

NASD Notice to Members 99-55

Questions And Answers Relating To Non-Cash Compensation Rules

Suggested Routing

- Senior Management
- Advertising
- Continuing Education
- Corporate Finance
- Executive Representatives
- Government Securities
- Institutional
- Insurance
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registered Representatives
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training
- Variable Contracts

Executive Summary

This *Notice to Members* addresses questions regarding the application of amendments recently adopted by the National Association of Securities Dealers, Inc. (NASD[®]) to NASD Rules 2820 (Variable Contracts Rule) and 2830 (Investment Company Rule). Generally, the new rules regulate compensation arrangements for the sale and distribution of variable products and investment company securities. To further facilitate member compliance with these rules, this *Notice* addresses questions that have been raised with respect to particular circumstances covered by the new rules.

Questions regarding this *Notice* may be directed to Joseph Savage, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, Inc., (NASD Regulation[®]), at (202) 728-8233; Lawrence N. Kosciulek, Assistant Director, Advertising/Investment Companies Regulation, NASD Regulation, at (202) 728-8329; and Stephanie M. Dumont, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

The Securities and Exchange Commission (SEC) approved the non-cash amendments on July 15, 1998. The new rules became effective January 1, 1999, under the implementation plan described in *Notice to Members 98-75* (*NtM 98-75*). Generally, the rules limit the manner in which members may pay or accept non-cash compensation for the sale or distribution of variable contracts and investment company securities.

Specifically, the rules:

- with limited exception, prohibit an associated person from accepting

compensation from any person other than the member with which the person is associated;

- prohibit the payment of securities as compensation;
- prohibit the acceptance of cash compensation by a member from an offeror for the sale of investment company securities unless the compensation is disclosed in a prospectus;
- permit receipt of certain *de minimis* types of non-cash compensation gifts and gratuities;
- permit, under certain conditions, payment or reimbursement in connection with training and education meetings; and
- permit non-cash compensation arrangements that are based on concepts of total production and equal weighting, are organized and run by the member, and comply with certain recordkeeping requirements.

After the publication of the non-cash rules in *NtM 98-75*, some members requested advice from NASD Regulation on how the rules would apply in particular situations. The following questions and answers are published in order to address some of these particular situations and provide additional guidance. However, the guidance contained herein is intended to be general in nature and is not intended to provide an exhaustive analysis of all non-cash arrangements subject to the rules. The facts and circumstances of various arrangements will differ, and members should feel free to seek additional advice from NASD Regulation by contacting the names listed in the Executive Summary above.

Frequently Asked Questions

Non-Cash Arrangements

Question #1: May a member conduct a non-cash contest that includes the sale of mutual funds, variable annuities, and new assets under management, where all three product categories will be included and the contest is based on total production and no preferential credits are given?

Answer: Yes. The contest is permissible provided that the member complies with all of the applicable provisions under Rule 2820(h)(4)(D) and Rule 2830(l)(5)(D). In particular, the member must ensure that the non-cash award is calculated on the basis of the equal weighting requirements of Rule 2820(h)(4)(D)(ii) and Rule 2830(l)(5)(D)(ii).

Question #2: An insurance affiliated broker/dealer sponsors and funds the costs of an annual sales meeting for its top producing 125 representatives. Production is determined by equal weighting of all variable life and annuity products sold by the representatives, with the exclusion of a proprietary variable universal life product. Instead, this product will be the basis for qualifying for a separate sales meeting sponsored by the broker/dealer's parent life insurance company. Is this permissible?

Answer: No. It would be impermissible for the broker/dealer and its parent life insurance company to conduct separate contests in the manner described, and the proposed arrangement would clearly contradict one of the basic goals of the rules, to prohibit product-specific contests. Whether the contest is sponsored by the broker/dealer or its parent life insurance company, Rule 2820(h)(4)(D) requires that the

contest include all variable products distributed by the member.

