

529 Market Development: Parallels for State-Sponsored Private Sector Retirement Plans

February 12, 2015

Presentation Summary: College Savings Parallels for Retirement

- **State tuition prepayment plans foreshadowed the enactment of Section 529 qualified tuition plans**
- **Federal legislation and key regulatory actions provided impetus for growth in number of 529 plans offered, and the assets and accounts accumulated nationwide**
- **The evolution of the 529 industry reflects increasing awareness of the rising costs of higher education coupled with the greater visibility for the solutions offered by 529 plans**

The Earliest Days: State-led Initiatives

- **Several States create tuition prepayment plans relying on State statutory authority:**
 - **Florida (1987)**
 - **Ohio (1989)**
 - **Kentucky (1990)**
 - **Pennsylvania (1993)**
 - **Texas (1996)**
 - **Michigan (1988)**
 - **Alabama (1990)**
 - **Alaska (1991)**
 - **Massachusetts (1995)**
 - **Virginia (1996)**
- **IRS taxes the Michigan Education Trust (“MET”) beginning in 1988, and MET sues for tax refund in 1990**
- **November 1994, Sixth Circuit Court of Appeals holds that MET is a tax-exempt agency of the State of Michigan**
 - **MET should be exempt from federal taxation**
 - **IRS refunds taxes paid by MET**
- **Other States enact legislation providing similar tax-exempt status**

The Federal Legislative and Regulatory Solutions

- **Four Congressional Acts authorize and enhance Section 529:**
 - **Small Business Job Protection Act of 1996**
 - **Taxpayer Relief Act of 1997**
 - **Economic Growth and Tax Relief Reconciliation Act of 2001**
 - **Pension Protection Act of 2006**
- **Treasury Department and IRS continually refine rules and regulations:**
 - **Private Letter Rulings and a series of Notices clarify tax treatment, simplify recordkeeping and penalty payments, and expand investment options**
- **SEC and MSRB clarify and provide direction on additional matters:**
 - **No-Action Letters confirm States' exemptions from certain securities laws**
 - **MSRB Rules guide marketing and disclosure by regulated entities and establish best practices for industry on a whole**

Net Effect of Federal Legislation and Regulations

- **Rapid movement by States to offer 529 plans with State appeal:**
 - **Thirty five States offer State tax benefits for 529 investments**
 - **Six of these States offer tax benefits for investments in ANY plan**
 - **Many States include other benefits (e.g., creditor protection, financial aid preferences, matching grants or scholarships)**
- **Extremely favorable federal tax treatment signaled wealth and investment management opportunities for the private sector**
 - **The direct-sold market was an entry point**
 - **Advisor-sold channels presented future growth**
- **The market for new plans eventually reaches saturation**

