



August 4, 2011

The Honorable Thomas P. DiNapoli
Comptroller
State of New York
110 State Street
Albany, New York 12236

Subject: New York's 529 College Savings Plan—Advisor Plan

Dear Mr. DiNapoli:

On behalf of the Coalition of Mutual Fund Investors (“CMFI”),¹ my purpose in writing is to inform you and your office about a new recordkeeping practice that is being promoted by large broker-dealers to increase the fees that they can charge for services rendered to advisor-sold Section 529 plans. This recordkeeping practice has recently been implemented for the Virginia College Savings Plan and it may be an issue in New York, as your office recently awarded a contract to a new vendor to manage the State's Advisor Plan.

CMFI is concerned that this recordkeeping practice is being implemented without any type of competitive bidding process and for the primary purpose of generating additional fee income for large brokerage firms. This broker-dealer initiative is being promoted as a more efficient recordkeeping process for the large brokerage firms; however, these “enhanced efficiencies” do not result in savings that benefit 529 plan participants. Instead, the fees generated by broker-dealers using this practice—and the insertion of an additional layer of intermediation between investors and a Section 529 plan—are only going to increase costs for all participants in 529 plans, without any quantifiable benefits to anyone but the broker-dealers themselves.

It is CMFI's conclusion that this broker dealer initiative is nothing more than a cleverly constructed illusion. For example, how many times have you heard of a more efficient process that saves nothing for consumers, and, instead, increases costs by taking advantage of a non-competitive business environment?

¹ The Coalition of Mutual Fund Investors (“CMFI”) is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors. CMFI is headquartered in Washington, D.C. and information about its advocacy activities can be accessed at www.investorscoalition.com.

Background on Section 529 Plans and the Current Recordkeeping Model

The New York College Savings Program (“New York 529 Program” or “Program”), authorized under Section 529 of the Internal Revenue Code, permits investors to purchase mutual fund shares in a tax-favored manner for the purpose of saving for college expenses. Investors in the New York 529 Program can choose one of two Plans. The first Plan permits investors to select and purchase mutual fund shares directly, without the use of a broker-dealer, financial advisor, or other intermediary (“Direct Plan”). The second Plan permits investors to select and purchase shares through a financial intermediary (“Advisor Plan”).

Investors in the New York 529 Program—whether purchasing directly or through a financial intermediary—have their Section 529 accounts held on the books and records of the mutual funds selected for this purpose. In administering investor accounts for the Program, the State’s current investment managers—Vanguard and Columbia—know the identity of each investor and possess information on all investor-level transactions. Each mutual fund and its compliance personnel are then responsible for administering individual Section 529 accounts in a manner that complies with state and federal laws and the prospectus provided to each investor.

The larger broker-dealers want to replace this very transparent recordkeeping model with a structure called omnibus accounting. Under this framework, broker-dealers would become responsible for mutual fund recordkeeping for their customers with 529 accounts. The mutual fund trading orders from all brokerage accounts would be consolidated together into one “omnibus” transaction for each trading day. A mutual fund would treat the brokerage firm as its shareholder of record and, in most instances, would not be provided with any information about the underlying investors and their transactions involving the fund’s shares.

In August of 2010, CMFI issued a White Paper analyzing the fee practices used in omnibus accounting.² CMFI’s analysis concluded that large broker-dealers using this accounting method are imposing unnecessary costs on individual investors each year of as much as \$1 billion in account maintenance charges and more than \$7 billion in shareholder servicing payments. A copy of the CMFI White Paper is attached to this letter.

These fees are also being paid despite the fact that securities issuers do not normally pay broker-dealers to hold positions in individual accounts for other types of investments. For example, broker-dealers are not paid to hold municipal or corporate bonds, equity securities, or exchange-traded funds (“ETFs”) in a brokerage account.

² Coalition of Mutual Fund Investors, CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts, August 18, 2010, available at <http://www.investorscoalition.com/CMFIWhitePaperAug18.pdf> (hereinafter “CMFI White Paper”).

These positions are tracked by broker-dealers in their accounting systems as a part of their required services to customers, typically at no charge to the account holder.

New York State Should Require Competitive Bidding for Broker-Dealer Recordkeeping Contracts

As noted earlier, the primary motivation behind omnibus accounting is the opportunity to extract additional fees for overseeing mutual fund accounts that are converted onto a brokerage account platform and are placed under the complete control of the broker-dealer.

Mutual funds are very reliant on broker-dealers—and especially the largest brokerage firms—to sell and distribute their shares to individual investors. As a result of the market power of these large firms, the fees paid by mutual funds and their investment advisers for services provided are typically set without any competitive bidding process and, in most circumstances, end up being more expensive than those set by competitive market forces.

