do this on their own.

B. State involvement gives families confidence to save for college. Many low- and moderate-income families are willing to save for college through their state's Section 529 plan precisely because it is a state program. They have confidence in the program because of the state's expertise and oversight as described above. They trust their elected, or appointed, state official who is responsible for the program.

If the requirement that Section 529 plans be established and maintained by a state were to be eliminated, it is likely that the Section 529 plan market place would become much more confusing and that confusion would deter more families from saving. More investment firms would create and offer programs. Choosing the "right" program would be a more daunting task and many families might be frozen in inaction. State involvement gives the small, unsophisticated saver the confidence to invest. More sophisticated investors have the wherewithal to start with their home state program but investigate other options and choose what is best for them. But the vast majority of low- to moderate-income families who are unsophisticated investors can count on their state to have done its homework, giving those families confidence to invest that they would not have otherwise.

C. State involvement ensures that Section 529 plans are accessible to low- and moderate-income families. Many investments, such as mutual funds, require initial investments and subsequent minimum investments that are too high for most low- and moderate-income families to meet. In negotiating agreements with their investment fund managers, states are usually insistent that these investment minimums be reduced so that families of all income levels can participate. In Pennsylvania, a family who invests monthly can save in the TAP 529 Investment Plan, our mutual fund based program, for as little as $50 per month. In our Guaranteed Saving Plan, the savings plan with growth indexed to tuition inflation, it is just $25 per contribution.

Additionally, our Section 529 plan is coordinated with our Individual Development Account (IDA) program, called the Family Savings Account Program. Through this program, run by Pennsylvania's Department of Community and Economic Development, low income families (200% of federal poverty) can save for higher education by putting their supervised savings into a TAP 529 account and earn a dollar for dollar government match up to $2,000. This coordination is possible only because TAP 529 is a state program.

D. State involvement ensures that marketing for the Section 529 reaches all segments of the population. Few, if any, private sector mutual fund firms or other investment firms actively market to low and moderate income families. The realities of the investment world are that larger dollar accounts are more profitable and small dollar accounts are costly to manage. State involvement in Section 529 plans, however, ensures that the marketing will reach those segments of the population not typically targeted by private-sector investment firms. In contracting with their private-sector partners, states insist that marketing is targeted to all segments.

Moreover, because Section 529 plans are state plans, many more outreach avenues are available for reaching the entire population of the state. The following are a sampling of the Section 529 program outreach that takes place in Pennsylvania that would not be available if the program were not a state program: Low-cost public service radio and television advertising. Inserts placed in our Department of Transportation mailing to every resident renewing a license. Inserts sent with each birth certificate for a newborn or newly adopted child. Outreach mailings and presentations to elementary, middle, and high school parents throughout the state. Statewide workshops given to elementary and middle school guidance counselors. Coordination with the Pennsylvania Higher Education Assistance Agency (PHEAA) Early Awareness Program, designed to encourage students and their families to plan for college starting earlier. Contact by members of Pennsylvania's General Assembly to their constituents through public service television shows, newsletter, and outreach events.

The Pennsylvania General Assembly has appropriated millions of dollars from general tax revenues for marketing our Section 529 plan. These funds allow us to purchase advertising through more traditional avenues, such as television and radio, that reach the entire state population as well. Additionally, the Treasury Department staff includes employees placed throughout the state whose primary job responsibilities are to educate Pennsylvania's families about our Section 529 program.

None of this extraordinary outreach would occur if Section 529 plans were not state sponsored.

E. State involvement brings additional program advantages. Because Section 529 plans are established and maintained by states, many state laws provide program advantages that a state simply would not be willing to provide if they did not exercise control over the program. In Pennsylvania these include the following: State income tax exemption on growth when the account is used for Qualified Higher Education Expenses. Exclusion of the account in determining eligibility for state financial aid. Exemption from state inheritance tax. Protection of accounts from attachment, levy, or execution by a creditor of the account owner or beneficiary. Matching government funds through the Family Savings Account Program (discussed above).

II. State involvement does not significantly increase the cost of Section 529 programs.

All the benefits state involvement brings to Section 529 plans do not significantly increase the costs associated with these plans. Some but not all states do receive some funds from the program to cover their costs in establishing and maintaining their program. For most states, the fees actually received by the state are quite small. Pennsylvania receives no funds from its TAP 529 Investment Plan. In Pennsylvania all of the fees associated with our Section 529 plan are received by the private sector firms providing investment, administrative, marketing, or operational management. And, in other states this is true of most of the fees.

Most of the fees associated with Section 529 plans are those associated with the mutual fund industry in general. Typically there is one additional fee, the Section 529 plan administrative fee, that does not otherwise exist in the general mutual fund industry. This fee is analogous to plan sponsor fees in 401k or 403 b plans. They cover such functions as more complex tax reporting, more intensive investor customer service,

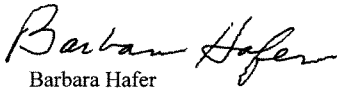
management of the "fund of funds" structure, special confirmations and statements, and systems management costs. In the 401k or 403b retirement plan arena, the plan sponsor fee is often paid by the employer. Since most state programs must be self-sufficient (are not supported by state tax dollars), however, the states must pass these costs on to the account owners.

III. States' Right to Set Their Own Tax Policies.

As noted above, many states provide unique benefits, including tax advantages, to their states' residents investing in their home-state Section 529 plan. Far from being "protectionist," such policies actually foster competition among Section 529 plans. Competition is not limited to what the private sector can provide but also includes the different features and benefits that only states can bring to the table. The result of this competition is better and more varied programs being offered to America's families. A federal prohibition on providing home-state tax advantages unless such tax advantages were given to all Section 529 plans would almost certainly result in the reduction or elimination of home-state tax advantages. Such a result would be contrary to the public policy of both Congress and the states of encouraging America's families to save for college. The attached position paper provides a fuller discussion of this topic.

In conclusion, let me reiterate that your leadership in trying to improve Section 529 plans is appreciated. Eliminating state involvement and restricting states from providing home-state tax advantages, however, would not further that objective. To the contrary, they would serve to weaken the plans and make them much less attractive especially to the lower- and middle-income families they were designed to serve.

