THE VISIBLE HAND IN GOVERNMENT-SPONSORED FINANCIAL SERVICES: WHY STATES SHOULD NOT BE ALLOWED TO OFFER 529 PLANS

Mercer E. Bullard[*]

INTRODUCTION

Since 2001, 529 plans have been one of the fastest growing investment products in America. Between 2001 and 2004, 529 plan assets increased from $2.6 billion to $52.2 billion, a 1,908% increase.[1] Assets in 529 plans are expected to reach $100 billion by 2006 and $300 billion by 2010.[2] Congress created 529 plans in 1999 to provide a tax-advantaged way for parents to invest for their children's college education. 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 some cases, low costs.

The rapid capture of market share by 529 plans might be expected to be the product of free market capitalism, where private actors respond promptly and efficiently to the constantly changing forces of demand and supply. Yet only states are authorized to sell 529 plans—or more precisely, investment products that boast the uniquely advantageous characteristics of 529 plans.[3] Private financial service providers have played a limited role in this fast-developing niche of the financial services marketplace. This Article argues that states' exclusive monopoly over 529 plans is harmful to investors and should be eliminated. Indeed, Congress should consider prohibiting states from

---

* Visiting Professor, Washington University in St. Louis School of Law; Assistant Professor of Law, University of Mississippi School of Law. Portions of this Article are based on the Author's testimony before the Subcommittee on Financial Management, the Budget and International Security of the U.S. Senate Committee on Governmental Affairs (Sept. 30, 2004). The Author wishes to thank the participants in the 2005 IHELG Houston Higher Education Law Roundtable, with special thanks to Michael Olivas and Matthew Hall for their helpful comments and suggestions.

1. *See* Inv. Co. Inst., 529 Plan Program Statistics, December 2004 (2004), http://www.ici.org/issues/edu/arc-stats/529s_12-04.html; MARGARET CLANCY & MICHAEL SHERRADEN, CTR. FOR SOC. DEV., THE POTENTIAL FOR INCLUSION IN 529 SAVINGS PLANS: REPORT ON SURVEY OF STATES 2 (2003), *available at* http://www.collegesavings.org/education/ResearchReport-529savingsplansurvey.pdf.

2. *See* Kathy Chu, *Investors Bullish On '529' Plans For College Saving*, WALL ST. J., Aug. 26, 2004, at D2; *see also* CLANCY & SHERRADEN, *supra* note 1, at 4.

3. *See* 26 U.S.C. § 529 (b)(1)(A)(ii) (2000).

offering 529 plans as long as they continue to be exempt from securities laws.

The government can and should use tax benefits to promote the public good, including increased investment in education, but no public good can be created by granting governmental entities an effective monopoly in an economic field already crowded with private actors. Governments can and should condition the availability of such targeted tax benefits to ensure that the relevant public good is maximized. This applies equally to the federal and state governments; each can and should exercise its prerogative to offer conditional tax benefits to promote federal and state goals.

No logical connection exists, however, between the need for states to be able to impose conditions on state-conferred tax benefits and the role of the state in developing, managing, and distributing the investment vehicle through which the tax benefit is conferred, any more than states need to enter the business of manufacturing cars in order to promote safety or clean air. States can impose conditions on state tax benefits without sponsoring the investment vehicles through which the tax benefits are realized, just as Congress concluded that it could successfully impose conditions on federal tax benefits for 529 plans without sponsoring the plans itself. Congress's error was its failure to recognize that the analysis it intuitively applied to itself is even more strongly applicable to states.

Permitting states to offer 529 plans may actually *harm* plan participants by effectively stripping them of rights and benefits to which they would be entitled if 529 plans were privately offered. Congress and the U.S. Securities and Exchange Commission (SEC or the Commission) have developed a comprehensive regulatory scheme for the regulation of investment companies that states' 529 plans have substantially (and legally) ignored. States have consistently opted, to the detriment of the plan participants, not to conform to securities laws designed to protect investors and promote competition. State sponsorship of 529 plans also interferes with Congress's purpose in creating them. Congress created 529 plans to increase investment in education, but state sponsorship of 529 plans makes it less likely that that will happen than if private firms were permitted to enter this market.

This Article argues not only that states should not have been given an effective monopoly over 529 plans, but also that Congress should consider prohibiting states from sponsoring 529 plans altogether. Part I of this Article describes the essential characteristics and regulation of 529 plans. Part II evaluates the costs and benefits of the state 529 plan monopoly and concludes that states offer no material benefits over what private firms would likely provide. Part III argues that state sponsorship of 529 plans will result in assets intended for increased investment in education being diverted to other uses, as rent-seeking constituencies skim increasingly larger shares from the 529 plan "college savings trough."[4] Part IV discusses how state sponsorship of 529 plans harms plan beneficiaries by effectively stripping them of the benefits of important investor protections and disclosure provisions under the securities laws that are designed to prevent fraud and promote competition. Part V concludes that Congress should act promptly, if not to ban states outright from the 529 plan business, at least to allow private competition.

I. BACKGROUND

A. Characteristics of 529 Plans

Section 529 of the Internal Revenue Code, from which 529 plans derive their name, actually covers two types of state-run education savings programs. One type offers contracts that allow the holder to prepay tuition at in-state post-secondary schools, with some contracts allowing for the transfer of the value of the account to be applied to out-of-state and private schools.[5] These are known as prepaid tuition programs. The 529 plans that are the subject of this Article (529 plans) involve state-sponsored, tax-deferred investment vehicles where the account value fluctuates based on the performance of the underlying investment. In prepaid tuition programs, the state assumes the risk that the cost of tuition will rise faster than the value of the account. In 529 plans, the participant assumes this risk.

State 529 plans are structurally similar to other tax-deferred investment vehicles such as variable annuities, 401(k) plans, 403(b) plans, and 457 plans.[6] Each of these investment vehicles has two layers. Participants' individual accounts are administered at the top level by the

4. *Oversight Hearing on Section 529 College Savings Plans: High Fees, Inadequate Disclosure, Disparate State Tax Treatment, and Questionable Broker Sales Practices: Hearing Before the Financial Management, the Budget, and International Security Subcomm. of the Comm. on Governmental Affairs U.S. S.*, 108th Cong. 1, 4 (2004) [hereinafter *Senate Hearing*] (statement of Chairman Peter Fitzgerald: "Right now, there are too many middlemen, including State bureaucrats, that are feeding at the Section 529 college savings trough.").

5. *See* 26 U.S.C. § 529. Prepaid tuition programs actually predated I.R.C. § 529, which was enacted in 1996 to clarify their tax status. *See Senate Hearing*, *supra* note 4, at 51 (statement of Steven T. Miller, Comm'r, Tax Exempt and Governmental Entities Division, Internal Revenue Service).

6. *See* 26 U.S.C. §§ 401(k) (qualified cash or deferred compensation plans), 403(b) (taxation of annuities purchased by 501(c)(3) organizations and public schools) & 457 (deferred compensation plans for employees of state and local governments).

sponsor of the investment vehicle: the employer in the case of 401(k), 403(b), and 457 plans; the insurance company for variable annuities; and the state for 529 plans. The second layer comprises the vehicle through which participants' assets are invested in the securities markets. Mutual funds are the predominant investment vehicles for 529 plans as well as for variable annuities, individual retirement accounts (IRAs),[7] and 401(k) plans.[8]

Like assets in many other tax-deferred investment vehicles, including IRAs, 401(k) plans, 403(b) plans, 457 plans, and variable annuities, income earned on 529 plan assets is not subject to federal tax. 529 plans are unique because withdrawals from 529 plans that are used for qualified educational expenses are tax free.[9] Except for Roth IRAs,[10] no other investment product offers both tax deferral and tax-free withdrawals. Many states parallel the federal treatment of 529 plan assets by providing state tax deferral during the life of the investment and freedom from tax for qualified withdrawals.[11] Some states have outdone Congress by permitting an upfront state tax deduction for 529 plan contributions in addition to tax deferral and freedom from tax for qualified withdrawals.[12] In these states, 529 plan investments generally enjoy superior tax advantages to all other investment vehicles.

Additionally, 529 plans are not handicapped by low investment limits

7. *See* 26 U.S.C. § 408.

8. *See* INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 38–39, 41 (2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf (mutual funds represent 43% of the IRA market, 97% of the 529 savings plan market, and 51% of the 401(k) market). A total of $294 billion in mutual fund assets were invested in 403(b) plans at year-end 2004. *See id*. at 41; *see also* INV. CO. INST., A GUIDE TO UNDERSTANDING 529 PLANS, 1, 5 (2005), *available at* http://www.ici.org/pdf/bro_529_plans.pdf ("At the end of 2003, 97 percent of 529 savings plan assets were invested in mutual funds.").

9. All other withdrawals are subject to an additional ten-percent penalty, unless the withdrawal is made in the event of the beneficiary's death, disability, receipt of a scholarship, or enrollment in a U.S. military academy or Merchant Marine Academy. *See* 26 U.S.C § 529(b)(6). Accounts can be transferred to another eligible beneficiary or to another 529 plan without triggering a tax liability. *See id*. A 529 plan must report on Form 1099-Q all earnings on any distributions made during the preceding year that includes identifying information about the recipient.

10. *See* 26 U.S.C. § 408A.

11. *See*, *e.g.*, Savingforcollege.com, Mississippi Conforms to Federal Exclusion for Non-Mississippi 529s (May 17, 2005), http://www.savingforcollege.com/529_news/?page=plan_news&plan_news_id=531. *But see* Savingforcollege.com, Alabama Legislature Fails to Pass 529 Exemption Bill (May 17, 2005), http://www.savingforcollege.com/529_news/?page=plan_news&plan_news_id=397 (reporting rejection of bill to permit exemption for qualified distributions from state tax).

12. *See* Savingforcollege.com Homepage, http://www.savingforcollege.com (reporting the following state tax advantages: California (pending bill would provide for state tax deduction for contributions to California's 529 plan); Illinois ($10,000 deduction); Louisiana ($2,400 deduction; $4,800 for joint filers; double deduction for low income families); Maryland ($2,500 per account); Mississippi ($10,000; $20,000 for joint filers), Oklahoma (same); New York ($5,000; $10,000 for joint filers)). Some states, such as Texas and Florida, do not have a state income tax.

that apply to most other tax-deferred investment vehicles. No federal limit exists on the amount of contributions that may be made to a 529 plan. The plan need only implement safeguards designed to ensure that contributions do not exceed qualified educational expenses that a beneficiary may incur,[13] which effectively limits 529 plan accounts to a few hundred thousand dollars.[14] The annual contribution limits that generally apply for other tax-deferred investment products are substantially lower: IRAs ($4,000); Roth IRAs ($4,000); 401(k) plans ($14,000); 457 plans ($14,000); and 403(b) plans ($14,000).[15]

A 529 plan must satisfy a number of requirements to qualify for these tax advantages. Participants may not direct the investment of their contributions or earnings in the plan except in selecting from among different broad-based investment strategies designed exclusively for the 529 plan.[16] Once the initial selection is made at the time of a contribution, transfers to other options may only occur once per calendar year or when the beneficiary is changed.[17] Contributions must be in cash, and plan interests cannot be pledged as security for a loan.[18] In addition, individuals cannot participate in a plan unless a specific individual is designated as beneficiary and a separate account is created for each beneficiary.[19]

B. Regulation of 529 Plans

Interests in 529 plans generally are exempt from federal securities laws because they are issued by government entities. Municipal

13. *See* 26 U.S.C § 529(b)(6). The I.R.S. has proposed a safe harbor that permits states to allow contributions up to the cost of tuition, fees, and room and board for a five-year matriculation at the highest cost school allowed in the plan. Again, this will be a few hundred thousand dollars. *See* 63 Fed. Reg. 45,019-01 (1998).

