



**Helping People with Disabilities  
Achieve Financial Security  
and Independence.**



# **The Board's Role and Responsibilities**

**April 3, 2018**

# Today's Discussion

	<u>Slides</u>
• Federal Framework	3 – 9
• Program Structure	10 – 13
• Governance and Fiduciary Duties	14 – 23
• Concluding Thoughts	24 – 27

## Appendix

# Section 1.

## Federal Framework

## Federal Statutory Foundation

- **Internal Revenue Code of 1986, as amended:**
  - Section 529A directs States or agencies or instrumentalities thereof to “establish and maintain” ABLE plans
- **Securities Act of 1933:**
  - Municipal issuers are exempt from registration
- **Securities Exchange Act of 1934:**
  - Municipal securities are exempt from most reporting requirements
- **Trust Indenture Act of 1939:**
  - Municipal trusts are exempt from registration
- **Investment Company Act of 1940 and Investment Advisers Act of 1940:**
  - Governmental entities are exempt from registration if “acting in the course of official duty”
- **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010:**
  - Advisors to and primary dealers in municipal securities are subject to oversight

## Federal Regulatory Underpinnings

- **529 programs operate in accordance with prior SEC no-action guidance:**
  - *Division of Corporate Finance* will not recommend enforcement action for the *sale of 529 plan interests as non-registered securities*
  - *Division of Investment Management* will not recommend enforcement action if the *municipal fund is not registered*
  - *Division of Market Regulation* will not recommend enforcement action if *state employees offer or sell units in the 529 plan without being registered*
- **ABLE plans also rely upon the 529 SEC no-action letters since:**
  - 529 and ABLE have an almost identical trust structure
  - There are not any novel issues of fact or law to distinguish ABLE from 529 plans
- **Proposed, not final, ABLE regulations issued by Internal Revenue Service:**
  - IRS Publication 907, “Tax Highlights for Persons with Disabilities,” provides guidance on 2017 tax treatment of ABLE accounts

## Federal Regulatory Underpinnings, cont'd

- **MSRB Rule D-12 Definition of Municipal Fund Securities:**
  - “...a municipal security issued by an issuer that, but for the application of Section 2(b) of the Investment Company Act of 1940, would constitute an investment company within the meaning of Section 3 of the Investment Company Act of 1940.”
  - *Bottom line: 529 and ABLÉ plans essentially would be mutual funds but for the State or public entity involvement*
- **Overriding Fundamentals:**
  - Anti-fraud provisions of the '34 Act always apply
  - MSRB lacks jurisdiction over 529 and ABLÉ issuers

## Securities Regulations Short and Sweet

- Issuers of municipal securities are exempt from registration under the '33 Act
- Municipal securities are exempt from most reporting requirements under the '34 Act
- Governmental entities are neither investment companies nor investment advisers under the '40 Act or the Advisers Act if “acting in the course of official duty”
- Advisers to and primary dealers in municipal trusts are subject to varying degrees of oversight by FINRA, the MSRB and applicable Bank Regulators

## The Importance of the '33 and '34 Acts Together

- An exempt issuer does not have to register securities or sales of securities
  - This is why units in municipal trusts are exempt from registration
  - Issuers do not have to register as broker-dealers
- BUT the anti-fraud provisions *always* apply:
  - Section 17(a) – Fraudulent Interstate Transactions ('33 Act)
  - Section 10(b) – Manipulative and Deceptive Devices ('34 Act)
  - Rule 10b-5 – Employment of Manipulative and Deceptive Devices ('34 Act)
- The “10b-5” Anti-Fraud Standard:
  - “It is unlawful to make *any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading*”
  - Standard applies to ALL portions of an ABLE disclosure document including descriptions of the plan, the trust, the investments and the risks involved