Sincerely,



Barbara Hafer
Pennsylvania State Treasurer

cc: The Honorable Arlen Specter
The Honorable Daniel K. Akaka
Alice Joe, Professional Staff Member

Section 529 Home-state Tax Advantages
Position Paper
Pennsylvania Treasury Department
October, 2004

I. The Issue

Should states be stripped of their right to give favorable state tax treatment to their residents who invest in their state's 529 plan by defining "qualified tuition plans" to exclude states that provide such a benefit?

II. Background

In discussing this issue, it is important to remember that these college savings programs are STATE programs. Many were started before section 529 of the Internal Revenue Code was enacted. Moreover, that provision requires that these programs be "created and maintained" by a state.[1] The enactment of section 529 has added essential benefits to the states' college savings plans by providing substantial federal tax advantages. The enactment and subsequent amendments have largely been responsible for the tremendous growth in these programs over the last few years. Nevertheless, these programs fundamentally remain state programs. They further the states' public policy of making higher education more accessible and affordable for their citizens.

In keeping with the federal/state structure of our nation, each state has created its own program aimed at meeting the needs of its citizenry. In doing so, most of the 43 states with income taxes provided state tax incentives to their residents who choose to save for college through their own state's plan. Approximately 35 of those 43 states provide that their residents will not be subject to state income tax on any earnings gained through the program when the account is used for qualified education expenses. Many states (26) have provided their residents an even greater incentive to save for college by giving a state income tax deduction for at least some of the contributions made into their state's college savings plan.

While providing incentives to save through its college savings program, most states' laws simply do not specifically address the state tax treatment of out-of-state section 529 plans. As a result, in most states taxation of an out-of-state section 529 account owned by a state resident is governed by the state's revenue code generally applicable to similar investments such as out-of state municipal securities or mutual funds.

[1] As authorized by the 2001 amendments, eligible educational institutions or groups of such institutions may also offer prepaid tuition programs that receive the same federal tax benefits as programs offered by the states.

As of January 1, 2002, however, federal law – the amendments making 529 plan earnings used for qualified expenses exempt from federal income tax -- has had an indirect effect on many states' treatment of out-of-state 529 plans owned by state residents. By state law, many states (34, including D.C.) have chosen to adopt the federal law regarding taxable income for general state tax purposes. These "conformity" states mirror the federal income tax treatment of section 529 plans. As a consequence, when federal tax treatment of section 529 plans changed, state tax treatment automatically changed as well in those states, without any action being taken by the state legislature. Thus, when used for qualified higher education purposes, income from any section 529 plan is not subject to that state's income tax. Of course, if the federal income tax exemption for section 529 plans were to sunset, as scheduled on December 31, 2010, many of these conformity states would, once again, subject residents' earnings on out-of-state 529 plans to state income tax.

III. States should remain free to determine their own tax policy.

The right to tax its own citizens is zealously guarded by each state. It is a fundamental right of the states grounded in our form of government. In determining its tax policy, each state is guided by its own public policy. And in formulating that public policy each state must balance often-competing interests. State tax exemptions and/or deductions for 529 plans invariable mean that other taxpayers will shoulder a bigger portion of the state's tax burden. The following are some of the interests that states should be free to consider in making their own tax policy decisions.

A. Section 529 savings plans are municipal securities and should remain taxable as such.

The investments offered through most 529 savings plans are municipal securities. For state taxation purposes, states should be able to treat 529 plans as they do other municipal securities such as municipal bonds. Most states provide state residents exemption from state taxation on the earnings when investing in their home-state municipal bonds while taxing those earnings if the municipal bonds are those of another state. This is the same treatment that most state give section 529 plans – absent the impact of the federal income tax exemption on conformity states.

B. States have an interest in providing their own 529 plans to their citizens and, consequently, in ensuring the success of their plans by providing home-state tax benefits.

Each state has expended much effort and many resources in creating a program that is best suited to the needs of its residents. They have passed enabling legislation; gone through an exhaustive process of selecting a program manager; worked closely with the program manager to create the program and determine policy and operational details; provided start-up funding and, in some cases, on-going general fund revenues; and provide

substantial ongoing oversight. Each believes that it has provided the best possible program taking into consideration numerous factors – many of which are unique to the state. Even those states that aggressively market outside their own borders do so to benefit their states residents: the resulting increase in the size of the fund helps to keep expenses and fees low.

Each state has a vested interest in its own citizenry saving through its 529 plan; and, providing state tax benefits for the home-state plan significantly fosters that goal.

C. Providing state tax benefits to saving in section 529 plans results in lost state revenues.

State tax advantages, both income tax exemptions and deductions, for section 529 plans negatively impact the state revenues. They result in a larger portion of the state tax burden falling upon those state residents that do not receive the tax advantage. Some states are willing to forego that revenue and shift the tax burden in order to serve the state's public policy interest of fostering its college savings program and ensuring its viability and continued success. Residents investing in out-of-state 529 plans simply do not advance that public policy interest. States should not be forced to forego state revenues to advantage those residents to the disadvantage of other residents.

Additionally, a state is able to project and anticipate lost revenues resulting from tax benefits for its own college savings plan. A state has no knowledge of the amount invested or earned by its residents using out-of-state 529 plans.

D. A state encourages participation in its plan through home-state tax benefits because it has control and oversight over its own program.

States are required by federal law to create and maintain their programs. Additionally, most, if not all, also have state law required control over their programs. States have fully investigated their own programs and done due diligence in the selection of program mangers, the investment options offered, and the funds being used. Fee structures have been carefully scrutinized. And features and benefits have been carefully constructed. Accordingly, each state knows the integrity of its own program. And in some way – through election or appointment – each state official administering a program is responsible and answerable to the electorate of his or her state. In short, a state literally and figuratively puts its name on its program. Obviously, this is not true of out-of-state programs. A state should not be forced to "endorse" other states' programs by providing state tax benefits to its residents choosing to invest in those programs.