14. For example, the 529 plan account balance limits for California, New York, and Texas are, respectively, $285,000, $250,000, and $257,460. *See* Savingforcollege.com, *supra* note 12.

15. JONATHAN D. POND, PERSONAL FINANCIAL PLANNING HANDBOOK: WITH FORMS & CHECKLISTS ¶ 11.09 (2d ed. 2005) (Section 403(b), 457, 401(k) limits for 2005), *available at* 2001 WL 643455; ROBERT E. MADDEN, TAX PLANNING FOR HIGHLY COMPENSATED INDIVIDUALS ¶ 7.06[1][a] (2005) (IRAs for 2005); DIANNE BENNETT ET AL., TAXATION OF DISTRIBUTION FROM QUALIFIED PLANS ¶ 15.05[2] (2005) (Roth IRAs for 2005). There is no limit on contributions to variable annuities, but financial professionals generally prefer the foregoing vehicles to variable annuities. *See, e.g.*, U.S. Sec. & Exch. Comm'n, Variable Annuities: What You Should Know (2005) (recommending that investors consider IRAs and 401(k)s before investing in a variable annuity), http://www.sec.gov/investor/pubs/varannty.htm.

16. *See* 26 U.S.C § 529(b)(4).

17. *See id.* § 529(c)(3)(C).

18. *See id.* § 529(b)(2) & (5).

19. *See id.* § 529(b)(1)(A)(ii) & (b)(3).

securities are exempt from the Securities Act of 1933,[20] which generally regulates the public offering and registration of securities, and the plans themselves are exempt from the Investment Company Act of 1940,[21] which generally regulates the public offering, registration, and operation of investment companies, also known as mutual funds.[22] The Securities Exchange Act of 1934 regulates, among other things, persons who effect transactions in securities for the account of others, but the Act's broker registration provisions do not apply to transactions in "municipal securities." This means that persons who effect transactions in 529 plan interests are not required to register with the Commission as brokers.[23] As a practical matter, however, this generally affects only state employees, because most other brokers who sell 529 plan interests also effect transactions in other securities that do trigger registration. Thus, while the SEC and the National Association of Securities Dealers (NASD), the self-regulatory organization for brokers, do not have direct regulatory authority over state employees who sell 529 plan interests, they generally do have direct authority over the sales practices of non-state employees. In the past, the SEC has used this authority to regulate the municipal securities market and—some might argue outside the scope of the authority[24]—municipal securities issuers (the states) themselves. Although the SEC and NASD have the authority to regulate sales of municipal securities, a third regulator has been most active in this area, as discussed below. Notwithstanding these exemptions,

20. *See* 15 U.S.C. § 77c(a)(2); *see also* Letter from Catherine McGuire, Assoc. Dir. & Chief Counsel, Div. of Mkt. Regulation, U.S. Sec. & Exch. Comm'n to Diane G. Klinke, Gen. Counsel, Mun. Sec. Rulemaking Bd., 1999 SEC No-Act. LEXIS 330 (1999) (noting that prepaid tuition plan interests are municipal securities).

21. *See* 15 U.S.C. § 80a-2(B); *see also id.* § 80a-3(c)(11) (excluding governmental plans under section 3(a)(2)(C) of the Securities Act from the definition of "investment company").

22. A "mutual fund" is a registered open-end management investment company. *See id.* §§ 80a-4 & 5(a)(1). For purposes of this Article, the term "mutual fund" does not include an exchange-traded fund. An exchange-traded fund (ETF) is a mutual fund that permits the direct purchase and redemption of shares only in very large aggregations. The shares of ETFs trade on exchanges, like stocks. *See generally* IShares, Inc. et al., Notice of Application, Investment Company Act Release No. 25,595, 67 Fed. Reg. 38,684 (June 5, 2002).

23. *See* 15 U.S.C. §§ 78c(a)(4)(A) (defining "broker"); 78c(a)(12)(A)(ii) (defining "exempted securities" to include "municipal securities" other than for purposes of sections 15 and 17A); 78c(a)(29) (defining "municipal security"); 78c(a)(30) (defining "municipal securities dealer"); 78c(a)(31) (defining "municipal securities broker"); & 78o(a)(1) (requiring registration of brokers who effect securities transactions except, *inter alia*, transactions in exempted securities). The Exchange Act also generally prohibits brokers from effecting transactions in securities on a national securities exchange, but this does not apply to municipal securities, *see id.* § 78l(a), and, in any case, no 529 plan interests are currently sold on an exchange.

24. *See* Christine A. Scheel, Comment, *Amended Rule 15c2-12: An Attempt to Improve Disclosure Practices in the Municipal Securities Market*, 45 DEPAUL L. REV. 1117, 1158–60 (1996) (arguing that Rule 15c2-12 exceeds the SEC's authority).

however, municipal issuers and their employees are subject to the general antifraud provisions of the federal securities laws.[25]

The Municipal Securities Rulemaking Board (MSRB) primarily regulates the sale of municipal securities. The MSRB is a statutorily created self-regulatory organization[26] that must obtain SEC approval of its rules.[27] The MSRB has the authority to adopt rules "designed to prevent fraudulent and manipulative acts and practices" in connection with transactions in municipal securities.[28] Neither the MSRB nor the SEC are authorized to require, directly or indirectly, municipal issuers to file pre-sale disclosure documents with the SEC or MSRB, and the MSRB is not authorized to require municipal issuers, directly or indirectly, to provide pre-sale disclosure documents to the MSRB or purchasers.[29] Thus, the SEC retains the authority to require broker-dealers to provide pre-sale documents to the SEC and to purchasers, but it lacks the direct authority to require municipal issuers to file documents with the Commission. In addition, the MSRB may require municipal broker-dealers to deliver information that is "generally available from a source other than such issuer."[30]

In many instances, 529 plan regulation is similar to mutual fund regulation. For example, mutual fund rules that operate internally—such as restrictions on funds' ability to use leverage, invest in certain types of securities, issue multiple classes of shares, engage in transactions with affiliates, and use their own assets to pay for the distribution of their shares[31]—effectively apply equally to 529 plans because virtually all 529 plan assets are invested in mutual funds that must follow those rules. To the extent that 529 plans invest outside of mutual funds, however, these rules do not apply.[32]

25. *See* 15 U.S.C. §§ 77q(a) & 78j(b); 17 C.F.R. § 240.10b-5 (2005); *see, e.g.*, Neshannock Twp. Sch. Dist., Admin. Proc. File No. 3-11,461, 2004 SEC LEXIS 861 (2004) (finding the school district violated antifraud provisions of the federal securities laws).

26. The MSRB was created by the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified at 15 U.S.C. § 78o). The creation of the MSRB by statute contrasts with the NASD, which operates under section 15A of the Exchange Act. *See* 15 U.S.C. § 78o. That section authorizes the creation of, but does not create, registered securities associations. *See id*.

27. *See* 15 U.S.C. §§ 78o-4(b)(1), 78c(a)(26) & 78s(b)(1).

28. *Id.* § 78o-4(b)(2)(C).

29. *See id.* § 78o-4(d).

30. *See id*. For an excellent overview of the role of the MSRB in regulating 529 plans, see *Senate Hearing*, *supra* note 4, at 65 (statement of Ernesto A. Lanza, Senior Associate General Counsel, MSRB).

31. *See id.* §§ 80a-12, 17 & 18.

32. Some plans invest in unregistered investment pools that are not subject to these rules. *See infra* discussion accompanying note 129; *see also infra* discussion following note 88 (discussing the possibility that 529 plan officials will invest plan assets in local firms).

Other mutual fund rules do not necessarily apply to 529 plan beneficiaries, such as the requirements that the mutual fund's board be fifty percent independent,[33] that the fund issue shares for which redeeming shareholders are entitled to receive their pro rata net asset value within seven days of tender,[34] and that the fund must obtain shareholder approval before raising its management fee.[35] Proxy rules under the Exchange Act also apply to mutual funds.[36] The federal securities laws exempt 529 plans from all of these requirements; the states must decide whether to extend these rules to their 529 plan customers.

The most significant difference between 529 plan regulation and mutual fund regulation relates to disclosure requirements. Neither the SEC nor the MSRB has the right to require issuers to make specific disclosure documents available or to file such documents with either regulator. Unlike other public issuers of securities, 529 plans are not required to file a prospectus or deliver it to purchasers prior to the completion of the sale.[37] In addition, if the 529 plans were not exempt from the securities laws, then the plans generally would be regulated as investment companies, which are required to include a wide range of specific disclosure information in their prospectuses, including, among other things, standardized information on investment performance, fees, investment objectives, strategies and risks, the investment advisor's background and expertise, distribution arrangements, and financial highlights.[38] Additional information must be provided in the fund's Statement of Additional Information, which must be provided to investors upon request.[39] None of these requirements applies to 529 plans.

33. Although the Investment Company Act requires only that a fund board be forty percent independent, *see* 15 U.S.C. § 80a-10(a), the SEC has adopted a number of exemptive rules that require a fifty percent independent board, and almost all funds rely on one or more of these rules. *See*, *e.g.*, 17 C.F.R. § 270.12b-1 (2005). The SEC has attempted to increase that to seventy-five percent and to require that the fund's chairman be independent, but that proposal is currently being litigated. *See* Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005); *see generally* Mercer Bullard, *Comments on Martin Lybecker's* Enhanced Corporate Governance, 83 WASH. U. L.Q. 1095 (2005).

34. *See* 15 U.S.C. §§ 80a-2(a)(32) & 80a-22(e); 17 C.F.R. § 270.22c-1(a).

35. *See* 15 U.S.C. § 80a-15(a).

36. *See id.* § 78n.

37. *See id.* § 5(b)(2).

38. *See* Form N-1A.

39. The mutual fund registration statement includes three parts: Part A: the Prospectus, Part B: Statement of Additional Information (SAI), and Part C: Other Information (e.g., exhibits). *See* Form N-1A. The prospectus must be provided to investors at or before the completion of a fund purchase. *See* 15 U.S.C. § 5(b)(2). The SAI must be provided only upon the request of the investor. *See* Instruction 3, Item 1(b)(1), Form N-1A.

The practical effect of this disclosure regulatory gap is mitigated somewhat for 529 plans sold by broker-dealers. As noted above, the MSRB cannot indirectly require issuer disclosure through its regulation of broker-dealers, but the SEC can.[40] The SEC requires municipal underwriters to obtain and disseminate certain information about any municipal securities they sell and to obtain updated information on an ongoing basis.[41] MSRB Rule G-32 supplements this requirement by mandating that broker-dealers deliver a copy of a 529 plan's program document to the investor before or at the time of settlement.[42]

The SEC also has proposed to require that broker-dealers deliver a point-of-sale document at the time of the investment in the 529 plan and a confirmation of the transaction.[43] The point-of-sale document would include information about the fees paid by the participant in connection with the investment and compensation received by the broker that is similar to standardized fee disclosure required in the fund prospectus.[44] Whether broker-dealers will be required to provide the point-of-sale document early enough that investors will have time to review and comprehend it before making an investment decision is not clear.[45] The SEC also has proposed to extend its transaction confirmation rule to transactions in 529 plan interests.[46] This rule generally would require that the contents of the confirmation, which is delivered to an investor at the completion of the transaction, disclose the amount of the broker's compensation.[47] Finally, these disclosure requirements apply or would

40. *But see* Scheel, *supra* note 24, at 1158–60 (arguing that Rule 15c2-12 exceeds the SEC's authority).