## The MSRB Overview, Rulemaking and Jurisdiction

- **Established by Congress in 1975:**
  - **Mission is to protect investors, municipal entities and obligated persons, and to promote a fair and efficient municipal market**
  - **Operates Electronic Municipal Market Access (“EMMA”) to promote transparency and provide widespread access to information**
- **MSRB rules are intended to:**
  - **Prevent fraudulent or manipulative practices**
  - **Promote just and equitable principles of trade**
- **Has no enforcement powers – its rules are enforced by:**
  - **FINRA for securities firms**
  - **Office of the Comptroller of the Currency, the Federal Reserve, or the FDIC for banks**
  - **SEC for municipal advisors, securities firms and bank dealers**
- **Bottom line: jurisdiction is over securities firms, municipal dealers and municipal advisors, NOT municipal issuers**

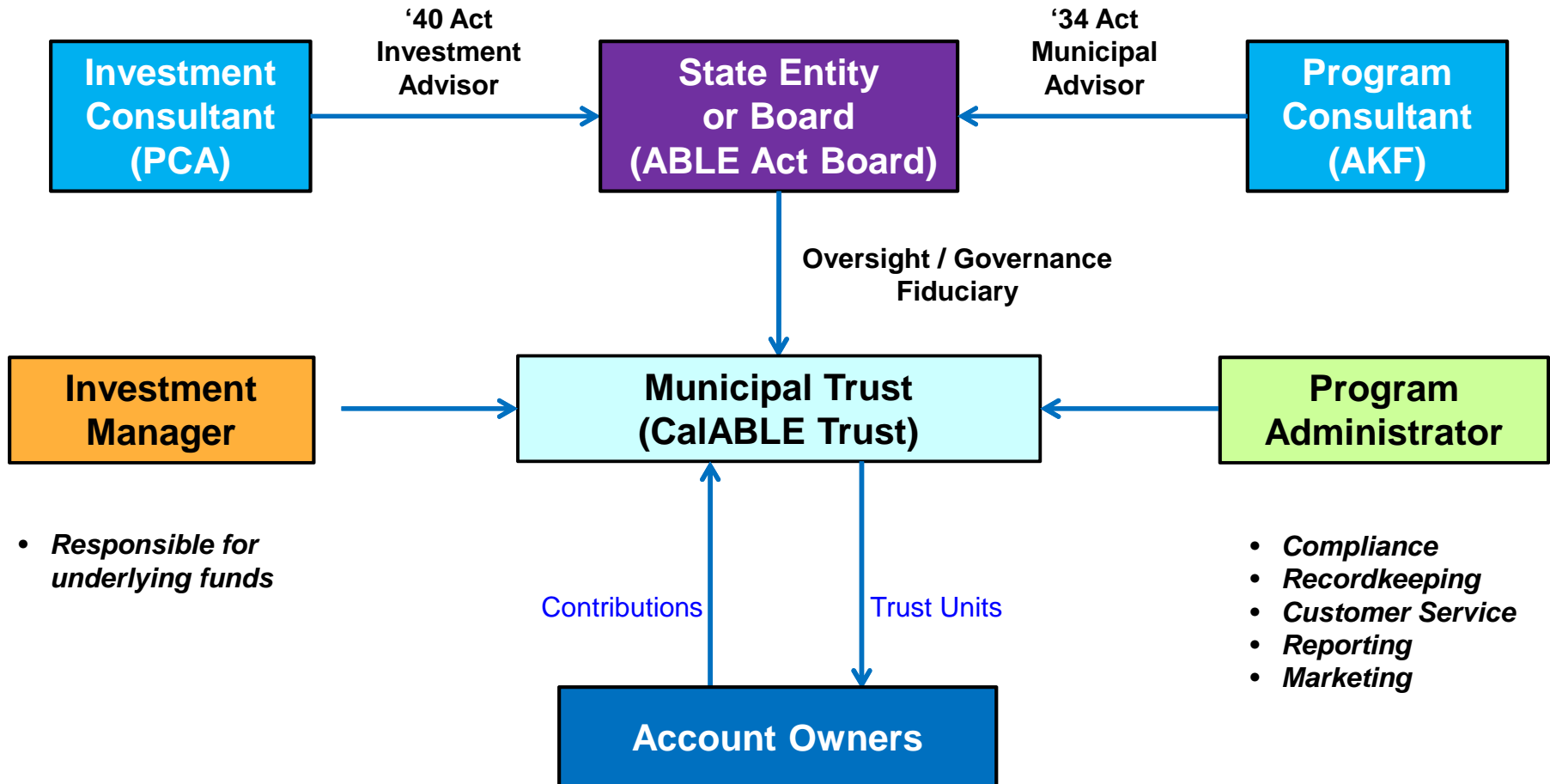
# Section 2.