Since omnibus accounting arrangements are not “arm’s length” transactions, these fees are rarely discounted to reflect economies of scale or large volumes of accounts. If a mutual fund wants a particular broker-dealer to distribute its shares, the fund must agree to let the broker-dealer handle recordkeeping and shareholder servicing tasks for its customers, at a price that is often dictated by the brokerage firm.

As you know, section 695-d of the State Education Law directs the Comptroller to use a competitive bidding process to select account depositories and managers for the New York 529 Program:

The comptroller may solicit proposals from financial organizations to act as depositories and managers of the program. Financial organizations submitting proposals shall describe the investment instrument which will be held in accounts. The comptroller shall select as program depositories and managers the financial organization, from among the bidding financial organizations that demonstrates the most advantageous combination, both to potential program participants and this state³

Under this section of the Education Law, one of the factors that must be evaluated by the comptroller in selecting a financial organization is “[t]he ability of the financial organization to satisfy recordkeeping and reporting requirements” of the Program.⁴ This section also requires any financial organization chosen to be able to keep “adequate records of each account, keep each account segregated from each other account, and

³ NY CLS Educ. § 695-d(2).

⁴ Id. at § 695-d(2)(d).

provide the comptroller with the information necessary to prepare the statements required
....”⁵

Additionally, the Education Law requires that each financial organization shall be a fiduciary to the Program:

‘Financial organization’ shall mean an organization authorized to do business in the state of New York and (a) which is an authorized fiduciary to act as a trustee pursuant to the provisions of an act of congress entitled ‘Employee Retirement Income Security Act of 1974’ as such provisions may be amended from time to time, or an insurance company; and (b)(i) is licensed or chartered by [a State or federal agency] ... or (v) is any other entity otherwise authorized to act in this state as a trustee pursuant to the provisions of an act of congress entitled ‘Employee Retirement Income Security Act of 1974’ as such provisions may be amended from time to time.⁶

As the primary trustee for the New York 529 Program, you should require that any broker-dealer recordkeeping contract for 529 account services be subject to the State’s competitive bidding process, so that these arrangements become arm’s length transactions, with prices established by competitive market forces.⁷ This proposed requirement is also in conformance with the fiduciary standard you must follow, which requires you to control costs in any delegation of an investment or management function.⁸

New York State Should Ensure That Any Improved Broker-Dealer Efficiencies Actually Result in Lower Costs for 529 Plan Participants

Broker-dealers using omnibus accounting claim that this recordkeeping system is more efficient operationally for them; however, this method for managing mutual fund accounts is only productive for the brokerage firms involved.⁹ In a conversion to

⁵ NY CLS Educ. § 695-d(5)(b).

⁶ NY CLS Educ. § 695-b(4).

⁷ The “arm’s length” standard is also used to evaluate the fiduciary duty of mutual fund directors in the most recent U.S. Supreme Court ruling on this subject. See *Jones v. Harris Associates, L.P.*, 559 U.S. ___ (2010), 130 S. Ct. 1418, 1427 (“The essence of the [fiduciary duty] test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain. If it does not, equity will set it aside.”) (quoting *Pepper v. Litton*, 308 U.S. 295, 306-307 (1939)).

⁸ See NY CLS EPTL § 11-2.3(c)(1) (“Delegation of an investment or management function requires a trustee to exercise care, skill and caution in: ... (D) controlling the overall cost by reason of the delegation.”).

⁹ See Jackie Noblett, “American Funds Cracks 529 Recordkeeping Puzzle,” *Ignites*, July 8, 2011 (“Edward Jones officials say omnibus accounting of 529 plans will make it easier for financial advisors to manage their clients’ college savings assets by reducing the amount of manual paperwork and providing a single point of contact for shareholder servicing.”); See *Id.* (“Our financial advisors, and frankly, all financial advisors in the industry, have been vocal that it’s been a waste of their time doing duplicate data entry,” she says. ‘American Funds also surveyed their financial advisors and found the same inefficiencies. So we started to have conversations about how we solve that.’”) (quoting Lisa Klassen, Principal, Edward Jones).

omnibus accounting, mutual funds (and their investors) end up paying higher fees and charges to these broker-dealers, when compared to the costs of the more direct recordkeeping systems used today by the funds and their transfer agents.

