

Notice to Members

SEPTEMBER 2002

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

INFORMATIONAL

Bulk Transfer of Customer Accounts

Use of Negative Response Letters for the Bulk Transfer of Customer Accounts

KEY TOPICS

Customer Accounts
Rule 2110

Executive Summary

In October 2000, the staff of NASD issued an interpretive letter concerning the use of "negative response letters" to transfer certain customer accounts to a new broker/dealer. Since the publication of the interpretive letter, the staff has received many inquiries from the membership for guidance on the use of negative response letters to transfer customer accounts. The purpose of this *Notice to Members* is to provide interpretive guidance to the membership on this topic.¹

Questions/Further Information

Questions concerning this *Notice to Members* may be directed to Sarah J. Williams, Assistant General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8083.

Background

NASD Rule 11870, Customer Account Transfer Contracts, describes the process by which a customer can transfer his or her account from one member firm to another. The process requires the customer to submit a completed transfer instruction to the member that is to receive the customer's account, and sets forth specific procedures pursuant to which the firm receiving the account and the firm transferring the account coordinate their efforts to accomplish the transfer.

Situations may arise where a firm seeks to initiate a bulk transfer of customer accounts. For example, a firm experiencing financial or operational difficulties may seek to transfer all of its accounts to another member. In this situation, soliciting customers individually to submit instructions directing the transfer of their accounts to a particular firm can be a lengthy process. Moreover, while the process is underway, the assets in the customer accounts may be at risk because of the member's precarious financial condition.

NASD rules do permit member firms to use "negative response letters" to obtain authorization to take certain actions on behalf of their customers without obtaining affirmative consent, but only in limited circumstances.² NASD Rule 2510(d) allows a member to use negative response letters in certain situations to effect the bulk exchange of a customer's money market mutual fund for a different fund without the affirmative consent of a customer, provided certain conditions are met.³ The staff also has interpreted the NASD trade-reporting rules regarding riskless principal trading to permit the use of negative response letters to document an institutional customer's agreement to trade with a firm on a net basis.⁴

The staff generally believes that a customer should affirmatively consent to the transfer of his or her account to another firm. Various factors may affect an investor's decision to move an account to a new firm, including, for example, the level and quality of service of the new firm, the fees and charges imposed by the new firm, and the cost of the transfer itself. However, when a firm initiates the transfer of a customer's account, there is

no assurance that the customer has had sufficient time or information with which to decide whether to object to the transfer. Further, members may be inclined to use negative response letters because of the convenience these letters provide without giving due consideration to whether soliciting affirmative customer consent is a viable alternative. For these reasons, transfers of customer accounts by a member using negative response letters may, under certain circumstances, conflict with a member's obligation to observe high standards of commercial honor and just and equitable principles of trade under NASD Rule 2110.

In October 2000, the staff of NASD Regulatory Policy and Oversight, Office of General Counsel, issued an interpretive letter to a member firm addressing the question of whether a departing registered representative could send a negative response letter to customers serviced by the registered representative to effect the transfer of those customers to the registered representative's new firm.⁵ The staff advised that the use of a negative response letter in those circumstances raised concerns under Rule 2110.

Bulk Transfers of Customer Accounts Using Negative Response Letters

With respect to the transfer by a member firm of a group of customer accounts, the staff believes that there are situations where a negative response letter may be appropriate to provide for the efficient transfer of those accounts. In identifying these situations, the staff has considered the need to effect a timely transfer of the account and the interests of customers affected by the transfer.

The staff generally believes the use of negative response letters may be appropriate in the following circumstances:

- ♦ **A Member Experiencing Financial or Operational Difficulties** – An introducing firm that is experiencing financial or operational difficulties may seek the transfer of all of its customer accounts to another introducing firm using negative response letters;
- ♦ **An Introducing Firm No Longer in Business** – When an introducing firm has gone out of business, the clearing firm may effect the transfer of all of the introducing firm's customer accounts to another introducing firm using negative response letters;
- ♦ **Changes in a Networking Arrangement with a Financial Institution** – Upon the conclusion or termination of a networking arrangement with a financial institution pursuant to NASD Rule 2350, a member may seek the transfer of all customer accounts established pursuant to the networking arrangement to a new firm with which the financial institution has formed a networking arrangement using negative response letters;
- ♦ **Acquisition or Merger of a Member Firm** – When a firm is acquired by or merges with another firm, the firm originating the accounts may seek the transfer of all of its accounts to the new firm using negative response letters; and

- ♦ **Change in Clearing Firm by an Introducing Firm** – When an introducing firm decides to enter into a clearing arrangement with a different firm, the introducing firm may use negative response letters to transfer customer accounts to the new clearing firm.

