

ACTION REQUESTED BY OCTOBER 29, 1999

Salesperson Compensation Practices

NASD Regulation
Requests Comment on
Proposed Salesperson
Compensation Rules;
Comment Period
Expires October 29,
1999

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Legal & Compliance
- Mutual Funds
- Registered Representatives
- Senior Management

KEY TOPICS

- Associated Persons of Members
- Compensation
- Investment Company Securities

Executive Summary

NASD Regulation, Inc. (NASD Regulation®) requests comment from National Association of Securities Dealers, Inc. (NASD®) members, investors, and other interested parties on the following three rule proposals which relate to salesperson compensation: (1) a rule prohibiting the payment of higher payout ratios to salespersons for the sale of proprietary investment company products; (2) a rule prohibiting single security sales contests; and (3) a rule requiring disclosure of accelerated payout arrangements for salespersons who change firms.

Included with this *Notice* are Attachment A (the text of the proposed amendments) and Attachment B (general questions that NASD Regulation requests comments on from members and interested parties).

Request For Comment

NASD Regulation encourages all members, investors, and interested parties to comment on the proposed rules. Comments must be received by **October 29, 1999**. For each proposal, we have included questions for you to consider in drafting your response. In addition, for your convenience, we have provided a checklist (see Attachment B) so that in a minimum amount of time you can provide NASD Regulation with your general comments.

Note: Each *Notice to Members* may contain different and more specific questions we encourage you to consider. While information concerning how many members are generally for or against a proposal is important to the Board, because this is not a vote in considering whether to proceed with or modify a proposal, the Board will also heavily rely upon information and data concerning the substantive merits

of a proposal. Therefore, even when using the checklist, we encourage you to provide any specific comments you can.

Members and interested parties can submit their comments using the following methods:

- 1) mailing in the checklist (Attachment B)
- 2) mailing in written comments
- 3) e-mailing written comments
- 4) submitting comments online at the NASDR Web Site (www.nasdr.com)

If you decide to send comments using both the checklist and one of the other methods listed above, please let us know. The checklist and/or written comments should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

You may also e-mail comments to:
pubcom@nasd.com

The only comments that will be considered are those submitted via e-mail or in writing.

Before becoming effective, the NASD Regulation Board of Directors must adopt, and the Securities and Exchange Commission (SEC) must approve, any rule change. The NASD Board of Governors also may review the rule change.

Questions/Further Information

As noted, written comments should be submitted to Joan C. Conley. Questions concerning this *Notice to Members—Request for Comments* may be directed to Louise Corso,

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Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-6939; or Stephanie M. Dumont, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

Historically, NASD Regulation has not attempted to regulate the internal compensation arrangements of member firms and their representatives. In general, examination of compensation practices at firms has been done on a case-by-case basis and has taken into account the nature of the firm's business and structure. In the early 1990s, SEC Chairman Arthur Levitt sought broader information about compensation practices throughout the securities industry. Chairman Levitt formed an industry committee that issued a report on compensation practices in 1995, known as the Tully Report. This report described a number of compensation practices that exist in the securities industry that may create conflicts of interest for member firms and their representatives. The Tully Report also identified best practices to address these actual or perceived conflicts of interest.

In *Notice to Members 97-50*, NASD Regulation sought member comment on cash compensation issues relating to the sale and distribution of investment company and variable contract securities. The cash compensation arrangements included, for example, the offering of higher commissions for sale of proprietary products (those sponsored by the member or an affiliated company) as compared to non-proprietary products, and the offering of cash awards for sales contests. The *Notice* asked generally whether certain forms of incentive-based cash compensation were harmful or

beneficial to investors. We also asked for comment on possible regulatory responses, such as requiring disclosure or prohibiting certain compensation practices. We did not propose any specific rules at that time, but rather solicited comments on a broad range of issues relating to compensation.