The real purpose of omnibus accounting is to provide an opportunity for broker-dealers to gather more assets, exercise more control over their clients, and garner additional fees. Evidence of this intention comes from many different public statements by broker-dealers and their recordkeeping agents, including this 2009 quote by an executive with PNC Global Investment Servicing, one of the largest omnibus accounts processors:

The broker-dealers' strategy is to have as much oversight and management of the investor experience as possible and [omnibus accounting] does just that. This method of recordkeeping helps broker/dealers continually reinforce their brand with respect to all client interactions, providing more opportunities to capture a greater share of the investor's wallet.¹⁰

The CMFI White Paper on shareholder servicing costs mentioned above documents these recordkeeping costs for omnibus accounting, using public sources of information. In addition to Rule 12b-1 and advisor revenue-sharing payments, the larger broker-dealers are typically charging between \$19 and \$25 for each shareholder account holding fund shares, or an average charge of about \$22 per account each year.¹¹ This is in contrast to the typical cost of between \$10-16 for each fund account charged by third-party transfer agents within the mutual fund industry, or an average charge of about \$13 per account each year.¹² The difference between the two averages—\$9 per account—is an unnecessary extra cost to a Section 529 Plan and its participants.

As an example, this type of accounting structure would add an extra \$9 to each of the 123,000 accounts (as of December 31, 2009) in the New York Advisor Plan, increasing the costs to the Program by as much as \$1.1 million each year, assuming that all current accounts in the Advisor Plan are converted to an omnibus accounting system. And this cost will only grow if the Advisor Plan is successful in attracting additional investors to the Program.

The New York 529 Program is considered a low-cost college savings plan.¹³ Any type of change to the Program's very efficient recordkeeping structure should only be permitted if it delivers additional operating efficiencies to both the Plan and to its

¹⁰ Christine Gill, Senior Vice President and Managing Director, PNC Global Investment Servicing, "Sub-Accounting's Rise Through a Distribution Lens," *NICSA News*, December 7, 2009, at 2, available at <http://www.nicsa.org/downloads/newsletter/NICSA120909.pdf>.

¹¹ See *CMFI White Paper* at 6-7. Within the mutual fund industry, individual accounts are also referred to as "positions."

¹² See *Id* at footnote #21.

¹³ See *infra* footnote #25.

participants, instead of causing the program to incur increased (and unnecessary) recordkeeping costs.

At the very least, you—as the primary trustee of the Program—should be asking the following questions about the use of any type of proposed omnibus accounting framework:

- Why are broker-dealers being selected to perform recordkeeping services without participating in a competitive bidding process?
- Where are the cost savings to the Program derived from the claimed “efficiency gains,” if this is such an improved recordkeeping model?
- Why should broker-dealers be paid to perform recordkeeping services for the New York 529 Program when they are not paid to hold other security positions, such as municipal or corporate bonds, stocks, or ETFs, in individual brokerage accounts?

New York State Should Require Full Transparency of Account Information in Any Broker-Dealer Recordkeeping Contract

Aside from the payment of unnecessary fees, a significant problem created by the use of omnibus accounting is the lack of adequate transparency of individual identities and transactions at the investor account level. Each omnibus account can involve thousands of investors in a particular mutual fund and, in most circumstances, the identity of the underlying investors and their specific transactions are not disclosed outside of the broker-dealer accounting platform. For Section 529 accounts, this lack of full transparency can create oversight and compliance challenges for the New York 529 Program, if permitted to be implemented.

This doesn't have to be the case. The substantial majority of broker-dealers and mutual funds use the Fund/SERV and Networking services of the National Securities Clearing Corporation (“NSCC”), a mutual fund order and account processing system. These NSCC services and systems link up account-level information for both broker-dealers and funds, providing full transparency within broker-controlled accounts on a real-time basis, for compliance and other purposes.¹⁴

As the primary trustee for the New York 529 program, you should require that any type of broker-dealer accounting structure provide full transparency at the investor account level, on a real-time basis, so that Program managers can meet their

¹⁴ The National Securities Clearing Corporation (“NSCC”) is developing a new service, called Omni/SERV, to facilitate information-sharing between mutual funds and broker-dealers holding Section 529 accounts. This new service, however, may not offer the same level of transparency, or provide account-level information on a real-time basis, as the NSCC Networking service does presently.

recordkeeping and reporting obligations, and the mutual funds involved can ensure the proper application of their prospectus policies and procedures.

The Use of Omnibus Accounting Will Cause Significant Problems in Ensuring
Compliance with Current IRS Recordkeeping Rules

The proposed conversion to an omnibus accounting structure by large broker-dealers is inconsistent with current guidance from the Internal Revenue Service (“IRS”), regarding the recordkeeping requirements of Section 529 qualified tuition programs.

