Information Memo

Member Firm Regulation

New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

NYSE

Number 05-11
February 15, 2005

ATTENTION: CHIEF EXECUTIVE OFFICER/MANAGING PARTNER, COMPLIANCE AND LEGAL DEPARTMENTS

TO: ALL MEMBERS AND MEMBER ORGANIZATIONS

SUBJECT: CUSTOMER ACCOUNT SWEEPS TO BANKS

INTRODUCTION

In view of market conditions and the increasingly competitive industry environment, member organizations continually seek to develop and offer customers new investment services and products, such as the "cash sweep" account programs. In some cases, however, cash sweep account programs at member organizations may have been instituted or changed without fully appropriate levels of disclosure and customer consent. Such programs transfer customer funds over time out of the member organization to an interest bearing account for the customer at a bank often affiliated[1] with the member organization. This memorandum addresses issues involving the adoption of new cash sweep programs and provides procedures designed to safeguard investor interests for programs currently in place. It has been prepared to set out best practices under current Exchange rules. The Exchange will further explore the need for rule-making in this area in the near future.

CURRENT PROGRAMS

Member organizations have chosen to offer varying ways of managing cash balances in customer accounts. Some firms offer one or more money market mutual funds while others offer accounts deposited in affiliated or third-party banks, and several offer both. In some cases customers are offered a choice and in others the funds are directed at the discretion of the firm.

Many of the bank sweep programs adopted to date have relied upon contractual language in customer agreements, which may have been signed before the actual implementation of the new program or changes to existing programs. This contractual language is seen to give the member organization authority to adopt or amend the sweep plan without further consent from the customer, and has been referred to as prior or negative consent.

[1] While the bank sweep accounts seen to date are chiefly with banks affiliated with a member organization, the concerns and problems discussed below would be essentially the same absent such affiliation.

The Exchange is concerned that certain program changes may be so significant and beyond the contemplation and reasonable expectations of the customer at the time of the prior agreement that without effective subsequent disclosure the use of prior or negative consent is not sufficient.[2] Instances of the use of prior or negative consent in this regard may be deemed to be violative of existing Exchange rules.

SUGGESTED PRACTICES

In light of the problems with certain programs noted to date, the Exchange is recommending the use of the good business practices discussed below. Failure to follow the practices set forth in this Information Memo may be deemed conduct inconsistent with good business practice under Exchange Rule 401 ("Business Conduct"), Rule 405 ("Diligence as to Accounts"), the supervisory requirements of Rule 342 ("Offices – Approval, Supervision and Control") and Rule 472 ("Communications With the Public"), and may constitute conduct inconsistent with just and equitable principles of trade under Rule 476(a)(6) ("Disciplinary Proceedings Involving Charges Against Members, Member Organizations, Allied Members, Approved Persons, Employees, or Others").

EXCHANGE REVIEW OF NEW PROGRAMS

The Exchange strongly recommends that prior to implementing any new program or making any significant change to an existing program, member organizations submit such plans to their Finance Coordinator for review.

PROSPECTIVE DISCLOSURE

The propriety of prior or negative consent depends upon the specific terms of the initial customer agreement and effective subsequent disclosure in view of the nature of the changes being proposed. Changes substantially detrimental to the interests of the customer require more extensive and specific explanation and disclosure than purely ministerial ones. Each change from the original plan must be considered in light of the specific disclosures made and the nature of the proposed changes.

DISADVANTAGEOUS CHANGES IN THE RATE STRUCTURE

The Exchange will review each new program and/or change to an existing program individually, and would expect that any customer agreement being used as a basis for prior or negative consent provides the customer with notice of the process by which the agreement could be amended, together with effective contemporary or subsequent disclosure, in order to justify such consent(s). Where the interest rate to be paid by the bank is materially less than the rate currently paid by the customer's prior money market mutual fund account; where the bank rate is a temporary promotional rate; or where the member organization's business model or known plans propose lowering the rate, whether in real terms or as against market rates, prior or negative consent may not be adequate.

[2] With regard to existing sweep programs, it is not intended that member organizations which secured prior consent and made effective subsequent disclosure secure affirmative consent for such programs.

CUSTOMER DISCLOSURES

As discussed more fully below, member organizations must disclose the terms and conditions, risks and features of their programs, conflicts of interest, current interest rates, the manner by which future interest rates will be determined, as well as the nature and extent of SIPC or FDIC insurance available. In addition, customers should be advised of which entity to contact should they wish to gain access to their funds. All such disclosures should be forthright, clear, complete, prominent and unambiguous. Given the complicated nature of these disclosures, these points should also be summarized in a concise document, preferably on one or two pages, written in plain English and referring customers to places where additional and more detailed disclosure is available. These disclosures should be made: (1) at the time when such programs are first implemented by the member organization, (2) at the opening of new accounts, and (3) as changes are made to an existing program.

