

April 4, 2003

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-2003-68 Amendments to the Non-Cash Compensation Provisions of NASD Rule 2710 (Corporate Financing) and Rule 2810 (Direct Participation Programs)

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions or comments, please contact Therese M. Woods, Deputy Director, Corporate Financing Department, NASD at (240) 386-4661, e-mail therese.woods@nasd.com; or Kosha K. Dalal, Assistant General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-6903, e-mail kosha.dalal@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2003-68
Consists of 37 Pages
April 4, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), NASD is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to codify in NASD Rules 2710 (Corporate Financing Rule) and 2810 (Direct Participation Programs or DPP Rule) NASD’s stated policies, practices and interpretations regarding members’ receipt of non-cash compensation in connection with the sale and distribution of securities. The express prohibitions on the receipt of non-cash compensation currently in the Corporate Financing Rule and the DPP Rule generally limit the receipt of such items to \$100 per person annually and do not include certain detailed exceptions under NASD Rules 2820 (Variable Contracts Rule) and 2830 (Investment Company Rule) for members selling mutual fund shares and variable annuities. The proposed rule changes would codify exceptions in the Variable Contracts and Investment Company Rules for members selling debt, equity, DPP and real estate investment trust (“REIT”) securities, while maintaining the current non-cash compensation prohibitions on the receipt of gifts with more than a *de minimus* value, payments and reimbursements preconditioned on the achievement of a sales target, and payments and reimbursements for travel and meetings that are not bona fide due diligence meetings or training and education meetings.

In addition, the proposed changes will codify NASD’s policy and practice of applying Interpretive Material issued by NASD staff relating to the non-cash compensation provisions uniformly and consistently to the Corporate Financing Rule, the DPP Rule, the Investment

Company Rule and the Variable Contracts Rule. Below is the text of the proposed rule change.

Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2710. Corporate Financing Rule – Underwriting Terms and Arrangements

(a) through (b) No Change.

(c) Underwriting Compensation and Arrangements

(1) through (5) No Change.

(6) Unreasonable Terms and Arrangements

(A) No Change.

(B) Without limiting the foregoing, the following terms and arrangements, when proposed in connection with the distribution of a public offering of securities, shall be unfair and unreasonable:

(i) through (xii) No Change.

(xiii) [for a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$100 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash sales incentive; or]

(xiv) – (xv) Renumbered (xiii) – (xiv).

(7) through (8) No Change.

(d) Non-Cash Compensation

(1) Definitions

The terms “compensation,” “non-cash compensation” and “offeror” as used in this Section (d) of this Rule shall have the following meanings:

(A) “Compensation” shall mean cash compensation and non-cash compensation.

(B) "Non-cash compensation" shall mean any form of compensation received in connection with the sale and distribution of securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(C) "Offeror" shall mean an issuer, an adviser to an issuer, an underwriter and any affiliated person of such entities.

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors¹ and are not preconditioned on achievement of a sales target.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (d)(2)(D);

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the issuer or affiliate thereof, the office of the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iii) the payment or reimbursement is not applied to the expenses of guests of the associated person; and (iv) the payment or reimbursement by

¹ The current annual amount fixed by the Board of Governors is \$100.

the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (d)(2)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement;
and

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (d)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by subparagraphs (d)(2)(C)-(E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with subparagraph (d)(2)(C)-(E).

(d) Renumbered as (e).

* * * * *

2810. Direct Participation Programs

(a) No Change.

(b) Requirements

(1) through (3) No Change.

(4) Organization and Offering Expenses

(A) through (D) No Change.