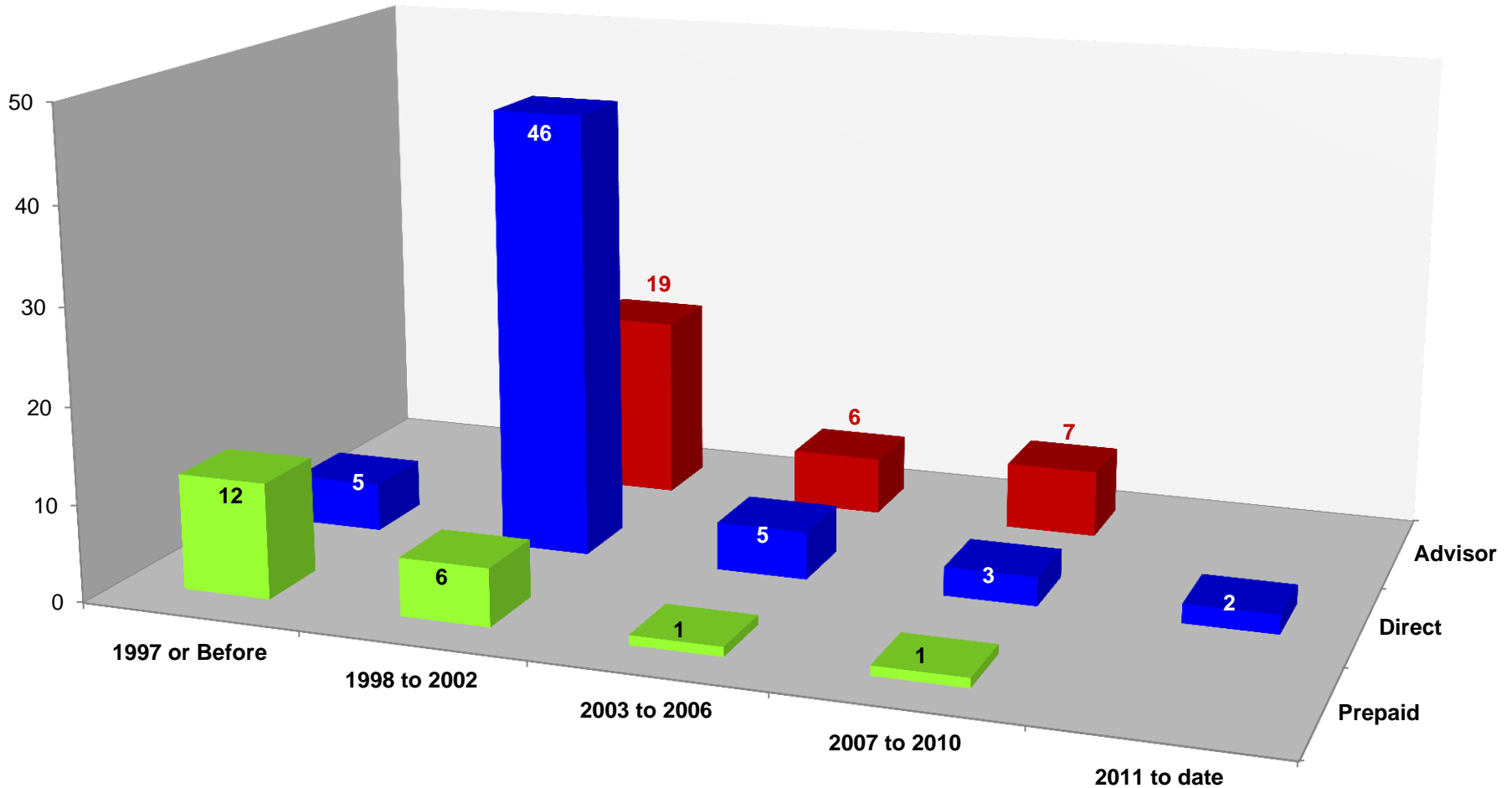
Five Phases of 529 Plan Development

- **1987 to 1997:** **Before the Federal Solution**
- **1998 to 2002:** **The Earliest 529 Days**
- **2003 to 2006:** **Re-Bids Begin**
- **2007 to 2010:** **Market Pressures Take Over**
- **2011 to Date:** **Growth Rebounds but Industry Consolidates**

Five Phases of 529 Plan Development

- **Before the Federal Solution (1987 to 1997)**
 - *Largely a State-led, defined benefit market*
 - *Participants “buy” tuition; they don’t make investment choices*
- **The Earliest 529 Days (1998 to 2002)**
 - *States and the private sector recognize growth opportunities*
 - *Defined contribution-style investments are initially limited to asset allocation, fund-of-funds structures*
 - *Broader investment choices emerge in late 2001*
- **Re-Bids Begin (2003 to 2006)**
 - *Apparent market opportunity increases competition among plans and private sector providers*
- **Market Pressures Take Over (2007 to 2010)**
 - *Volatility leads to new products and new messages*
 - *Federally-insured investments grow in numbers and appeal*
- **Growth Rebounds (2011 to Present)**
 - *529 market recovers but undergoes consolidation among providers*

