

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. EAF0400340002

TO: Department of Enforcement
NASD

RE: American Express Financial Advisors Inc., Respondent
BD No. 6363

Pursuant to Rule 9216 of NASD's Code of Procedure, Respondent American Express Financial Advisors Inc. ("AEFA" or "the firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against it alleging violations based on the same factual findings.

AEFA understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC") Review Subcommittee or Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against AEFA; and
3. If accepted:
 - a. this AWC will become part of AEFA's permanent disciplinary record and may be considered in any future actions brought by NASD or any other regulator against AEFA;
 - b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about AEFA's disciplinary record;
 - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
 - d. AEFA may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in this AWC or create the impression that the AWC is without factual basis. Nothing in this provision affects AEFA's

testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which NASD is not a party.

AEFA also understands that its experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

AEFA has been an NASD member since 1972. Its principal offices are located in Minneapolis, Minnesota. The firm has no relevant disciplinary history.

I.

WAIVER OF PROCEDURAL RIGHTS

AEFA specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against AEFA;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, AEFA specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

AEFA further specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

II.

ACCEPTANCE AND CONSENT

AEFA hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by NASD:

Summary

From May 2001 through the end of 2004, AEFA sold over \$1.1 billion of 529 college savings plans ("529 plans") to over 138,000 customer accounts. During this period, AEFA failed to establish and maintain procedures, including written supervisory procedures, that were reasonably designed to achieve compliance with suitability obligations as they related to the sale of 529 plans. In fact, from May 2001 through October 20, 2003, when AEFA sold over \$625 million of 529 plans to its customers, the firm had no effective procedures in place specifically addressing the firm's suitability obligations relating to the sale of 529 plans. Most of the procedures in place at that time were general compliance requirements relating to the sale of all products offered by AEFA. Although the firm established some procedures in October 2003, those procedures were not adequate.

From May 2001 through October 2003, the only 529 plan offered and sold by AEFA was the tomorrow's scholarSM College Savings Plan sponsored by the state of Wisconsin ("the Wisconsin plan"). During this period, state tax benefits either were available or became available for investors residing in twenty-three states (other than Wisconsin) and the District of Columbia who purchased 529 plans offered by their state of residence. AEFA sold over \$200 million of the Wisconsin plan to customers who lived in those twenty-four states¹ during this time period, at a time when an income tax deduction was available or became available in those states for such an investment. As a result, numerous customers did not receive state income tax benefits that might have been available if they had purchased a 529 plan offered by their state of residence.

These sales occurred when AEFA did not have adequate procedures governing the sale of 529 plans. For instance, AEFA did not have procedures during this time period requiring that registered representatives weigh the state income tax benefit that might be obtained by purchasing an in-state plan against any benefits that might be provided by a recommended out-of-state plan, such as investment performance, investment choices, fees and expenses, or other factors.

¹ As noted above, tax benefits were available in twenty-three states and the District of Columbia. For simplicity, these jurisdictions are referred to as "the twenty-four states."

By failing to have procedures or a system for supervision reasonably designed to achieve compliance with suitability requirements as they related to the sale of 529 plans, AEFA violated Municipal Securities Rulemaking Board ("MSRB") Rule G-27.

Facts

A. College Savings Plans

529 plans are tax-advantaged investment programs designed to help parents and others pay for qualified higher education costs. The name is derived from the section of the Internal Revenue Code governing the plans. Each of the fifty states, and the District of Columbia, currently has at least one type of 529 plan. All 529 plans offer the same federal tax advantages, including tax deferral on earnings. However, each state's 529 plan offers different state income tax benefits. In particular, approximately half the states offer a tax benefit based on investments by residents in the state's 529 plan. Investors who purchase out-of-state plans, however, do not receive that benefit. In addition, each plan has different costs and expenses.

B. AEFA's Sales of 529 Plans

From May 2001 through the end of 2004, AEFA sold over \$1.1 billion of 529 plans to over 138,000 customer accounts. The firm received approximately \$27.4 million from these sales in the form of dealer concessions.