Question #3: Continuing with the same fact pattern in Question #2, if credit for the sales of fixed products was included in the non-cash arrangement, would either the member or the insurance company be required to include all fixed products and ensure that the credit given for the fixed products is equally weighted?

Answer: No. The rules do not apply to the sale of fixed insurance products.

Question #4: A salesperson is licensed to sell insurance with a life insurance company that offers proprietary variable products. The salesperson is also separately licensed to sell securities with a broker/dealer that is unaffiliated with the life insurance company. The salesperson sells the life insurance company's proprietary variable products through his broker/dealer pursuant to a dealer agreement with the company. May the salesperson attend a non-cash compensation trip sponsored by the life insurance company for the sale of its variable products?

Answer: No. Rule 2820(h)(4) prohibits an associated person from accepting non-cash compensation unless an exception applies. Rule 2820(h)(4)(D) provides an exception that permits non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an *affiliated* member. In this case, the salesperson is an associated person of an *unaffiliated* member.

Question #5: May non-cash credits to registered representatives be based on gross dealer concessions?

Answer: Yes, if the contest meets all the requirements of the rules, including the equal weighting requirement. In particular, the amounts of non-cash credits for representatives based on dealer concessions must be equally weighted among different funds.

Question #6: *NiM 98-75* states that, because of the substantial differences in design, purpose, cost structure, commission payouts, and target audience for variable annuity and variable life products, they do not need to be combined in the same incentive arrangement. Could separate contests be designed for different product categories such as non-IRA individual variable annuity products, IRA individual variable annuity products, or Roth IRA individual variable annuity products?

Answer: No. The differences in the suggested categories would not justify permissible non-cash arrangements for just those product categories.

Training And Education

Question #7: May an offeror conduct and pay for a training and education meeting for registered representatives of unaffiliated dealers that sell the offeror's products?

Answer: Yes. This arrangement is permissible so long as neither the attendance at the meeting nor the payment for the meeting is pre-conditioned on the achievement of a sales target, and approval from the member is obtained prior to the meeting.

Question #8: May attendance at training or education meetings held by an offeror be pre-conditioned on achieving certain overall targets not exclusively tied to the sale of specific mutual funds, such as gathering of a certain level of assets or opening a particular number of new accounts?

Answer: No. Rule 2830(l)(5)(C)(ii) prohibits preconditioning attendance at a training and education meeting held by an offeror "...on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (l)(5)(D)."

Question #9: May a member reimburse its associated persons for the expenses of their guests that attend training and education seminars?

Answer: Yes. However, Rules 2820(h)(4)(C)(iv) and 2830(l)(5)(C)(iv) preclude an *offeror* from making payments to reimburse guests of associated persons attending training and education seminars.

Application To Senior Management

Question #10: Do the non-cash compensation rules apply to officers or managers of the broker/dealer who are not involved in "point of sale" activities?

Answer: Yes. The non-cash compensation rules apply to *any associated person*, including officers and managers of members, if they receive, directly or indirectly, such compensation in connection with the sale and distribution of variable contracts or investment company securities.

Payment In Securities

Question #11: May an associated person receive stock (or options to purchase stock) in the publicly-traded parent of the associated person's broker/dealer?

Answer: Yes. Rule 2820(h)(2) and Rule 2830(l)(2) prohibit members and associated persons of members from receiving compensation from an offeror in the form of securities of any

kind. However, these provisions were not intended to prohibit an associated person from receiving stock or stock options of the member's parent company as compensation.

Question #12: May insurance company wholesalers receive stock options of the insurance company's parent holding company as compensation for reaching certain production levels?

Answer: Yes, as long as the specified production levels are in compliance with the equal weighting and total production requirements of Rule 2820(h)(4)(D) or Rule 2830(l)(5)(D).

Gifts And Occasional Meals, Tickets, Or Other Entertainment

Question #13: How are holiday parties, receptions, and other local events where local transportation and dinners may be provided to associated persons by offerors (and which are not organized specifically for training or educational purposes) treated?