## Program Structure

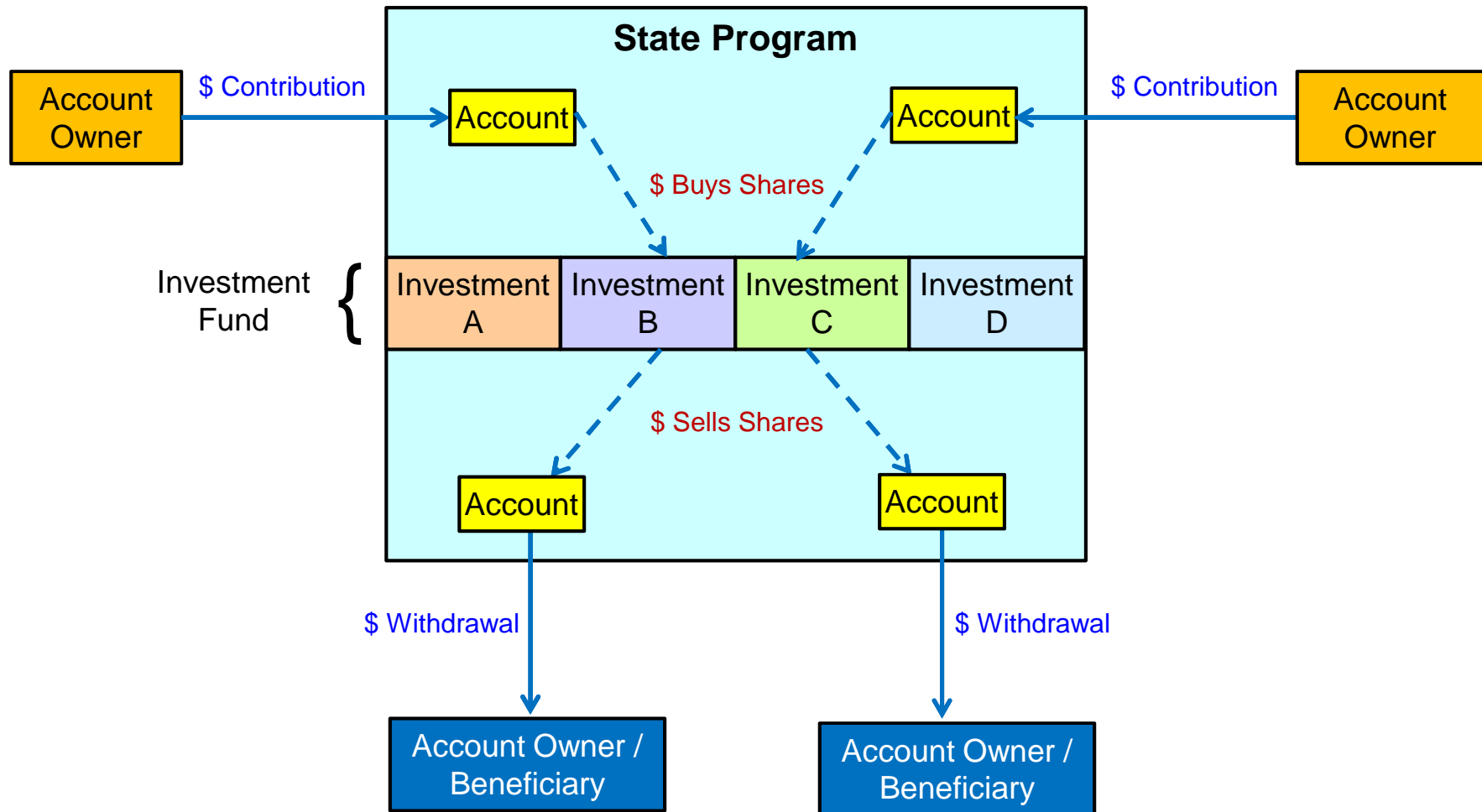
## Key Structural Elements

- **A municipal Trust is created and overseen by a state entity (“State”)**
  - **State acts in a fiduciary capacity**
  - **State is advised by a number of other fiduciaries**
- **Account contributions are deposited into the Trust**
  - **Trust invests in underlying investments approved by the State**
- **Account Owners select investment options that reflect the underlying investments**
  - **Account owner’s investments are evidenced by “units” of the Trust**
  - **Account owner does not directly own shares of the underlying investments**
- **Asset-based fees are charged against each account to pay administrative and management costs**

# Typical ABLE Structure



# Typical Flow-of-Funds



## **Section 3.**

# **Governance and Fiduciary Duties**

## Governance of ABLE Plans

- **Sections 529A directs States or agencies or instrumentalities to “establish and maintain” ABLE plans**
- **Boards act as fiduciaries:**
  - **Act on behalf of ABLE beneficiaries**
  - **Exercise discretion or control over audits, investments and all policies related to account matters**
- **Fiduciary duty is based upon common law, Internal Revenue Service overlay and State statutes**
- **Employee Retirement Income Security Act (“ERISA”) and ‘40 Act governance standards may also provide guidance**

# Foundation for Fiduciary Duties

- **Common Law:**
  - **Duty of Care**
    - Act in good faith, in the best interest of the entity
    - Standard: ordinarily prudent person acting under similar circumstances
  - **Duty of Loyalty**
    - Put entity's interests ahead of personal interests
    - Act solely for the benefit of participants and beneficiaries
  - **Duty of Obedience**
    - Follow governing documents and the entity's mission
    - Comply with the law
    - Seek professional assistance where necessary
- **Statutory Duties Derived from Common Law:**
  - **Duty of Prudence**
  - **Duty of Loyalty**
  - **Diversification**