In response, we received 20 comment letters from member firms, individual representatives, and other interested parties. Most commenters generally favored the continued application of current sales practice and suitability rules or, alternatively, some form of generic disclosure for cash compensation practices. Some commenters, however, recognized that certain practices create particularly strong point-of-sale incentives or "product favoritism" and felt that it was important to distinguish those practices from other cash compensation arrangements between offerors and broker/dealers that are not passed on to salespersons and do not create such incentives.

In 1998, the SEC approved amendments to Rules 2820 and 2830 regulating non-cash compensation arrangements in the sale of variable contracts and investment company securities, respectively ("Non-Cash Compensation Rules"). As described in *Notice to Members 98-75*, the Non-Cash Compensation Rules limit the manner in which members can pay or accept non-cash compensation and impose certain recordkeeping requirements. "Non-cash" compensation includes, for example, merchandise offered to brokers, gifts and prizes, or reimbursement of travel expenses. These rules are based on the belief that the increased use of non-cash compensation creates significant point-of-sale incentives that may compromise the requirement to match the investment needs of the

customer with the most appropriate investment product. The Non-Cash Compensation Rules do permit certain non-cash compensation arrangements that are based on total production and equal weighting of sales of a variety of products and are organized and run by the member or certain affiliates. In addition, with limited exceptions, the Non-Cash Compensation Rules prohibit a person associated with a member from accepting any compensation, cash or non-cash, from any person other than the member with which the person is associated.

Discussion

We are soliciting comment on certain compensation practices described as problematic in the Tully Report, as well as three rule proposals addressing such practices. A number of NASD Regulation committees, including the District Committees, the Small Firm Advisory Board, the Membership Committee, the Investment Companies Committee, and the Bank Broker/Dealer Committee, had the opportunity to review and comment on some or all of the three potential regulatory responses proposed in this *Notice*. Committee members expressed a wide range of opinions in discussing these topics. We have incorporated many of the committees' suggestions in the proposals and questions presented in this solicitation of comment. We are publishing these rule proposals for comment to the full membership to give all members and other interested parties an opportunity to express their views as well.

Specifically, we are requesting comment on rule proposals to address the following compensation practices:

- Payment of higher payout ratios to representatives for the sale

of proprietary investment company products;

- Single security sales contests; and
- “Accelerated payouts,” which are higher commission payouts offered to representatives who move from one broker/dealer to another.

We are also requesting comment on additional issues regarding current salesperson compensation practices. Commenters should consider the need to provide members and associated persons the flexibility to structure compensation arrangements in the most effective manner possible in accordance with their business requirements, while addressing any investor protection concerns that may result.

Payment Of Differential Cash Compensation

Compensation Practice: The Tully Report concluded that the payment of higher compensation to registered representatives for the sale of proprietary products can create incentives to inappropriately favor such products over non-proprietary products. Such compensation arrangements can create conflicts of interest by encouraging representatives to recommend proprietary products to maximize their commissions, rather than to best meet their customers' needs. Such arrangements may provide point-of-sale incentives that could compromise proper customer suitability determinations and may present a situation where the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers. In this regard, the Tully Report cited as a “best practice” the use of identical payout ratios for representatives that offer both proprietary and non-proprietary

products, noting that most firms interviewed had already adopted this practice.

The Proposal: NASD Regulation is proposing for comment the attached amendment to NASD Rule 2830, which applies to the sale and distribution of investment company securities. The proposed amendment prohibits the payment of a higher percentage of gross dealer concessions to representatives for the sale of proprietary investment company securities than the percentage provided on the same dollar amount of non-proprietary investment company securities with similar investment objectives.

Although firms use differential compensation arrangements for a variety of products, the importance of mutual funds to retail investors may make differential payouts involving investment company products of particular concern, and we have therefore limited our current proposal to those types of products. However, NASD Regulation is soliciting comments on the extent to which these restrictions should extend to other kinds of products as well.