41. *See* 17 C.F.R. § 240.15c2-12 (2005).

42. In addition, primary distributors must submit the program document to the MSRB's Municipal Securities Information Library. *See Senate Hearing*, *supra* note 4, at 83 (statement of Ernesto A. Lanza, Senior Associate General Counsel, MSRB).

43. 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 Release No. 26,341, 69 Fed. Reg. 6438 (proposed Feb. 10, 2004) (proposing release); Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26,778, 70 Fed. Reg. 10,521 (proposed Mar. 4, 2005) (reopening comment period and supplemental request for comment).

44. *See supra* note 43.

45. *See* Letter from Mercer Bullard, Founder & President, Fund Democracy, Inc.; Barbara Roper, Dir. of Investor Prot., Consumer Fed'n of Am.; Kenneth McEldowney, Executive Dir., Consumer Action; & Sally Greenberg, Senior Counsel, Consumers Union, to Jonathan Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 5, 2005), *available at* http://www.sec.gov/rules/proposed/s70604/fdcfacacu040605.pdf.

46. *Id*.

47. *Id*.

apply only to 529 plans sold by broker-dealers and not to plans sold directly by states and their employees.[48]

The regulation of the sale of 529 plans has other similarities (in addition to the point-of-sale and confirmation rules, if adopted) to the regulation of the sale of mutual funds. As noted above, the SEC and MSRB can regulate 529 plans indirectly through their authority over broker-dealers who sell them. Although the sales activities of the state and its employees are exempt, the sales activities of others are not exempt. Since the inception of 529 plans, the MSRB has adopted a number of rules regarding the sale of interests in 529 plans. Some of these rules are of general applicability, such as MSRB G-17, which requires fair dealing and prohibits deceptive, dishonest, and unfair practices,[49] and G-19, which requires that brokers have reasonable grounds to believe that the municipal securities are suitable investments for the customer.[50] These rules generally parallel NASD rules that apply to broker-dealers generally.[51]

Significant differences, however, exist between the regulation of sales of 529 plans and mutual funds. One difference is that sales of 529 plans are not subject to specific limits on sales charges. The NASD has authority to set limits on the amount of mutual fund sales charges, which it has exercised in NASD Rule 2830. Although MSRB Rule G-30(b) prohibits broker-dealers from charging excessive commissions and service fees, the MSRB is not authorized to impose fixed specific limits.[52] The MSRB may consider whether charges on transactions in 529 plans exceed NASD limits on charges on transactions in mutual funds to be a "significant factor" in determining whether the former are excessive, but it acknowledges that this does not necessarily preclude broker-dealers from imposing charges in excess of NASD limits.[53]

Another difference relates to mutual fund advertisements. Mutual fund regulations prohibit advertisements that include performance projections and require that any advertisements that refer to performance

48. *Id*.

49. For example, the MSRB interprets Rule G-17 to require broker-dealers to disclose to investors that an in-state plan may offer more favorable tax benefits than an out-of-state plan. *Senate Hearing*, *supra* note 4, at 82 (statement of Ernesto A. Lanza, Senior Associate General Counsel, MSRB).

50. The MSRB has provided specific guidance regarding suitability obligations in the context of sales of 529 plans. *Id*.

51. *See*, *e.g.*, NASD Rules 2120 (use of manipulative, deceptive or other fraudulent devices) & 2310 (suitability).

52. *See* 15 U.S.C. § 78o-4(b)(2)(C) (2005).

53. *See Senate Hearing*, *supra* note 4, at 80 (statement of Ernesto A. Lanza, Senior Associate General Counsel, MSRB).

include standardized one-, five-, and ten-year returns.[54] Any advertisement that refers to a fund's after-tax performance must be accompanied by standardized one-, five-, and ten-year after-tax returns.[55] In contrast, advertisements placed by 529 plans themselves are subject only to general antifraud rules under federal securities laws, and MSRB Rule G-21 only prohibits broker-dealers from using advertisements that are materially false or misleading. Neither standard requires that 529 plans comply with the mutual fund advertising rule.

Finally, 529 plans are regulated somewhat by their enabling statute. For example, a 529 plan must provide participants with an annual statement of their account balances and their contributions to, earnings in, and distributions from their accounts. In addition, as noted above, investments in 529 plans have a number of restrictions, including the maximum amount allowed to be invested and limitations on a 529 plan participant's ability to direct or reallocate the investment, transfer, or pledge of his or her 529 plan account. Further, the structure and operation of state plans could be viewed as a form of state regulation, although whether the state, as the 529 plan sponsor, is acting as a regulator rather than as an entrepreneur is unclear.

II. THE STATE 529 PLAN MONOPOLY

To justify the state 529 plan monopoly, one must conclude that Congress's goal of promoting investment in education through tax incentives will be better achieved if states, and only states, are permitted to offer 529 plans. The burden here is to prove that permitting private firms to offer 529 plans alongside of states would result in comparatively less investment in education. In other words, there must be some reason that investment in 529 plans would be lower if both states and private firms offered them than if only states offered them.

Unfortunately, the legislative history of 529 plans provides no insight as to why Congress believed that states and only states should be permitted to offer 529 plans. One can reasonably assume that the general purpose behind 529 plans was to promote investment in education, but no record indicates why Congress granted the state monopoly or whether it considered permitting private firms to offer plans. If the lack of any legislative history speaks to anything, it may be that if a Republican Congress—with a reputation for preferring private over public solutions to problems relating to personal investing—had

54. *See* 17 C.F.R. § 230.482 (2005).
55. *See id*.

thought about what it was doing, it would not have created a state monopoly in a highly competitive and successful market dominated by private actors.[56]

Without legislative history as a guide, one can still reasonably speculate as to why a state 529 plan monopoly might help accomplish Congress's purpose of increasing investment in education. One reason is that granting states a 529 plan monopoly might limit the number of providers, thereby fostering greater concentration of assets and lower costs. If $100 billion in 529 plan assets were spread among one thousand plans, the average plan size would be only $100 million. If the same assets were spread among fifty state plans, the average plan size would be $2 billion. The $2 billion plans' costs would be lower because of economies of scale, thereby leaving more assets for investment in education.[57] Congress might have thought that the state 529 plan monopoly would promote such economies of scale.

If the monopoly was intended to promote economies of scale, evidence of its success is lacking. To date, states have created 126 separate 529 plans,[58] with each plan offering at least two or three investment options, and some offering more than a dozen.[59] Thus, while the hundreds of funds in which 529 plans are invested seem insignificant

56. For example, Republicans generally have supported the concept of shifting responsibility for Americans' retirement security away from Social Security toward greater reliance on private accounts.

57. New York has announced that it will lower its all-inclusive fee for its plan from 0.60% of assets to 0.55% of assets once the plan reaches a specified size. *See* Savingforcollege.com, *supra* note 12. Some 529 plan service providers have exited the business, possibly because they were unable to achieve economies of scale. *See, e.g.*, Press Release, State Street Corp., In Third Quarter State Street Corporation Saw Less Favorable Market Conditions Than in First Half (Oct. 12, 2004), *available at* http://media.corporate-ir.net/media_files/nys/stt/1012.pdf (announcing its exit from the 529 plan servicing business); *see also* Charles Paikert, *Sparks Set to Fly in 529 Biz*; *Executives See Consolidation Among Program Managers This Year*, INVESTMENT NEWS, Jan. 10, 2005, at 3 (discussing importance of economies of scale in 529 plan business and likelihood that firms that do not gather enough assets will drop plans).

58. *See* 529 Plan Details, http://www.savingforcollege.com/529_plan_details (last visited June 16, 2006).

59. For example, the Texas 529 plan sold through intermediaries offers three types of avenues for investment: age-based portfolios, static allocation portfolios, and single-fund portfolios. *See* ENTERPRISE CAPITAL MANAGEMENT, TOMORROW'S COLLEGE INVESTMENT PLAN: PLAN DESCRIPTION (May 3, 2004), *available at* http://www.enterprise529.com/downloads/529PLANDES_CA5_04.pdf [hereinafter TOMORROW'S PLAN]. The aged-based and static allocation options invest in seven different funds, and the single-fund option invests in an additional twelve funds, for a total of nineteen different funds (one fund is offered under all three options). *Id.*; *see also Investing for the Future: 529 State Tuition Saving Plans; Hearing before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 136–37 (2004) [hereinafter *House Hearing*] (statement of Michael Olivas, William B. Bates, Distinguished Chair in Law & Director, Institute for Higher Education Law and Governance, University of Houston Law Center, questioning efficacy of offering large number of investment options in 529 plan).

when compared with the more than 8,000 mutual funds sold on the market today, the average amount of assets in each 529 plan investment option is a fraction of the average asset size of mutual funds.[60] If private firms offered 529 plans, most 529 plan assets would be invested in large, preexisting funds that would be more likely to realize economies of scale than state plans. To the extent states already have invested 529 plan assets in classes of large, preexisting mutual funds, the resulting economies of scale can be attributed to the success of these privately offered funds, not to the state 529 plan monopoly. Some private firms already have retreated from the 529 plan arena, perhaps because they found that they could not provide services profitably to such a small asset base.[61]

One might argue that economies of scale are not always shared with shareholders, and that private firms might charge higher fees and keep economies of scale for themselves, but no evidence indicates that 529 plans are any less expensive than privately offered funds would be.[62] The range of fees charged by 529 plans generally reflects the range of fees charged by similar tax-deferred investment vehicles. In fact, Congress has expressed concern that 529 plan fees are higher, not lower, than fees charged by comparable investment vehicles.[63]

A broader problem with the economies of scale argument is its premise that limiting supply will result in lower, rather than higher, prices. Limiting suppliers and supplies of a good or service normally

60. Assuming $52 billion in five hundred 529 plan funds, *see supra* note 1, the average fund size would be approximately $100 million. There are $8 trillion in assets in approximately eight thousand mutual funds, or an average of approximately $1 billion per fund. *See* INV. CO. INST., *supra* note 8, at 59.

61. *See supra* note 57 (discussing firms that have withdrawn from the 529 plan market, possibly because of inefficiencies).

62. As an example of high state 529 plan fees, a $10,000 investment by a non-resident in Class A shares of the Enterprise Global Socially Responsive Fund option in the Texas 529 plan may pay up to $735 (7.35%) in fees and sales charges the first year and up to $260 (2.60%) each year thereafter (assuming no account appreciation). *See* TOMORROW'S PLAN, *supra* note 59, at 18–22; *see also* Charles Paikert, *Best and Worst: Morningstar Rates 529 College Savings Plans*, INVESTMENT NEWS, Feb. 28, 2005, at 13 (quoting Morningstar, a fund rating entity: "Wyoming's 529 plan 'charges a 0.95% annualized program management fee [on top of the cost of the underlying funds] that can only be categorized as obscene'"); *see generally House Hearing*, *supra* note 59, at 130 (statement of Dan McNeela, describing "exorbitant fees" of 529 plans).