  - **Adherence to Plan Documents (Duty of Obedience)**
  - **Prohibited Transactions**



## Internal Revenue Service Expectations

- Exercise due diligence
- Have accountability for actions
- Meet standards for transparency and disclosure
- Establish financial controls
- Act independently

## Federal Guidance on Fiduciaries

- In the absence of explicit statutory guidance:
  - Public retirement plans rely on ERISA for fiduciary standards
  - Unregistered funds and separate accounts may rely upon '40 Act standards for governance
  - A combination of both may provide appropriate guidance to ABLE plans
- ERISA on Fiduciaries:
  - Fiduciary status is based on the *functions performed for the plan, not just a person's title.*
  - Fiduciaries are held to a “prudent expert standard”:  
“With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man **acting in a like capacity and familiar with such matters** would use in the conduct of an enterprise of like character and with like aims...” \*
  - Fiduciaries include the trustee, investment advisers, municipal advisors and any individuals exercising discretion in plan administration
  - Attorneys, accountants and actuaries are not fiduciaries when acting in their professional capacity

\* ERISA 404(a)(1)(B) (*Emphasis added*)

## **'40 Act Governance Standards**

- **Directors of investment companies and public companies generally share common responsibilities**
- **Examples of duties specific to investment company directors:**
  - **Approve time of Net Asset Value (“NAV”) calculations and procedures for valuation of securities**
  - **Approve trading practices and procedures**
  - **Approve investment objectives and policies**
  - **Monitor credit quality and valuation of money markets**
  - **Approve distribution plan of open-ended funds pursuant to Rule 12b-1**

## Board Member's Responsibilities

- Act in the interest of ABLE beneficiaries
- Carry out duties prudently
- Follow plan documents
- Diversify plan investments
- Pay only reasonable plan expenses

