

MEMO# 8761

March 31, 1997

NASDR PROPOSALS CONCERNING REFERRAL FEES AND CUSTOMER CONFIDENTIALITY

1 See NASDR Notice to Members 97-11 (March 1997) ("NTM 97-11"). 2 See NASDR Notice to Members 97-12 (March 1997) ("NTM 97-12"). 3 The Institute opposed both provisions in its comment letter to the SEC on the proposed bank broker-dealer rule. See Memorandum to Bank Investment Management Members No. 8-96 and SEC Rules Committee No. 48-96, dated May 29, 1996. March 31, 1997 TO: SEC RULES COMMITTEE No. 35-97 BANK MUTUAL FUND TASK FORCE RE: NASDR PROPOSALS CONCERNING REFERRAL FEES AND CUSTOMER CONFIDENTIALITY

The NASDR has proposed a new Rule 2460 that would restrict the payment of referral fees to unregistered third parties for the referral of retail business.¹ In addition, the NASDR has proposed Rule 3121, which would impose restrictions on NASD members ability to share customers personal financial information with other entities.² The NASD's proposed bank broker/dealer rule previously contained provisions addressing each of these matters but only with respect to bank broker-dealers. In response to negative comments on the provisions as set forth in the bank broker-dealer rule,³ they have been deleted from that rule and published for comment in a revised form that would apply to all NASD members. Both proposals are attached and they are summarized below. Comments on the proposals must be filed by April 30th. If there are issues you would like the Institute to consider addressing in its comment letter, please contact me at (202) 326-5822 or by e-mail to frances@ici.org by Friday, April 11th. Referral Fee Rule Proposed Rule 2460 would prohibit an NASD member or person associated with a member from directly or indirectly giving cash or non-cash compensation to any person, "other than persons registered with the member and other members," in connection with locating, introducing, or referring prospective brokerage account customers to the member. According to NTM 97-11, the NASD receives many inquiries about the propriety of paying referral fees to third parties who introduce or refer prospective brokerage customers to a firm. The proposed rule is intended to clarify the NASD's position and apply it to all members. NTM 97-11 states that "the NASD consistently has taken the position in published interpretations that it is improper for a member or a person associated with a member to make payments of 'finders* or referral fees to third parties who introduce or refer prospective brokerage customers to the firm, unless the recipient is registered as a representative of an NASD member firm." The NTM specifically requests comments on, among other things, whether the proposed rule should include an exception in the case of a nominal referral fee where the payment is occasional and not determined by the outcome of the referral, and where

the recipient does not regularly engage in activity that might reasonably be expected to result in continued referrals. It notes that the NASD, on an informal basis, previously has permitted one-time fees not tied to the completion of a transaction or the opening of an account and that the Interagency Statement on Retail Sales of Nondeposit Investment Products contains such an exception. The NTM asks, if such an exception is necessary, what types of payments should be permissible under the exception. Use and Release of Customer Confidential Financial Information Proposed Rule 3121 would prohibit an NASD member from releasing "confidential financial information" regarding a customer to anyone other than a "business affiliate," unless the member first discloses to the customer that the information may be released and that the customer has the right to object. The proposed rule would define "confidential financial information" as any financial information about a customer. Specifically excluded from the term are (1) a customer's name, address and telephone number (unless the customer specifies otherwise), and (2) information that can be obtained from unaffiliated credit bureaus or similar companies in the ordinary course of business. A "business affiliate" would be defined as "any person that, directly or indirectly, controls, is controlled by, or is under common control with, [a] member, or any person with which the member has a contractual arrangement for servicing customers." 4 This appears to be inconsistent with the definition of "confidential financial information," which specifically excludes a customer's name, address and telephone number. After making the required disclosure, the member would have to obtain written consent from the customer before releasing the information. NTM 97-12 states that this provision would be triggered, for example, when a member sells a customer list to an unaffiliated entity.⁴ The provision would not apply to the release of information to a governmental, regulatory or self-regulatory authority with jurisdiction over the member or a court of competent jurisdiction. Under the proposed rule, the same disclosure would have to be made before an NASD member could release confidential financial information to a business affiliate. The rule would require the member to provide the customer with a reasonable period of time during which to object before the information is released. The NTM indicates that this provision would apply, for example, to the sharing of information with an affiliated insurance or mortgage company. Finally, proposed Rule 3121 would prohibit an NASD member from using confidential financial information provided to it by a business affiliate unless the member determines that the affiliate has complied with the requirements described in the previous paragraph or the member complies with those requirements itself. According to NTM 97-12, this provision would apply, for example, to a member's use of "confidential financial information provided by a financial institution with which it has a networking arrangement to provide securities services to the customers of the financial institution." The NTM states that while not required, members should consider informing customers that this information may be used to make investment recommendations. The proposed rule would provide exceptions from its requirements for the sharing of information pursuant to clearing, custodial, or transfer arrangements with member firms necessary to service customer accounts or where the information pertains to customers other than natural persons. NTM 97-12 suggests that commenters "consider as a factor in evaluating the usefulness of the proposed disclosures that such information may be available from sources other than the member and that a customer's objection to the member's release of information therefore will not necessarily protect the confidentiality of the information." As proposed, the rule would require that the disclosures be made to both new and existing customers. The NTM requests comment on whether it should be applied only to new customers and on whether the required disclosure should appear in the account-opening document or a separate document. According to NTM 97-12, any entity that initially obtains the confidential information may make the required disclosures, and other entities should be able to rely on that entity's compliance with the required disclosures. The NTM

describes the requirements of the Fair Credit Reporting Act with respect to the use and release of confidential financial information, which are more limited than the restrictions contained in proposed Rule 3121. It states that "NASD Regulation preliminary believes that customer protection concerns dictate that more stringent standards should apply to member firms before they may release or use customer confidential financial information. Thus, the Rule goes further than the FCRA in imposing specific requirements on member firms that share such information with affiliates or non-affiliates." Frances M. Stadler Associate Counsel Attachments (in .pdf format)

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