(E) [No member or person associated with a member shall directly or indirectly accept any non-cash compensation or sales incentive item including, but not limited to, travel bonuses, prizes, and awards offered or provided to such member or its associated persons by any sponsor, affiliate of a sponsor or program. Notwithstanding the foregoing, a member may provide non-cash compensation or sales incentive items to its associated persons provided that no sponsor, affiliate of a sponsor or program, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash compensation. Further, this subparagraph shall not prohibit a person associated with a member from accepting any non-cash sales incentive item offered directly to that person by a sponsor, affiliate of a sponsor or program where:

(i) the aggregate value of all such items paid by any sponsor or affiliate of a sponsor to each associated person during any year does not exceed \$100.00;

(ii) the value of all such items to be made available in connection with an offering is included as compensation to be received in connection with the offering for purposes of subparagraph (B); and

(iii) the proposed payment or transfer of all such items is disclosed in the prospectus or similar offering document,]

(F) Renumbered to (E).

(5) through (6) No Change.

(c) Non-Cash Compensation

(1) Definitions

The terms “compensation,” “non-cash compensation” and “offeror” as used in this Section (c) of this Rule shall have the following meanings:

(A) “Compensation” shall mean cash compensation and non-cash compensation.

(B) "Non-cash compensation" shall mean any form of compensation received in connection with the sale and distribution of direct participation securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(C) "Offeror" shall mean an issuer, sponsor, an adviser to an issuer or sponsor, an underwriter and any affiliated person of such entities.

(2) Restriction on Non-Cash Compensation

In connection with the sale and distribution of direct participation securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors¹ and are not conditioned on achievement of a sales target.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (c)(2)(D);

¹

The current annual amount fixed by the Board of Governors is \$100.

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iii) the payment or reimbursement is not applied to the expenses of guests of the associated person; and

(iv) the payment or reimbursement by the offeror is not conditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (c)(2)(D).

(D) Non - cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (c)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by subparagraphs (c)(2)(C)-(E). The records shall include: the names of the offerors, non-members or other members making the non-cash

compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with subparagraph (c)(2)(C)-(E).

(c) Renumbered as (d).

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on May 22, 2002, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on May 23, 2002. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of NASD By-Laws permits NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval. As further discussed below, NASD is filing the proposed rule change for immediate effectiveness.

(b) Questions regarding this rule filing may be directed to Therese M. Woods, Deputy Director, Corporate Financing Department at (240) 386-4661 or Kosha K. Dalal, Assistant

General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-6903.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

NASD is proposing to codify a stated policy, practice and interpretation that the more detailed non-cash compensation provisions in the Variable Contracts Rule and Investment Company Rule apply to the sale and distribution of public offerings of securities and direct participation securities as governed by the Corporate Financing Rule and DPP Rule, respectively.

NASD is proposing to conform the language in the Corporate Financing Rule and the DPP Rule to be consistent with the more detailed language contained in the Variable Contracts Rule and the Investment Company Rule. NASD staff has consistently applied the more detailed provisions in Variable Contracts Rule and the Investment Company Rule to the sale and distribution of public offerings of securities and DPP securities.

Since 1994, the Commission, NASD, and the securities industry have raised concerns about actual and potential conflicts of interest in the retail brokerage business created by a broad range of compensation practices whereby program sponsors or issuers provide incentives or rewards to individual broker/dealers and their registered representatives for selling the issuer's products. NASD staff believes that the use of non-cash compensation can create significant point-of-sale incentives that may compromise suitability determinations and heighten the potential for loss of supervisory control over sales practices. In addition, NASD staff believes that the use

of non-cash compensation incentives may result in the loss of investor confidence by increasing the perception of inappropriate practices.

Responding to these concerns, in January 1999, NASD amended the Variable Contracts Rule and the Investment Company Rule to establish comprehensive restrictions on the use of non-cash compensation in connection with the sale and distribution of investment company securities and variable contracts.² These amendments generally limited the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible. The amendments also provided limited exceptions to the non-cash compensation restrictions for payments or reimbursements that are in connection with training and education meetings. The 1999 amendments also defined certain key terms, such as “compensation” and “non-cash compensation”.

Current provisions of the Corporate Financing Rule and the DPP Rule limit the receipt of non-cash compensation by member firms and associated persons in connection with the sale and distribution of DPP securities, REIT programs, and corporate debt and equity offerings. These non-cash compensation provisions were adopted in 1988. These restrictions on the use of non-cash compensation, however, are not as comprehensive as the restrictions that were later adopted in the Variable Contracts Rule and the Investment Company Rule in 1999.