In May 2001, AEFA began selling the Wisconsin plan. From May 2001 through October 2003, the Wisconsin plan was the only 529 plan offered and sold by AEFA.² During that period, AEFA sold over \$625 million of the Wisconsin plan to over 59,000 customer accounts in over 935,000 transactions.³ Over \$606 million of that amount was sold to non-Wisconsin residents.

During the period AEFA was selling only the Wisconsin plan, twenty-four other states offered or began offering an income tax deduction for residents who invested in their state's 529 plan.⁴ Customers living in those twenty-four states who purchased the Wisconsin plan from AEFA were thus not able to receive the state income tax benefits that might have been available by investing in a 529 plan offered by their state of residence. Of the \$625 million in sales of the Wisconsin plan by AEFA from May 2001 through October 20, 2003, over \$200 million, or approximately 32%, was sold to customers who lived in the twenty-four states, at a time when a deduction might have been available in those states for such an investment.

Moreover, investors in five states (New Mexico, South Carolina, Illinois Colorado, and West Virginia) could receive unlimited income tax deductions for investments in their state's 529

² During this time period, AEFA had a selling agreement only with Wisconsin and was not able to sell other 529 plans.

³ Approximately 912,000 of these transactions were subsequent investments in the 59,000 accounts.

⁴ Whether an individual investor receives a tax benefit, and the amount of any such benefit, are individualized determinations dependent on a number of factors.

plan during this period, if eligible and subject to any limits placed on total annual contributions by the state's 529 plan. From May of 2001 through the end of 2004, AEFA sold over \$55 million of out-of-state 529 plans to customers residing in those five states, at a time when such deductions were available in those states. The customers who purchased these plans thus did not receive the unlimited deduction that might have been available to them if they had invested in the 529 plan offered by their state of residence.

The amount of state income tax benefit available for residents of those states from an investment in their state's 529 plan could be significant, depending on certain factors. For example, a South Carolina resident with joint taxable income between \$56,800 and \$114,650 who invested \$50,000 in 2003 in a South Carolina 529 plan could have received a tax benefit of approximately \$2,625. A West Virginia resident with joint taxable income between \$60,000 and \$114,650 who invested \$50,000 in 2003 in a West Virginia 529 plan could have received a tax benefit of approximately \$2,437. A Colorado resident with joint taxable income between \$56,800 and \$114,650 who invested \$50,000 in 2003 in a Colorado 529 plan could have received a tax benefit of approximately \$1,736.⁵

C. AEFA's Lack of Procedures Regarding Sale of 529 Plans

From May 2001, when AEFA first began selling 529 plans, until October 2003, the firm had no effective procedures specifically addressing the sale of 529 plans, including procedures governing suitability requirements, and the procedures in effect generally related to the sale of other products sold by AEFA. Although the firm established new procedures in October of 2003, after AEFA had sold over \$625 million of 529 plans in over 935,000 transactions, those procedures did not adequately address the firm's suitability obligations relating to the sale of 529 plans.

At the time AEFA first began offering the Wisconsin plan, it issued a bulletin, dated May 17, 2001, introducing the product to its registered representatives. The bulletin did not contain adequate procedures relating to the sale of 529 plans. For instance, while it stated that registered representatives needed to adhere to compliance requirements regarding suitability, disclosures, and documentation, the bulletin did not provide effective guidance regarding those requirements as they related to 529 plans. The firm's procedures also did not require that registered representatives, when making a recommendation for a customer to purchase an out-of-state 529 plan, weigh the state income tax benefit that a customer might obtain by purchasing an in-state plan against benefits that might be provided by the recommended out-of-state plan, such as investment performance, investment choices, fees and expenses, or other factors. AEFA also had no procedures requiring registered representatives to document any such analysis.

