



June 14, 2011

The Honorable Kenneth T. Cuccinelli, II
Attorney General
Commonwealth of Virginia
900 East Main Street
Richmond, Virginia 23219

Dear General Cuccinelli:

On behalf of the Coalition of Mutual Fund Investors¹ ("CMFI"), I want to bring to your attention a new recordkeeping practice by large broker-dealers in Virginia that will adversely impact the Virginia College Savings Plan ("Virginia 529 Plan").

This new recordkeeping practice is being implemented without any type of competitive bidding process and for the sole purpose of generating additional fee income for large brokerage firms. While this broker-dealer initiative is being promoted as a more efficient recordkeeping process than current practices, the reality is that this type of account structure will not reduce costs for investors participating in the Virginia 529 Plan. Instead, the higher fees generated by broker-dealers using this practice—and the insertion of an additional layer of intermediation between investors and the Virginia 529 Plan—will only increase costs for all participants, without discernable benefits to anyone but the broker-dealers themselves.

After a careful analysis, CMFI believes that this new broker-dealer recordkeeping practice for the Virginia 529 Plan is inconsistent with the requirements of the Virginia Consumer Protection Act, the Virginia Administrative Code, and the guidance issued by the Internal Revenue Service, regarding mutual fund shares sold within the Virginia 529 Plan. CMFI also believes that the trustees of the Virginia 529 Plan are subject to fiduciary duties that require the use of a competitive bidding process for the selection of broker-dealers seeking to provide any type of third-party recordkeeping services to the Plan.

The Virginia 529 Plan, authorized under Section 529 of the Internal Revenue Code, permits investors to purchase mutual fund shares through broker-dealers and other financial advisers. Individual investors purchasing mutual fund shares through a broker-

¹ CMFI is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors on public policy issues. You can learn more about CMFI and its advocacy activities at www.investorscoalition.com.

dealer in Virginia currently have their Section 529 accounts held directly on the books and records of the mutual fund selected for this purpose by the Virginia 529 Plan.

As you know, mutual funds are sold subject to a prospectus document, which is sent to each investor and filed with the U.S. Securities and Exchange Commission. In administering investor accounts for Section 529 Plans, a mutual fund generally knows the identity of each investor and possesses information on all investor-level transactions. An individual mutual fund and its transfer agent are then responsible for administering each 529 account in a manner that uniformly applies the policies and procedures disclosed in a fund prospectus.

The Proposal by Large Broker-Dealers to Generate Additional Fees from Section 529 Accounts

This direct and transparent recordkeeping system has worked very well over the years for investor accounts in state-administered Section 529 Plans. Unfortunately for the individual investor, certain broker-dealers want to change this recordkeeping arrangement, so that they can collect fees for assuming additional recordkeeping functions.

Starting with the Virginia 529 Plan, at least one large broker-dealer has converted directly-held investor accounts onto its own recordkeeping platform. This will be the first of what is expected to be many such conversions that will result in decentralizing what was a very simple and centralized recordkeeping structure for the Virginia 529 Plan.

In December of last year, CMFI wrote a letter about this emerging problem to the Virginia State Treasurer and to the other members of the Board responsible for administering the Virginia 529 Plan. Our letter also included a copy of an August 2010 CMFI White Paper analyzing the fee practices being employed by the largest broker-dealers using this recordkeeping structure, which is called "omnibus accounting" within the financial industry.²

Copies of these documents are attached. To date, we have not received a reply to this letter.

² See 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"). Under the omnibus accounting structure, individual investor share positions are kept on the books and records of the brokerage firm and not on the books and records of the mutual fund. Orders from individual customers of the brokerage firm to purchase, redeem, or exchange mutual fund shares are consolidated together into one "omnibus" order for each trading day. A mutual fund records only the brokerage firm as the shareholder of record and, in most instances, is not provided with any information about the underlying investors and their transactions involving the fund's shares.