Generally, consistent with the current non-cash compensation requirements in Rules 2820 and 2830, the proposed rule change would conform the text of Rules 2710 and 2810 to Rules 2820 and 2830 to: (1) adopt definitions of the terms “compensation,” “non-cash compensation”

² See Securities Exchange Act Release No. 40214 (July 15, 1998), 63 FR 39614 (July 23, 1998), File No. SR-NASD-97-35 (May 7, 1997).

and “offeror”; (2) provide express exceptions from the non-cash compensation limitations for bona-fide training and education meetings; and (3) prohibit, with certain exceptions, members or persons associated with members from directly or indirectly accepting or paying any non-cash compensation in connection with public offerings of debt or equity securities or transactions in direct participation programs.

Consistent with Rules 2820 and 2830, the proposed rule change would provide express exceptions from the non-cash compensation provisions that would permit: (1) gifts of up to \$100 per associated person annually; (2) an occasional meal, ticket to a sporting event or theater, or comparable entertainment; (3) payment or reimbursement for training and education meetings held by broker/dealers or issuers/sponsors for the purpose of educating associated persons of broker/dealers, so long as certain conditions are met; (4) in-house sales incentive programs of broker/dealers for their own associated persons; and (5) contributions by any non-member company or other member to a broker/dealer’s permissible in-house sales incentive program, provided there is compliance with certain criteria.

NASD staff has consistently been concerned about the use of sales incentives in connection with the sale of any type of securities to a member’s customers, including transactions in DPP securities, REIT programs, and corporate debt and equity offerings. For example, these incentive programs may offer registered representatives exotic trips or expensive merchandise if they sell a specific dealer’s product. NASD believes that the potential conflicts of interest that arise from the receipt of non-cash compensation in connection with the sale of variable products and mutual fund securities also exist in connection with the sale of these types of securities.

Since January 1999, through interpretive advice, responses to exemptive requests, and in the course of the filing review process under the DPP and Corporate Financing Rules, NASD staff has consistently applied the non-cash compensation prohibitions in Rules 2820 and 2830 to sales of variable annuities, mutual funds, DPP securities, REIT programs, and corporate debt and equity offerings. Accordingly, although training and education meetings are not specifically permitted under the DPP and Corporate Financing Rule, NASD has recognized that bona fide training and education meetings that meet the strict requirements set out in the Variable Contracts Rule and Investment Company Rule can be held consistent with the non-cash compensation prohibitions.

DPP Rule. Paragraph (b)(4)(E) of the DPP Rule currently prohibits a member or associated person from accepting, directly or indirectly, non-cash compensation or sales incentive items from any sponsor or affiliate of a sponsor, unless the following requirements are satisfied: (1) the aggregate value of all such items received annually does not exceed \$100; (2) the value of all such items is included as compensation received in connection with the offering; and (3) the proposed payment of such items is disclosed in the prospectus.

The Rule currently does not contain an exception for training and education meetings. Through interpretive advice, NASD has approved members' receipt of non-cash compensation in connection with bona-fide training and education meetings. NASD considers such a meeting to be one that educates registered representatives and assists them in making a suitability determination regarding a DPP product for their customers and that is otherwise in compliance with the training and education provisions of Rules 2820 and 2830. In Notice to Members 85-29

(April 1985), NASD announced that reimbursement for training and education meetings is permitted under the DPP Rule if the expenses are recognized as underwriting compensation, disclosed in the prospectus, and come within the 10% limit on underwriting compensation permitted under the Rule. NASD staff has applied the 10% compensation limit and training and education policies in the DPP Rule set forth in NASD Notice to Members 85-29 to REIT offerings that are filed with the Corporate Financing Department under the Corporate Financing Rule.

