

Notice to Members

SEPTEMBER 2003

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

KEY TOPICS

Rule 2710
Rule 2810
Non-Cash Compensation Provisions
Rule Modernization

INFORMATIONAL

Non-Cash Compensation

SEC Announces Immediate Effectiveness of Amendments to Non-Cash Compensation Provisions of Rule 2710 and Rule 2810

Executive Summary

On April 7, 2003, NASD filed with the Securities and Exchange Commission (SEC) for immediate effectiveness a proposed rule change to codify existing staff interpretations regarding the non-cash compensation provisions in Rule 2710 (Corporate Financing Rule) and Rule 2810 (Direct Participation Program or DPP Rule) and to make the rule text in such Rules consistent with the non-cash compensation provisions in Rule 2820 (Variable Contracts Rule) and Rule 2830 (Investment Company Rule).¹ The rule change has become effective as of April 7, 2003.

Rule 2710 and Rule 2810, as amended, are set forth in Attachment A.

Questions concerning this *Notice* may be directed to Therese M. Woods, Deputy Director, Corporate Financing Department, NASD, at (240) 386-4661; or Kosha K. Dalal, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-6903.

Background and Discussion

Since 1994, the SEC, 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 and Investment Company Rules 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.”

Since January 1999, through interpretive advice, responses to exemptive requests, and in the course of the filing review process under the Corporate Financing and DPP Rules, NASD staff has consistently applied the non-cash compensation prohibitions in the Variable Contracts and Investment Company Rules to sales of variable annuities, mutual funds, DPP securities, public offerings of debt and equity securities, and real estate investment trust (REIT) programs. Although training and education meetings were not permitted under the original non-cash compensation provisions of the Corporate Financing and DPP Rules, NASD has recognized that *bona-fide* training and education meetings that meet the strict requirements set out in the Variable Contracts and Investment Company Rules can be held consistent with the non-cash compensation prohibitions.

The amendments to the Corporate Financing and DPP Rules codify a stated policy, practice, and interpretation that the more detailed non-cash compensation provisions in the Variable Contracts and Investment Company Rules apply to the sale and distribution of securities governed by the Corporate Financing and DPP Rules. NASD is conforming the language in the Corporate Financing and DPP Rules to be consistent with the more detailed language contained in the Variable Contracts and Investment Company Rules by: (1) adopting definitions of the terms “compensation,” “non-cash compensation” and “offeror”; (2) providing express exceptions from the non-cash compensation limitations for *bona-fide* training and education meetings; and (3) prohibiting, 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, REIT programs, or DPP securities.

Consistent with the Variable Contracts and Investment Company Rules, the rule amendments 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.

The amendments to the Corporate Financing and DPP Rules codify the application of the training and education meetings exception, and corresponding interpretive guidance, to the sale and distribution of public offerings of debt and equity securities, REIT programs, and DPPs. Currently, the Variable Contracts and Investment Company Rules 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 two rules, however, contain conditions that must be satisfied before the exception can be used. Specifically, they require the following: receipt of 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; that the location of the meeting be appropriate and meet certain requirements;³ and that no reimbursement 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.

Effective Date

The rule amendments were effective immediately upon filing with the Commission, which was April 7, 2003.

Endnotes

- 1 See Securities Exchange Act Release No. 47697 (April 18, 2003), 68 FR 20191 (April 24, 2003) (Notice of Filing and Immediate Effectiveness of File No. SR-NASD-2003-68 (April 7, 2003)).
- 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).
3. The non-cash compensation provisions specify that the location of a training and education meeting must be 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.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

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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

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

(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).

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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

(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).

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

(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).

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