IV. Providing home-state tax benefits fosters healthy competition among section 529 plans.

In the area of section 529 plans, states are, to some extent, competing for the college savings dollars of their residents and, for some states, residents of other states. While this type of competition among states is unusual (and somewhat unfamiliar to states) it has served to foster innovation among 529 plans. Each state strives to have the best possible plan for its citizens -- to offer strong features and benefits that are unique. Home-state tax benefits are a result of this healthy competition. There are many factors that a family should consider in choosing the section 529 plan that is best for them. State tax treatment is simply one of them.

Some have argued that home-state tax benefits add to the complexity of section 529 plans and should be prohibited so that families can choose the 529 plans that is best for them regardless of the state tax consequences. In essence they are arguing to eliminate one feature of competition. A similar argument could be made for uniform sales commissions and fees. Certainly the myriad sales commissions and fees add to the complexity of section 529 plans and making them uniform would allow families to choose the best plan regardless of commissions and fees (although a standardized fee structure would almost certainly force at least some plans to raise their fees). Neither prohibiting home-state tax benefits nor mandating uniform sales commissions and fee, however, would be in keeping with the entrepreneurial traditions of our nation.

V. A federal prohibition on providing home-state tax benefits is likely to disadvantage American families struggling to pay for college.

If states were prohibited from providing state tax benefits to residents investing in their own college savings plan without providing the same benefit to residents investing in out-of-state plans, many state legislatures might choose to reduce or eliminate the tax benefit. This, of course, would disadvantage the many families who would be investing in home state programs. In fact, the only interest served by such a federal mandate would be the narrow, self-interests of investment firms who wish to sell their out-of-state products in states with home-state tax benefits. Those firms desire a "level playing field" for themselves even if leveling reduces the value and benefits to the families states serve by offering college savings plans. Who wins then? Only the investment firms.

VI. Conclusion

States should not be stripped of their rights to give favorable state tax treatment to their residents who invest in their state's 529 plan. It is fundamental to our system of government that states remain free to determine their own tax policy. In deciding whether to offer state tax benefits for saving in section 529 plans – whether all plans or just home state plans -- a state must take many factors into consideration, weighing competing

interests. Striking a balance among those competing interests must remain a prerogative of the state, the exercise of which shapes state public policy.

Most section 529 savings plans are municipal securities and each state should remain free to tax those plans in the same manner it taxes other municipal securities, should the state choose to do so. As in the general municipal securities area, the state has an interest in ensuring the success of its section 529 plan. Providing home-state tax benefits is one method of helping to achieve this state objective. And, states are willing to forego state tax revenue in order to do so.

Because a state maintains and controls its own college savings plan, state officials – whether elected or appointed – can have confidence in encouraging participation in their own state plan through home-state tax benefits. That same confidence does not automatically extend to out-of-state plans.

Moreover, home-state tax benefits add to the healthy competition that exists among the state-offered section 529 plans. And, of course, home-state tax benefits add great value to families' college savings. A federal prohibition on providing such benefits is more likely to result in the restriction or elimination of the benefits to home-state plans rather than in the expansion of those benefits to out-of-state plans. And, American families struggling to pay for college would be greatly disadvantaged.

NAST National Association of State Treasurers

October 8, 2004

The Honorable Peter G. Fitzgerald
Chairman, Governmental Affairs Subcommittee on
Financial Management, the Budget, and International Security
Room 445 Hart Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for conducting the September 30, 2004 hearings of the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security regarding Section 529 plans. We appreciate the opportunity to share with you the states' efforts to make Section 529 plans the best way for families to save for college. We are also taking this opportunity to respond to numerous comments and questions you and others raised during the hearing, which we believe are based on serious misconceptions of the state administered college savings programs. These comments and line of questions create the erroneous perception that the state programs are unsafe or unwise investment options for American families. This perception, if left unanswered, would harm the families saving in these programs to the long-term detriment of the participants in the programs, the states and the nation.

College Savings Plans and Public Policy

The state-administered college savings programs are unique investment vehicles, specifically designed to achieve several public policy goals. These goals respond to the special challenges states face in ensuring and increasing access to higher education and building a better-educated workforce. In this light, the programs are inextricably linked to, and are an important component of, the overall higher education policies of the individual states. At their core, these programs are entities of the states, with a different purpose and different set of goals than private sector investment vehicles. This fundamental aspect of the state-administered college savings plans must be kept in mind when examining the operation, oversight and performance of the state plans.

SECRETARIAT: The Council of State Governments
Director: Pam Taylor, 2760 Research Park Dr., PO Box 11910, Lexington, KY 40578-1910 (859) 244-8175 Fax: (859) 244-8053
E-mail: nast@csg.org Internet: www.nast.net
Office of Federal Relations: 444 N. Capitol St., NW, Suite 401, Washington, DC 20001
(202) 624-8595 Fax: (202) 624-8677

What lies behind the development of the state plans?

Over the past 30 years, college tuition rates have consistently increased at two to three times the annual rate of inflation. During this same period of time, federal financial aid funding has shifted away from student grants to providing access to guaranteed student loans. Today, nearly 60 percent of all federal financial aid is in the form of loans, substantially increasing the number of college graduates faced with the burden of repaying enormous student loan debt upon entering the workforce.

Concerned by the mounting financial strain placed on young professionals, states began to develop innovative programs to help families and students save for their college education. The programs are also intended to be a method of investing in a better educated workforce. The original plans were created by states such as Florida, Michigan, Ohio and Wyoming in the late 1980s. Since that time, over 6.8 million families have saved more than $54 billion in Section 529 college savings plans. Additionally, nearly 475,000 students nationwide have used their assets in these programs to help pay for their college education.

Although states created Section 529 plans more than 15 years ago to encourage their citizens to save for college, the movement started to gain momentum in 1994 with Michigan's victory in the Sixth Circuit Court of Appeals. As a result of this court decision, the Michigan Education Trust prepaid tuition plan was declared to be nontaxable as an instrumentality of the state.

