

Notice to Members

FEBRUARY 2007

SUGGESTED ROUTING

Executive Representatives
Legal and Compliance
Operations
Senior Management

KEY TOPICS

Mutual Funds
Registered Representatives
Rule 11870
Supervision
Variable Products

GUIDANCE

Supervision of Recommendations after a Registered Representative Changes Firms

Special Considerations When Supervising Recommendations of Newly Associated Registered Representatives to Replace Mutual Funds and Variable Products

Executive Summary

Registered representatives with an established customer base may, from time to time, change their association from one firm to another and may wish to bring with them customer assets, including mutual funds and variable products. In some cases these mutual funds or variable products may be held directly with the product issuer or they may be proprietary to the representative's prior firm and the sponsor may not permit them to be transferred into the customer's account at the new firm. Even nonproprietary products may not be freely transferable if the sponsor does not have a dealer or servicing agreement with the new firm.

In cases such as these, the new firm may not sell or in some cases even service the investment or receive trail commissions from the distributor. In these situations, the representative may be inclined to recommend the liquidation and replacement of the customer's investments with other, similar investments. Although the ability to provide the customer with service in connection with an investment can be a relevant factor to consider in connection with the decision whether to retain the investment, any recommendation by the firm or its associated persons to sell a product and to replace it with another one may be made only after fully assessing the suitability of the transaction for the customer and determining that the transaction is in the customer's best interests in view of all considerations. Member

firms and their associated persons may not reach any suitability determination or make any recommendation on the basis that the purchase of a security or sale and replacement of a security will yield greater remuneration for them. Moreover, the representative should disclose to the customer all of the relevant facts and bases for the recommendation. See, e.g., *Notice to Members 99-35* (May 1999).

Questions/Further Information

Questions concerning this *Notice* should be directed to Kosha K. Dalal, Associate General Counsel, Office of General Counsel, at (202) 728-6903.

Background and Discussion

It is not uncommon for an individual registered representative or a group of representatives with an established customer base to terminate their association with one firm in favor of another. In such instances, one of the principal interests of the acquiring firm is ensuring that the newly associated representatives retain as much as possible of the customer base they serviced. Depending upon the nature of the business in which the representative was engaged, a number of the customers he or she serviced may own mutual funds and variable products that the prior firm was authorized by a sponsor to sell and service pursuant to a dealer or servicing agreement. The agreements frequently require that the sponsor pay the prior firm various distribution, marketing and/or servicing fees, also referred to as "trail commissions," which may benefit the representative.

When a representative who has sold such a product chooses to associate with a new firm, however, there may be impediments to the representative's ability to continue selling or servicing these investments, as well as receiving trail commissions from the sponsor for products the representative previously sold or serviced. For example, the product might be held directly with the issuer, it might be proprietary to the customer's prior firm and not portable, or the product sponsor might not permit the product to be transferred to the customer's account at the new firm. Even in the case of nonproprietary products, the new firm might not have a dealer or servicing agreement with the sponsor.¹ In other cases, the new firm may have such an agreement, but the representative's new firm may not be able to receive trail commissions on previously sold business because those trail commissions contractually belong to the previous firm that sold the product and it might not agree to relinquish them to the representative's new firm.

In these situations, the transferring representative may be tempted to recommend to customers that they replace their existing mutual funds and variable products with other investments, without adequately considering the customer's best interests and the suitability for the customer of those recommendations. Such inappropriate recommendations might be premised upon the fact that the new firm or the representative will no longer receive trail commissions for the customer's current investments or that the representative will generate more income by replacing an investment than recommending that the customer continue to hold the investment through the representative's prior firm.