Corporate Financing Rule. Although the rule language of the non-cash compensation provision in the Corporate Financing Rule is different from the language of the non-cash compensation provision in the DPP Rule, paragraph (c)(6)(B)(xiii) of the Corporate Financing Rule currently contains a provision that prohibits a member or associated person from accepting, directly or indirectly, non-cash compensation or sales incentive items in excess of \$100 per person per issuer annually from any issuer or affiliate thereof. The Rule does not contain an exception for training and education meetings.

Training and Education Meetings. Currently, both the Variable Contracts Rule and the Investment Company Rule contain an express exception to the non-cash compensation provisions for training and education meetings that the industry believes are necessary to educate representatives about their products. The Rules, however, contain conditions that must be satisfied before the exception can be used. Specifically, they require prior approval of attendance by the associated person from his or her member firm, satisfaction of the recordkeeping requirements, that attendance at the meeting not be preconditioned on the achievement of a sales

target, the location of the meeting be an office of the offeror or facility in the vicinity of the office, and no reimbursement will be provided for expenses of a guest.

Since the adoption of these provisions, NASD has issued strict guidelines on the appropriate use of the training and education exception through *Regulatory & Compliance Alerts*, interpretive letters, and other correspondence with members. This guidance has stated that a sponsor is not permitted to pay for certain expenses in connection with a training and education meeting, including, but not limited to, golf outings, cruises, tours, and other entertainment. NASD believes that amending the non-cash compensation provisions of the DPP and Corporate Financing Rules will codify stated policy, practice and interpretive advice and make these rules generally consistent with those governing variable annuities and mutual funds. The amendments also will allow this body of interpretive guidance to be applied consistently with respect to training and education meetings relating to any of the relevant products.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes the proposed rule change will make the non-cash compensation provisions of the Corporate Financing Rule and the DPP Rule comparable to the more detailed non-cash compensation provisions that are currently in the Variable Contracts Rule and the Investment Company Rule. The proposed rule change also will codify NASD's policy and practice of applying Interpretive

Material issued by NASD staff relating to the non-cash compensation provisions uniformly and consistently to all four rules.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A)(ii) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder, in that the proposed rule change constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

NASD

BY: _____
Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

Date: April 4, 2003

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- [leave space] ; File No. SR-NASD-2003-68)
[leave space for date]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend the Non-Cash Compensation Provisions in NASD Rules 2710 and 2810 to be Consistent with the Non-Cash Compensation Provisions in NASD Rules 2820 and 2830

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on April __, 2003, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. NASD has designated the proposed rule change as one that constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule pursuant to paragraph (f)(1) of Rule 19b-4 under the Act³, which renders the proposed rule change effective upon receipt of the filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing a proposed rule change to codify in NASD Rules 2710 (Corporate Financing Rule) and 2810 (Direct Participation Programs or DPP Rule) NASD's

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR 240.19b-4(f)(1).

stated policies, practices and interpretations regarding members' receipt of non-cash compensation in connection with the sale and distribution of securities. The express prohibitions on the receipt of non-cash compensation currently in the Corporate Financing Rule and the DPP Rule generally limit the receipt of such items to \$100 per person annually and do not include certain detailed exceptions under NASD Rules 2820 (Variable Contracts Rule) and 2830 (Investment Company Rule) for members selling mutual fund shares and variable annuities. The proposed rule changes would codify exceptions in the Variable Contracts and Investment Company Rules for members selling debt, equity, DPP and real estate investment trust ("REIT") securities, while maintaining the current non-cash compensation prohibitions on the receipt of gifts with more than a *de minimus* value, payments and reimbursements preconditioned on the achievement of a sales target, and payments and reimbursements for travel and meetings that are not bona fide due diligence meetings or training and education meetings.

In addition, the proposed changes will codify NASD's policy and practice of applying Interpretive Material issued by NASD staff relating to the non-cash compensation provisions uniformly and consistently to the Corporate Financing Rule, the DPP Rule, the Investment Company Rule and the Variable Contracts Rule. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2710. Corporate Financing Rule – Underwriting Terms and Arrangements

(a) through (b) No Change.