63. *See*, *e.g.*, *House Hearing*, *supra* note 59, at 4 (statement by Chairman Richard H. Baker: "I have become concerned about certain aspects of some of these [529] plans. . . . Have the fees charged by these State-sponsored plans become so exorbitant that they actually outstrip the tax benefit that Congress has attempted to provide?"); *Senate Hearing*, *supra* note 4, at 4 (statement by Chairman Peter Fitzgerald: "So the bottom line is that in a high-cost college savings plan, the brokers and fund managers, together with a new actor, the State Governments which set up the plans, in effect can swallow up the tax benefits, leaving the uninformed consumer worse off than if he or she had invested in a fully taxable but low-cost mutual fund.").

would cause its price to rise, not fall. In some cases, limiting suppliers may result in lower prices, such as when a communication network or other similar utility or commodity can be profitably sold only if one or a few suppliers are granted a monopoly that creates the necessary economies of scale. Over time, enterprises adapt to such scenarios through Schumpeterian competition and consolidation, but in some cases governments may intercede, successfully, to expedite the process.

The ideas that (1) investment management services might be a commodity similar to a public utility, and (2) creating a state monopoly (or even a state-run enterprise) might be necessary to realize the full potential of a particular investment product, are intriguing notions, but they do not support the argument for a state 529 plan monopoly. Congress could have opted for far more efficient ways to limit fees, such as by granting a monopoly to the five largest money managers by assets under management, or the five largest mutual fund providers with the lowest fees. Alternatively, it could have itself administered all 529 plan accounts in one centralized system, allocating participants' accounts to qualified investment options according to their instructions. If anything, the effect of the state 529 plan monopoly has not been to create economies of scale and reduce costs, but to create inefficiency and raise costs, although more empirical analysis is needed to validate this view.

Permitting private firms to offer 529 plans, on the other hand, provides a real prospect of reducing costs. If private firms were permitted to offer 529 plans, they could be expected to use their established relationships with tens of millions of clients to promote their 529 plans and increase 529 plan sales. If states, novices in designing and marketing retail investment products, have managed to raise more than $50 billion in 529 plans over the last four years, private firms with decades of professional experience selling financial products likely could raise even more money. Granted, many states have retained these same private firms to market their plans, but one may reasonably expect that firms work harder selling their own products than someone else's products, especially because they would no longer incur the costs of potentially having to accommodate the 529 plan design of fifty different states and would receive additional revenues for providing the administrative services the states currently provide.

Perhaps the reason to support the state 529 plan monopoly is that states would exit the 529 plan market if forced to compete with private firms. For this theory to be true, two propositions must be met: if states leave the 529 plan playing field, (1) investors would be deprived of state-provided benefits that private firms would not replace; and (2) the value of these benefits would exceed the benefits of increased competition and choice. In addition, one might argue that such state benefits must somehow promote Congress's goals for 529 plans or at least not undermine those goals. None of these propositions holds up under analysis.

Some individuals argue that state 529 plans offer unique benefits. One plan administrator has argued, for example, that state 529 plans offer account minimums that are lower and investment plans that are more flexible than privately sponsored funds.[64] The implication is that state plans will increase investment in education by persons who do not have sufficient assets to meet investment minimums in other funds or that other persons will be more likely to free up liquid assets for investment in 529 plans if the minimums are sufficiently low. Another plan administrator has argued that state 529 plans offer age-sensitive portfolios that are not available elsewhere.[65]

Both of these advantages are illusory because privately sponsored mutual funds offer low minimums,[66] flexible investment options,[67] and age-sensitive portfolios.[68] Even if such options were not already available, they could be made available if private sponsors were allowed

64. *See Senate Hearing*, *supra* note 4, at 24, 35–36 & 43 (statements of Michael A. Ablowich, Treasurer, State of New Hampshire, & Jacqueline Williams); *see also House Hearing*, *supra* note 59, at 7 (statement of Diana Cantor, Executive Director, Virginia College Savings Plan and Chair, College Savings Plans Network: "Our feelings as State administrators are that the unique features of our plans provide their prime attraction . . ."); *but see* Michael A. Olivas, *State College Savings and Prepaid Tuition Plans: A Reappraisal and Review*, 32 J.L. & EDUC. 475, 490–92 (2003) (questioning "stateness" of plans and characterizing plans, in view of the significant role of private firms in operating state plans, as "rent-a-state, operating these programs as branch offices of a larger network of financial services institutions").

65. *See Senate Hearing, supra* note 4, at 37–38 (statement of Michael A. Ablowich).

66. Some mutual funds have very low minimums. *See generally* Aleksandra Todorova, *Low-Minimum Investments*, WALL ST. J., Aug. 30, 2005, at D2. Joshua Albertson, *High-Minimum Funds*, WALL ST. J., June 21, 2005, at D2; Dustin Woodward, *Mutual Funds with Low Minimums*, ABOUT.COM, May 4, 2001, http://mutualfunds.about.com/cs/fundfees/a/ lowmin.htm (identifying funds with $500 and $250 or under minimum initial investment amounts); Randall J. Schultz, *Investing on the Cheap*, CNN MONEY, Oct. 6, 1998, *available at* http://money.cnn.com/1998/10/06/investing/q_limitedmeans. *But see* Jonathan Clements, *Wall Street to Small Investors: Scram!*, WALL ST. J., Dec. 11, 2004, at C1.

67. Most large fund complexes offer funds with a wide variety of investment objectives. For example, Fidelity offers four different types of stock funds, five different types of bond funds, three different types of money market funds, three types of asset allocation funds, and two types of index funds. Fidelity Investments, http://personal.fidelity.com/products/funds/content/browse.shtml (last visited June 16, 2006).

68. For example, many fund complexes offer funds that are designed for a specific expected retirement date that are more conservatively invested each year. *See, e.g.*, Vanguard Target Retirement 2015 Fund Summary, http://flagship2.vanguard.com/VGApp/hnw/content/Funds/FundsVanguardFunds Target2015SummaryJSP.jsp (last visited June 16, 2006); About Fidelity Freedom Funds, http://personal.fidelity.com/products/funds/content/freedomfunds.shtml (last visited June 16, 2006); *see generally* Kaja Whitehouse, *Age-Old Questions for Investors*, WALL ST. J., July 11, 2005, at C17 (discussing age-sensitive mutual funds in 401(k) plans).

to compete for 529 plan assets. To the extent that states claim to offer services or benefits that respond to unmet market demand, private sponsors may be just as responsive.[69] One benefit that a market of competing firms offers is superior responsiveness to market demand. If anything, states will be less responsive than private firms. The incredible diversity of mutual fund offerings in the market today attests to the industry's ability to evaluate and respond to the needs of investors in tax-deferred investment vehicles.

This does not necessarily mean, however, that there are no benefits that state 529 plans might offer that private sponsors might not offer—i.e., benefits that might be lost if states withdrew from the 529 plan market. In a sense, the enabling statute for 529 plans creates such benefits by ensuring that, for example, all 529 plan assets are invested in broad-based investment options and transfers are permitted only once a year. These restrictions may provide, respectively, greater assurance that 529 plan assets will actually be used for investment in education rather than as vehicles for riskier investments or market timing.[70] The most direct restriction, of course, is that 529 plan redemption proceeds that are not used for qualified educational expenses are subject to taxes. These restrictions admittedly may fail at the margins, as investors can reallocate other parts of their portfolios to increase risk, sector concentration, or market-timing activities in a way that their overall mix is unaffected by restrictions on their 529 plan investments. Nonetheless, the point is not whether the perceived benefits achieve their purpose, but whether the government arguably offers the prospect of benefits that would not be universally available if private firms were permitted to offer 529 plans. While many private sponsors might impose similar restrictions on their 529 plans, many undoubtedly would not.

States similarly can create and have created unique benefits by imposing their own restrictions on their 529 plans. Congress gave exclusive authority to states to create and sell 529 plans; therefore, Congress likely contemplated that states may add their own overlay of restrictions that reflected state-specific policies. Congress may have intended that state public policy also play a role in the design of specific plans. As the creators of 529 plans, states necessarily make numerous decisions about their design that reflect their policy views about how 529 plans can best accomplish federal and state purposes. For example,

69. This discussion may give to much credit to the states, which for the most part have designed their 529 plan offerings with substantial guidance from the very same private mutual fund sponsors that would offer 529 plans directly if they could.

70. *See* Jane Kim, *Fund Investors Gain By Sitting Tight*, WALL ST. J., July 13, 2005, at D2 (describing studies finding that investors that do not trade funds frequently have higher returns).

states must decide whether to offer actively managed funds, index funds, or both; direct-sold funds, broker-sold funds, or both; many investment options or few investment options. At least seven states provide matching contributions to qualifying participants,[71] which promotes investment in education by a targeted group that, presumably, underinvests in education.[72]

States could favor underinvesting groups in other ways, such as price discounts or personalized financial advice. A portion of revenues from 529 plan fees could be used to promote investment in education, such as through marketing of the plan itself to targeted groups[73] or general financial literacy education regarding, for example, the importance of an early start to saving for a child's education. Consistent with "new federalism" principles, Congress might view state-refined 529 plans as having the advantage of providing local solutions to local educational needs, i.e., using states as "laboratories of democracy."[74] Thus, states could impose restrictions that create benefits similar to those Congress created that private sponsors of plans, if left to their own designs, might rarely, if ever, impose. If states left the 529 plan to market factors, these state-specific benefits might not be offered.

The foregoing argument, that Congress accepted the states' promotion of state policies through their 529 plans, fails because Congress also necessarily contemplated that states might offer 529 plans that did not seek to promote any state-specific policies. States are not required to offer any additional benefits beyond those mandated by Congress. Investors are entitled to the same federal tax benefits if they invest in a state plan that does not offer such additional benefits. If Congress was satisfied with such a plan, but would not be satisfied with a functionally

71. *See* Savingforcollege.com, *supra* note 12 (Colorado: up to $500 annually for five years for income-eligible state residents; Louisiana: between 2% and 14% of contributions by state residents, depending on income level; Maine: $200 first year, $100 each year thereafter for income-eligible state residents; Michigan: up to $200 for income-eligible state residents; Minnesota: up to $300 for income-eligible state residents; New Jersey: up to $1,500 scholarship for eligible state beneficiaries; Rhode Island: up to $1,000 annually for five years for income-eligible state residents).

72. *See House Hearing*, *supra* note 59, at 23 (statement of Diana Cantor, Executive Director, Virginia College Savings Plan and Chair, College Savings Plans Network: "It is a goal I know of the States of Ohio and Virginia, in particular, to reach those middle income and lower income families who get lost in the shuffle, not, you know, poor enough for financial aid, if you will, but nowhere near being able to meet the cost of higher education.").

73. *See House Hearing*, *supra* note 59, at 23 (statement of Diana Cantor, Executive Director, Virginia College Savings Plan and Chair, College Savings Plans Network: regarding 529 plans, "We conduct marketing campaigns that maybe traditionally would not be a great marketing decision.").

74. Exec. Order No. 13,132, 64 Fed. Reg. 43,255 (Aug. 4, 1999) ("[A]gencies shall be guided by the following fundamental federalism principles: . . . (e) The Framers recognized that the States possess unique authorities, qualities, and abilities to meet the needs of the people and should function as laboratories of democracy.").

identical plan offered by a private firm, the only explanation would be that Congress believed that only states, and not private firms, should be allowed to decide that no additional benefits should be provided. Conceivably, Congress believed that intrinsic value exists in 529 plans being designed only by state officials and not by private actors, but this is unlikely in light of the fact that Congress has repeatedly sought to restrict state regulation of securities products over the last ten years.[75]

Even if states had no involvement in 529 plans, they could still, following Congress's lead, use the proverbial state tax carrot to promote their 529 policy goals. States could easily promote their policy goals by permitting beneficial state tax treatment for 529 plan contributions, earnings, or distributions only for 529 plans that satisfy those goals. For example, Illinois's 529 plan officials lobbied for a bill that would have extended state tax breaks to investments in out-of-state plans that did not impose sales charges in excess of four percent.[76] This example is the exception, however, as not one state has used its tax benefits this way. States have treated earnings and distributions either as tax-free for all 529 plans or for no 529 plans; in other words, they have ignored the plans' policies or whether the plans are in- or out-of-state. States' tax treatment of 529 plan earnings and distributions may be a reflexive response that parallels the treatment of other tax-deferred investment vehicles, with some exceptions. Their treatment of 529 plan contributions, however, may reflect state policies, but those policies may be more self-serving than altruistic.