Following the court decision, the Internal Revenue Service declared its intention to contest the tax status of each plan on a case-by-case basis, which prompted the states to increase their efforts in Congress to clarify the federal tax treatment of the existing state programs and to implement income tax benefits to encourage families to save for higher education. In 1996, Senator Bob Graham of Florida (which has a well-established prepaid plan) and Senator Mitch McConnell of Kentucky (which had a savings trust program) led a bipartisan effort to provide federal tax relief for all plans, resulting in the creation of Section 529 of the Internal Revenue Code.

The enactment by Congress of Section 529 and the resulting federal tax treatment (taxes deferred on the earnings when used for higher education) spurred the development of college-savings plans nationwide. From 1996 to 2000, 30 states developed and launched Section 529 plans, dramatically increasing the opportunities for families to begin to save for the rising costs of higher education.

The enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (signed into law on June 7, 2001) provided further congressional support for state-run Section 529 college savings plans. The 2001 Tax Act exempted the earnings of Section 529 plans from federal taxation when used for higher education, further solidifying the partnership between the federal government and the states in the promotion of college savings, rather than asking families to rely on loans to fund their children's education.

In their work to promote saving for college, states have provided leadership and innovation to improve educational and economic opportunities for all Americans. In an era of increasing concern over corporate governance activities and expanded governmental regulations in the financial markets, Section 529 college savings plans are a wonderful example of what can be achieved by a public / private partnership administered through a state mandate.

What Benefits do States Bring to these Plans?

The principal focus of the state programs, which are directly linked to the overall higher education policy of the states, is to encourage families to save for the growing expense of higher education. A major aspect and key goal of the programs is to encourage middle- and lower-income families to save specifically for higher education. This unique feature of the state programs points out the vital role the states play in the college savings market. Without this focus, it is unlikely that the 529 market would be so vibrant, and that these families would be underserved.

Many low- and moderate-income families are not sophisticated investors. Additionally, they are not a target market for financial firms, financial planners and investment advisors. These families typically do not have much discretionary income to invest or save. These are the families the state administered college savings plans are designed to help. For example, most savings plans offer age-based investment options that automatically re-balance assets depending on the age of the beneficiary, thereby simplifying the risk-return analysis for and monitoring by many families. Additionally, state oversight of these programs insures that families have access to low fee options that are sold directly by the program, allowing families to participate without high sales commissions or fees. These programs also offer low initial and subsequent contribution minimums, making it very easy for low- and moderate-income families to participate in the program.

In setting up these programs, the states leveraged their experience as major institutional investors to establish low-cost, low-fee college savings investment options for their residents. Many investments, such as mutual funds, require initial investments and subsequent minimum contributions that are too high for most low- and moderate-income families to meet. In negotiating agreements with investment fund managers, states have insisted that these investment minimums be reduced so that families of all income levels can participate. Without this state involvement, financial firms would have little interest in marketing these programs to these demographic groups. The history of the college savings market prior to the state establishment of the college savings programs bears this out. The private sector had done little to establish targeted college savings initiatives. The states saw a need and moved forward to establish these innovative and highly successful programs.

Furthermore, the states' role in the selection of financial service firms and investment managers through state-regulated competitive procurement processes assures participants that they receive better pricing and account servicing than they could obtain independently. States have been able to contract with the private sector and secure lower fee structures for participants in the plans than those participants would receive were they to invest in the very same mutual fund through a broker or dealer.

If the requirement that Section 529 plans be established and maintained by a state were eliminated, it is likely that the Section 529 market would become much more confusing, which would deter families from saving for higher education. More investment firms would create and offer programs. Choosing the "right" program would be a more daunting task and many families would be frozen in inaction. State involvement gives the small, unsophisticated saver the confidence to invest. Sophisticated investors have the wherewithal and willingness to pay for advice to investigate all options and choose what is best for them. But the vast majority of low- to moderate-income families can count on their state to have done its homework, giving those families confidence to invest when they would not have otherwise.

In addition, the states protect their own citizens from high commissions, unsuitable sales pitches, and other negative sales practices prevalent in the mutual fund industry by providing direct-sold, low-cost products to

participants in the state plans. In fact, states have been quick to respond to concerns about high fees and expenses by revising their investment options to emphasize low cost plans. Now, every state offers a low cost, low- or no-load option to 529 plan investors.

Few, if any, private sector mutual fund firms or other investment firms actively market to low- and moderate-income families. The realities of the investment world are that larger dollar accounts are more profitable and small dollar accounts are costly to manage. State involvement in Section 529 plans, however, ensures that the marketing will reach those segments of the population not typically targeted by private-sector investment firms. In contracting with their private-sector partners, states insist that marketing is targeted to all segments.

Moreover, because Section 529 plans are state plans, many more outreach avenues are available to the entire population of the state. The following examples show how Section 529s are promoted with the assistance of state involvement:

- low-cost public service radio and television advertising;
- inserts placed in automobile licensing notices sent to every resident renewing a license; inserts sent with each birth certificate for a newborn or newly adopted child;
- outreach mailings and presentations to elementary, middle, and high school parents throughout the state;
- statewide workshops given to elementary and middle school guidance counselors; and
- contact by members of a state's legislature to their constituents through public service television shows, newsletter, and other outreach events.

The states provide an essential additional layer of consumer protection for program participants. This role further distinguishes Section 529 plans from other private-sector investment vehicles available to use for college savings. In fact, we believe that the substantial level of state involvement brings more focused, and stronger investment protections to families who save for their children's college education.

Fees Associated with 529 Plans

In addition to questioning the role of the states in 529 plans, the Subcommittee suggested that state involvement added an unnecessary layer of fees without benefit. To the contrary, we believe that all the benefits state involvement brings to Section 529 plans do not significantly increase the costs associated with these plans. Some but not all states receive some program funding to cover their costs in establishing and maintaining their programs. For most states, the fees actually received are quite small. In most states, the bulk of the fees associated with the Section 529 plan are received by the private sector firms providing investment, administrative, marketing, or operational management.