The staff believes that the use of a negative response letter to facilitate the bulk transfer of customer accounts in these situations is appropriate, given the potential risk to investors and costs to firms that could result if firms were required to solicit individual transfer instructions from each customer. The bulk transfer of accounts in these situations also helps minimize interruptions to customers' access to their accounts and the trading markets. The staff recognizes that circumstances may exist outside of the scenarios described above where the use of negative response letters may be appropriate. The staff is prepared to provide guidance on specific situations through NASD's interpretive letter process, as needed. While the use of negative response letters by firms to transfer customer accounts may be appropriate in the situations described above, the staff continues to believe that negative response letters may not be used by registered representatives to transfer customer accounts.

Recommended Disclosures in Negative Response Letters

The staff expects a member seeking to transfer customer accounts using negative response letters to provide account holders, consistent with just and equitable principles of trade under Rule 2110, with adequate time and information to decide whether to object to the transfer. The staff advises members seeking to transfer customer accounts using negative response letters as permitted under this *Notice to Members* to provide each customer with the following information in the negative response letter:

- (1) A brief description of the circumstances necessitating the transfer;
- (2) A statement that the customer has the right to object to the transfer;
- (3) Information on how a customer can effectuate a transfer to another firm;
- (4) A sufficient time period for the customer to respond to the letter (at least 30 days from the receipt of the letter unless exigent circumstances exist that warrant a shorter timer period);
- (5) Disclosure of any cost that will be imposed on the customer as a result of the transfer, including costs to the customer if the customer initiates a transfer of the account after the account is moved pursuant to the negative response letter; and

- (6) A statement regarding the firm's compliance with Securities and Exchange Commission (SEC) Regulation S-P (Privacy of Consumer Financial Information) in connection with the transfer.⁶

Member firms that receive customer accounts pursuant to a transfer by a negative response letter should furnish customers with any applicable customer account information and agreements upon the receipt of the accounts.

Both the transferring and receiving firms in a customer account transfer situation are reminded that the firms must be in full compliance with SEC Regulation S-P. Regulation S-P governs the collection, use, and maintenance by a financial institution of nonpublic personal information of consumers and customers. Unless the transfer is being conducted pursuant to a permitted exception to Regulation S-P, the transferring firm should have reserved the right to transfer customer accounts in its privacy notice that was previously sent to its customers.⁷ Generally, firms receiving the customer accounts must provide privacy notices upon the establishment of a customer account. Member firms that have questions or require additional information regarding the application of Regulation S-P should consult the Office of the Chief Counsel, Division of Market Regulation, SEC.

Endnotes

- 1 This *Notice to Members* does not apply to transfers of special product accounts such as mutual fund or variable annuity accounts, nor does it apply to the transfer of specific securities. Further, certain account transfers may require NASD approval under Rule 1017.
 - 2 A negative response letter generally informs the recipient of the letter of an impending action, and requires the recipient to respond or act within a specified time frame if the recipient objects to the action. If the recipient does not respond, he or she is deemed to have consented to the action.
 - 3 NASD Rule 2510(d)(2) limits the use of negative response letters to situations involving mergers and acquisitions of funds, changes of clearing members, and exchanges of funds used in sweep accounts. Moreover, the rule requires that the negative response letter contain certain disclosures about the funds being exchanged and that the negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.
 - 4 See *Notice to Members 00-79, "Riskless Principal Trade Reporting,"* (November 2000).
 - 5 See Letter to Merit Capital Associates, Inc., from Office of General Counsel, NASD Regulation, Inc. (predecessor to NASD Regulatory Policy and Oversight) dated October 16, 2000.
 - 6 See Exchange Act Rel. No. 42974 (June 22, 2000), 65 Fed. Reg. 40334 (June 29, 2000) ("Privacy of Consumer Financial Information").
 - 7 If applicable, firms must also abide by any opt out notices received from customers.
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