(c) Underwriting Compensation and Arrangements

(1) through (5) No Change.

(6) Unreasonable Terms and Arrangements

(A) No Change.

(B) Without limiting the foregoing, the following terms and arrangements, when proposed in connection with the distribution of a public offering of securities, shall be unfair and unreasonable:

(i) through (xii) No Change.

(xiii) [for a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$100 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash sales incentive; or]

(xiv) – (xv) Renumbered (xiii) – (xiv).

(7) through (8) No Change.

(d) Non-Cash Compensation

(1) Definitions

The terms “compensation,” “non-cash compensation” and “offeror” as used in this Section (d) of this Rule shall have the following meanings:

(A) “Compensation” shall mean cash compensation and non-cash compensation.

(B) "Non-cash compensation" shall mean any form of compensation received in connection with the sale and distribution of securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(C) "Offeror" shall mean an issuer, an adviser to an issuer, an underwriter and any affiliated person of such entities.

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors¹ and are not preconditioned on achievement of a sales target.

¹ The current annual amount fixed by the Board of Governors is \$100.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (d)(2)(D);

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the issuer or affiliate thereof, the office of the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iii) the payment or reimbursement is not applied to the expenses of guests of the associated person; and (iv) the payment or reimbursement by the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (d)(2)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (d)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by subparagraphs (d)(2)(C)-(E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with subparagraph (d)(2)(C)-(E).

(d) Renumbered as (e).

* * * * *

2810. Direct Participation Programs

(a) No Change.

(b) Requirements

(1) through (3) No Change.

(4) Organization and Offering Expenses

(A) through (D) No Change.

(E) [No member or person associated with a member shall directly or indirectly accept any non-cash compensation or sales incentive item including, but not limited to, travel bonuses, prizes, and awards offered or provided to such member or its associated persons by any sponsor, affiliate of a sponsor or program. Notwithstanding the foregoing, a member may provide non-cash compensation or sales incentive items to its associated persons provided that no sponsor, affiliate of a sponsor or program, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash compensation. Further, this subparagraph shall not prohibit a person associated with a member from accepting any non-cash sales incentive item offered directly to that person by a sponsor, affiliate of a sponsor or program where:

(i) the aggregate value of all such items paid by any sponsor or affiliate of a sponsor to each associated person during any year does not exceed \$100.00;

(ii) the value of all such items to be made available in connection with an offering is included as compensation to be received in connection with the offering for purposes of subparagraph (B); and

(iii) the proposed payment or transfer of all such items is disclosed in the prospectus or similar offering document,]

(F) Renumbered to (E).

(5) through (6) No Change.

(c) Non-Cash Compensation

(1) Definitions

The terms “compensation,” “non-cash compensation” and “offeror” as used in this Section (c) of this Rule shall have the following meanings:

(A) “Compensation” shall mean cash compensation and non-cash compensation.

(B) "Non-cash compensation" shall mean any form of compensation received in connection with the sale and distribution of direct participation securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(C) "Offeror" shall mean an issuer, sponsor, an adviser to an issuer or sponsor, an underwriter and any affiliated person of such entities.

(2) Restriction on Non-Cash Compensation

In connection with the sale and distribution of direct participation securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors¹ and are not conditioned on achievement of a sales target.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (c)(2)(D);

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iii) the payment or reimbursement is not applied to the expenses of guests of the associated person; and

¹ The current annual amount fixed by the Board of Governors is \$100.

(iv) the payment or reimbursement by the offeror is not conditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (c)(2)(D).

(D) Non - cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement;
and

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (c)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by subparagraphs (c)(2)(C)-(E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with subparagraph (c)(2)(C)-(E).

(c) Renumbered as (d).

* * * * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

NASD is proposing to codify a stated policy, practice and interpretation that the more detailed non-cash compensation provisions in the Variable Contracts Rule and Investment Company Rule apply to the sale and distribution of public offerings of securities and direct participation securities as governed by the Corporate Financing Rule and DPP Rule, respectively.