Commenters are asked to consider the proposed rule as well as any alternative regulatory approaches to such compensation arrangements. One option would permit such differential compensation arrangements to continue, but require oral or written disclosure to customers at or before the point of sale. A disclosure approach would be consistent with the NASD's long-standing practice of not substantively regulating internal compensation arrangements of member firms and their registered representatives and instead permitting investors to evaluate whether a registered representative's particular product recommendation was influenced by such arrangements.

However, as noted by the NASD Regulation committees, questions arise as to the form and timing of such disclosures, as well as the message that such a disclosure may send to customers, implying, for example, that representatives may not have their customers' best interests in mind. Further, customers are rarely in a position to evaluate the impact of a compensation arrangement on the ultimate recommendation. Commenters in favor of a disclosure approach are asked to provide input on the type of information that would be useful to investors and the format and timing of such a disclosure. In addition, commenters are asked to discuss the firm's ability to monitor and enforce a disclosure requirement in this area.

NASD Regulation also recognizes that existing commission-based compensation systems reflect legitimate business considerations that derive from a competitive market. For example, certain fund issuers may provide additional compensation to members in order to encourage their representatives to learn more about their products and how those products can help customers meet their investment objectives. NASD Regulation would appreciate any comments on the effect this proposal may have on such strategic business considerations or initiatives.

Finally, NASD Regulation is soliciting views on whether these types of compensation arrangements and the resulting potential conflicts of interest are adequately addressed under existing NASD rules. For example, when recommending to a customer the purchase, sale, or exchange of any security, NASD Rule 2310 requires that the member have reasonable grounds for believing that the recommendation is suitable for the customer. Would these potential conflicts of interest be

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adequately addressed through the provision of more detailed guidance concerning the applicability of the suitability requirements?

Attachment A includes the draft rule language for this proposal.

Questions For Members And Other Interested Parties

- A-1. To what extent do member firms pay representatives higher compensation for selling proprietary products compared to non-proprietary products?
- A-2. If a disclosure approach were taken, should the disclosure be oral or provided in a written document? What would be the appropriate content of such disclosure?
- A-3. How would firms ensure compliance with a requirement to disclose these arrangements?
- A-4. Should the NASD's rules regarding variable products restrict similar compensation arrangements involving those products? Should restrictions extend to other kinds of products as well?
- A-5. What business reasons or considerations exist for providing differential compensation to representatives?
- A-6. Rather than substantive regulation or disclosure, is it more appropriate to address concerns regarding compensation arrangements under existing NASD sales practice rules, such as rules regarding suitability requirements? Are there additional supervisory procedures that could be put in place to deal with potential

conflicts of interest related to salesperson compensation?

Single Security Sales Contests

Compensation Practice: Some firms have used single security sales contests to stimulate the sales of particular securities, including equities and proprietary mutual funds. A "sales contest" is an arrangement that promotes the sale of a security by offering an incentive payment to a salesperson who achieves a specified level of sales of the security over a specified period of time. The argument against this practice is that a representative may recommend a security to increase his or her chances of earning a cash award, without proper consideration as to whether it is a suitable security for the customer. Arguably, an incentive like this, offered at the point of sale, may be more likely to influence (or at the least, gives the appearance of influencing) the sale of a security than an incentive which is earned on a delayed basis and takes into account total production.

The Non-Cash Compensation Rules governing variable products and investment company products prohibit the payment of non-cash compensation through sales contests, except under certain specified conditions.¹ However, the Non-Cash Compensation Rules do not regulate contests that result in cash awards,² nor do they prohibit contests involving products other than mutual funds and variable contracts.

The Proposal: We are proposing a new rule that would prohibit *all* single security sales contests, not just those involving investment company shares and variable products. The proposed rule is intended to prohibit all single security sales contests that could

improperly influence the advice of a representative. The proposed rule does not prohibit a sales contest involving a type or family of securities, such as mutual funds, or a group of equities.

