



The Commonwealth of Massachusetts
Secretary of the Commonwealth
State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth
August 5, 2005

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1506

RE: Proposal to Prohibit All Product-Specific Sales Contests and to Apply Non-Cash Compensation Rules to Sales of All Securities (NASD Notice to Members 05-40)

Dear Ms. Sweeney:

The Massachusetts Securities Division appreciates this opportunity to comment on NASD Notice to Members 05-40, regarding product-specific sales contests and non-cash broker compensation.

The Massachusetts Securities Division is a department within the Office of the Secretary of the Commonwealth of Massachusetts. The Securities Division is charged with the responsibility to implement and enforce the Massachusetts securities laws. As such, the Secretary of the Commonwealth is the chief securities regulator for Massachusetts.

Introduction.

The Massachusetts Securities Division recognizes that the proposals on sales contests and non-cash compensation would, to a certain degree, improve the NASD's existing rules. However, we urge the NASD to take stronger remedial action against abuses in these areas by: (1) banning sales contests of all kinds, and (2) severely restricting the permitted types of non-cash compensation available to brokers.

The rule changes described in NTM 05-40 would replace the current rules governing non-cash compensation and sales contests with new NASD Rule 2311. The proposed rule would tighten existing NASD rules by applying those rules to all kinds of securities, rather than just certain types, such as investment company securities, direct participation programs, variable insurance contracts, and public offerings of REITs. The proposed rule also would prohibit all product-specific cash and non-cash "sales contests" as defined in the rule.

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Background and Discussion.

Current Rules Governing Non-Cash Compensation and Sales Contests.

The NASD seeks to extend its current rules which limit the ways that non-cash compensation can be provided to selling agents. For example, the NASD rules permit:

- (1) Gifts that do not exceed \$100 per year and that are not preconditioned on achievement of a sales target;
- (2) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment that is neither so frequent nor so extensive as to raise any question of propriety; and is not preconditioned on the achievement of a sales target;
- (3) Reimbursement by the offerors of securities in connection with meetings held by an offeror, or by a member firm for training and education, provided the arrangement meets certain criteria;
- (4) Non-cash compensation arrangements between a member firm and its associated persons, or a non-member company and its sales personnel who are associated persons of an affiliated member, provided the arrangement meets certain criteria; and
- (5) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, or contributions by a member to a non-cash compensation arrangement of a non-member, provided the arrangement meets the requirements for a non-cash compensation arrangement between a member and its associated person.

Current NASD rules permit a member firm to hold internal non-cash sales contests with respect to the sale of investment company securities or variable insurance products, provided the contest is based on total production and the credit for each type of security sold is equally weighted (with no preference for particular types of products). This exception permits sales contests that award credit for all sales within a particular category of securities (e.g., all sales of mutual funds), subject to the total production and equal weighting requirements.

The new proposal makes the prohibitions relating to non-cash compensation applicable to all types of securities, as the conflicts underlying the prohibitions exist with respect to all securities. The NASD states in the rule proposal that it believes that product-specific sales contests—even those that conform to the total production and equal weighting requirements of the current non-cash rules—should be prohibited.

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Sales Contests.

We urge the NASD to ban sales contests of all kinds. Contests have been a continuing source of regulatory problems. And as the rule proposal acknowledges, sales contests create severe conflicts of interest for securities sales personnel.

Contests increase the conflicts of interest that sales personnel already face by providing increased compensation for selling more securities and financial products, and by focusing the pressure to make sales within a limited timeframe (before the contest deadline). In the face of these pressures, the best interests of customers and the implementation of the best investment strategies for customers can be lost.

Contests incentivize selling. We have never encountered a contest to promote more suitable sales and we have never seen a contest aimed at saving customers fees and expenses. Instead, contests pit the interests of selling personnel directly against the interests of customers.

