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on

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

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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.

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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]

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[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

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[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]

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[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

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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

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[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

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[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

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[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

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[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]

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[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

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[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

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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.

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[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

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[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

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[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.

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[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.

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[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.

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[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

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[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.

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[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

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[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%.

making it prohibitively costly for a participant to change plans. For 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

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[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.

case 90% of the time.[69] A more likely explanation is that brokers may be recommending 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.

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[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 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.

Nor is there anything inherently questionable about sales compensation.[72] The payment of sales compensation essentially reflects the investor's decision to use -- and 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

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[72] See generally supra note 50.

[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.

Commission's progress to ensure that it requires useful, transparent disclosure of selling compensation.

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.

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[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.

B. Differential Sales Compensation and Conflicts of Interest

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

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[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

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

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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 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).

regulate hedge fund advisers who provide investment advice only to financially 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

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[79] See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (July 20, 2004).

regulated as investment advisers, unless the advice was "solely incidental" and the broker received no special compensation. The Commission has expressly repealed the special 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]

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[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.

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-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.

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[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.'").