NASD is proposing to conform the language in the Corporate Financing Rule and the DPP Rule to be consistent with the more detailed language contained in the Variable Contracts Rule and the Investment Company Rule. NASD staff has consistently applied the more detailed provisions in Variable Contracts Rule and the Investment Company Rule to the sale and distribution of public offerings of securities and DPP securities.

Since 1994, the Commission, NASD, and the securities industry have raised concerns about actual and potential conflicts of interest in the retail brokerage business created by a broad range of compensation practices whereby program sponsors or issuers provide incentives or

rewards to individual broker/dealers and their registered representatives for selling the issuer's products. NASD staff believes that the use of non-cash compensation can create significant point-of-sale incentives that may compromise suitability determinations and heighten the potential for loss of supervisory control over sales practices. In addition, NASD staff believes that the use of non-cash compensation incentives may result in the loss of investor confidence by increasing the perception of inappropriate practices.

Responding to these concerns, in January 1999, NASD amended the Variable Contracts Rule and the Investment Company Rule to establish comprehensive restrictions on the use of non-cash compensation in connection with the sale and distribution of investment company securities and variable contracts.⁴ These amendments generally limited the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible. The amendments also provided limited exceptions to the non-cash compensation restrictions for payments or reimbursements that are in connection with training and education meetings. The 1999 amendments also defined certain key terms, such as "compensation" and "non-cash compensation".

Current provisions of the Corporate Financing Rule and the DPP Rule limit the receipt of non-cash compensation by member firms and associated persons in connection with the sale and distribution of DPP securities, REIT programs, and corporate debt and equity offerings. These non-cash compensation provisions were adopted in 1988. These restrictions on the use of non-

⁴ See Securities Exchange Act Release No. 40214 (July 15, 1998), 63 FR 39614 (July 23, 1998), File No. SR-NASD-97-35 (May 7, 1997).

cash compensation, however, are not as comprehensive as the restrictions that were later adopted in the Variable Contracts Rule and the Investment Company Rule in 1999.

Generally, consistent with the current non-cash compensation requirements in Rules 2820 and 2830, the proposed rule change would conform the text of Rules 2710 and 2810 to Rules 2820 and 2830: (1) adopt definitions of the terms “compensation,” “non-cash compensation” and “offeror”; (2) provide express exceptions from the non-cash compensation limitations for bona-fide training and education meetings; and (3) prohibit, with certain exceptions, members or persons associated with members from directly or indirectly accepting or paying any non-cash compensation in connection with public offerings of debt or equity securities or transactions in direct participation programs.

Consistent with Rules 2820 and 2830, the proposed rule change would provide express exceptions from the non-cash compensation provisions that would permit: (1) gifts of up to \$100 per associated person annually; (2) an occasional meal, ticket to a sporting event or theater, or comparable entertainment; (3) payment or reimbursement for training and education meetings held by broker/dealers or issuers/sponsors for the purpose of educating associated persons of broker/dealers, so long as certain conditions are met; (4) in-house sales incentive programs of broker/dealers for their own associated persons; and (5) contributions by any non-member company or other member to a broker/dealer’s permissible in-house sales incentive program, provided there is compliance with certain criteria.

NASD staff has consistently been concerned about the use of sales incentives in connection with the sale of any type of securities to a member’s customers, including transactions

in DPP securities, REIT programs, and corporate debt and equity offerings. For example, these incentive programs may offer registered representatives exotic trips or expensive merchandise if they sell a specific dealer's product. NASD believes that the potential conflicts of interest that arise from the receipt of non-cash compensation in connection with the sale of variable products and mutual fund securities also exist in connection with the sale of these types of securities.

Since January 1999, through interpretive advice, responses to exemptive requests, and in the course of the filing review process under the DPP and Corporate Financing Rules, NASD staff has consistently applied the non-cash compensation prohibitions in Rules 2820 and 2830 to sales of variable annuities, mutual funds, DPP securities, REIT programs, and corporate debt and equity offerings. Accordingly, although training and education meetings are not specifically permitted under the DPP and Corporate Financing Rule, NASD has recognized that bona fide training and education meetings that meet the strict requirements set out in the Variable Contracts Rule and Investment Company Rule can be held consistent with the non-cash compensation prohibitions.