In June 2002, AEFA issued a bulletin requiring its registered representatives to disclose that non-Wisconsin residents purchasing the Wisconsin plan might:

⁵ Customers who purchase a 529 plan may be required to pay federal income taxes on the amount of the state tax benefit they receive. The tax benefit amounts in the above examples take into account the increase in federal income tax that is attributable to the reduction in state income taxes for those taxpayers who itemize deductions.

wish to consider your own state's college savings plan. Your state's plan may offer state income tax benefits or other benefits that you might want to evaluate with your tax advisor.⁶

The bulletin provided a link to a comparison tool that allowed registered representatives to perform a side-by-side comparison of the Wisconsin plan and two other 529 plans, and to view *state income tax benefits for each plan*. However, AEFA did not require that its registered representatives use the comparison tool.

In October 2003, AEFA began selling seven additional 529 plans sponsored by states other than Wisconsin. At the time it began selling these 529 plans, the firm issued a bulletin to its registered representatives outlining certain compliance and supervisory requirements for the sale of 529 plans. This was the first time AEFA had established these requirements. The bulletin advised AEFA's registered representatives to consider the existence of state income tax benefits when recommending 529 plans. Registered representatives were required to document the rationale for their recommendation of an out-of-state plan and to recommend that clients consider consulting a tax advisor to determine the most appropriate plan from a tax perspective. The bulletin also identified the five states that offered unlimited tax deductions for investments in 529 plans by their residents in any one year. The bulletin required supervisors to confirm that an advisor had disclosed the existence of the in-state plan when selling a 529 plan.⁷ Supervisors were required to document their review of sales in an internal system.

The October 2003 bulletin did not provide any criteria or guidance for AEFA's registered representatives to use in making suitability determinations when recommending 529 plans. It also contained no criteria or guidance for supervisors to use when reviewing sales of 529 plans by registered representatives. In addition, while the bulletin identified the five states that offered unlimited tax deductions for investments in 529 plans by their residents, it did not contain any guidance, procedures or standards regarding sales of 529 plans to residents of those states.

⁶ AEFA's June 2002 bulletin was issued in response to a notice issued by the MSRB in May 2002. Among other things, the MSRB stated in that notice that:

in the case of sales to a customer of out-of-state Section 529 college savings plan interests, Rule G-17 [MSRB's fair dealing rule] requires a dealer to disclose that, depending upon the laws of the customer's home state, favorable state tax treatment for investing in a Section 529 college savings plan may be limited to investments made in a Section 529 college savings plan offered by the customer's home state.

The notice also stated that "the MSRB has determined to delay the effectiveness of the disclosure obligation with respect to state tax consequences of investments in out-of-state Section 529 college savings plans until July 15, 2002. Nonetheless, the MSRB urges dealers to comply with this guidance as soon as practicable."

⁷ The bulletin required advisors to make the following disclosure: "[i]f your state has special tax benefits only available to residents who purchase the in-state plan, and you are recommending a different 529 plan, you must disclose the existence of the state plan and potential tax benefits, regardless of whether the plan can be sold by AEFA."

Violations

From May 2001 through December 2004, AEFA failed to establish and maintain supervisory systems and procedures that were reasonably designed to achieve compliance with suitability obligations relating to the sale of 529 plans.

During this period, when AEFA sold over \$1.1 billion of 529 plans to over 138,000 customer accounts, the firm failed to establish and maintain adequate procedures relating to the sale of 529 plans. Most of the procedures in place at AEFA during this time period were general compliance requirements relating to the sale of other products offered by the firm. While the firm told its registered representatives that they needed to adhere to compliance requirements regarding suitability, disclosures, and documentation, it did not provide effective guidance regarding those requirements as they related to 529 plans. For instance, as described above, AEFA did not have adequate procedures to guide registered representatives concerning the *factors to consider in determining whether a 529 plan was suitable, or for supervisors to use when reviewing those sales*. AEFA also had no effective procedures, prior to October 2003, to require that documentation be created or maintained regarding suitability determinations for the sale of 529 plans.