The Omnibus Accounting Structure is Inconsistent with the Virginia Consumer Protection Act

CMFI believes that the use of omnibus accounting in this manner and the fees being charged for these recordkeeping services are inconsistent with the Virginia Consumer Protection Act (“Consumer Protection Act”), which prohibits any “deception, fraud, false pretense, false promise, or misrepresentation in connection with a consumer transaction.”³

Mutual funds are highly reliant on brokerage firms—and especially the largest broker-dealers—to sell and distribute their shares to individual investors. Many of the large broker-dealers have the market power to demand that mutual funds allow individual shareholder accounts to be converted onto an omnibus accounting platform. As documented in the CMFI White Paper attached to this letter, the fees paid by funds and their investment advisers for services provided are generally established without any competitive bidding process, as broker-dealers possess the leverage to charge fees that are higher than the fees set by normal market forces.

The Virginia 529 Plan also will be subject to increased compliance costs, as the recordkeeping of the Virginia 529 Plan is decentralized through the omnibus accounting structure. The Virginia 529 Plan will have to establish duplicative and expensive compliance processes to ensure that it meets its regulatory responsibilities regarding Section 529 accounts.

The practice of omnibus accounting is being used by broker-dealers to improve the internal operating efficiencies of their brokerage platforms. This practice, however, does not increase efficiencies or reduce costs for 529 Plan participants. Instead, this accounting structure only benefits broker-dealers through the payment of new (and more expensive) recordkeeping fees than those which were previously paid to mutual funds.

A conversion of investor accounts to omnibus accounting platforms will result in a more complex and costly recordkeeping arrangement for the Virginia 529 Plan, with the only beneficiary of this conversion being the broker-dealers.

The practice of paying a broker-dealer to perform recordkeeping is also completely unnecessary and, in CMFI’s opinion, a deceptive practice under the Virginia Consumer Protection Act, as the recordkeeping and other post-sale services being provided by broker-dealers are already required to be provided by them under current federal regulatory rules.⁴ And these fees are being paid despite the fact that securities issuers do not normally pay broker-dealers to hold positions in individual accounts for

³ Va. Code Ann. § 59.1-200(A)(14).

⁴ See NASD Rule 2340: Customer Account Statements, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3647; and NASD Rule 2310: Recommendations to Customers (Suitability), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638.

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

CMFI believes that the offering of broker-dealer recordkeeping services for a fee in a Section 529 account is certainly a "consumer transaction" involving the "[t]he ... sale ... of goods or services to be used primarily for personal, family, or household purposes," as those terms are defined by the Consumer Protection Act.⁵

In response, the broker-dealers seeking to convert Section 529 accounts onto their brokerage platforms will argue that their activities are specifically excluded from the Consumer Protection Act.⁶ However, this exclusion only applies to broker-dealers "engaged in the business of selling any type of security" and does not apply, by definition, to activities by broker-dealers that are separate from the sale and distribution of securities.⁷

For example, the primary Self-Regulatory Organization for broker-dealers at the federal level has long interpreted recordkeeping fees as being distinct and separate from shareholder service fees, which are designed to compensate broker-dealers for the sale and distribution of mutual fund shares. As stated by the National Association of Securities Dealers ("NASD") in a Notice to Members published in 1993:

The term 'service fees' is defined in subparagraph (b)(9) of the amended Rules to mean 'payments by an investment company for personal service and/or the maintenance of shareholder accounts.' As noted in the explanatory section of NASD *Notice to Members* 90-56 (September 1990), the term 'service fees' is not intended to include transfer agent, custodian, or similar fees paid by funds. In addition, the phrase is not intended to include charges for the maintenance of records, record-keeping, and related costs.⁸

This is also the view of the U.S. Securities and Exchange Commission, as expressed as recently as July 2010.⁹

⁵ Va. Code Ann. § 59-1-198.

⁶ Va. Code Ann. § 59.1-199 excludes from the Act all "broker dealers as defined in § 13.1-501."

⁷ See Va. Code Ann. § 13.1-501 ("Broker-dealer" means any person engaged in the business of selling any type of security ...").

⁸ NASD Notice to Members 93-12, Question #17, 1993, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1627. The definition of "service fees" can be found in NASD Conduct Rule 2830(b)(9). In 2007, NASD and NYSE Regulation consolidated operations and formed the Financial Industry Regulatory Authority (FINRA). FINRA is in the process of consolidating NASD and NYSE rules into a consolidated FINRA rulebook.