CONFLICTS OF INTEREST

Rule 472(i) ("General Standards For All Communications") provides, in pertinent part: "No member or member organization shall utilize any communication which contains (i) any untrue statement or omission of a material fact or is otherwise false or misleading". Member organizations therefore must include in their agreements or disclosure documents any conflicts of interest in connection with the cash sweep program, including whether the member organization receives compensation or other benefits for customer balances maintained at the bank, and if so the expected range of such compensation, as well as a disclosure of the difference, if any, between the rates of return at the existing money market fund and the proposed bank sweep fund. A change from a money market mutual fund to a bank sweep fund may be inconsistent with the customer's reasonable expectations with regard to money market rates. While a registered investment company, such as a money market mutual fund, is bound by fiduciary obligations to its shareholders (customers of the member organization) to seek the highest rates prudently available (less disclosed fees and expenses), when customer funds are swept to an affiliated bank it is in the interest of the member organization and its affiliates to pay as low a rate as possible, consistent with their views of competitive necessities. There may be no necessary linkage with rates prevailing in the market, and these funds are not being managed, in this instance, under the same fiduciary obligations.

FDIC LIMITS OF COVERAGE

Generally, FDIC insurance provides protection for bank deposits up to $100,000. Member organizations that sweep amounts in excess of $100,000 per customer to any single bank could cause customers to exceed the FDIC insurance limit, thereby leaving the excess amount uninsured. For this reason, member organizations must assure that initial agreements and continuing disclosures assist the customer in understanding whether or not bank balances have insured status. Such disclosure should address the possibility that prior or free-standing bank accounts might exist that may impact insurance coverage, as when the member organization utilizes a bank which accepts customers independent of the sweep program.

The Exchange would regard the placement of customer funds by member organizations with banks in excess of the insured limits of the FDIC as requiring either specific notice and agreement at the time of the signature of the customer agreement being relied upon for the prior or negative consent or effective subsequent disclosure. In the absence of effective contemporary or subsequent disclosure and the prominent placement of the clause in question, prior or negative consent may not be relied upon for the investment of customer funds in amounts in excess of the applicable FDIC limit in new programs going forward. Similarly, appropriate disclosure must be made and consents obtained for new customers in existing bank sweep programs where funds may be placed in banks in amounts exceeding FDIC limits.

SIPC COVERAGE

Member organizations comparing the risk of loss in an FDIC insured account to the risk of loss of an investment in a money market mutual fund for which SIPC protection is or is not available should be certain that their descriptions are accurate and not misleading.

Comparing the SIPC protection which is available when a member organization fails financially due to malfeasance and other reasons to investment risk of loss is misleading. SIPC does not protect ordinary market loss of any security, including loss in value of a money market mutual fund. Sales materials and other similar types of communications that are misleading or that do not clearly set forth all applicable information and/or disclosures would be in violation of Exchange Rule 472.

POSTING OF INTEREST RATES

Member organizations maintaining or instituting bank sweep programs are expected to post applicable bank and money market mutual fund interest rates and information regarding conflicts of interest on their website, if they have one, with prominent notice of the availability of such information. Use of statement legends or inserts to disclose interest rates may be an effective alternative for member organizations that do not have a website. Further, applicable interest rates posted on member organizations' websites should be updated on a regular basis to enable customers to reassess their investment decisions in changing interest rate environments. The use of an "800" number for rate information may be a useful supplement.

TRAINING AND DUE DILIGENCE OF REGISTERED REPRESENTATIVES

In order to satisfy the requirements of Rule 405, member organizations should conduct appropriate training of registered representatives to assure that they are familiar with the characteristics and risks of the available choices as they relate to the needs of their customers. Where the member organization's business model is "full service," the registered representative's obligations under Rule 405 would include advising on and discussing significant changes to the money market sweep program, such as material changes to the interest rate model versus comparable alternatives, structural changes in the sweep program (such as the change from a money market mutual fund to a bank sweep fund, or vice versa) to assure that customers understand their options, and to communicate investment choices to new customers. In addition, it would be expected that registered representatives would work with their customers to determine the appropriate money market choices and seek to maximize their return within the context of their investment objectives and risk tolerance. Consistent with the application of Rules 405 and 401, where customers affirmatively choose to utilize sweep options which substantially disadvantage them vis a vis other investment alternatives, that choice should be memorialized.

Where the member organization's business model is such that customer account activity is self-directed, all of the other requirements set forth in this Information Memo are applicable.