## Board Member's Responsibilities, cont'd

- **Have an affirmative duty to seek the assistance of an independent expert if the board member does not possess the education, experience or skill necessary to carry out his/her duties**
- **Cannot rely solely on the advice of experts**
- **Must understand the subject matter so that they can question or challenge advice**
- **Cannot abdicate their fiduciary duties**

## Processes for Governance

- **Selection of Program and Investment Managers**
  - Open and fair solicitations
  - Selections should reflect weighted criteria that bidders understand
  - If sole source procurement, basis for closed process should be clear
- **Establishment of Performance Benchmarks**
  - Administration and operations
  - Marketing costs and results
  - Investment policies and performance targets
- **Investment Policy Statements**
  - Establish roles, responsibilities and process
  - Also defines selection criteria and monitoring procedures
  - Separately or in the same policy – ramifications for underperformance should be clear
- **On-going Reviews**
  - Monthly investment results to key staff and or Board member(s) and independent investment consultant from Investment Manager
  - Quarterly reports to the Board from Program Manager and Investment Manager

## CSPN Guidance for Governance

- Adopted in May 2010 in response to SEC and Morningstar concerns about plan oversight by State Administrators
- Guidance as adopted acknowledges that State structures all differ
- Intent is to provide a framework for operating standards that:
  - Complement each plan's enabling legislation
  - Provide transparency of performance
  - Facilitate oversight and monitoring
- “Matters State Administrators should consider in the operation of [529] plans”:
  - Structure and procedures should be **appropriate to the size** of the Administrator
  - Governance should assure **adequate oversight of operations**
  - Procedures should assure **compliance with legal and regulatory requirements** and oversee accounting and financial reporting
  - Structure should provide **investment oversight**

# Section 4.

## Concluding Thoughts



## Observations from Afar

- **ABLE plans operate in a highly regulated and overly scrutinized environment:**
  - **Plans with third party program managers are subject to strict federal oversight**
  - **But for the “municipal” nature of the ABLE Act Board, the federal securities laws would apply to every aspect of Cal ABLE’s business**
- **Governance and stewardship matter:**
  - **Federal expectations and guidelines should guide best practices**

## Best Practices Generally

- **In all appearances and communications:**
  - **Although Staff and the Board are exempt from oversight by Federal Securities regulators, the principles of Federal Securities Laws still apply**
  - **All communications are subject to the Anti-Fraud provisions of the Securities Laws**
- **Financial professionals (e.g., professionals working for a registered entity) must be licensed discuss investments**
- **No one should ever provide an opinion as to the suitability or appropriateness of any Cal ABLE investment option**

## Available ABLE Plans as of March 26, 2018

	Ohio Partner States	Oregon Partner States	Nebraska Partner States	ABLE Alliance	Independent Plans
States	Ohio Arizona Georgia Kentucky Missouri New Hampshire New Mexico South Carolina Vermont West Virginia Wyoming	Oregon Maryland	Nebraska Alabama	Alaska Colorado District of Columbia Illinois Indiana Iowa Kansas Minnesota Montana Nevada North Carolina Pennsylvania Rhode Island	Florida Louisiana Massachusetts Michigan New York Tennessee Virginia
Total	11 States	2 States	2 States	13 States	7 States
2017 Q4	\$22,634,559 4,900 accounts \$4,437 avg	\$5,128,159 1,100 accounts \$4,620 avg	\$4,250,544 1,175 accounts \$3,617 avg	\$11,079,544 2,566 accounts \$4,318 avg	\$28,885,873 7,573 accounts \$3,814 avg

# Appendix

## The Securities Act (the “33 Act”)

- Exempts issuers of municipal securities from registration (Section 3(a)(2))
- “Truth in securities” has two basic objectives:
  - Requires that investors receive financial and other significant information about securities being offered
  - Prohibits deceit and misrepresentation in the sale of securities
- [sec.gov/about/laws/sa33.pdf](https://www.sec.gov/about/laws/sa33.pdf)