⁹ See *Mutual Fund Distribution Fees; Confirmation*, SEC Release Nos. 33-9128, 34-62544, and IC-29367, 75 Fed. Reg. 47,064, at 47,071 (footnote 100) (Aug. 4, 2010) ("[S]ervices compensated by a distribution

The broker-dealer industry and its regulators have long considered recordkeeping activities and fees to be separate from the sales and distribution of mutual fund shares. Therefore, omnibus account recordkeeping activities—and the unnecessary fees being charged by broker-dealers—should be subject to the Virginia Consumer Protection Act and should be considered a “deception, fraud, false pretense, false promise, or misrepresentation in connection with a consumer transaction.”¹⁰

The Virginia 529 Plan Trustees Are Subject to Fiduciary Duties That Require a Competitive Bidding Process in the Selection of Third-Party Recordkeeping Vendors

Unlike the selection of an outside program manager for a 529 Plan, the payment of fees to broker-dealers for recordkeeping services—in connection with omnibus accounting—are not typically subject to competitive bidding, as would be the case in a true “arm’s length” negotiation. As a result, these fees are not usually 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.

In Virginia, the Public Procurement Act (“VPPA”) requires a competitive bidding process for most procurements by State agencies.¹¹ However, the statute establishing the Virginia 529 Plan expressly exempts this State agency from VPPA requirements, including the selection of vendors for recordkeeping services:

The selection of services related to the operation and administration of the Plan, including, but not limited to, contracts or agreements for the management, purchase, or sale of authorized investments or actuarial, recordkeeping, or consulting services, shall be governed by the foregoing standard and shall not be subject to the provisions of the Virginia Public Procurement Act (§ 2.2-4300 et seq.).¹²

The “foregoing standard” referred to in this statutory provision—to be used for the procurement of services by the Virginia 529 Plan—is a standard of care for investment trusts that is known as the Prudent Man Rule or the Prudent Investor Rule. As stated in the statute establishing the Virginia 529 Plan:

service fee] could include responding to customer inquiries, providing information on investments, and reviewing customer holdings on a regular basis, but would not include sub-transfer agency services, sub-accounting services, or administrative services.”)

¹⁰ See Va. Code Ann. § 59.1-200(A)(14).

¹¹ See Virginia Public Procurement Act (“VPPA”), Va. Code Ann. §2.2-4300, et seq.

¹² Va. Code Ann. § 23-38.80(C). See also VPPA, Va. Code Ann. § 2.2-4343(A)(6) (“The provisions of this chapter shall not apply to ... (6) The Board of the Virginia College Savings Plan for the selection of services related to the operation and administration of the Plan, including, but not limited to, contracts or agreements for the management, purchase, or sale of authorized investments or actuarial, record keeping, or consulting services. However, such selection shall be governed by the standard set forth in § 23-38.80.”).

In acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of the Plan, the Board, and any person, investment manager, or committee to whom the Board delegates any of its investment authority, *shall act as trustee and shall exercise the judgment of care under the circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but to the permanent disposition of funds, considering the probable income as well as the probable safety of their capital.*¹³ (emphasis added)

The Prudent Man Rule is a legal standard first established for trustees of investment funds in an 1830 Massachusetts court decision, Harvard College v. Amory.¹⁴ Over the years, this standard has evolved into the Prudent Investor Rule, which has been codified in the Virginia Code for investment trusts.¹⁵

In Virginia, the Prudent Investor Rule establishes the following fiduciary duties for trustees:

- a duty of loyalty and a duty of impartiality, meaning that the trustees must invest and manage the trust assets solely in the interest of the beneficiaries;¹⁶
- a prohibition on incurring unnecessary costs in investing or managing trust assets;¹⁷ and
- restrictions on the delegation of investment and management functions of the trust to third-party agents;¹⁸

¹³ Va. Code Ann. § 23-38.80(A).

¹⁴ 26 Mass. (9 Pick.) 446, 461 (1830) (“All that is required of a trustee to invest is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”).

¹⁵ Va. Code Ann. § 26-45.3 (“Except as otherwise provided ... a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this Act.”). See also Va. Code Ann. § 26-45.4 (“A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.”).

¹⁶ Va. Code Ann. § 26-45.7 (“A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.”).

¹⁷ Va. Code Ann. § 26-45.8 (“In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.”).