In reviewing drafts of the rule proposal, NASD Regulation committees, including the Membership Committee and the Investment Companies Committee, expressed a number of concerns, many of which are reflected in the questions below. For example, committee members discussed whether prohibition or disclosure would be the appropriate solution. They also questioned whether existing NASD rules, such as those relating to suitability, may already address the issue adequately.

Attachment A includes the draft rule language for this proposal.

Questions For Members And Other Interested Parties

- B-1. To what extent do member firms conduct single security sales contests?
- B-2. What types of securities are sold through sales contests today?
- B-3. Are sales contests necessary to encourage new product innovation? Please explain.
- B-4. The proposed rule addresses contests involving one security only, which may limit its impact. Is there a significant benefit to investors to this type of prohibition? Should the prohibition extend to contests involving more than one security or a group of securities? What are the advantages or disadvantages of such an approach?
- B-5. The proposed rule applies to all types of securities. Should

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we limit the rule to only certain types of securities? If so, identify the types of securities and explain why.

- B-6. As an alternative approach, we could require disclosure of sales contests to investors.

a. Would disclosure of the fact that the representative is participating in a sales contest be an effective alternative to prohibiting sales contests?

b. How, when, and in what manner would the disclosure be made?

c. Describe the burden on firms to supervise for compliance with a disclosure rule.

- B-7. NASD Rule 2310 requires that representatives must have reasonable grounds for believing that a recommendation is suitable for a customer. Does this rule (or other rules) adequately cover the type of potential misconduct that the proposed rule addresses? Are they more or less easily enforced than a disclosure rule would be?

Accelerated Payouts

Compensation Practice: As part of an incentive package, representatives who move from one member firm to another may receive higher commission payouts for a short, specified period of time, sometimes three to six months or a year. These temporarily increased commission payouts, known as “accelerated payouts,” are often offered to attract a representative to a new firm.

The perceived problem with this practice is that it could act as an

incentive for the representative to trade customer accounts inappropriately by, for example, “churning” or trading the accounts excessively, in order to generate as much revenue as possible during the time that higher commission payouts are being paid.

An argument in favor of accelerated payouts is that they make up for the potential financial losses associated with moving to a new firm. For example, it takes time for the representative to complete the administrative tasks associated with transferring customer accounts from the former firm to a new firm. Also, it is likely that not all of the representative’s customers will transfer to the new firm so the accelerated payouts can make up for some lost income.

The Proposal: Our proposal would require that, when a representative transfers to a new firm, the firm must disclose, in writing, the existence and general nature of the compensation arrangements to customers whose accounts are being transferred. The firm would also provide this written disclosure to new customers as long as the higher payout arrangement is in effect. The specific compensation formula or amount paid to the representative would not need to be disclosed.

NASD Committees, including the Membership Committee and a number of the District Committees, reviewed earlier drafts of the rule and expressed their views as to whether we need to propose such a rule. A number of committee members observed that the accelerated payouts serve legitimate business purposes and questioned why their use should be limited, especially in the absence of documented evidence of abuse. Moreover, many committee members noted that there are rules already in place to address suitability and churning, and

therefore, questioned the need for more regulation in this area.

Attachment A includes the draft rule language for this proposal.

Questions For Members And Other Interested Parties

C-1. To what extent do member firms offer accelerated payouts to representatives who transfer from one broker/dealer to another?

C-2. The proposed rule is based on the assumption that accelerated payouts act as an incentive for a representative to act improperly, for example, to trade excessively in customer accounts. Is this assumption correct?

C-3. The proposed rule does not prohibit the payment of accelerated payouts offered by a firm to *keep* a representative at a firm, which raises the same point-of-sale concerns. First, to what extent do member firms offer accelerated payouts to retain representatives who are considering transferring to another firm? Second, should the proposed rule be expanded to include this type of compensation practice?

C-4. The proposed rule does not dictate the specific language of the required disclosure. Should we mandate the specific form that a disclosure statement should take?

C-5. The proposed rule does not specify how the written disclosure should be made. For example, it could be provided on account opening forms or on a separate disclosure sheet. Should we specify how the disclosure should be made?