Over \$364 million of the 529 plans sold by AEFA from May 2001 through the end of 2004 were to residents of the twenty-four states that offered or began to offer a tax deduction for investments in that state's 529 plan. As a result, numerous customers did not receive state *income tax benefits that might have been available if they had purchased a 529 plan offered by their state of residence*. Moreover, because the benefit available in five states was based on the full amount invested by the customer in any year, the amount of lost state income tax benefit in these instances could be significant for some investors. However, AEFA did not have procedures requiring representatives to undertake an analysis weighing the lost income tax benefit that customers might obtain against benefits available through an out-of-state plan, such as investment performance, investment choices, fees and expenses, or other factors. AEFA also did not have procedures requiring that registered representatives document reasons why an *out-of-state plan was suitable notwithstanding the lost state income tax benefit*.

529 plans are municipal securities. As a result, when offering and selling 529 plans, member firms must comply with the applicable rules of the Municipal Securities Rulemaking Board. MSRB Rule G-27 requires that member firms supervise the conduct of the municipal securities activities of the firm and its associated persons to ensure compliance with MSRB rules and the federal securities laws, and that firms adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that municipal securities activities are in compliance. As described above, AEFA failed to establish and maintain procedures, including written supervisory procedures, or a supervisory system reasonably designed to achieve compliance with suitability requirements as they related to the sale of 529 plans. As a result, AEFA violated MSRB Rule G-27.

Sanctions

AEFA also consents to the imposition, at a maximum, of the following sanctions:

1. A censure;
2. A fine of \$500,000;
3. Payment of approximately \$750,000 in remediation, in accordance with a schedule to be provided by the Department of Enforcement, to compensate certain customers who, during the period from May 2001 through December 2004, purchased a 529 plan from AEFA sponsored by a state other than the customer's state of residence, at a time when AEFA did not have adequate procedures in place in connection with recommendations for such purchases.

Satisfactory proof of payment or of reasonable and documented efforts undertaken to effect such payment shall be provided to the NASD staff no later than 120 days after the schedule is provided by the Department of Enforcement. If for any reason AEFA cannot locate any customer identified in the schedule after *reasonable and documented efforts within such period, or any such additional period agreed to by the staff*, AEFA shall forward any undistributed payment and interest to the appropriate escheat, unclaimed property, or abandoned property fund for the state or country in which the customer is last known to have resided.

4. Within 60 days after issuance of the AWC, a senior officer of AEFA shall certify to NASD that the firm has reviewed its procedures regarding the sale of 529 plans and has established systems and procedures reasonably designed to achieve compliance with the laws, regulations, and rules concerning the sale of 529 plans. At the time AEFA provides NASD with this certification, the firm shall also provide NASD with a report describing the systems and procedures adopted by the firm concerning the sale of 529 plans.

The sanctions imposed herein shall be effective on a date set by NASD staff.

III.

OTHER MATTERS

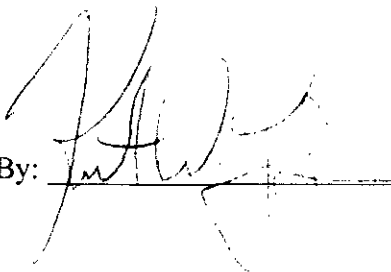
- A. AEFA understands that it may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. AEFA understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.

- B. AEFA agrees to pay any monetary sanctions imposed on it upon notice that this AWC has been accepted and that such payments are due and payable and has attached an Election of Payment form showing the method by which it proposes to pay any fine imposed.
- C. AEFA specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

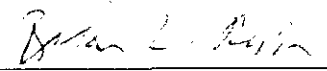
AEFA certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce AEFA to submit it.

8/4/05
Date

American Express Financial Advisors Inc.
Respondent

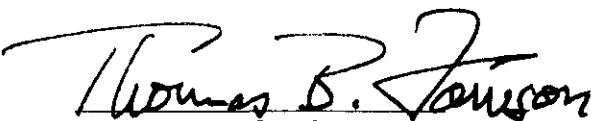
By: 

Reviewed by:


Brian L. Rubin, Esquire
Sutherland, Asbill & Brennan, LLP

Accepted by NASD:

8/19/05
Date


Department of Enforcement
NASD
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Signed on behalf of the Director of ODA, by
delegated authority