Most of the fees associated with Section 529 plans are no different than those associated with the mutual fund industry in general. Typically one additional fee, the Section 529 administrative fee, does not otherwise exist in the general mutual fund industry. However, this fee is analogous to plan sponsor fees in 401(k) or 403(b) plans, covering such functions as complex tax reporting, intensive investor customer service, management of the "fund of funds" structure, special confirmations and statements, and systems management costs. In the 401(k) or

403(b) retirement plan arena, the plan sponsor fee is often paid by the employer. Since most state programs must be self-sufficient (since they are not supported by state tax dollars and participants must bear the costs of the program), the states must pass these costs on to the account owners of Section 529 plans. We are aware of no state that commingles this fee with their general fund.

Section 529 college savings plans have been extremely successful in motivating parents to invest and save for a child's higher education expenses. An estimated $70 to $100 billion more is expected to flow into Section 529 plans over the next five years. For millions of American children, the prospect of a brighter future is becoming a reality through the efforts of states and their private sector partners who operate the programs, and the families who participate in them.

Commitment to Improved Disclosure

During the hearings, the Subcommittee and several witnesses also commented upon and questioned the lack of uniformity in disclosure among the different Section 529 plans. As we indicated in our testimony on behalf of the states, NAST and CSPN are firmly committed to simplifying and enhancing disclosure on these programs. To this end, our associations drafted Voluntary Disclosure Principles, which include precise, uniform tables to show fees and expenses associated with these plans. The format we drafted mirrors those required and adhered to by all registered mutual fund companies. We believe this will assist consumers in comparing 529 programs and in making better decisions about where to invest their hard-earned dollars. To date, over 30 states have committed to implementing the Voluntary Principles in their next round of document revision.

Conclusion

I hope this letter clarifies for you the essential role the states have in the college savings plan marketplace. Eliminating state involvement would not further the goal of encouraging savings for college and thereby increasing access to higher education. To the contrary, it would serve to weaken the plans and make them much less attractive especially to the lower- and middle-income families they were designed to serve.

Sincerely,

Tim Berry
Indiana State Treasurer and
NAST President

cc:

The Honorable Ted Stevens	The Honorable Daniel K. Akaka
The Honorable George G. Voinovich	The Honorable Carl Levin
The Honorable Arlen Specter	The Honorable Thomas R. Carper
The Honorable Robert F. Bennett	The Honorable Mark Dayton
The Honorable John E. Sununu	The Honorable Frank Lautenberg
The Honorable Richard C. Shelby	The Honorable Mark Pryor

QUESTIONS BY SENATOR FRANK R. LAUTENBERG
GOVERMENTAL AFFAIRS COMMITTEE
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY
Oversight Hearing on Section 529 College Savings Plans: High Fees, Inadequate Disclosure, Disparate State Tax Treatment and Questionable Broker Sales Practices
Thursday, September 30, 2004

1.) QUESTION FOR PANEL ONE: MR. MILLER, MS. SCHAPIRO, MR. LANZA:

Why is it necessary for investors not to have any control over their investments in 529 plans? Is this an attempt at consumer protection?

2.) QUESTION FOR MS. SHAPIRO:

Are the requirements on broker-dealers who are selling these plans any different from those on people who sell mutual funds? If so, why is this, and should this be changed to harmonize the two?

3.) QUESTION FOR MR. LANZA:

Are 529 plans adhering to the voluntary disclosure guidelines the Municipal Securities Regulatory Board (MSRB) has set, or has the voluntary disclosure requirement had little effect?

4.) QUESTION FOR MR. LANZA, MS. SHAPIRO AND MR. BULLARD:

Is the MSRB a sufficiently powerful regulator, with the right expertise, to regulate securities as complex as 529 plans? Should the SEC take over in order to harmonize 529 plan disclosure requirements with those of IRAs, 401(k)'s and mutual funds?

5.) QUESTION FOR MR. MCNEELA AND MR. BULLARD:

Is there any reason to restrict administration of 529 plans to the states? If we are going to have tax-advantaged savings plans, why shouldn't these 529's be administered like IRAs and 401(k)'s, through private financial institutions and subject to all our securities laws?

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

NOV 9 2004

Chief Clerk, Subcommittee on Financial
Management, the Budget, and International Security
Committee on Governmental Affairs
United States Senate
446 Hart Senate Office Building
Washington, DC 20510

Dear Ms. Baird:

Thank you for your letter dated October 7, 2004, about my September 30, 2004 testimony before the Senate Subcommittee on Financial Management, the Budget, and International Security on 529 college programs. You enclosed Senator Frank Lautenberg's additional questions for the official record. I reviewed the enclosed transcript and made some minor grammatical corrections.

Senator Lautenberg asked why investors cannot have any control over their investments in 529 plans. He asked if this is an attempt at consumer protection. I hope the following explanation of the statutory requirements and how the Internal Revenue Service (IRS) and Department of Treasury have interpreted them is helpful. However, I am not in a position to address the specific reasons for the statutory requirements.

Under the law a qualified tuition program cannot permit any contributor to, or designated beneficiary of the program to directly or indirectly direct any of the program's contributions or earnings. (Section 529(b)(4) of the Internal Revenue Code). The proposed regulations provide that a program does not violate this requirement if it merely permits a participant, at the time he or she makes contributions to the account, to select among different broad-based investment strategies designed exclusively for the program. We have also issued guidance that a program does not violate section 529(b)(4) merely because the contributor or designated beneficiary can change the investment selection once per calendar year or on a change in beneficiary.

Investment options offered by various state programs are generally mutual funds operated by an affiliate of the investment manager selected by the program. The mutual fund choices vary by degree of risk to allow contributors to shift to more conservative portfolios as the designated beneficiary nears matriculation.

I hope this information is helpful. If you have further questions, please contact me at (202) 283-2500 or Thomas J. Miller (ID#50-04980) at (202) 283-9472.

Sincerely,

Steven T. Miller

QUESTION FOR PANEL ONE: MR. MILLER, MS. SCHAPIRO, MR. LANZA:

Why is it necessary for investors not to have any control over their investments in 529 plans? Is this an attempt at consumer protection?