We note that investors are virtually never told about sales contests. Investors would clearly wish to know this material information, particularly since a contest is likely to create a strong incentive for a broker to recommend transactions of some kind in a customer's account.

Current NASD rules attempt to control the conflicts of interest that contests create by requiring that any contest be based on a broker's total production and that all products be equally weighted. We observe that the products sold by large brokerages are seldom "equally weighted." Many large brokerages purport to make available a wide array of mutual funds, often from dozens or even a hundred fund families. But in practice, many brokerages put most customers into just a few funds and fund families; these favored funds are typically proprietary funds or non-affiliated funds that pay "revenue sharing" and other kinds of compensation to the brokerage firm. In view of these practices, sales contests will only increase pressures to sell a brokerage's favored mutual funds.

An example of the detrimental impact that sales contests have on retail investors is found in the NASD's 2003 case against Morgan Stanley DW, Inc. (see, Disciplinary and Other NASD Actions, October 2003, page D18). While the NASD action focused on Morgan Stanley's structuring its contests to promote the sale of particular funds, the case gives a clear picture of the pressures and incentives that contests create for sales personnel. Moreover, it is clear that the contests led to substantially increased fund sales, which increased profits for Morgan Stanley, but at a cost to the investment needs of its customers.

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Non-Cash Compensation Rules.

Non-cash compensation creates a variety of problems relating to the offer and sale of securities. We urge that most types of non-cash compensation be banned, and the few permitted types of non-cash compensation be watched vigilantly.

Non-cash compensation is often invisible to customers, who certainly would want to know if such compensation is being paid to the broker and the amount paid.

The distribution of items such as tickets to sports events, entertainment, and meals has been a source of serious regulatory problems. We note in this regard press reports that the U.S. Securities and Exchange Commission is considering a civil enforcement action against a Boston-based mutual fund company for violations relating to gifts and gratuities.

The fact that gratuities like tickets and meals are often available gives rise to a culture of sales personnel expecting, and sometimes demanding, these benefits. These benefits can form part of a web of reciprocal favors that are traded amongst brokers, traders, and the sponsors of financial products. As these benefits and favors are exchanged, the best interests of customers are often traded away.

The most egregious non-cash compensation is often tied to the sale of proprietary mutual funds or to high-fee, high-risk products like direct participation programs. In this regard, we note the NASD's 2003 case against Leo F. Wells and Wells Investment Services for violations relating to "educational conferences" that were actually lavish affairs held at resorts (NASD Case #CAF30046). The Wells meetings included rounds of golf, accommodations for brokers' guests, fireworks displays, and "beach bash" and "sock hop" parties. Wells is a sponsor of non-traded REITs: products that carry some of the highest selling compensation and that charge high ongoing fees. Such products are unsuitable for many retail investors, yet brokers are presented with tremendous incentives, including non-cash compensation, to sell customers those products.

Most forms of non-cash compensation should simply be abolished. In light of the chronic problems in this area, it is our view that only two forms of non-cash selling compensation are justifiable:

-*De minimis* items (the current limit is up to \$100); and

-True educational meetings and seminars. We urge that any rulemaking on this issue should place the burden on member firms and their compliance staff to assure that such meetings are truly educational and will not become a form of selling compensation or bonus.

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In the event that the new rule continues to allow non-cash compensation in the form of an occasional meal, event ticket, or comparable entertainment, we strongly believe that the current standard applicable to this type of entertainment needs to be defined with more particularity. Based on recent investigations, we have found that the current standard is widely misinterpreted and open to abuse. As a result, we urge that the standard allowing "entertainment that is neither so frequent nor so extensive as to raise any question of propriety," be defined with more clarity, perhaps by setting an annual dollar limitation similar to that applicable to gifts.

If you have any questions about this letter, or we can assist you in any way, please contact me or Bryan Lantagne, Director of the Massachusetts Securities Division, at (617) 727-3548.

Sincerely,



William F. Galvin
Secretary of the Commonwealth