The tax treatment of 529 plan contributions relates a final theory regarding the special benefits of state sponsorship of 529 plans: private firms exist solely for the pursuit of profit, whereas states and their officials are primarily motivated to serve the public interest; therefore, state-sponsored 529 plans will better serve investors' interests. States' tax treatment of 529 plan contributions provides an interesting segue into this theory because it suggests that states and their officials may, in

75. *See*, *e.g.*, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998); National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995); *see also* H.R. 2179, 108th Cong. § 8(b) (2004) (restricting state securities enforcement authority).

76. *See Senate Hearing*, *supra* note 4, at 48 (statement of Martin M. Noven, Deputy Chief of Staff, on behalf of Judy Baar Topinka, Illinois State Treasurer); *see also* David Nicklaus, *Broader Breaks in 529 Plans Would Be Disservice to Parents*, ST. LOUIS POST-DISPATCH, Mar. 14, 2004, at E1 (arguing that state deduction should not be extended to high-cost out-of-state plans). Why a state would limit state tax deductions for 529 plan contributions to in-state plans, but not impose the same limit on state tax treatment of 529 plan earnings and/or distributions, or for that matter, state tax benefits afforded to other tax-deferred vehicles such as 401(k) plans is unclear (although the latter may be explained by a heightened interest in citizens' education investments than in their secure retirement).

fact, be more interested in their own welfare than in enhancing their citizens' 529 plan experience. States have uniformly conditioned state tax deductions for 529 plans on the investor choosing the states' own 529 plan.[77] The deduction is not available for out-of-state plans. As noted above, if the state had a policy basis for this distinction, the state could easily link that policy to the tax deduction for out-of-state plans, just as Illinois considered linking its deduction to its policy of keeping sales charges low. But no state has taken this opportunity to promote its particular 529 plan policies. Contributions to out-of-state plans that are identical to an in-state plan are denied the tax deduction, even if the out-of-state plans satisfy all of the in-state plans' policies.

The unseemly, but rational, explanation for this anomaly is as follows: states and state officials use the state tax deduction for 529 plan contributions to protect their 529 plan franchise for their own interests,[78] rather than—indeed, contrary to—the interests of their citizens.[79] As discussed in the next Part of this Article, states may offer 529 plans not to achieve their own 529 plan-related purposes, but to achieve ulterior—or rent-seeking—purposes. Notwithstanding the conventional wisdom that states are more likely to promote the public interest than private firms, 529 plan investors may prosper in private rather than public control.

III. RENT-SEEKING AND 529 PLANS

Unfortunately, a fair amount of evidence shows that states' interests

77. A number of states have considered bills that would extend the state tax deduction for 529 plan contributions to out-of-state plans, but none have been enacted. *See* John Kostrzewa, *R.I. Bill Would Extend College-Savings Break*, PROVIDENCE J., May 10, 2004 (discussing Rhode Island bill); Nicklaus, *supra* note 76 (discussing Missouri and Illinois bills); Rick Miller, *Industry Challenges Disparity in Tax Treatment*, INVESTMENT NEWS, Mar. 1, 2004, at 13 (discussing bills in Illinois, Iowa, Missouri, Rhode Island, Tennessee, and Wisconsin).

78. *See House Hearings, supra* note 59, at 132 (statement of Dan McNeela, Senior Analyst, Morningstar, Inc.: "The end result [of in-state only tax benefits] is that citizens in many states become captive to their home-state plan.").

79. *See* Miller, *supra* note 77 (quoting financial planner Philip C. Johnson regarding extending state tax deductions to out-of-state plans, "'I suspect that's not going to happen, . . . I can't imagine any state is going to be willing to take a pass on revenue or give up revenues that are generated by its own plan.'"); Nicklaus, *supra* note 76 ("If legislators extend the tax breaks to out-of-state 529 plans, the investor-friendly plans sponsored by Missouri and Illinois might wither and die."). The comments of Diana Cantor, Chairman, College Saving Plans Network, the 529 plan lobbying organization, are illuminating: states do not extend tax breaks to out-of-state plans because 529 plans "are no different from a taxation basis in general from municipal bonds that are issued by a State." *See House Hearing*, *supra* note 59, at 31. Ms. Cantor did not note that the proceeds of out-of-state municipal bonds are spent on out-of-state projects, whereas the proceeds of 529 plans that are exempt from state tax are spent on the education of in-state children, regardless of whether the plan is in-state or out-of-state.

in exclusive sponsorship of 529 plans are based on rent-seeking opportunities that their 529 plan monopolies create. The states' monopoly power conferred by their exclusive rights to offer 529 plans creates an asset that can be exploited by interest groups or the state itself. "Given the value of monopoly power, we would expect interest groups, behaving rationally, to expend significant resources in attempting to secure market power through the political process."[80] Public and private interest groups can exploit state monopoly power over 529 plan benefits in a number of ways, and, although 529 plans are still in their infancy, a substantial amount of anecdotal evidence demonstrates that such exploitation is already occurring.

Investment advisers who make campaign contributions have long been rewarded with contracts to manage state funds;[81] the awarding of contracts to manage 529 plan assets will not be an exception. A 1999 SEC proposal sought to prohibit investment advisers from providing advisory services to a government client after making a contribution to any government official in a position to influence the awarding of the contract.[82] The SEC had previously approved an MSRB rule banning such contributions by municipal underwriters,[83] and it was concerned that, with the drying up of contributions from municipal underwriters, investment advisers would experience even greater pressure to "pay-to-play." Although such pay-to-play abuses have been well documented,[84] the SEC quietly buried the proposal after heavy opposition from the industry and state treasurers.[85]

---

80. MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW 121 (1997).

81. *See* Mercer Bullard, *Pay-to-Play in America*, THESTREET.COM, Apr. 26, 2001, http://www.thestreet.com/funds/mercerbullard/1406251.html.

82. *See Political Contributions by Certain Investment Advisers*, 64 Fed. Reg. 43,556 (proposed Aug. 10, 1999) (to be codified at 17 C.F.R. pt. 275).

83. In 1994, the SEC approved MSRB rule G-37, which generally prohibits dealers from underwriting municipal securities within two years of contributing to an official of the issuer. *See* Self-Regulatory Organization; Municipal Securities Rulemaking Board, Exchange Act Release No. 33,868, 59 Fed. Reg. 17,621 (Apr. 13, 1994). Rule G-37 generally applies to the underwriting of 529 plans and accordingly provides a check against states using their monopoly power to extract campaign contributions from underwriters. *See generally* Kevin Opp, Comment, *Ending Pay-to-Play in the Municipal Securities Business: MSRB Rule G-37 Ten Years Later*, 76 U. COLO. L. REV. 243 (2005); Jon B. Jordan, *The Regulation of "Pay-to-Play" and the Influence of Political Contributions in the Municipal Securities Industry*, 1999 COLUM. BUS. L. REV. 489.

84. *See* Bullard, *supra* note 81.

85. *See* BROWN & WOOD LLP, SPRING 2000: THE YEAR IN REVIEW, *available at* http://www.sidley.com/db30/cgi-bin/pubs/Spring 2000 Investment Newsletter.pdf (2000). In response to the SEC's proposal, the American Bar Association adopted Rule 7.6 of the Model Rules of Professional Conduct, which prohibits accepting a government legal engagement if the lawyer made a political contribution "for the purpose" of obtaining the engagement. MODEL RULES OF PROF'L CONDUCT R. 7.6 (2004).

Thus, one area in which rent-seeking by interest groups should be expected is the awarding of contracts to manage 529 plan assets and execute 529 plan trades to firms that, along with their employees, have contributed to state officials' election campaigns. Anecdotal evidence suggests that 529 plans have not been immune from such pay-to-play practices.[86] 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. Both T. Rowe Price and Strong Capital have made substantial contributions to state officials with influence over the award of 592 plan business.[87]

State actors also have an incentive to favor in-state managers and brokers for purposes of boosting the state economy, regardless of whether they make political contributions.[88] Not surprisingly, the Baltimore-based T. Rowe Price manages assets in Maryland's 529 plan.[89]

Rent-seeking may also take the form of local firms soliciting investment of 529 plan assets in their businesses, or interest groups pressuring states to divest from certain companies or countries for political reasons. A 529 plan should not be generally immune to pressure to invest its assets in local enterprises, although this practice may be indirectly limited by 529 plan rules. As noted above, 529 plan assets must be invested in investment vehicles that follow broad-based investment strategies, which would make it more difficult for a 529 plan to offer investment options that were heavily concentrated in securities of local issuers. In addition, many 529 plan investment options are replicas of existing retail mutual funds, and their managers may be resistant to state attempts to adjust existing stock and bond allocations to favor those issued by local firms. Nonetheless, the size of many existing 529 plans and the states' absolute authority over their investment options would make it easy for state agents to divert a substantial part of plan assets to local investments.

---

86. *See Restrictions Lessen Benefits of State College Savings Plans*, USA TODAY, Dec. 1, 2003, at A20 ("Massachusetts, Maryland, Pennsylvania and Wisconsin have rewarded politically powerful companies based in their states with exclusive contracts to manage . . ." the state's 529 plan).

87. Elliot Blair Smith, *Fund Scandal Worries Tuition Plan Investors*, USA TODAY, Nov. 19, 2003, at B1 (describing campaign contributions by Richard Strong to Wisconsin politician indirectly responsible for choosing Strong to manage the state's 529 plan).

88. *See* Avrum D. Lank, *State Seeks New Options for EdVest*, MILWAUKEE J. SENTINEL, Nov. 22, 2003, at 1D (quoting Wisconsin state treasurer Jack C. Voight, "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.").

89. *See Restrictions Less Benefits of State College Savings Plans*, *supra* note 86.

Political interest groups as well as private ones may seek to use 529 plans to accomplish social or political goals. For example, interest groups may seek to have fund managers excluded from 529 plans on political grounds.[90] During hearings in 2004, for example, one congressman questioned a plan representative about the need to target the plan's marketing efforts to specific racial groups that had historically underinvested.[91] While this may be a worthy goal, its proponents should have to compete for legislative resources with the other interest groups, rather than by circumventing the legislative process and availing themselves of 529 plan resources.

One might argue that a state's ability to use its control over 529 plans to accomplish social or political goals creates net benefits for society and should be tolerated. For example, some may believe that CalPERS appropriately used its position as a Safeway shareholder to assist striking Safeway workers.[92] The 529 plan situation is fundamentally different, however, from that of state pension plans and other state funds. State pension plans are, in fact, public assets, and the extent to which these assets should be used to achieve social or political "returns," possibly at the risk of lower investment returns, is a legitimate public policy issue. In contrast, the assets of 529 plans belong to private individuals, and the diversion of these assets for any purpose other than to benefit plan beneficiaries is an improper taking of private property.