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C-6. Does the proposed rule affect the ability of smaller firms to attract experienced representatives? Please explain.

C-7. Rather than requiring written disclosure, should we propose a rule that would require firms to provide more supervision during the time that a newly transferred representative is receiving accelerated payouts?

C-8. Do existing rules that cover sales practice abuses, such as those prohibiting unsuitable recommendations and churning, adequately address the type of potential misconduct that the proposed rule is intended to address?

Other Questions

We have additional questions for members, investors, and interested parties to address regarding the regulation of compensation practices:

D-1. The proposed rules will increase the burden on firms to ensure compliance with the proposed requirements. Will the cost of compliance with each of the proposed rules be significant? Will the cost to firms for increased compliance activities be greater than the benefit to the investor?

D-2. As an alternative to imposing the specific requirements above, should we instead

require that customers receive a general disclosure statement that explains how representatives are compensated, including both cash and non-cash compensation arrangements?

D-3. Are there other compensation practices that NASD Regulation should address in addition to, or instead of, the three practices above?

ATTACHMENT A

Text Of Proposed Amendments

*Proposed additions are underlined;
proposed deletions are bracketed.*

Payment Of Differential Cash Compensation

Rule 2830. Investment Company Securities

(a) No change

(b) Definitions

(1) The terms “affiliated member,” “compensation,” “cash compensation,” “non-cash compensation,” [and] “offeror,” “differential cash compensation,” “gross dealer concessions,” “non-proprietary investment company” and “proprietary investment company” as used in paragraph (l) of this Rule shall have the following meanings:

(A) - (E) No change

(F) “Differential cash compensation” shall exist if a member pays to its associated persons a higher percentage of its gross dealer concessions for the sale of a stated dollar amount of proprietary investment company securities than the percentage of its gross dealer concessions for the sale of the same dollar amount of securities of a non-proprietary investment company with similar investment objectives.

(G) “Gross dealer concessions” shall mean the total amount of any discounts, concessions, fees or commissions provided by the offeror to the member in

connection with the sale and distribution of investment company securities.

(H) “Non-proprietary investment company” shall mean any investment company other than a proprietary investment company.

(I) “Proprietary investment company” shall mean an investment company for which the member, or an affiliate of the member, is the investment adviser or principal underwriter.

(l) Member Compensation

In connection with the sale and distribution of investment company securities:

(1) - (5) No change

(6) No member shall pay or offer to pay, and no associated person shall accept payment of, differential cash compensation.

Single Security Sales Contest

Proposed New Rule XXXX

(a) No member or person associated with a member shall accept or make payments or offers of payments of any cash compensation that is related to a single security sales contest.

(b) The terms “cash compensation,” and “sales contest” as used in this Rule shall have the following meanings:

(1) “Cash compensation” shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override, or cash employee benefit received in connection with the sale or distribution of

securities.

(2) “Single security sales contest” shall mean any arrangement that promotes the sale of a single security whereby a member offers to an associated person an incentive payment or payments of cash compensation based on the achievement of a specified level of sales of such security over a pre-determined period of time.

Accelerated Payouts

11870. Customer Account Transfer Contracts

(a) Responsibility to Expedite Customer’s Request

(1) When a customer whose securities account(s) is carried by a member (the “carrying member”) wishes to transfer the entire account(s) to another member (the “receiving member”) and gives written notice of that fact to the receiving member, both members must expedite and coordinate activities with respect to the transfer. If a customer desires to transfer a portion of an account, a letter of authorization should be transmitted to the carrying member indicating such intent and specifying the portion of the account to be transferred. Although such transfers are not subject to the provisions of this rule, members must expedite authorized partial transfers of customer securities accounts and coordinate their activities with respect thereto. The automated customer account transfer capabilities referred to in paragraph (m)(1) of this Rule shall be utilized for partial transfers.