ANSWER:

It is not an exactly correct characterization to say that investors have no control over their investments in 529 plans. While each plan differs, in many cases investors may choose different portfolios that have different time horizons and investment objectives. For example, a plan may offer growth, growth and income, income, and money market portfolios that invest in underlying mutual funds with similar objectives. In other cases (such as the Virginia 529 plan), investors may directly select the mutual funds in which they wish to invest. Of course, 529 plans do differ from IRAs, in which an investor can choose whatever investment they want that is available through the broker-dealer. However, 529 plans are considered Qualified Tuition Programs under the Internal Revenue Code and the IRS's regulations, and thus subject to a different tax regulatory regime than IRAs. Although there may be consumer protection reasons for structuring the investment options in each 529 plan, the states that run these plans are better suited to answer this question.

QUESTION FOR MS. SCHAPIRO:

Are the requirements on broker-dealers who are selling these plans any different from those on people who sell mutual funds? If so, why is this, and should this be changed to harmonize the two?

ANSWER:

Broker-dealers that sell 529 plans are subject to MSRB rules as well as SEC and NASD rules, while the sale of mutual funds is subject only to NASD and SEC rules. Many of the general principles, such as the requirement to recommend only suitable investments, are the same in both cases. However, there are differences, such as the application of specific advertising rules and the rules governing the payment of cash and non-cash compensation in connection with the sale of these products. There are also special registration requirements that apply if a broker-dealer sells 529 plans that do not apply to the sale of mutual funds, due to the fact that 529 plans are considered to be municipal securities. We believe that the advertising and sales practice rules should be the same for both products.

QUESTION FOR MR. LANZA, MS. SCHAPIRO and MR. BULLARD:

Is the MSRB a sufficiently powerful regulator, with the right expertise, to regulate securities as complex as 529 plans? Should the SEC take over in order to harmonize 529 plan disclosure requirements with those or IRAs, 401(k)'s and mutual funds?

ANSWER:

The MSRB has historically provided important written rules and rule interpretation for municipal securities brokers and dealers. Importantly, 529 plans are a unique form of municipal security and one that, like other municipal securities, is exempt from many of the standard SEC or NASD disclosure requirements applicable to other

types of securities. 529 plans are functionally much more closely aligned in structure to mutual funds, than they are to a traditional municipal security. Accordingly, the MSRB has had to modify the interpretation of its rules, or the text of their existing rules to accommodate the differences between 529 plans and traditional municipal securities. Because of the similarity between the retail sale of 529 plans and the retail sale of mutual funds, we believe the SEC and NASD should play an important role in regulating the sales activities. We do now and we will continue to do so. However, the complexity and resulting possible inconsistency of this retail sales regulation arises from the difference in existing regulatory framework i.e.. the MSRB writes and interprets the rules governing the sale of 529 plans, and the SEC and NASD write an interpret the rules governing the sale of mutual funds. Many of the same issues that arise in the sale of mutual funds through tax-advantaged accounts also arise in the sale of 529 plans. NASD has many years of experience in overseeing its members' sales of mutual funds, both directly by member firms and through tax-advantaged accounts.

Answers of Ernesto A. Lanza, Senior Associate General Counsel, Municipal Securities Rulemaking Board, to Questions by Senator Frank R. Lautenberg, Governmental Affairs Committee, Subcommittee on Financial Management, The Budget, and International Security

Oversight Hearing on Section 529 College Savings Plans, Thursday, September 30, 2004

1) Q) Why is it necessary for investors not to have any control over their investments in 529 plans? Is this an attempt at consumer protection?

A) The requirement that investors have no control over their investments in 529 plans springs from the statutory provisions of Section 529 itself. As the MSRB was not involved in the drafting of the statute or the establishment of any of the state plans, we cannot say for certain what purpose it was felt this provision served. Nonetheless, it appears that this requirement may have been intended to achieve two objectives.

First, there seems to have been some thought that states would exercise their role as servants acting in the interest of their citizens by establishing menus of investments that meet such consumer protection thresholds as each state might deem appropriate, in the exercise of this public service role. We understand that the requirement in the statute that the states "establish and maintain" the plans was intended to require actual oversight and control on the part of the states over the plans, presumably with the purpose that such oversight and control would provide some degree of investor protection.

Second, the prohibition on investor direction of investments may have been viewed as a way to ensure that investors use 529 plans solely as long-term investment vehicles. Thus, it was not intended that 529 plans serve merely as a tax-advantaged alternative avenue through which investors could undertake shorter-term buy-and-sell investment practices in the hopes of bettering the market but which, as is all too often the case, instead result in increased investment costs and investors falling behind the market as they attempt to chase the highest return from one "hot" investment to another.

2) Q) Are the requirements on broker-dealers who are selling these plans any different from those on people who sell mutual funds? If so, why is this, and should this be changed to harmonize the two?

A) [Question not addressed to MSRB.] The MSRB would like to add that broker-dealers that market 529 plans are subject to rules that, in most respects, are substantially similar to the rules that apply to broker-dealers selling mutual funds. There are some exceptions, however. Two of those exceptions will be gone in the very near future as the MSRB moves to adopt standards for advertising investment performance in advertisements and for the use of sales incentives in connection with 529 plans that will parallel those applicable to mutual funds. Most of the remaining differences derive directly or indirectly from statutory authority. For example, the MSRB is prohibited by statute from imposing fixed schedules of fees on broker-dealers marketing municipal securities, including 529 plans. NASD is provided a specific statutory exemption from this prohibition for mutual fund sales. Furthermore, many NASD and SEC rules

that apply to broker-dealers marketing mutual funds are structured based on the assumption that the mutual funds they market can only exist with certain specific terms permitted by statute. Since, however, the structures that state 529 plans are permitted to put in place are in most respects unlimited, the rules that regulate broker-dealers cannot be based on the assumption that only features that exist for mutual funds will be used in the 529 plan market. Regulation that rigidly imposes requirements that are tied too tightly to such assumption could create significant impediments to a fair and efficient market. In fact, in some cases, differences in the 529 plan market from the mutual fund market have resulted in the MSRB creating regulatory requirements on broker-dealers marketing 529 plans that may go beyond the regulatory obligations that broker-dealers face in the mutual fund market. These additional obligations – including the point-of-sale disclosure obligation of broker-dealers – are designed specifically to fit the contours of the 529 plan market to better protect investors.