Section 529(b)(3) of the Internal Revenue Code states that “[a] [state] program shall not be treated as a qualified tuition program unless it provides separate accounting for each designated beneficiary.”¹⁵ Proposed Treasury Regulation § 1.529-2(f) requires each 529 program to maintain records for each beneficiary account showing the total investment in the account, any earnings and distributions, and the total account balance.¹⁶

Current guidance requires state programs to file a Form 1099-G with the IRS, for each account owner and beneficiary who receives a taxable distribution.¹⁷ A state program must include account-level information in any Form 1099-G filed, including: (1) the name, address, and taxpayer identification number of the distributee; and (2) the amount of earnings distributed to the distributee in the calendar year.¹⁸

Current IRS guidance also requires that all accounts maintained by a state 529 program for the benefit of a designated beneficiary are to be aggregated and treated as a single account for the purpose of calculating the earnings portion of any distribution.¹⁹ Similarly, there is a federal statutory prohibition on excess contributions for each designated beneficiary within a state program.²⁰

Finally, the IRS proposed an anti-abuse rule in 2008 that would limit the ability of individuals to change beneficiaries or use 529 accounts for retirement savings, in order to

¹⁵ 26 U.S.C. § 529(b)(3).

¹⁶ U.S. Department of the Treasury, Qualified State Tuition Programs, Proposed Rule, 63 Fed. Reg. 45,019 (Aug. 24, 1998).

¹⁷ Prop. Treas. Reg. § 1.529-4. 63 Fed. Reg. 45,019, at 45,030-45,031 (Aug. 24, 1998).

¹⁸ Prop. Treas. Reg. § 1.529-4(b)(3). 63 Fed. Reg. 45,019, at 45,030-45,031 (Aug. 24, 1998). See Section 529 Programs, Notice 2001-81, Internal Revenue Bulletin No. 2001-52, at 618 (Dec. 26, 2001) (“Prop. Treas. Reg. § 1.529-4 requires a State tuition program to report on Form 1099-G, Certain Government Payments, the earnings portion of any distributions made during the year, together with other information such as the name, address and TIN of the distributee.”).

¹⁹ Prop. Treas. Reg. § 1.529-4(c). 63 Fed. Reg. 45,019, at 45,031 (Aug. 24, 1998).

²⁰ See 26 U.S.C. § 529(b)(6) (“*Prohibition on excess contributions.* A program shall not be treated as a qualified tuition program unless it provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.”). In New York, 2 NYCRR § 151.3 limits total contributions on behalf of a designated beneficiary to \$100,000. A website for the New York 529 Program states that the aggregate maximum balance for all Program accounts on behalf of the same beneficiary is \$375,000. See <https://uui.nysaves.s.upromise.com/content/programfeatures.html>.

minimize transactions that evade transfer taxes and qualified retirement account rules.²¹ In order to enforce this new anti-abuse rule, it will be necessary to track the “actual source of the funds for the contribution, the person who actually contributes the cash to the section 529 account, and the person who ultimately receives any distribution from the account.”²²

All of these IRS recordkeeping rules require that state agencies maintain oversight of individual Section 529 accounts and track all contributions, earnings, distributions, and other transactions. It is also important that state programs be able to track the identities of all individual account owners and designated beneficiaries through taxpayer identification numbers and other necessary information.

The use of omnibus accounting for Section 529 accounts will make it difficult for the New York 529 Program to fulfill its tax compliance responsibilities, unless the Program is provided full transparency of account owner and designated beneficiary information, on a real-time or same-day basis.

Conclusion

Broker-dealers claim that omnibus accounting is more efficient operationally; however, the only beneficiary of this model is the brokerage industry. The reality is that mutual funds are paying higher fees and charges to these broker-dealers than the cost of recordkeeping through more direct means.

The New York 529 Program should reject the premise advanced by the broker-dealers that omnibus accounting improves the internal operation of Section 529 accounts. The rebuttal to this argument is a simple one: If the omnibus accounting platform improves a broker-dealer’s operating efficiencies, then why are recordkeeping fees increasing and why are the participants in a 529 plan account not seeing a reduction in their costs?

This broker-dealer initiative is a step backwards in Section 529 account recordkeeping. The conversion of directly-held investor accounts into an omnibus accounting structure will replace a system using a smaller number of recordkeepers—the group of mutual funds selected for this purpose by the New York 529 Program—with a system that will utilize multiple broker-dealer recordkeepers. This diffusion of responsibility for account maintenance and recordkeeping will make it much more difficult for the Program to oversee investor activities and comply with IRS requirements for separate accounting and reporting at the account owner and designated beneficiary levels.