Launch of 529 Plans and Market Development



Source: Savingforcollege.com for year of launch data as of February 10, 2015

Certain plans received double counts: District of Columbia (direct and advisor) and University of Alaska (prepaid and direct)

Reflects snapshot of plan growth for plans currently in operation today. Excludes plans permanently closed prior to February 10, 2015

Snapshot of the 529 Market Today

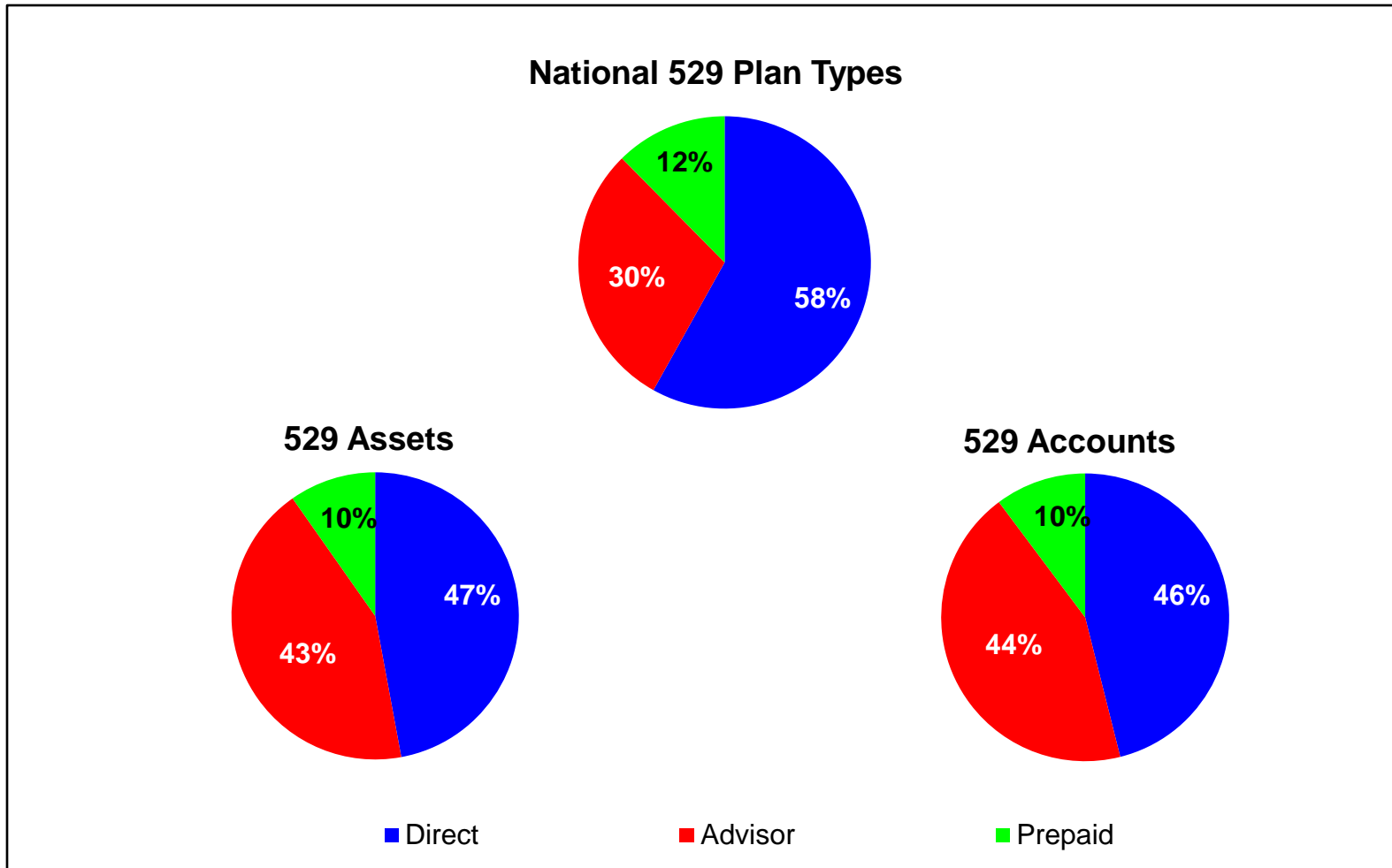
	Prepaid Plans	Direct Savings Plans	Advisor Savings Plans	Total
States	12	49 (with DC)	30 (with DC)	50 (with DC)
Plans	13 (with Private College Plan)	61	31	105
Assets	\$23,820,569,563	\$115,103,062,867	\$105,529,574,142	\$244,453,206,572
Accounts	1,208,598	5,449,745	5,169,907	11,828,250