The state and its officials may even seek side benefits from 529 plans for themselves. Fees paid to plans provide a potential source of revenue for the state treasury. Part of 529 plan fees could be directly diverted to the state treasury, or plans could be structured to indirectly transfer wealth from out-of-state to in-state interests. For example, a number of plans charge out-of-state investors more than in-state investors for identical services, with the differential effectively operating as a wealth transfer from out-of-state investors to in-state investors (or to all state residents if the differential is paid to the state treasury).

With the creation of a 529 plan comes the creation of a new state bureaucracy that supports the plan and a new power center represented

90. *See* Margaret Talev, *Unions Turn up Heat on Brokers*, SACRAMENTO BEE, Mar. 15, 2005, at A1 (pressure by unions controlling $400 billion in pension assets on financial services firms not to actively support Social Security privatization; Dean Calbreath, *California State Treasurer Wants to Curb Executive Excesses*, SAN DIEGO UNION-TRIB., Dec. 18, 2002, at C1 (picketing of Fidelity by unions to force fund manager to disclose its proxy votes).

91. *See House Hearing*, *supra* note 59, at 24–25, 33 (statements of Rep. Joe Baca); *see also id.* at 26 (statement of Rep. Patrick J. Tiberi: "I was hoping we could maybe get an Italian plan in Ohio.").

92. *See* Steven Brull, *A Truly Civil Servant*, INSTITUTIONAL INVESTOR, June 2005, at 1. CalPERS (the California Public Employees' Retirement System) is a pension fund for California state workers.

by that bureaucracy. Administrators of 529 plans, like any political actors, have an incentive to enhance their job security and increase their compensation and power. A rent-seeking 529 plan administrator has an interest in increasing the size of the plan and the bureaucracy he oversees, just as managers in the private sector have an incentive to increase their assets under management, their own compensation and the profits of the management firm. Whereas state actors normally must compete for political support to build empires, such as through tax increases or the re-allocation of tax revenues from other agencies, 529 plan administrators can build their 529 plan empires by growing plan assets or inhibiting competition from other plans. State officials may even use 529 plan assets for personal self-promotion. In one case, a 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.[93]

The administrators of 529 plans should be expected to promote the plan, even at the expense of investors.[94] For example, during a congressional hearing an Ohio plan administrator was asked her position on lifetime savings accounts (LSAs), a form of tax-deferred account being considered by Congress that would permit tax-free withdrawals for any purpose.[95] The administrator correctly surmised that LSAs would compete with 529 plans and expressed her concern that they, therefore, would be a threat to 529 plans.[96] Not surprisingly, the representative from the securities industry chimed in that the industry

93. Brooke A. Masters, *College Savings Get Closer Study; With Little Oversight, State-Sponsored 529 Plans Vary in Expenses, Benefits*, WASH. POST, Apr. 14, 2004, at E1 (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).

94. *See Request for Comments on Draft Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans*, MSRB Notice 2005-28 (May 19, 2005), http://www.msrb.org/msrb1/archive/2005/2005-28.asp ("However, one commentator stated that it would be inappropriate to suggest to investors that they seek help from their home state programs because it is unclear whether the programs can provide complete information regarding such consequences and because some states may seek to persuade investors to make an investment in their program rather than to impart disinterested information.").

95. *See House Hearing*, *supra* note 59, at 33–34 (statement of Rep. William Lacy Clay).

96. *See House Hearing*, *supra* note 59, at 34 (statement of Jacqueline Williams, Executive Director, Ohio Tuitions Trust Authority and Member of the Executive Committee, College Savings Plans Network: "I do think that if LSAs were created that they would siphon off savings that have accrued to 529 plans. And I think specifically of States like Ohio, which have added tax benefits to these plans, and I think that it would be a critical issue, which we would have some difficulty with because if we are going to provide some kind of Federal and other State tax advantage, it needs to accrue to a higher purpose than allowing people potentially to use savings accounts potentially for higher purposes, but maybe to buy a new wardrobe or for other such purposes. So I think it would be detrimental to 529s.").

strongly supported LSAs.[97] The securities industry would be able to offer both LSAs and 529 plans, but the state would have a monopoly only on the latter, hence the state's predictably defensive response to a competitive threat.

Rent-seeking in the 529 plan context might be defensible if it promotes 529 plan goals, or at least is consistent with these goals, but such rent-seeking often will directly contradict the public purpose of 529 plans. For example, choosing money managers based on the amount of their political contributions does not serve any 529 plan purpose, but it does increase the likelihood that 529 plan participants will pay higher fees or receive inferior services as the additional cost of doing business is passed on to the consumer.[98] Favoring in-state service providers, such as T. Rowe Price in Baltimore, Maryland, might serve the arguably laudable state purpose of improving the state economy, but Congress did not create 529 plans to enable states to boost the local financial services industry. Choosing local firms because they are local will result in 529 plans paying higher fees or receiving inferior services when superior out-of-state managers are snubbed.

Admittedly, rent-seeking can indirectly promote 529 plan goals in many ways. For example, empire-building that results in 529 plan asset growth may result in assets being invested in education that otherwise would not have been. Increased asset size also frequently leads to reduced expenses, which again will leave more assets available for investment in education. Similarly, using targeted marketing to increase participation by historically undereducated groups may accomplish a 529 plan purpose by increasing investment in education by such groups. Investments in LSAs that would otherwise have been invested in 529 plans may be used for non-educational purposes, thereby reducing total investment in education. The potential for a coincidence of rent-seeking effects and 529 plan goals does not necessarily justify the state tax monopoly, however. Empire-building and resulting asset growth also would occur if private parties were permitted to offer 529 plans.

97. *See House Hearing*, *supra* note 59, at 34 (statement of Marc E. Lackritz, President, Securities Industry Association, that LSAs and 529 plans could coexist because they serve different purposes).

98. *See Political Contributions by Certain Investment Advisers*, 64 Fed. Reg. 43,556, 43,564 (proposed Aug. 10, 1999) (to be codified at 17 C.F.R. pt. 275) (referring to the fact that "[w]hile not readily quantifiable, . . . advisers, and their partners, executive officers and solicitors, have made substantial contributions to elected officials from whom the advisers are seeking business" and that a decrease in these contributions "could result in lower advisory fees being paid by the state or local government for advisory services, as advisers would not have to recoup the cost of contributions through fees the advisers charge the government client"; also noting that "[c]ampaign contributions create artificial barriers to competition for firms that cannot or will not make political contributions," but which may nevertheless offer the best service).

Notwithstanding the foregoing examples of rent-seeking and self-serving in the 529 plan context, one is still left with the comparative problem of showing that their adverse effects are greater than the adverse effects resulting from private actors' profit-driven motives. The question is: if investors are better off with a state monopoly on 529 plans, then why not grant states a monopoly on all mutual funds or on all financial services products? The answer is that either one believes that markets are more efficient mechanisms for maximizing utility, and that private firms accordingly would be more efficient at realizing Congress's goal of increased investment in education through 529 plans, or one does not. If the issue was really so simple, then why *do* states have a monopoly on 529 plans?

In any case, at least investors in privately offered mutual funds are aware that their private sponsors are motivated to generate profits, and investors presumably evaluate funds with an appropriately skeptical eye. In contrast, many 529 plan investors probably subscribe to the conventional wisdom that state actors are more likely to act in investors' best interests, or at least that their ethics would resolve the conflicts of interest described above. These expectations will often be realized, but when they are not, investors are less likely to be as circumspect about protecting their interests. In fact, many investors in 529 plans who trust their states to provide them with a reasonable investment return at reasonable cost will in fact achieve poor returns and pay very high fees. Investors' faith in municipal paternalism may be the most insidious aspect of the state 529 plan monopoly, as it may leave these investors unable to pay for their children's education. This vulnerability is echoed in the next Part of this Article, which evaluates the effect of Congress's similar faith in municipal paternalism, as reflected in the broad exemption from the federal securities laws that it has granted to state 529 plans.

IV. THE INADEQUATE REGULATION OF 529 PLANS

The preceding Part of this Article argued that states should be stripped of their monopoly over 529 plans; this Part questions whether they should be permitted to offer 529 plans at all—at least as 529 plans are currently regulated. The vast majority of 529 plan assets are invested in mutual funds, for which Congress and the SEC have created a comprehensive regulatory scheme. Significant aspects of this scheme do not apply to 529 plans, which are generally exempt from the federal regulation. Municipal securities generally are exempt from regulation under federal securities laws, with federal jurisdiction generally extending only to fraudulent and deceptive practices. Federal regulators can indirectly regulate some substantive aspects of 529 plans, but their authority to do so is extremely limited. The inadequate regulation of 529 plans may leave beneficiaries worse off than if they had invested in privately offered mutual funds.[99]

Subparts A and B of the following discussion build on the regulatory background provided above in Part I.B by identifying the significant inadequacies in 529 plan regulation with respect to disclosure and other requirements. Subpart C addresses two possible responses to the argument that state 529 plans are inadequately regulated. The first is that the critique in subparts A and B is actually a critique of the municipal securities exemption that is not limited to 529 plans. The second is that the exemption offers the prospect of superior regulation by ridding 529 plans from some of the inefficiencies created by the federal securities laws.

A. Disclosure Requirements

After a preliminary review of 529 plan disclosure in 2004, the SEC concluded that:

> the wide variations in disclosure among the various state 529 tuition savings plans we reviewed, as well as the absence of significant 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.[100]

If anything, the SEC's preliminary conclusion understates the inadequacy of 529 plan disclosure.

The disclosure of 529 plan fees provides the best illustration of the inadequacy of 529 plan disclosure. Fee disclosure for 529 plans[101] is

99. *Contra House Hearing*, *supra* note 59, at 7 (statement of Diana Cantor, Executive Director, Virginia College Savings Plan and Chair, College Savings Plans Network: "State oversight of their 529 plans provides an additional layer of accountability and protection for participants in these plans"; citing state "administrative procedure laws, procurement laws, ethics and conflict-of-interest statutes and freedom of information or Government in the Sunshine acts")

100. Memorandum from Annette L. Nazareth, Dir., Div. of Mkt. Regulation, U.S. Sec. & Exch. Comm'n, to William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n A-2 (Mar. 2, 2004), *available at* http://financialservices.house.gov/media/pdf/3-16-04 529 lttr part two_001.pdf [hereinafter Nazareth Memorandum]; *see also* Letter from William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, to the Honorable Michael G. Oxley, Chairman, Subcomm. on Capital Mkt., Ins. & Gov't Sponsored Enter. Comm. on Fin. Serv., U.S. H.R. (Mar. 12, 2004), *available at* http://financialservices.house.gov/media/pdf/3-16-04 529 lttr part two_001.pdf ("[T]he current state of affairs with respect to 529 plans is complicated and likely difficult for parents to understand.").

101. Fees have a direct and dramatic impact on investment returns of 529 plans. The SEC has estimated, for example, that $10,000 invested in each of the Utah and Rhode Island 529 plans over an

often obtuse and buried in long disclosure documents.[102] The information typically presents a multiplicity 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. The fees may be charged at the opening of the account, on a periodic basis, or upon the closing of the account. Additionally, 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.

Mutual fund fee disclosure rules illustrate the inadequacies of 529 plan fee disclosure.[103] 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 one-, three-, five-, and ten-year periods. This disclosure enables investors to easily compare mutual fund fees and thereby promotes competition and reduces costs.[104] Although mutual

eighteen-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. *See* Nazareth Memorandum, *supra* note 100, at A-3.

