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A Look At FINRA's New 529 Plan Self-Reporting Initiative

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On Jan. 28, 2019, Financial Industry Regulatory Authority announced a novel leniency initiative that will offer no-fine enforcement resolutions for member firms that self-report supervisory deficiencies related to recommendations of savings plans under Internal Revenue Code Section 529, and promptly remediate those failures by, among other things, making affected customers whole.[1]

Background

The initiative, officially dubbed the "529 Plan Share Class Initiative," is the latest example of FINRA following through on its "FINRA 360" commitment to increase transparency, engagement and collaboration with member firms. It follows closely on the heels of FINRA's revamped 2019 version of its annual exam priorities letter — with a new focus on areas of emerging risk eclipsing the old "kitchen sink" approach to listing areas of recurring concern[2] — as well as FINRA's December 2018 report on cybersecurity best practices[3] and new custom of issuing annual reports on its overall exam findings. It is also consistent with the U.S. Securities and Exchange Commission's current enforcement focus on protecting retail investors and seeking to recover losses for them through regulatory enforcement action.

This new FINRA initiative offers member firms a strong incentive to review their supervisory procedures and systems governing recommendations of 529 savings plans, especially firms already questioning the effectiveness of their procedures and systems for currently dealing with FINRA examinations focused in this area. For individual registered representatives who have actively recommended 529 plans to clients, however, the initiative introduces the unwelcome risk that those recommendations will soon become exposed to a fresh round of suitability review.

The primary focus of the initiative is firm supervision of recommendations pertaining to the share classes that clients chose for their 529 plan investments. FINRA appears

particularly focused on the extent to which firm representatives may have recommended 529 share classes that were not well-suited to their clients' time horizons. For example, Class A shares typically have front-end sales charges and lower annual fees than other classes, while Class C shares typically have no front-end sales charges but higher annual fees. This distinction could render unsuitable a recommendation of Class A shares to fund the education of a child who is already close to the level of education requiring funding — or conversely a recommendation of Class C shares for a younger child who likely will not tap the funds for many years.

How the Initiative Works

Timing

The deadline to file a notice of self-reporting with FINRA under the 529 plan initiative is April 1, 2019, so time is of the essence for firms seeking to take advantage of the initiative. Eligible firms will then have until May 3, 2019, to submit certain required additional information concerning 529 plan recommendations made by firm representatives from 2013 through 2018. Firms may request an extension of the May 3 deadline if they do so by May 1, but FINRA does not appear willing to extend the April 1 deadline for the notice of self-reporting.

The Carrot

For firms that meet FINRA's self-reporting requirements, enforcement staff will generally recommend a settlement imposing restitution and a censure but no fine. Settlements will typically feature a charge under Municipal Securities Rulemaking Board Rule G-27, which governs supervision in the context of municipal securities — including Rule 529 plans — and they will not result in a statutory disqualification. Firms should keep in mind, however, that enforcement staff recommendations will remain subject to review and formal approval by FINRA's Office of Disciplinary Affairs, acting on behalf of FINRA's National Adjudicatory Council, or by the NAC itself, so there is at least theoretical risk that a given settlement will be rejected as insufficiently remedial even if enforcement staff agreed to it.

The Stick

FINRA is offering "no assurances" to firms that fail to self-report, and the notice announcing the 529 plan initiative ominously warns that any disciplinary action taken against a non-self-reporting firm involving violations relating to 529 plan share-class recommendations "likely will result in the recommendation of sanctions beyond those described under the initiative."

Registered Representatives Beware

FINRA is also explicitly giving "no assurances" with respect to the liability of individual registered representatives and supervisors who were responsible for any violations self-reported by their firms, which presumably means it is enforcement business as usual for these representatives and supervisors. And because their firms are now incentivized to thoroughly review 529 plan recommendations from

2013 through 2018, these individuals have ample reason for concern that their exposure to potential second-guessing — or worse — has materially increased.

Key Takeaways

The April 1 deadline for self-reporting is not far away. Thus, member firms that have engaged in significant 529 plan activity in recent years should consider promptly reviewing at least a representative sample of their 529 plan recommendations between 2013 and 2018 and otherwise self-evaluating for potential suitability or supervisory issues in this area.

Firms currently being examined by FINRA for their 529 plan sales practices are still eligible to take advantage of the 529 plan initiative and should strongly consider doing so, especially if an enforcement referral appears likely or inevitable.

To the extent firms discover potential issues as they evaluate their 529 plan recommendations and supervision, and especially if they anticipate self-reporting, it is never too early to begin thinking about restitution. The earlier and more proactively firms get in front of identifying affected clients and coming up with a fair methodology for calculating restitution, the easier it will be to convince FINRA staff to accept the firm's chosen methodology when settlement discussions commence.

Registered representatives actively engaged in 529 plan recommendations and their supervisors should prepare for increased scrutiny and second-guessing of those recommendations by their firms and potentially by FINRA.

Although the 529 plan initiative is the first time FINRA has formalized this type of leniency program, the underlying approach is not entirely unprecedented. In a video interview accompanying FINRA's announcement of the initiative, FINRA's enforcement chief specifically alluded to earlier no-fine settlements involving other aspects of supervision where firms had self-reported, remediated, paid restitution and cooperated — presumably referring to several mutual fund fee-waiver cases since 2015 and a more recent case involving sales of volatility-linked exchange-traded products.

Finally, firms should not underestimate the possibility that a diligent internal review and self-report could result in only an informal cautionary action letter or even a full declination, rather than formal enforcement action, especially if the review finds problems that were not widespread or intentional and that were quickly identified and remediated. A footnote in the FINRA notice announcing the 529 plan initiative expressly contemplates this possibility. And such outcomes are more common than most people probably realize because they typically are not publicized, but they do happen.

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[1] FINRA Reg. Notice No. 19-04, available at www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-04.pdf.

[2] See FINRA 2019 Annual Risk Monitoring and Examination Priorities Letter, available at www.finra.org/sites/default/files/2019_Risk_Monitoring_and_Examination_Priorities_Letter.pdf.

[3] See FINRA Report on Selected Cybersecurity Practices – 2018, available at www.finra.org/sites/default/files/Cybersecurity_Report_2018.pdf.