¹⁸ Va. Code Ann. § 26-45.10(A) (“A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in: (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the

As a State trust with fiduciary duties to its beneficiaries, the Virginia 529 Plan is subject to a higher standard than State public procurement requirements. Under State trust law, and as a minimum requirement, the Board of the Virginia 529 Plan should permit only arm's length transactions and competitive bidding procedures for recordkeeping contracts with broker-dealers seeking to provide services to the State's Plan.

The Use of Omnibus Accounting Should Not Increase Overall Costs for Virginia 529 Plan Beneficiaries

The broker-dealers using omnibus accounting claim that this recordkeeping system is more efficient operationally; however, this method for managing mutual fund accounts is only productive for the brokerage firms involved. Mutual funds (and their investors) end up paying higher fees and charges to these broker-dealers than the costs of the more direct recordkeeping systems used today by mutual funds and their transfer agents.

The CMFI White Paper on shareholder servicing costs mentioned above documents these recordkeeping costs, using available and public sources of information. In addition to Rule 12b-1 and adviser 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.¹⁹ 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.²⁰ The difference between the two averages—\$9 per account—is an unnecessary increased cost to beneficiaries and to the 529 Plan itself. For the Virginia CollegeAmerica Plan, which is sold by broker-dealers, an extra \$9 for each of the Plan's 1.9 million accounts (as of June 30, 2010) would add additional costs of \$17.1 million each year, assuming that all CollegeAmerica accounts are converted to an omnibus accounting system.²¹

The Virginia 529 Plan has been considered one of the best college savings programs in the country, based on its low costs and above-average performance.²² Any

agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.").

¹⁹ See CMFI White Paper at 6-7. Within the mutual fund industry, individual accounts are also referred to as "positions."

²⁰ See Id. at footnote #21.

²¹ See Virginia 529 College Savings Plan, Annual Report, Supplemental Information: CollegeAmerica Plan, June 30, 2010, available at

http://www.virginia529.com/documents/annual_reports/annual_report_2010.pdf ("As of June 30, 2010, approximately 1.9 million unique accounts had been opened with net assets in excess of \$25 billion.").

²² See Laura Pavlenko Lutton, Morningstar Names Best 529 College-Savings Plans, Morningstar, October 25, 2010 (citing Virginia's CollegeAmerica Plan); and Top Five [529] Plans, Kiplinger's, August 2010

type of change to the Plan's very efficient recordkeeping structure should only be permitted if it delivers additional operating efficiencies to both beneficiaries and the Plan itself, instead of causing the program to incur increased (and unnecessary) recordkeeping costs.

At the very least, the trustees for the Virginia 529 Plan should be asking the following questions about the use of any type of proposed omnibus accounting framework:

- Where are the cost savings, if this is such an efficient recordkeeping model?
- Why are broker-dealers being selected to perform recordkeeping services without participating in a competitive bidding process?
- Why should broker-dealers be paid to perform recordkeeping services for Virginia 529 Plan accounts when they are not paid to hold other security positions, such as stocks, bonds, or ETFs in customer accounts?

The Problem Facing Investors Entitled to Sales Load Discounts for Section 529 Investments

In addition to the policy and operational issues raised above, CMFI believes that the omnibus accounting structure prevents broker-dealers from fulfilling their regulatory responsibilities in Virginia to properly calculate and apply sales load discounts for mutual fund shares purchased by investors through this third-party distribution channel.

For example, an investor in the Virginia 529 Plan who is subject to a front-end sales load may reduce that charge by aggregating together all existing share positions in the same group of funds held by the investor and his or her immediate family.²³ Under the recordkeeping system currently used by the Virginia 529 Plan, the participating mutual funds are in possession of all the requisite information and, thus, can correctly determine whether an investor and his or her immediate family qualify together for a sales load discount. Using current technology, each fund can apply the appropriate discount without relying on assistance from a broker-dealer or other intermediary.

In the omnibus accounting structure proposed by the large broker-dealers, participants in the Virginia 529 Plan will need to rely on brokerage firms to calculate and apply the correct discount in a manner consistent with the policies of each fund.

(citing Virginia's CollegeAmerica Plan). See also Jackie Noblett, In-House Administration Yields Lowest 529 Fees: Study, *Ignites*, August 26, 2010 (citing the Virginia Education Savings Trust).