102. For example, the Program Description for Maine's NextGen College Investing Plan is more than one hundred pages. The fee structure is so complicated that it takes eighteen pages to describe. FIN. AUTH. OF ME., NEXTGEN COLLEGE INVESTING PLAN PROGRAM DESCRIPTION AND PARTICIPATION AGREEMENT (2006), *available at* http://www.nextgenplan.com/pdfs/NexGen_Direct.pdf. Similarly, the Plan Description for Texas's Tomorrow's College Investment Plan is thirty-one pages and fees are not discussed until page 18, although the discussion of fees is relatively clear. *See* TOMORROW'S PLAN, *supra* note 59. The Plan Disclosure Document for Alaska's Manulife College Savings Plan is sixty-one pages, fees are not discussed until page 45, and the discussion of fees is difficult to understand. MANULIFE FIN., MANULIFE COLLEGE SAVING: A NATIONAL PLAN SPONSORED BY THE EDUCATIONAL TRUST OF ALASKA (2003), *available at* http://www.manulifecollegesavings.com/files/common/pdf/DisclosureDoc.pdf. These examples, as with other examples in this Article 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 $20 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%." Delaware College Investment Plan Fast Facts (Jan. 25, 2006), *available at* http://www.doe.state.de.us/high-ed/DCIPfacts.htm.

103. *See generally House Hearings, supra* note 59, at 129–30 (statement of Dan McNeela, Senior Analyst, Morningstar, Inc., describing inadequacies of 529 plan disclosure documents).

104. *See Mutual Funds: Who's Looking Out for Investors?: Before the Subcomm. on Capital*

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. Prospectus delivery requirements apply only to the purchaser of the fund's securities, which for legal purposes is the 529 plan. Even if a 529 plan participant were to seek out a fund prospectus, it would not include information on the plan-level fees charged by the state sponsor.

In many instances, disclosure of 529 plan fee expenses can be misleading. For example, the fee table for various AllianceBernstein funds offered in the Rhode Island 529 plan in 2005 showed fees after a temporary waiver of fees had been deducted and did not disclose the amount of the fee once the waiver has expired.[105] Thus, the fee could rise to an undisclosed level without notice to investors. In contrast, the mutual fund fee table must show the higher contractual fee before the waiver has been deducted, and that fee cannot be increased without prior notice to plan participants.

In 2004, the College Savings Plans Network (CSPN), an affiliate of the National Association of State Treasurers, issued voluntary disclosure principles (Principles) that include guidelines regarding the disclosure of 529 plan fees.[106] The CSPN 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 disclosure principles are also not intended to provide guidance concerning the disclosure obligations of broker-dealers or investment managers who are involved with Section 529 Plans.[107]

As the CSPN Principles expressly concede, they are strictly aspirational;

Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services, 108th Cong. 206 (2003) [hereinafter *Haaga Statement*], *available at* http://financialservices.house.gov/media/pdf/108-61.pdf.

105. *See* ALLIANCEBERNSTEIN INV. RESEARCH & MGMT., COLLEGEBOUND*FUND* PROGRAM DESCRIPTION 51–54 (2005), *available at* http http://www.alliancebernstein.com/CmsObjectABD/PDF/Prospectus/529RIPRO-R_PPS.pdf.

106. *See College Savings Plans Network Disclosure Principles Statement No. 1 Adopted December 2, 2004*, CSPN (Dec. 2, 2004), http://www.collegesavings.org/media/Disclosure.Principles.12.2.04.pdf [hereinafter *CSPN Disclosure Principles*]; *see generally* Kathy Chu, *States Draft Guidelines for 529 Plans*, WALL ST. J., June 15, 2004, at D9. The CSPN Disclosure Principles were revised and restated in July 2005. *See* College Savings Plans Network Disclosure Principles Statement No. 2 Adopted July 26, 2005, CSPN (July 26, 2005), http://www.collegesavings.org/pdf/CSPN.Disclosure.Principles.statement2.7.26.05.pdf.

107. *CSPN Disclosure Principles*, *supra* note 106, at 1.

they do not have the force of law.[108]

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.[109] Some argue that competition will force plans to abide by the Principles,[110] but this flatly contradicts decades of experience regulating investment products similar to 529 plans. In fact, fully transparent cost disclosure by high-cost plans would place them at a competitive disadvantage to other plans with lower costs. Competition has never caused providers of high-cost products, in any area of business, to choose to highlight their cost disadvantage, and high-cost 529 plans would not 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 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 the average 529 plan to 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. They do not 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 an inefficient bifurcation of fee disclosure in two separate documents

108. *See House Hearing*, *supra* note 59, at 10 (statement of Jacqueline Williams, Executive Director, Ohio Tuitions Trust Authority and Member of the Executive Committee, College Savings Plans Network: "While disclosure information should be standardized across the 529 industry, each State must be able to shape and define its own plan to meet the unique needs of its citizens.").

109. *See* Albert Crenshaw, *No Quick Fix for Section 529 Plans*, WASH. POST, June 6, 2004, at F4 ("[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.").

110. *See* Judith Burns, *Revising College-Savings Plans*, WALL ST. J., July 6, 2004, at D4 ("[T]he 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." (quoting Indiana Treasurer Tim Berry)).

and make it likely that either investors will not review both documents or be confused if they do. Fee disclosure is unlikely to be effective unless provided in a single, short, easy-to-read document, accompanied by other key factors that investors should consider when evaluating a 529 plan. The adoption of the SEC's point-of-sale rule would ensure that standardized fee information is provided to investors, but whether the rule will require that it be delivered in enough time to be useful to investors is unclear. The SEC's point-of-sale rule does not apply to direct-sold 529 plans. Also, the rule is opposed by CSPN and may not be adopted.

Widespread agreement attests to the efficacy of existing mutual fund disclosure rules; 529 plan investors should not be deprived of these benefits. Fee disclosure rules promote competition among different funds and are credited with reducing fees in the fund industry. Investors in state 529 plans would benefit equally from the increased transparency and competition that these rules would provide.

B. Other Regulatory Inadequacies

Participants in 529 plans forgo not only their right to relatively clear, transparent disclosure, but also a host of investor protection measures that apply to direct investors in mutual funds. In many respects, the regulation of 529 plans falls short of the regulation of the mutual funds in which they typically invest. For example, mutual funds, unlike operating companies, generally must file a new prospectus every sixteen months. The funds are required to deliver the prospectus to the state 529 plan sponsor, but the state is not required to deliver the prospectus to investors, much less provide updated financial information on the plan. Instead, states typically provide a lengthy and complex product description.

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.[111] In contrast, a state has no limit on the amount of time that it can hold a participant's assets pending a transfer[112] or on the amount of fees

111. 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 two percent of the redemption amount and the fee must be paid to the fund. *See* Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328 (Mar. 11, 2005) (to be codified at 17 C.F.R. pt. 270).

112. In addition, mutual funds typically must accept purchases the same business day they are received, *see* 17 C.F.R. § 270.22c-1(a) (2005), whereas states have no limits on their ability to hold 529 plan contributions pending investment in the plan. For example, the Virginia Education Savings Trust holds participants' contributions for up to thirty days before investing them in the plan. *See* Masters,

charged on the transfer.[113] New York punishes in-state investors that abandon its 529 plan for an out-of-state plan by stripping them of the in-state tax exemption that would otherwise apply to distributions.[114] Generally, mutual fund shareholders are also entitled to receive a current prospectus on an annual basis, whereas no such requirement applies to participants in 529 plans, where the investor is considered the state itself.

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 and without notice to participants.[115] 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 in Part III, it may not have the same interests to negotiate the low fees that 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.[116] The beneficiaries of 529 plans lose the voting rights they would have had as mutual fund shareholders on many other issues, such as a fund merger, a change from being a diversified to a non-diversified fund, or other change in a fund's fundamental policies.[117]

---

supra note 93; Nazareth Memorandum*, supra* note 100, at A-4 (stating that, in effect, the "delay in investment [is] an interest-free loan from investors" to the state).

113. For example, Rhode Island imposes $50 fee on transfers to another state's 529 plan. ALLIANCEBERNSTEIN INV. RESEARCH & MGMT., *supra* note 105, at 11, 12.

114. *See* Savingforcollege.com, New York Will Impose Tax on Outbound Rollovers (Oct. 22, 2002), http://www.savingforcollege.com/529_news/?page=plan_news&plan_news_id=157.

115. *See*, *e.g.*, Crenshaw, *supra* note 109 (describing Maryland's twenty-five percent 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." MANULIFE FIN., *supra* note 102, 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* TOMORROW'S PLAN, *supra* note 59, at 18.

116. *See* Nazareth Memorandum, *supra* note 100, 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 J. SENTINEL, Dec. 4, 2003, at D1. Oregon's contract included an "at-will" provision. *See* Kathleen Gallagher, *Oregon Ousts Strong from College Fund*, MILWAUKEE J. SENTINEL, Nov. 14, 2003, at D2.

117. 15 U.S.C. § 80a-13 (2000). For example, when AXA Financial merged its Enterprise Funds, which serve as Texas 529 plan investment options, into its AXA Enterprise Funds, beneficiaries with assets invested in the Enterprise Funds were not entitled to vote on the merger. *See* TOMORROW'S PLAN, *supra* note 59, at 6–7. Similarly, when the Texas 529 plan closed its Strategic Allocation Portfolio, the assets in that portfolio were transferred to the Balanced Allocation Portfolio. *Id*. at 8–12. For investors who had already reached their one-transfer-annually limit, the only way out of either the

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,[118] possibly providing some restraint on fees. Participants in 529 plans, however, have no such rights absent a violation of the antifraud rules under federal securities laws. Although participants have political recourse against state officials, whether this provides an effective restraint on fund fees is uncertain.

Notably, these regulatory shortcomings are not unique to 529 plans, but apply equally to similar investment vehicles that offer mutual funds in a tax-deferred wrapper. Other investment vehicles such as IRAs, 401(k) plans, and variable annuities strip investors, in varying degrees, of rights that they would have as direct investors in mutual funds. Permitting states to offer 529 plans effectively added fifty new regulators for yet another tax-deferred wrapper for mutual funds, which are subject to too many different regulators and sets of rules as it is.[119] The SEC 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.[120]

C. Self-Regulation and the Municipal Securities Exemption

This subpart discusses two possible responses to the foregoing regulatory analysis. One response is that much of the foregoing critique of the inadequate regulation of 529 plans is more about the municipal securities exemption under which plans operate than the plans themselves. In other words, the culprit is the policy underlying the exemption, not its exploitation by state 529 plans. A second, very

new AXA Enterprise Fund or the Balanced Allocation Portfolio would have been to redeem his or her shares. *Id*.

118. The Commission also has the authority to sue a fund's directors and manager with respect to fees paid to the manager, *see* § 80a-36, but it has never exercised that authority, and that authority therefore cannot be considered to restrain mutual fund fees to any degree.

119. A substantial percentage of mutual fund assets are invested through these tax-deferred wrappers. At the end of 2004, thirty-eight percent of mutual fund assets ($3.1 trillion) were held in retirement plans, primarily in 401(k) accounts and IRAs. *See* INV. CO. INST., *supra* note 8, at 38.

120. 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.

different kind of response is that while the exemption removes the regulatory floor below which issuers may not fall, it also raises the operational ceiling that issuers may reach. Some regulatory requirements do not provide additional investor protection, and therefore they impose unnecessary and costly operational burdens. The municipal exemption permits greater operational freedom and the possibility of concomitant operational economies or improved services.