Sources: Assets and Accounts are from the College Savings Plans Network ("CSPN") and certain States as of June 30, 2014

Washington, D.C. is included in Direct Plan count

Open Prepaid Plans: AK, FL, IL, MD, MA, MI, MS, NV, PA, TX, VA, WA, Private College Consortium

Snapshot of the 529 Market Today, cont'd



Sources: CSPN and certain States as of June 30, 2014

Washington, D.C. is included in Direct Plan count

Conclusion: 529 Parallels for State-Sponsored Retirement Plans

- **Like the burgeoning State initiatives to provide retirement options for private sector employees, State tuition prepayment plans foreshadowed the enactment of Section 529**
- **Federal tax legislation and SEC and IRS regulatory actions enhanced the opportunities for State college savings plans**
 - **Analogous federal solutions (e.g., ERISA clarification) could do the same for State-sponsored private sector retirement initiatives**
- **Extremely favorable federal income, gift and estate tax laws provided the impetus for private sector involvement in 529 plans**
 - **State-sponsored retirement initiatives must demonstrate a compelling value proposition for private sector partner commitments**

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Appendix

The Federal Solution

- **Senators Bob Graham (D-FL) and Mitch McConnell (R-KY) jointly introduce legislation seeking tax-exemption for qualified state tuition plans**
- **Small Business Job Protection Act of 1996 creates Section 529:**
 - **Confers tax-exempt status on “qualifying state tuition plans”**
 - **Identifies prepaid tuition and savings plans**
 - **Defers tax on undistributed earnings but taxes earnings at withdrawal as ordinary income (like a non-deductible IRA)**
- **Taxpayer Relief Act of 1997:**
 - **Room and board are qualified higher education expenses (“QHEE”)**
 - **Creates favorable estate and gift tax provisions**
- **Proposed Treasury Regulations released in 1998**
- **Treasury issues various Private Letter Rulings regarding qualification under Section 529**
- **Securities and Exchange Commission issues various No-Action Letters related to States’ exemptions from certain securities laws**

Additional Significant Federal Statutory Refinements

- **Economic Growth and Tax Relief Reconciliation Act of 2001:**
 - **Authorizes tax-free withdrawals through 2010**
 - **Creates the possibility of private prepaid plans**
- **Treasury Notice 2001-55:**
 - **Permits changes in investment selection without changing beneficiary (clarifying “investment direction”)**
 - **Leads to individual mutual funds in savings plans**
- **Treasury Notice 2001-88:**
 - **Eases recordkeeping obligations (e.g., eliminates substantiation of expenses)**
 - **Removes plans from collecting federal penalties for non-qualified withdrawals**
 - **Creates Form 1099-Q**
- **Pension Protection Act of 2006:**
 - **Makes permanent tax-free withdrawals for QHEE**
 - **Introduces possibility of Treasury regulations to “prevent abuse” of 529**

Related Federal Actions

- **Various Presidential Revenue Proposals (2003 through 2008; 2015):**
 - **Lifetime Savings Accounts**
 - **Saver's Credit for 529 Contributions**
 - **Proposed elimination of federal tax-exemption for 529s**
- **Advance Notice of Proposed Rulemaking (2008):**
 - **Targets perceived abusive transactions in 529 accounts**
 - **Seeks to clarify income and estate tax treatment of certain account changes**
- **Various Rules promulgated by the Municipal Securities Rulemaking Board, including:**
 - **Professional Qualifications**
 - **Advertising**
 - **Disclosure**
 - **Data Collection**