Answer: Such items of value must be treated either as occasional meals, tickets, or comparable entertainment or as gifts and therefore subject to the limitations of Rule 2820(h)(4)(A) or (B), or Rule 2830(l)(5)(A) or (B).

Question #14: May an offeror provide a registered representative business development and educational enhancement items, such as software packages containing fund data for broker use or prospecting lists?

Answer: Yes. The provision of such items that are utilized by registered representatives for business purposes is permitted, provided that these items are not preconditioned on the achievement of a sales target.

Question #15: May an offeror reimburse a registered representative's "prospecting trip" expenses, such as travel and lodging expenses, meals during the trip, the cost of renting rooms or space for the purpose of meeting with prospects, or the cost of marketing materials to promote investment company or variable contracts sales meetings with prospects at centralized locations?

Answer: Yes, as long as the payment is made through the member and complies with the recordkeeping requirements of Rule 2820(h)(3) and 2830(l)(3) and, with respect to investment company securities, the prospectus disclosure requirements of Rule 2830(l)(4).

Question #16: Are gifts of a personal nature, such as wedding gifts or congratulatory gifts for the birth of a child, permissible?

Answer: Yes. The rules do not apply to these types of gifts.

Question #17: Are promotional items of nominal value that display the offeror's logo, such as golf balls, shirts, towels and pens, subject to the \$100 annual gift limit?

Answer: No. The rules do not apply to these types of nominal promotional items.

Prospectus Disclosure

Question #18: Rule 2830(l)(4) prohibits members from accepting cash compensation from offerors unless it is disclosed in the prospectus. In 1998, the SEC adopted amended Form N-1A as part of its effort to improve mutual fund disclosure. Under the N-1A amendments, much of the narrative disclosure regarding distribution arrangements, such as Rule 12b-1 fees, sales charges, sales charge waivers, broker reallowances, multi-class plans, and master-feeder

arrangements, is now required to be placed in the Statement of Additional Information (SAI), which is incorporated into the prospectus by reference and made available to customers upon request. May members satisfy the prospectus disclosure requirement of Rule 2830(l)(4) by placing such disclosure in the SAI?

Answer: Yes. To the extent that various cash compensation arrangements would qualify as the types of distribution arrangements now required to be disclosed in the SAI, disclosure in the SAI would satisfy the NASD disclosure requirements.

Recordkeeping

Question #19: An offeror provides cash or non-cash compensation to registered representatives of its affiliated member. May the offeror maintain on behalf of its affiliated member the records required under Rule 2820(h)(3) and Rule 2830(l)(3), so long as the records are made accessible to the member, and in

turn made available to NASD Regulation for examination?

Answer: Yes, the offeror may perform this ministerial function on behalf of its affiliated member.

Miscellaneous

Question #20: May a member contribute to a non-cash compensation program sponsored by a bank?

Answer: Yes. Rule 2830(l)(5)(E) permits contributions by a member to a non-cash arrangement of a non-member, such as a bank, provided that the arrangement conforms to the criteria in Rule 2830(l)(5)(D), including the total production and equal weighting requirements. Thus, the member making the contribution must establish procedures through which it could be reasonably assured that the non-cash arrangement of the non-member conforms to the required criteria.

Question #21: May a registered representative receive commissions

or any compensation directly from an unaffiliated product manufacturer?

Answer: Generally no. Rules 2820(h)(1) and 2830(l)(1) require that registered representatives only accept compensation from the member with whom they are associated unless, among other things, an interpretive or no-action letter specifically permits such an arrangement.

Question #22: May a member structure a non-cash arrangement that is limited only to a specific division of the firm, such as an institutional sales division that offers only certain products?

Answer: Yes, as long as any such arrangement is based on the entire universe of products that the specific division is authorized to sell and otherwise complies with the equal weighting and total production requirements of Rule 2820(h)(4)(D) or Rule 2830(l)(5)(D).

© 1999, National Association of Securities Dealers, Inc. (NASD). All rights reserved.