²¹ Guidance on Qualified Tuition Programs Under Section 529, Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3,441-3,442 (Jan. 18, 2008).

²² *Id.* at 3,442.

For all these reasons, CMFI urges the New York 529 Program to establish at least three (3) requirements for any use of omnibus accounting in its Advisor Plan:

1. Competitive Bidding for Broker-Dealer Recordkeeping Services. New York's Education Law requires the Comptroller to use competitive bidding to select financial organizations providing account depository and management services to the New York 529 Program.²³ As the primary trustee for the Program, you should mandate that the selection of all third-party recordkeepers be established through a Request for Proposal ("RFP") process, with the awarding of a contract to the lowest responsible bidder meeting the standards established by the Program.
2. Operational Efficiencies That Reduce Recordkeeping Costs. The New York 529 Program should ensure that any savings through the implementation of operational efficiencies by broker-dealers—in the processing of individual accounts—be passed along to all participants in the Program, through lower recordkeeping fees and expenses.
3. Full Transparency at the Investor Level. The New York 529 Program should require full transparency within omnibus accounts at the investor level, on a real-time or same-day basis.²⁴

These proposed requirements, if implemented, will ensure that individual investors in the New York 529 Program are protected through market-basing pricing practices, savings from operational efficiencies that are passed along to Program participants, and full transparency measures in the administration of individual participant accounts.

As the trustee of the New York 529 Program, you have worked very hard to ensure that both the Advisor and Direct Plans are two of the lowest cost programs in the country.²⁵ The Program should not take a step backwards from this important goal through the improper use of omnibus accounting within the Advisory Plan.

²³ See NY CLS Educ. § 695-d(2).

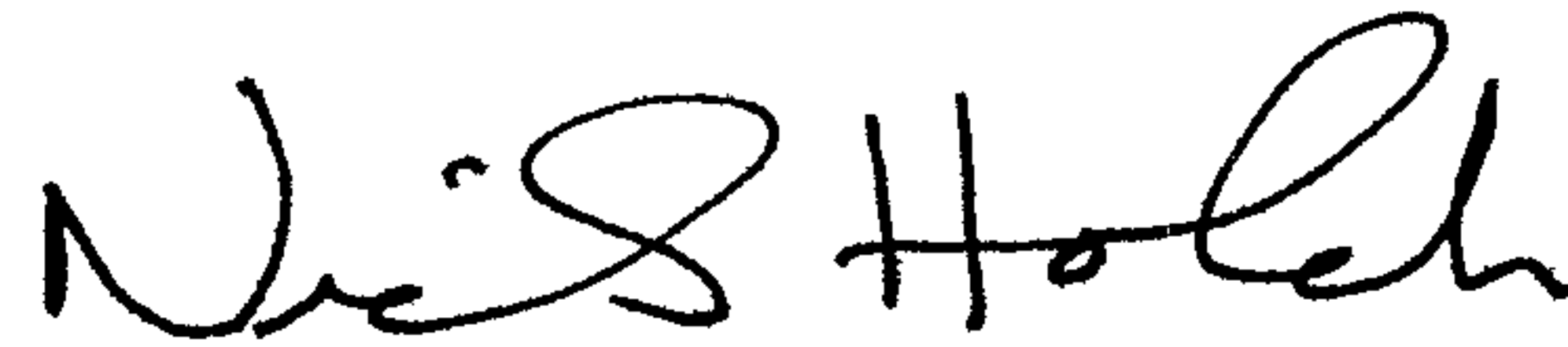
²⁴ This can be accomplished through the use of the Networking service offered by the National Securities Clearing Corporation ("NSCC"), as noted earlier in this letter. The terms "real-time" or "same-day" would require full transparency through omnibus accounts at the same time, or within the same day, as mutual fund orders are placed. See CMFI White Paper at 22.

²⁵ Office of the New York State Comptroller, DiNapoli Announces Expense Reduction For State's 529 College Savings Plan, August 30, 2010 ("Family budgets are getting tighter, but families still need to save for college,' DiNapoli said. 'The 529 Plan is a low-cost, easy-to-use program that helps make college more accessible to New Yorkers. And now the cost is one of the lowest in the nation. When you're saving for college, every dime counts. The lower cost should be even more of an incentive for New York families to prioritize saving.'").

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Thank you for considering these views. Please contact me if CMFI can provide you with any additional information about the issues described in this letter. My address and phone number are on the letterhead and my email is nielsholch@att.net.

Sincerely,

A handwritten signature in black ink that reads "Niels Holch". The signature is written in a cursive style with a large, looped "N" and "H".

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: Eileen C. Bagnoli, Chairwoman, New York State Higher Education Services Corporation