Phases of 529 – Before the Federal Solution (1987 to 1997)

- ***State-led defined benefit plans for tuition***
 - Tuition prepayment plans for State residents:
 - Participants entered into contracts for tuition units or semesters
 - The value of the benefit – future tuition at current costs – ultimately depends on the college the beneficiary attends
 - Defined benefit plans based upon actuarial valuations:
 - States “guarantee” future tuition payments
 - Guarantees range from full, faith and credit (e.g., Texas, Ohio, Florida) to a pledge of plan assets (e.g., Alabama, Pennsylvania)
 - Bottom line:
 - Prepaid plan contracts are not viewed as investments

Phases of 529 – The Earliest 529 Days (1998 to 2002)

- ***Simple but evolving business model***
 - **Variety of early vendor business models:**
 - **Multiple mandates (e.g., TIAA-CREF, Citigroup, Merrill)**
 - **Single State focus (e.g., Alliance Bernstein, Putnam, American Funds)**
 - **Morphing of State models:**
 - **Direct-sold only (e.g., New Hampshire, New York)**
 - **Emergence of the advisor market (e.g., Rhode Island, Ohio)**
 - **Private label opportunities (e.g., New Mexico, Nevada, Oregon)**
 - **Investment options multiply:**
 - **Age-based predominate**
 - **Static style options emerge**
 - **Stable value / GICs grow in response to equity instability**

Phases of 529 – Re-Bids Begin (2003 to 2006)

- ***Increasing competition in a growing market***
 - **Substantial pressure on fees and expenses:**
 - **Direct-sold market appears more price sensitive**
 - **Some pressure on advisor-sold structures (e.g., Virginia)**
 - **Opportunities for economies of scale:**
 - **Re-bids result in program manager changes (e.g., California, Illinois)**
 - **Indexed investment options mushroom:**
 - **Substantially reduces the cost of investment options (e.g., New York, California, Missouri)**

Phases of 529 – Market Pressures Take Over (2007 to 2010)

- ***Volatility leads to new products and new messages***
 - **Fee reductions to win and retain business:**
 - **Asset fees decreased with every re-bid (e.g., Illinois, Vermont)**
 - **Asset fees cut voluntarily (e.g., Iowa, Nevada Vanguard, New York)**
 - **Account maintenance fees reduced (e.g., Maine, Nebraska)**
 - **Repricing of multi-manager programs (Alaska, Missouri, West Virginia)**
 - **Program closures and marketing combinations (e.g., Wyoming – Colorado, Tennessee – Georgia (both now undone))**
 - **New products for safety and indexing:**
 - **Federally-insured options (e.g., Ohio, Oregon, Virginia, Wisconsin, Utah, Indiana, North Carolina, Nevada)**
 - **ETF options (e.g., Arkansas, Indiana, Iowa and Missouri)**

Phases of 529 – Growth Rebounds (2011 to Present)

- ***Market recovers but undergoes consolidation***
 - Asset growth recovers with strong stock market performance
 - 529 market consolidates but there's room for growth:
 - Advisor Plans closures (e.g., California, Wisconsin, Mississippi)
 - Other Plans enter the market
 - New Direct Plan launched in Tennessee
 - Prepaid Plans reopen in Illinois and Mississippi (while Colorado closes permanently)
 - Program Managers shift:
 - Fidelity chooses not to rebid for California Advisor Plan
 - Oppenheimer chooses not to rebid for Texas Plans
 - Upromise (now Ascensus) foregoes rebid in Iowa Advisor Plan
 - Wells Fargo leaves 529 business for good
 - JPMorgan, NorthStar, Voya and Intuition enter on rebid mandates