## The Exchange Act (the “34 Act”)

- Created the SEC and empowers it to register, regulate and oversee:
  - Brokerage firms, clearing agencies and transfer agents
  - Self regulatory organizations (“SROs”) including Financial Industry Regulatory Authority (“FINRA”) and the Municipal Securities Rulemaking Board (“MSRB”)
- Establishes periodic reporting requirements for registered entities or transactions
  - Municipal securities generally are exempt from reporting requirements (Section 3(a)(29))
  - BUT some initial and ongoing disclosures apply (Rule 15c2-12)
- Identifies and prohibits deceitful conduct
- Grants the SEC disciplinary powers over regulated entities and the persons associated with them
  - SROs are essential to the entire process (municipal broker-dealers may not contravene any rules of the MSRB (Section 15B))
- [sec.gov/about/laws/sea34.pdf](https://www.sec.gov/about/laws/sea34.pdf)

## Investment Company Act (the “40 Act”)

- **Regulates companies that engage primarily in investing, reinvesting and trading in securities**
- **Focus of the Act is to provide the public with information about a fund and its objectives, and about the investment company structure and operations**
- **Explicitly not applicable to government entities or officers or employees “acting as such in the course of his official duty” (Section 2(b))**
- **[sec.gov/about/laws/ica40.pdf](https://www.sec.gov/about/laws/ica40.pdf)**

## Investment Advisers Act (the “Advisers Act”)

- Firms that provide advice about securities investments must conform to regulations designed to protect investors:
  - Advisers with more than \$100 million in client assets must file Form ADV with SEC
  - If assets > \$25 million but < \$100 million, adviser registers with state
- Does not apply to states or subdivisions or to officers or employees “acting as such in the course of his official duty” (Section 202(b))
- [sec.gov/about/laws/iaa40.pdf](https://www.sec.gov/about/laws/iaa40.pdf)



## Trust Indenture Act

- Applies to debt securities – including bonds and interests in publically offered trusts
- Requires a trustee to protect and enforce the rights of bondholders and rights must be included in a trust indenture
- Municipal trusts are exempt based upon '33 Act exemption (Section 304(a)(4)(A))
- [sec.gov/about/laws/tia39.pdf](https://www.sec.gov/about/laws/tia39.pdf)

## **Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)**

- **Amends Section 15B (‘34 Act) to require registration of municipal advisors and imposes fiduciary duty on them**
- **“Municipal advisor” is any person that provides advice to or on behalf of a municipal entity regarding municipal securities, including advice with respect to the structure, timing, terms and similar matters concerning such issues**
- **Excludes registered Investment Advisers, attorneys offering “legal advice”, engineers and accountants**
- **Act also creates the Consumer Financial Protection Bureau**
- **MSRB has just solicited comments on proposed conduct rules for Municipal Advisors**
- **[sec.gov/about/laws/wallstreetreform-cpa.pdf](http://sec.gov/about/laws/wallstreetreform-cpa.pdf)**

## Key MSRB Principles and Rules

- Fair Practice = **Consumer Protection and Fair Dealing**
  - G-17 Conduct of Activities
  - G-19 Suitability of Recommendations
  - G-21 Advertising
  - G-27 Supervision
  - G-32 Disclosures in Primary Offerings
  - G-37 Political Contributions
  - G-38 Solicitation of Business
  - Notice 2006-07 on Marketing 529 Plans
- Uniform Practice = **Consistency of Operations**
  - G-8 Books and Records
  - G-15 Uniform Practice Requirements (confirms, etc.)
  - G-41 Anti-Money Laundering Compliance

## Key MSRB Principles and Rules, cont'd

- Professional Qualification = **Who Conducts Municipal Business**
  - G-3 Principals and Representatives
    - Series 53 Municipal Principals
    - Series 51 Limited Principals
    - Series 52 Representatives (together with Series 7, General Securities Representative)
    - Series 50, Municipal Advisors
  - G-42 Municipal Advisors
    - Advice or recommendations relating to structure, term or timing of issuance of municipal securities
    - Fiduciary duty owed to issuers
    - Certain exemptions exist for investment advisers and lawyers