EXISTING SWEEP PROGRAMS

Member organizations which have previously instituted or changed sweep arrangements without providing all of the appropriate disclosures discussed herein should effectively provide customers with those omitted disclosures promptly, but no later than three months after the date of this Information Memo. The utilization of the one or two page, plain English disclosure document discussed herein is required, and if so deemed by the member organization may be sufficient to satisfy these disclosure requirements.

MAINTENANCE OF RECORDS

In some instances, a member organization may maintain customer balances on an omnibus basis with an affiliated bank. In such case, a member organization must maintain detailed individual customer balances in its books and records on behalf of the bank and its customers, as the bank will know only the aggregate balance attributable to all customers. In order to maintain accounts in this manner, member organizations must ensure that the bank's business continuity plan would enable it to comply with Rule 446 ("Business Continuity and Contingency Plans") and appropriate bank regulatory requirements for business continuity. Rule 446 requires that a member organization's plan must specifically address how it will assure customers prompt access to their funds in the event of a significant business disruption. Further, all such records must be made in accordance with and available for Exchange inspection pursuant to Rule 440 ("Books and Records").

POTENTIAL NET CAPITAL AND CUSTOMER PROTECTION IMPLICATIONS

Member organizations that have sweep arrangements whereby customer funds leave the broker-dealer and are held for any period of time by a party other than the bank must address critical issues relating to customer protection and net capital requirements.[3] Customer credit balances that leave the broker-dealer and are not immediately reinvested in an FDIC protected account may be deemed to be included as a credit in the reserve formula. In addition, any receivable on the broker-dealer's books resulting from a sweep may be deemed to be a non-allowable asset. Member organizations proposing to adopt such plans should review them with their Finance Coordinator prior to implementing them.

CUSTOMER ACCOUNT STATEMENTS

While many of the sweep programs seen to date preserve member organization control over the funds, as discussed above, where such control is absent differing standards are applicable. Where customer balances swept to a bank are not under the control of the member organization, they may be reflected on the customer's account statement only in accordance with the following combined account statement[4] requirements, as applicable:

- Member organizations must indicate that the statement is informational, and is provided as a courtesy and includes assets held at different entities;

[3] See Exchange Act Rules 15c3-1 ("Net Capital Requirements for Brokers and Dealers") and 15c3-3 ("Customer Protection – Reserves and Custody of Securities").

[4] See Information Memo 97-56 (December 18, 1997), which elaborates upon Rule 409 ("Statements of Accounts to Customers").

- Member organizations must identify each other entity, their relationship (if any) to each other and their respective functions; and

- Relative to services provided for assets included on the summary: clearly distinguish between assets held at each entity; identify the customer's account numbers at each entity; and provide a customer service telephone number at each entity (if the account number and customer service numbers are not included on the underlying statements).

ANTI-MONEY LAUNDERING PROCEDURES

Member organizations should be aware that some forms of cash sweep programs may raise anti-money laundering ("AML") concerns. Specifically, if the customer's account at the bank allows the customer to make deposits and/or withdrawals into or out of the account, the member organization must, where appropriate, incorporate procedures for review of this type of account in its AML policies and procedures, pursuant to Rule 445 ("Anti-Money Laundering Compliance Program").

SUMMARY OF RECOMMENDATIONS

EXCHANGE REVIEW OF NEW PROGRAMS

The Exchange strongly recommends that prior to implementing any new program or making any significant change to an existing program member organizations submit such plans to their Finance Coordinator for review.

USE OF PRIOR OR NEGATIVE CONSENT

Member organizations proposing to rely upon customer agreements signed prior to the implementation of the bank sweep programs to effect significant changes of the type discussed in this Information Memo are urged to submit such agreements to their Finance Coordinator well in advance of taking any action. The Exchange will review such documents and plans and advise the member organization whether it may rely upon the prior or negative consent of its customers given the specific facts and disclosures.

DISCLOSURES

Disclosures must be made clearly, prominently and in plain English, and must be summarized for the customer in a concise statement, preferably on one or two pages. Disclosures must address conflicts of interest, the method or basis for setting interest rates, the risks and features of the sweep program and applicable insurance coverage. Disclosures must be made upon the adoption of a new program, material changes in an existing program and upon the opening of a new account.

DISCLOSURES REGARDING EXISTING BANK SWEEP PROGRAMS

Where the disclosures made in adopting an existing bank sweep program did not address the elements discussed in this Information Memo, member organizations should make such disclosures, including the one or two page, plain English summary, promptly, but no later than three months after the date of this Information Memo.

POSTING INTEREST RATES

Good business practice would recommend the posting of information on available interest rates prominently, on websites where applicable or customer statements, on a current and continuing basis.

Questions concerning this Information Memo may be addressed to Gregory Taylor at 212-656-2920 or William Jannace at 212-656-2744.

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