(2) When a customer transfers an account from the carrying member to the receiving

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member in connection with the transfer of employment of a registered representative from the carrying member to the receiving member, and where the receiving member provides the registered representative with increased transaction-based compensation for a specific period of time in connection with the transfer of employment or the transfer of the customer's account, the receiving member shall provide to the customer written notice describing the existence and the general nature of the compensation arrangements. For the period of time that such compensation arrangements are in effect, such written notice shall also be provided to new

customers of the registered representative at the receiving member at or prior to opening an account.

(b) No change

Endnotes

¹A non-cash contest can be held only if it meets the following requirements: (1) the non-cash compensation arrangement must be based on the total production of associated persons with respect to all investment company or variable product securities distributed by that member; (2) the credit received for each investment company or variable contract security must be equally weighted; (3) no unaffiliated non-member company or other unaffiliated member may

directly or indirectly participate in the member's or non-member's organization of a permissible non-cash compensation arrangement; and (4) recordkeeping requirements must be satisfied. See Rule 2820(h)(4)(D) and Rule 2830(l)(5)(D).

²In response to comments received on an earlier version of the Non-Cash Compensation Rules that would have imposed substantive prohibitions on cash compensation, NASD Regulation decided to delete those provisions pertaining to cash compensation, and instead, solicit specific comments on cash compensation arrangements in *Notice to Members 97-50*.

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ATTACHMENT B

Request For Comment Checklist—Questions For Members And Other Interested Parties

The following list of questions provides a quick and easy means to comment on some of the provisions contained in the proposal regarding salesperson compensation. This list of questions does not cover all of the changes contained in the proposal; therefore, we encourage members and other interested parties to review the entire proposal and to comment separately on all aspects of the proposal.

Instructions

Comments must be received by **October 29, 1999**. Members and interested parties can submit their comments using the following methods:

- mailing in this checklist
- e-mailing written comments to *pubcom@nasd.com*
- mailing in written comments
- submitting comments online at the NASDR Web Site (*www.nasdr.com*)

The checklist and/or written comments and should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Differential Compensation

1. Should the NASD adopt a rule addressing the practice of paying registered representatives higher compensation for selling proprietary mutual funds than non-proprietary mutual funds?

☐ Yes ☐ No ☐ See my attached written comments

2. If your response to question #1 is yes, what type of rule should be adopted:

☐ a. A rule requiring a firm to orally disclose to customers the difference in compensation.

☐ b. A rule requiring a firm to disclose in writing the difference in compensation.

☐ c. A rule prohibiting this practice altogether.

☐ d. Other (See my attached written comments)

3. Should the NASD adopt rules addressing differential compensation practices with respect to other types of products?

☐ Yes ☐ No

4. If your response to question #3 is yes, please provide written comments regarding the other types of products.

Single Security Sales Contest

5. Should the NASD ban sales contests that promote the sale of a single security by offering cash compensation as a prize if a representative reaches a certain level of sales?

☐ Yes ☐ No ☐ See my attached written comments

6. If your response to question #5 is no, should the NASD instead require firms to disclose to investors the existence of sales contests that offer representatives cash compensation?

☐ Yes ☐ No ☐ See my attached written comments

Attachment B continued on next page

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ATTACHMENT B *(continued)*

Request For Comment Checklist—Questions For Members And Other Interested Parties

Accelerated Payouts

7. Should the NASD adopt a disclosure rule addressing the payment of increased payouts for a period of time to representatives who transfer from one firm to another?

☐ Yes ☐ No

8. If your response to question #7 is no, should the NASD instead require firms to more strictly supervise representatives who are receiving accelerated payouts?

☐ Yes ☐ No ☐ See my attached written comments

9. Should the NASD prohibit firms from offering such payouts to representatives in these circumstances?

☐ Yes ☐ No ☐ See my attached written comments

Other

10. Please discuss any other practices relating to compensation of representatives that the NASD should address.

☐ See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

☐ An NASD Member

☐ An Investor

☐ A Registered Representative

☐ Other: _____