3) Q) Are 529 plans adhering to the voluntary disclosure guidelines the Municipal Securities Rulemaking Board (MSRB) has set, or has the voluntary disclosure requirement had little effect?

A) The MSRB has no authority over issuers and therefore has no authority over whether the state plans produce program disclosure documents and, if so, what information is included in them. The College Savings Plans Network published its voluntary disclosure guidelines for 529 plans in draft form this past spring and we understand that some states have begun to conform their disclosures to the terms of the draft voluntary guidelines. However, it is unknown whether the guidelines will be universally followed. In addition, the guidelines provide significant leeway in how each state can prepare its disclosure and still meet the standards set out in the guidelines. Thus, even if every state ultimately adheres to the CSPN guidelines, the real test of whether the guidelines have a significant positive effect on issuer disclosure is whether the states meet the standards only minimally or with robust disclosures that provide the information that investors need.

MSRB rules require a broker-dealer that markets 529 plans to provide to the customer at the point-of-sale disclosure of all material facts about the investment known to the broker-dealer or otherwise available to the marketplace through established industry sources. Broker-dealers should generally be able to learn about such material facts and provide them to their customers through the state plan's program disclosure document.

4) Q) Is the MSRB a sufficiently powerful regulator, with the right expertise, to regulate securities as complex as 529 plans? Should the SEC take over in order to harmonize 529 plan disclosure requirements with those of IRAs, 401(k)'s and mutual funds?

The MSRB has, we believe, effectively provided for the regulation of broker-dealers active in the municipal securities market over the past 29 years, and we believe that we have at least as thorough an understanding of the complex 529 plan market as any other securities regulator in the country. The MSRB has a unique expertise in one of the principal components of this market's complexity, which is that only one group of participants in the market – the broker-dealers – are subject to comprehensive regulation under the federal securities laws. It is the fact of issuer exemption from the federal securities laws – not the identity of the regulator in which

Congress places the responsibility of writing broker-dealer rules – that is at the root of the differences in the disclosure requirements between the 529 plan market, on the one hand, and the mutual fund and retirement savings market, on the other.

Thus, if the state plans were to become subject to federal securities law regulation to the same extent as are mutual funds, we would agree that no significant purpose would be served by retaining authority within the MSRB for this market. However, so long as states enjoy this exemption, the harmonization of 529 plan disclosure requirements with those of other markets would remain difficult, regardless of the identity of the regulator. Over the years, the MSRB has come to understand the types of alternative avenues for ensuring that vital disclosure reaches customers that do not depend on the ability to directly regulate issuers. As a result, in some respects, broker-dealers in the municipal securities market carry a heavier load of the disclosure responsibilities than do broker-dealers in the other securities markets.

In addition, the 529 plan market operates in a political environment that is alien to all other securities markets, except for the tax-exempt bond market which the MSRB also regulates. The MSRB has put in place unique conflict of interest rules crafted specifically to deal with the political pressures that can be brought to bear when publicly elected officials are positioned to award business to private sector securities firms. We note that several years ago the SEC attempted to adopt rules, modeled in many respects after our own rules, designed to address such pressures in the public funds management sector but was ultimately unable to successfully put such rules in place. Our pay-to-play rule currently applies to the 529 plan market as an important tool to sever the connection between the making of political contributions and the awarding of business to broker-dealers.

5) Q) Is there any reason to restrict administration of 529 plans to the states? If we are going to have tax-advantaged savings plans, why shouldn't these 529's be administered like IRAs and 401(k)'s, through private institutions and subject to all our securities laws?

[Question not addressed to MSRB.]

Answer to Question 5 asked by Senator Frank R. Lautenberg

5.) Question for Mr. McNeela and Mr. Bullard:

Is there any reason to restrict administration of 529 plans to the states? If we are going to have tax-advantaged savings plans, why shouldn't these 529's be administered like IRA's and 401(k)'s, through private financial institutions and subject to all our securities laws?

Answer:

The states could make the case that they can consolidate assets and use their buying power to negotiate lower fees from fund companies. Indeed, it is true that states have access to institutional shareclasses, which often have considerably lower fees. Investors in 529 plans end up paying higher total expenses, however, because states have not been able to bring down costs associated with administering the plans and providing services to investors. Thus the total costs to 529 investors are higher than if they went directly to fund companies.

States could also claim that they perform due diligence and ensure that only high quality firms are allowed to serve as investment managers. This argument also appears to be weak. States have not been forthcoming in providing details of the search criteria used to select investment managers. Cumbersome state bidding procedures have left many states with few viable options from which to choose. Other states have granted multiple 529 mandates, in a move that seems designed for the benefit of fund companies, not for investors. In my opinion, states have not meaningfully improved the quality of underlying asset management relative to what investors receive in publicly available mutual funds.

States have also made the claim that they have negotiated lower minimum initial investments to broaden access to a wider segment of the population. Most 529 plans do, in fact, have very low minimum initial investments, but it is questionable how much value is added. 529 plans are attractive because of their tax benefits and I'm skeptical that those benefits are high enough to cover the added administrative costs involved with handling account balances as low as $15. Currently, many mutual funds are available to investors with small initial investments and often minimums of $25 or $50 are accepted if investors commit to an automatic investment plan.

In conclusion, I see no reason for states and educational institutions to be the only administrators of 529 plans. At present, that restriction leads to higher costs and less choice for citizens.

Respectfully,

Daniel E. McNeela, CFA
Morningstar, Inc.

QUESTIONS BY SENATOR FRANK R. LAUTENBERG
GOVERNMENTAL AFFAIRS COMMITTEE
SUBCOMMITTEE ON FINANCIAL MANGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY
Oversight Hearing On Section 529 College Savings Plans: High Fees, Inadequate Disclosure, Disparate State Tax Treatment and Questionable Broker Sales Practices
Thursday, September 30, 2004

Questions for Mr. Lanza, Ms. Shapiro, and Mr. Bullard:

Is the MSRB a sufficiently powerful regulator, with the right expertise, to regulate securities as complex as 529 plans? Should the SEC take over in order to harmonize 529 plan disclosure requirements with those of IRAs, 401(k)'s and mutual funds?