Much of the foregoing critique is actually a critique of the municipal securities exemption as opposed to a critique of state-sponsored 529 plans, and this Author admits a healthy skepticism for an exemption that is premised primarily on the idea that governments as issuers of securities need less oversight than private firms because governments' interests are more closely aligned with investors' interests.[121] A full analysis of the benefits and costs of the municipal securities exemption, as a general matter, is unfortunately beyond the scope of this Article, but some commentary on its efficacy in the 529 plan context is necessary.

In a number of respects, the policies and assumptions underlying the municipal securities exemption are inapplicable to 529 plans. First, the purpose of the municipal securities exemption was not to enable states to compete with private enterprise in the financial services arena, but to relieve states and municipalities of the burdens of regulation when raising capital for public projects. State 529 plans are neither a means of raising capital (although there is a risk that they might be) nor a form of public project, although in view of the recent interpretations of "public project" in the takings context,[122] perhaps the Supreme Court might consider asset management services as a kind of public good.

Second, the assumption that states' interests are more closely aligned with investors' interests and that the investor protection provided by federal securities law, therefore, is not necessary has been discredited in numerous municipal securities enforcement actions,[123] as well for many other exemption categories.[124] The number of reported cases probably

121. *See* William J. Kiernan, Jr., *Disclosure Responsibilities in Municipal Securities Offerings—Some Problems Under SEC Rule 15c2-12*, 20 STETSON L. REV. 701, 701 (1991) (commenting that "[o]ne reason for the exemption was that the perceived abuses that gave rise to federal regulation of the securities industry involved corporate securities, not municipal securities and their largely discrete market").

122. *See*, *e.g.*, Kelo v. City of New London, 125 S. Ct. 2655 (2005).

123. *See*, *e.g.*, Neshannock Twp. Sch. Dist., Admin. Proc. File No. 3-11,461, 2004 SEC LEXIS 861 (2004) (finding the school district violated antifraud provisions of the federal securities laws); *see generally* Robert W. Doty, *Expanding Responsibilities: Recent Disclosure Actions Involving Municipal Securities Issuers*, 37 URB. LAW. 113 (2005).

124. *See, e.g.*, *In re* Christian Life Center, 45 B.R. 905, 906–07 (B.A.P. 9th Cir. 1984) (involving an Assemblies of God Church pastor who organized a "trust fund"—administered two instruments, a trust agreement and a certificate of deposit, both of which bore a set rate of interest—to benefit church-

understates the scope of financial abuses in municipal securities, as regulators may be less likely to take aggressive enforcement action against government officials than against private actors.[125] The SEC seems to share the view that municipal securities need greater regulation, as evidenced by the recent trend toward greater regulation of municipal securities.[126]

No empirically based evidence supports the assertion that government officials are less likely than private actors to use 529 plans for their own benefit. This Article discusses a number of examples of rent-seeking behavior that, as a general matter, would be prohibited for mutual funds, but this behavior is unregulated or more difficult to detect and prosecute in the 529 plan context. Even if state officials' interests may be aligned with the interests of their citizens, to whom they have at least some degree of political accountability, they are not necessarily aligned with the interests of out-of-state investors, as reflected in instances where states treat in-state and out-of-state investors in their 529 plans differently.

Permitting states to offer 529 plans also creates a conflict of interest for their regulators. A state securities regulator or attorney general has an added incentive to pressure or take action against private firms that offer investment products that compete with 529 plans. As noted above, an Ohio 529 plan administrator and a representative of the securities industry took opposite positions on the advisability of creating LSAs. If LSAs are created, might Ohio enforcement officials create difficulties for securities firms that offer LSAs to Ohio residents, in competition with Ohio's 529 plan? They certainly would have an economic incentive to do so. Conversely, the same enforcement officials have an added incentive to overlook problems in their states' 529 plans, an incentive that would not exist if the plans were instead sponsored by private firms. Thus, many reasons why the *raison d'etre* for the municipal exemption does not apply in the 529 plan exist, but to some

member/participants or their named beneficiaries, but seventy percent of the funds deposited were nevertheless used directly by the church, instead of being invested).

125. For example, the SEC seemed to concede that the Utah 529 plan received lighter sanctions in a recent enforcement action than might otherwise have been imposed. *See* James Amend, *529 Plans Now Under Scrutiny of SEC: Utah Case a Warning Shot to Other Plan Administrators*, MONEY MGMT. EXECUTIVE, Aug. 15, 2005, at 1.

126. *See*, *e.g.*, *Recent Legislation: Securities Law—Municipal Securities Disclosure Statute—Newly Amended Securities Exchange Act Rule 15c2-12 Requires Municipal Securities Issuers to Provide Additional Information to the Market.—Muncipal Securities Disclosure, 17 C.F.R. § 240.15c2-12 (1995)*, 109 HARV. L. REV. 882, 882 n.2 (1996); Frederic H. Marienthal III & Wendy W. Wolfe, *Recent Developments in Disclosure Requirements for Municipal Securities*, 28 REV. SEC. & COMMODITIES REG. (S & P) No. 3 (Feb. 8, 1995).

extent this Article's regulatory critique is founded on a broader view regarding the efficacy of the municipal exemption as a general matter.

The second response to this Article's regulatory critique—that just as the exemption lowers the regulatory floor for 529 plans, it also may raise the operational ceiling—is also a valid one. The inadequacies of mutual fund regulation discussed above reflect only the ways in which it provides inadequate protection for investors; mutual funds are overregulated in many ways that impose unnecessary and costly operational burdens on funds. The municipal securities exemption provides states the opportunity to shed these burdens thereby creating efficiencies not available to privately offered mutual funds.

For example, mutual funds are effectively required to send current shareholders the entire prospectus annually, even if there have been no material changes. This requirement imposes significant annual costs on funds. It also fails, when there have been material changes, to ensure that investors' attention is directed to such changes. Instead, material changes are buried within a lengthy document that shareholders pay for but are unlikely to read. Another example is the regulation of virtually all types of mutual funds under the same disclosure rules. Index funds have substantially different risk characteristics from actively managed funds, yet both types are subject to essentially the same disclosure rules.[127]

Ironically, almost all states have exercised this freedom from mutual fund regulation by investing 529 plan assets in regulated mutual funds. The states themselves, as the shareholders of the mutual funds, receive the benefits and pay the costs of mutual fund regulation, yet for the most part they pass only the costs on to 529 plan beneficiaries. Indeed, many states exacerbate this problem by replacing comparatively efficient and effective mutual fund regulation with their own well-intended but unnecessary and burdensome self-regulation. For example, states as shareholders receive the mutual fund prospectus, which for all of its shortcomings, is a fairly effective disclosure document. At least the prospectus is markedly superior to the often Byzantine plan descriptions that many states provide to their 529 plan beneficiaries in lieu of the prospectus. These plan descriptions generally omit the most important information contained in the prospectus while providing extensive discussion of trivial details, and because of their length the printing of these plan descriptions costs more than the printing of prospectuses.

127. The SEC has adopted some innovative reforms. *See*, *e.g.*, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244 (Mar. 9, 2004) (to be codified in 17 C.F.R. pts. 210, 239, 249, 270, 274) (eliminating requirement to send shareholders complete list of portfolio holdings).

Perhaps the obtuse nature of 529 plan descriptions results from the absence of the standardization that a single outside regulator provides, or this obtuse nature manifests an attempt to hide the plans' deficiencies, such as their high costs; or simply display states' lack of experience as financial services providers. Whatever the cause, states' general dismal disclosure practices reflect a missed opportunity to deregulate the mutual fund structure and provide a more efficient, profitable alternative to investors.

States do take advantage of their freedom from mutual fund regulation. Some states have eschewed mutual funds for separate accounts, which are subject to virtually none of the rules that apply to mutual funds. These states then can develop individually tailored rules under which their funds will operate. For example, Utah's 529 plan, consistently cited as one of the best 529 plans by financial publications and other financial services providers,[128] invests its 529 plan assets in unregistered separate accounts offered by Vanguard. The Utah plan description booklet, while not a model of clarity, provides respectable competition for the prospectus, and Utah does not waste beneficiaries' money by mailing it to them every year. The Utah 529 plan offers mutual-fund equivalents at a fraction of the cost of retail mutual funds, and its fees, not surprisingly, are transparently and prominently disclosed. Utah's 529 plan ironically is the only one that has been the subject of any government enforcement action.[129] At the same time the SEC was charging Utah with disclosure failures relating to the theft of $85,500, or approximately 0.015% of plan assets, other 529 plans were charging fees that were more than ten times higher than Utah's fees.[130]

Utah's 529 plan illustrates how the municipal exemption allows a state to raise the operational ceiling under which mutual funds operate, but this plan is the exception. Far more common are plans that, by investing in mutual funds, incur all of the costs of regulation while preventing their beneficiaries from receiving some of the most important benefits.[131] The potential benefits of raising the operational ceiling are

128. *See* Paikert, *supra* note 62. This Author invests in the Utah plan, eschewing the substantial tax benefits of his in-state plan (Mississippi) in consideration of Utah's more substantial cost savings.

129. *See* Utah Educational Savings Plan Trust, Admin. Proc. File No. 3-12,004 (U.S. Sec. & Exch. Comm'n Aug. 4, 2005), *available at* http://www.sec.gov/litigation/admin/33-8601.pdf.

130. Based on the example in *supra* note 62, a $10,000 investment in the Texas plan would incur an average of about $355 in fees during the first five years, whereas a typical investment option in the Utah plan would cost about an average of $30 to $40 each year for Utah residents (about $55 each year for non-residents), or about one-twelfth the Texas fee. *See* UTAH STATE BD. OF REGENTS, UTAH EDUCATIONAL SAVINGS PLAN 26 (2006), *available at* http://www.uesp.org/pdfs/UESP_description.pdf.

131. Some plans have even increased the regulatory costs for the underlying mutual funds, without creating any corresponding benefit for beneficiaries. California's 529 plan, for example, has

largely unrealized, whereas the potential cost of nontransparent disclosure and other regulatory shortcomings in 529 plans is high.

V. CONCLUSION

State 529 plans are one of America's fastest growing investment vehicles, yet their true potential will go unrealized as long as states are granted an effective monopoly as their sponsors. Congress's purpose in creating 529 plans was to increase investment in education, but exclusive state sponsorship of 529 plans will inevitably result in some assets being diverted from investment in education to other purposes. As with any government program, 529 plans are vulnerable to rent-seeking by constituencies that are unable to achieve their goals through the political process. State sponsorship of 529 plans nets benefits that might offset rent-seeking costs, because all of the benefits that states have to offer would be provided by private firms either by operation of free market forces or, as needed, state regulation or tax incentives. Indeed, to achieve the full potential of 529 plans, Congress should consider prohibiting states from sponsoring 529 plans in order to ensure that appropriate investor-protection measures apply and private firms are not subject to a competitive handicap.

directed the TIAA-CREF mutual funds in which it invests to comply with investor protection principles promulgated by certain state officials. Ironically, these principles require the funds, for example, to disclose annually to shareholders the dollar amount of their expenses, but the California 529 plan does not provide the same information to its beneficiaries. *See* Press Release, California Treasurer Phil Angelides, North Carolina Treasurer, Moore, New York State Comptroller Hevesi, California Treasurer Angelides, Joined by New York State AG Spitzer, Announce Landmark Mutual Fund Principles to Protect Investors and Pensioners (Jan. 15, 2004), *available at* http://www.treasurer.ca.gov/news/releases/2004/011504_mutualfund.pdf.