

Notice to Members

OCTOBER 2004

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

KEY TOPICS

Broker-Dealer of Record
Customer Account Transfers
Mutual Funds
Negative Response Letters
Rule 2110
Variable Annuities

GUIDANCE

Transfers of Mutual Funds and Variable Annuities

Impermissible Use of Negative Response Letters for the Transfer of Mutual Funds and Variable Annuities (Changes in Broker-Dealer of Record)

Executive Summary

In September 2002, NASD issued *Notice to Members (NtM) 02-57* addressing when a member firm can use “negative response letters” for the bulk transfer of customer accounts, consistent with NASD rules. Since the publication of NtM 02-57, the staff has received a number of inquiries from the membership for guidance on the use of negative response letters to change the “broker-dealer of record” (hereinafter, BD of record) on a mutual fund or variable insurance product account held directly with the issuer. As indicated in NtM 02-57, changes in BD of record under these circumstances fall outside the scope of NtM 02-57. Accordingly, a member must obtain affirmative consent from a customer to direct a change in the BD of record in either a mutual fund or variable annuity account.

Questions/Further Information

Questions concerning this *Notice* may be directed to Patricia M. Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8026.

Background and Discussion

In September 2002, NASD issued NtM 02-57 concerning the use of negative response letters¹ for the bulk transfer of customer accounts. In NtM 02-57, NASD staff expressed its general view that a customer should affirmatively consent to the transfer of his or her account to another firm. The staff explained that when a firm initiates the transfer of a customer's account via a negative response letter, there is no assurance that the customer has had sufficient time or information with which to decide whether to object to the transfer. The staff further observed that 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. The staff concluded that 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 2110.²

The staff, however, identified five specific situations in which it believed negative response letters could be appropriate to transfer customer accounts. These situations involve:

- ◆ A member experiencing financial or operational difficulties;
- ◆ An introducing firm no longer in business;
- ◆ Changes in a networking arrangement with a financial institution;
- ◆ An acquisition or merger of a member firm; and
- ◆ A change in a clearing firm by an introducing firm.

The staff specifically indicated in NtM 02-57 that the guidance in the *Notice* did not apply to transfers of special product accounts such as mutual fund or variable annuity accounts, nor did it apply to the transfer of specific securities.³ This statement reflected the staff's belief that such situations did not merit an exception from the general principle that firms should obtain affirmative consent from a customer prior to transferring such accounts (including changing the BD of record) or specific securities.

Since the issuance of NtM 02-57, however, NASD staff has received a number of inquiries regarding the potential application of the principles in the *Notice* to changes in BD of record, specifically whether members can use negative response letters to change the BD of record in mutual fund or variable insurance product accounts held directly with the issuer. The BD of record refers to the broker-dealer identified on a customer's account application for accounts held directly at a mutual fund or variable insurance product issuer. Accounts held in this manner are sometimes referred to as "check and application," "application way," or "direct application" (for consistency, this *Notice* uses the term "direct application") business. The BD of record generally receives fees or commissions resulting from the customer's transactions in the account.

NASD staff is issuing this *Notice* to reaffirm that the guidance provided in NtM 02-57 regarding the use of negative response letters does not apply to changes of BD of record for mutual fund and variable insurance product accounts where the account is held directly with the issuer. As explained in NtM 02-57, the use of negative response letters to facilitate a bulk transfer of customer accounts is generally appropriate in the five specified situations primarily because the bulk transfer of accounts helps minimize interruptions to customers' access to their accounts and the trading markets. However, because a change in the BD of record does not affect the owner's access to his or her account, changing the BD of record on a "direct application" account does not present such concerns. Nor does a change in the BD of record materially alter any of the account features, such as account holders, assets, investment objectives, etc. Rather, the change predominantly affects who will receive any fees and commissions the mutual fund or variable insurance product issuer may pay.

Given that the considerations that make the use of negative response letters appropriate in the five situations outlined in NtM 02-57 are not present when a "direct application" account's BD of record is changed, a member should seek a customer's affirmative consent prior to changing the BD of record on the customer's "direct application" account. The staff understands that the member may incur some cost and encounter some inconvenience when seeking affirmative consent to change a BD of record. However, a customer should be given sufficient time and information with which to decide whether a new BD of record should be named on the customer's account.

Endnotes

- 1 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.
- 2 See *also* 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.
- 3 See NtM 02-57 (September 2002) n.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.").

©2004. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.