Response from Mr. Bullard:

The MSRB is not sufficiently powerful to oversee 529 plans. This results primarily from constraints on its legal authority, as discussed below.

The MSRB does not have direct authority to impose substantive disclosure requirements on issuers of interests in 529 plans. It is prohibited from requiring an issuer to deliver a disclosure document that it not already publicly available. Notwithstanding this prohibition, the MSRB can use its authority over brokers to indirectly require disclosure of material information. The MSRB takes the view that the disclosure of material information is required by MSRB rules that require municipal securities brokers to deal fairly with their customers. While this approach may help address the most egregious sale practices abuses, it is inadequate as a means of regulating the disclosure of information about 529 plans and inapplicable to direct-sold plans, which are sold by government employees who are exempt from regulation as brokers.

The MSRB also is statutorily prohibited from imposing substantive limits on sales loads charged in connection with the sale of 529 plans. The MSRB can only require that such sales loads not exceed a fair and reasonable amount. This contrasts with the NASD's express authority to impose specific limits on sales loads, which authority it has exercised through NASD Rule 2830. Rule 2830 imposes substantive limits on the amount of sales charges imposed in connection with sales of mutual funds. The MSRB has stated that whether 529 plan sales charges exceed the limits of Rule 2830 is a factor in determining whether the sales charges are "fair and reasonable" for purposes of MSRB rules, but this factor is not dispositive, and brokers accordingly may impose sales charges on 529 plan sales that would be illegal outside of the 529 plan context.

These and other constraints on the MSRB's authority are discussed further in the MSRB's testimony before the Subcommittee dated September 30, 2004. That testimony also illustrates another difficulty with having the MSRB regulate 529 plans. The MSRB's experience lies in the regulation of traditional municipal securities that are used by states and local governments to finance public projects. The MSRB has no experience

regulating investment pools, and, as its testimony indicates, it has had to work quickly to adapt its rules to this new responsibility. The MSRB is not well-suited to oversee the regulation of 529 plans. Over time, the MSRB probably could become proficient in this area, but it would be inefficient and unnecessarily complex to add yet another regulator of investment pools to an already over-crowded field.

The SEC is in the best position to regulate 529 plans. It has decades of experience regulating similarly structured investment vehicles, including mutual funds, which are the predominant funding vehicle for 529 plans. In fact, the SEC and the NASD are already taking the lead in some areas. The SEC has proposed rules that would require the delivery of a point-of-sale document by brokers who sell interests in 529 plans, and that the confirmation of the transaction include additional information about the brokers' compensation (these rules will also apply to mutual funds). The NASD is investigating whether brokers have violated NASD rules by failing to inform investors of the state tax advantages of certain 529 plans. These plans may be disfavored by brokers because they pay little or no sales compensation. Regulation by the SEC and NASD has the added advantage of improving the consistency of regulation across similar types of investment products. Both regulators are handicapped, however, by their limited authority to directly regulate 529 plans, especially with respect to direct-sold plans.

It should be noted that even if the SEC were to regulate 529 plans directly, it could not harmonize 529 plan and mutual fund disclosure with disclosure for IRAs and 401(k) plans. The SEC does not directly regulate IRAs, which are regulated by the IRS and the regulator of the IRA custodian, which is often a bank subject to banking regulation (broker custodians are subject to SEC regulation). Nor does the SEC directly regulate 401(k) plans, which are regulated by the Department of Labor. In significant respects, the regulation of IRAs and 401(k) plans falls short of regulation of mutual funds, despite the fact that both of these types of accounts essentially operate as vehicles through which to invest in mutual funds on a tax-advantaged basis. The regulation of variable annuities suffers the same weakness, as the SEC's and state securities commissioners' regulatory authority over these products is also limited, despite the fact that variable annuities, like 529 plans, IRAs and 401(k)s, often serve as nothing more than tax-deferred wrappers for mutual funds.

Question for Mr. McNeela and Mr. Bullard:

Is there any reason to restrict administration of 529 plans to the states? If we are going to have tax-advantaged savings plans, why shouldn't these 529's be administrated like IRAs and 401(k)'s, through private financial institutions and subject to all our securities laws?

Response from Mr. Bullard:

There is no good reason to restrict the offering of 529 plans to the states. The only reason to restrict the administration of 529 plans to states would be to give states an incentive to offer plans that they otherwise would not offer and that would not be offered by private

financial institutions. If the states would offer 529 plans regardless of whether there was competition from private firms, and those state plans would be the same as the plans they would offer if they continued to have a monopoly, there would be no reason to restrict the offering of 529 plans to states.

For example, it is theoretically possible that states may offer features that private actors would not offer, and that the states would offer these features only if they had a monopoly. Ohio's 529 plan representative has expressed the view that Ohio's plan offers a special benefit because of its low investment minimum of $15. To my knowledge, no retail mutual fund has a minimum of less than $250 (except for certain funds tailored for minors), and it therefore is possible that this feature might not be offered by a private firm.

This is not, however, a sufficient reason to maintain a state 529 plan monopoly. Ohio might continue offering 529 plan options with a $15 minimum, even if private firms entered the 529 plan arena. If it did, permitting private firms to offer 529 plans would only benefit consumers with more investment options.

One might argue that added competition from private firms might make it more difficult for Ohio's plan to survive, and we might lose its $15 minimum investment option as a result. But to the extent that this is caused by a general market preference for 529 plans offered by private firms, this development should be viewed as being beneficial, for consumers will have expressed a preference for products that they believe better serve their overall investing needs. Thus, it is unlikely that there would be any detrimental effect of permitting private firms to offer 529 plans alongside the states.

As for IRAs and 401(k)s, these products are, in important respects, not subject to the federal securities laws. They should be, and I encourage the Subcommittee to continue to consider how to rationalize the regulation of similar investment vehicles under one regulator and one set of rules.

○