²³ See e.g., American Funds AMCAP Fund Prospectus, at 28-29, May 1, 2010, available at https://www.americanfunds.com/pdf/mfgepr-902_amcapp.pdf ("To receive a reduced Class A sales charge, investments made by you and your immediate family ... may be aggregated if made for your own account(s) and/or certain other accounts ... You may take into account your accumulated holdings in all share classes of the American Funds (excluding American Funds Money Market Fund) to determine the initial sales charge you pay on each purchase of Class A shares.").

However, a broker-dealer often has insufficient information to calculate the appropriate amount under the mutual fund aggregation and accumulation rules for these discounts.

For example, an individual shareholder may hold shares in a mutual fund (or family of funds) through several different broker-dealers and only the investor can provide this information to a brokerage firm. Similarly, the investor may have separate retirement accounts with shares in the same mutual fund held through a third-party fiduciary that is unconnected to the broker-dealer selling the shares for a 529 account. Members of the shareholder's immediate family also may hold shares in the same mutual fund (or group of funds), in accounts with different financial intermediaries, making it very difficult for any one broker-dealer to obtain this information and properly calculate the sales load discount under the prospectus policies followed by each fund.

The proper application of breakpoint discounts is the legal obligation of both the mutual fund and its broker-dealer intermediaries, although the parties differ in their respective economic interests. It is in a mutual fund's economic interest to correctly calculate breakpoint discounts in order to avoid losing unnecessary investment monies to third-party brokerage commissions. On the other hand, a broker-dealer is the direct beneficiary of an overcharge of sales loads, as the broker-dealer receives these amounts as additional commissions. And the broker-dealer is not in the best position to administer a fund's breakpoint discount policies because of the multiple accounts and intermediary relationships that most investors and their immediate family members have.

In CMFI's view, the mutual fund is the only entity with the ability to correctly calculate and apply breakpoint discounts in accordance with its stated policies. A fund's recordkeeping and transfer agent function is under the direct jurisdiction of the mutual fund's board and the fund lacks the conflict of interest possessed by a broker-dealer.

The Omnibus Accounting Structure is Inconsistent with the Virginia Administrative Code Regarding Sales Load Discounts

Any type of process to convert directly-held investor accounts onto a broker-dealer omnibus accounting platform is in conflict with the provisions in the Virginia Administrative Code requiring the proper application of sales load breakpoint discounts. Specifically, 21 VAC 5-20-280 A25 states the following:

[No broker-dealer shall] [i]n transactions subject to breakpoints, fail to:

- a. Utilize advantageous breakpoints without reasonable basis for their exclusion;
- b. Determine information that should be recorded on the books and records of a member or its clearing firm, which is necessary to determine the availability and appropriateness of breakpoint opportunities; or

- c. Inquire whether the customer has positions or transactions away from the member that should be considered in connection with the pending transaction, and apprise the customer of the breakpoint opportunities.²⁴

Without the information possessed by a mutual fund regarding its shareholders, a broker-dealer does not possess the necessary information to determine the “availability and appropriateness of breakpoint opportunities” for any individual investor (or immediate family member) with multiple accounts among different intermediaries.²⁵ And the term “reasonable basis for exclusion” should not apply to a broker-dealer conversion from a transparent recordkeeping structure to one in which the omnibus accounting process prevents an investor from obtaining all of the “breakpoint opportunities” to which he or she is entitled under a mutual fund’s aggregation and accumulation rules.

The Use of Omnibus Accounting is Inconsistent with Internal Revenue Service Guidance on Recordkeeping Requirements for Section 529 Plans

This proposed conversion to an omnibus accounting structure by large broker-dealers is also inconsistent with current guidance from the Internal Revenue Service (“IRS”), regarding the recordkeeping requirements of Section 529 qualified tuition programs. Section 529(b)(3) states that “[a] [state] program shall not be treated as a qualified tuition program unless it provides separate accounting for each designated beneficiary.”²⁶ 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:

(f) *Separate accounting.* A program shall not be treated as a [Qualified State Tuition Program] unless it provides separate accounting for each designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and any earnings attributable thereto must be allocated to the appropriate account. If a program does not ordinarily provide each account owner an annual account statement showing the total

²⁴ This provision was adopted in July 2007. See 23 Va. Regs. Reg. 3939 (July 23, 2007). The term “breakpoint” is defined as “the dollar level of investment needed to qualify a purchaser for a discounted sales charge on a quantity purchase of open-end management company shares.” 21 VAC 5-10-40.