DPP Rule. Paragraph (b)(4)(E) of the DPP Rule currently prohibits a member or associated person from accepting, directly or indirectly, non-cash compensation or sales incentive items from any sponsor or affiliate of a sponsor, unless the following requirements are satisfied: (1) the aggregate value of all such items received annually does not exceed \$100; (2) the value of all such items is included as compensation received in connection with the offering; and (3) the proposed payment of such items is disclosed in the prospectus.

The Rule currently does not contain an exception for training and education meetings. Through interpretive advice, NASD has approved members' receipt of non-cash compensation in connection with bona-fide training and education meetings. NASD considers such a meeting to be one that educates registered representatives and assists them in making a suitability determination regarding a DPP product for their customers and that is otherwise in compliance with the training and education provisions of Rules 2820 and 2830. In Notice to Members 85-29 (April 1985), NASD announced that reimbursement for training and education meetings is permitted under the DPP Rule if the expenses are recognized as underwriting compensation, disclosed in the prospectus, and come within the 10% limit on underwriting compensation permitted under the Rule. NASD staff has consistently applied the 10% compensation limit and training and education policies in the DPP Rule set forth in NASD Notice to Members 85-29 to REIT offerings that are filed with the Corporate Financing Department under the Corporate Financing Rule.

Corporate Financing Rule. Although the rule language of the non-cash compensation provision in the Corporate Financing Rule is different from the language of the non-cash compensation provision in the DPP Rule, paragraph (c)(6)(B)(xiii) of the Corporate Financing Rule currently contains a provision that prohibits a member or associated person from accepting, directly or indirectly, non-cash compensation or sales incentive items in excess of \$100 per person per issuer annually from any issuer or affiliate thereof. The Rule does not contain an exception for training and education meetings.

Training and Education Meetings. Currently, both the Variable Contracts Rule and the Investment Company Rule contain an express exception to the non-cash compensation provisions for training and education meetings that the industry believes are necessary to educate representatives about their products. The Rules, however, contain conditions that must be satisfied before the exception can be used. Specifically, they require prior approval of attendance by the associated person from his or her member firm, satisfaction of the recordkeeping requirements, that attendance at the meeting not be preconditioned on the achievement of a sales target, the location of the meeting be an office of the offeror or facility in the vicinity of the office, and no reimbursement will be provided for expenses of a guest.

Since the adoption of these provisions, NASD has issued strict guidelines on the appropriate use of the training and education exception through *Regulatory & Compliance Alerts*, interpretive letters, and other correspondence with members. This guidance has stated that a sponsor is not permitted to pay for certain expenses in connection with a training and education meeting, including, but not limited to, golf outings, cruises, tours, and other entertainment. NASD believes that amending the non-cash compensation provisions of the DPP and Corporate Financing Rules will codify stated policy, practice and interpretive advice and make these rules generally consistent with those governing variable annuities and mutual funds. The amendments also will allow this body of interpretive guidance to be applied consistently with respect to training and education meetings relating to any of the relevant products.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes the proposed rule change will make the non-cash compensation provisions of the Corporate Financing Rule and the DPP Rule comparable to the more detailed non-cash compensation provisions that are currently in the Variable Contracts Rule and the Investment Company Rule. The proposed rule change also will provide expressly that NASD Interpretive Materials will apply to all four rules.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A)(ii) of the Act⁵ and paragraph (f)(1) of Rule 19b-4⁶ thereunder, in that the proposed rule change

⁵ 15 U.S.C. S78s(b)(3)(A)(ii).

⁶ 17 CFR S240.19b-4(f)(1).

constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule.

At any time within 60 days of this filing, the Commission may summarily abrogate this proposal if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland
Deputy Secretary