A recommendation to liquidate, replace or surrender an existing investment must be suitable and based upon the customer's investment needs and not the financial needs of the firm or its associated persons. See, e.g., *Notice to Members 99-35* (May 1999).² A firm may consider the fact that the firm lacks a dealer or servicing agreement with the product sponsor and, therefore, the registered representative cannot provide the customer with the service that the customer desires with respect to the product. The suitability analysis must also include other considerations, however, including whether the customer's mutual fund or variable product is subject to a contingent deferred sales charge or a required holding (surrender) period, or has other features that materially affect its value or liquidity, and the fees and expenses associated with the new product being recommended. Accordingly, firms should have procedures in place, including supervisory procedures, that are specifically designed to review and evaluate investment recommendations relating to mutual funds and variable products that are made by newly associated persons to their existing customers. See NASD Rule 3010 and *Notice to Members 99-45* (June 1999).

These procedures should include at least the following:

- ▶ When conducting due diligence concerning a prospective new registered representative, the new firm should seek to learn the nature of the representative's business and the extent to which he or she offers investment products for which the new firm would need a dealer or servicing agreement in order for the representative to sell and provide service. The new firm should determine whether it would seek such agreements.
- ▶ If the new firm is unable or unwilling to service a customer's mutual fund or variable product, the new firm or the registered representative should advise the customer of this fact, as well as the options the customer may have to continue to hold the investment at the customer's prior firm, before recommending that the customer liquidate or surrender the investment.³

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- ▶ Any recommendation to liquidate, replace or surrender a mutual fund or variable product must be suitable for the customer based upon the customer's financial needs and investment objectives. Recommendations should not be a function of the desire of the firm or its new representative to obtain compensation that it would not otherwise receive were the customer to retain the previously sold investment.
 - ▶ For a reasonable period following the association of a new representative, the new firm should review replacements recommended by the associated person with a view to identifying any recommendations to liquidate or surrender mutual funds or variable products that may be inconsistent with the customer's investment needs and objectives or that have not been preceded by appropriate disclosure to the customer. Special supervisory consideration should be given to those transactions involving the replacement of a customer's existing variable annuity product with a "bonus variable annuity" offered by the new firm.⁴ The firm should review these transactions with a view to ensuring that full disclosure is made to the customer regarding all fees, expenses and surrender charges that may apply to the replacement product; a "bonus" on premium payments may not be considered an "offset" against any other fees or expenses, including surrender charges applied to the replaced product.⁵

Endnotes

- 1 Rule 11870 of the Uniform Practice Code (Customer Account Transfer Contracts) addresses the transfer of assets held in a customer's securities account. While the rule provides that member firms must, upon a customer's request, expedite and coordinate the transfer of securities account assets from a carrying firm (*i.e.*, the customer's current firm) to a receiving firm (*i.e.*, the customer's new firm), the rule identifies several categories of securities as "non-transferable assets," including, but not limited to, an asset that is a proprietary product of the carrying member, as well as an asset that is "a product of a third party ... with which the receiving member does not maintain the relationship or arrangement necessary to receive/carry the asset for the customer's account...." See Rule 11870(c)(1)(D). In such instances, Rule 11870(c)(3) provides that where the non-transferable product is proprietary to the customer's carrying firm, the carrying firm must notify the client of the status of the non-transferable asset and seek instructions as to whether to liquidate the product, continue holding it for the customer's benefit or deliver it to the customer. Similarly, Rule 11870(c)(4) provides that where the customer's receiving firm cannot accept a product because, for example, the receiving firm does not have a servicing agreement with the product sponsor, the receiving firm must notify the customer and seek instructions as to whether to liquidate the product, leave the product with the carrying firm for the customer's benefit, deliver it to the customer or deliver it to the product issuer to hold for the customer's benefit.
- 2 "The registered representative and the registered principal should determine, based on the information provided by the customer and their own knowledge of the product features, that replacing the existing contract with a new contract is suitable for the customer. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges."
- 3 See *also supra* note 1 discussing transfer requirements under Rule 11870.
- 4 A bonus variable annuity offers premium credits toward the value of the variable annuity contract at a specified percentage usually ranging between 1 percent and 5 percent of the purchase payment made.
- 5 The guidance set forth in this *Notice* would also apply in those situations in which a firm or its registered representative attracts a new customer who has mutual fund or variable product holdings with his prior firm. In such cases, the customer's new firm and representative must be cognizant of the aforementioned when making recommendations that concern these holdings.

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