²⁵ This is also the view of the U.S. Securities and Exchange Commission. See U.S. Securities and Exchange Commission, Disclosure of Breakpoint Discounts by Mutual Funds, Final Rule, 69 Fed. Reg. 33,262, at 33,265 (“Typically, a brokerage firm has one omnibus account with each of the mutual funds with which it does business and through which all of its brokerage customers purchase and redeem shares of those mutual funds. Consequently, these mutual funds do not have information on the identity of the underlying brokerage customer who is purchasing or redeeming the funds’ shares. In the breakpoint context, omnibus accounts make it difficult for funds to track information about the underlying shareholder that could entitle the shareholder to breakpoint discounts.”).

²⁶ 26 U.S.C. § 529(b)(3).

account balance, the investment in the account, earnings, and distributions from the account, the program must give this information to the account owner or designated beneficiary upon request.²⁷

Current guidance also requires state programs to file a Form 1099-G with the IRS, for each account owner and beneficiary who receives a taxable distribution.²⁸ 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.²⁹

Additionally, current IRS guidance 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.³⁰

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. The use of omnibus accounting for Section 529 accounts will make it difficult for the Virginia 529 Plan to fulfill its tax compliance responsibilities, by permitting the conversion of a very transparent recordkeeping system into one with multiple recordkeepers and an unnecessary layer of intermediaries in between the Virginia 529 Plan and the investor accounts it is responsible for overseeing.

Conclusion

The conversion of directly-held investor accounts into an omnibus accounting structure will cause a diffusion of responsibility for account maintenance and recordkeeping within the Virginia 529 Plan. Utilizing multiple broker-dealers for recordkeeping services in this manner is inconsistent with the Virginia Consumer Protection Act, the Virginia Administrative Code, and the guidance issued by the Internal Revenue Service. Additionally, the trustees of the Virginia 529 Plan are subject to fiduciary duties that require, at a minimum, the use of a competitive bidding process for the selection of broker-dealers seeking to provide third-party recordkeeping services.

For the reasons presented in this letter, CMFI urges your Office to investigate this new accounting practice by large broker-dealers and the unnecessary and non-

²⁷ U.S. Department of the Treasury, Qualified State Tuition Programs, Proposed Rule, 63 Fed. Reg. 45,019 (Aug. 24, 1998).

²⁸ Prop. Treas. Reg. § 1.529-4. 63 Fed. Reg. 45,019, at 45,030-45,031 (Aug. 24, 1998).

²⁹ 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.").

³⁰ Prop. Treas. Reg. § 1.529-4(c). 63 Fed. Reg. 45,019, at 45,031 (Aug. 24, 1998).

The Honorable Kenneth T. Cuccinelli, II

June 14, 2011

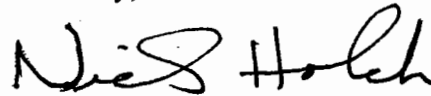
Page 12

competitive fees they are charging for recordkeeping services. Your Office should reject the premise advanced by broker-dealers that omnibus accounting improves the efficiency of 529 account administration. 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?

In order to protect the interests of investors in the Virginia 529 Plan, your Office should take steps to ensure that any and all fees paid to broker-dealers within the Plan are established by market-based processes, so that investors in these accounts have the lowest costs possible. Your Office should ensure that the Virginia 529 Plan is approving only practices that lower recordkeeping costs. And your Office should oppose the use of omnibus accounting for investor accounts in the Virginia 529 Plan, unless there is full transparency within these accounts at the investor level and on a real-time basis.³¹

Thank you in advance for your attention to this problem. Please contact me if CMFI can provide you with any additional information about the issues described in this letter. My address and telephone number are listed on the letterhead and my email is nielsholch@att.net.

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

³¹ This can be accomplished through the use of the Networking service offered by the National Securities Clearing Corporation ("NSCC"). See [CMFI White Paper](#) at 22.