NASD NOTICE TO MEMBERS 97-50

NASD Regulation Requests Comment On Regulation Of Payment And Receipt Of Cash Compensation Incentives; **Comment Period Expires October 15, 1997**

Suggested Routing

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Executive Summary

NASD Regulation, Inc. (NASD Regulation[SM]) requests comment on appropriate regulation regarding the participation by members and their associated persons in arrangements for the payment and receipt of various forms of incentive-based cash compensation for the sale and distribution of investment company and variable contract securities.

Questions concerning this *Request For Comment* may be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325 and Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

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

or e-mailed to:
pubcom@nasd.com

Comments must be received **by October 15, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation, Inc. Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD Regulation Request For Comment 97-50

Executive Summary

NASD Regulation, Inc. (NASD Regulation[SM]) requests comment on appropriate regulation regarding the participation by members and their associated persons in arrangements for the payment and receipt of various forms of incentive-based cash compensation for the sale and distribution of investment company and variable contract securities. In addressing this issue, commenters are asked to consider whether certain forms of incentive-based cash compensation designed to encourage sales of these products, such as "revenue sharing" agreements and differential commission payments, are harmful or beneficial to customers or the industry. Commenters are also asked to consider the appropriate regulatory approach to such arrangements, including possible disclosure requirements or substantive prohibitions. NASD Regulation requests that National Association of Securities Dealers, Inc. (NASD®) members, investors, and others, in considering their responses and comments, focus in particular on the need to permit 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 arise in connection with some compensation practices.

Questions concerning this Request For Comment may be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325 and Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

Current NASD Rules

Paragraph (l)(1) to NASD Conduct Rule 2830 prohibits principal underwriters of investment company shares from making cash and non-cash payments to NASD members selling such shares unless the payments are disclosed in the prospectus.[1] Conduct Rule 2830(l) further states that "special compensation arrangements" made available to individual dealers which are not generally made available to all dealers must be disclosed in detail, including the identity of particular dealers involved.[2] This requirement includes disclosure of all such payments to dealers, regardless of whether other prospectus disclosure rules apply.[3] The disclosure provisions were intended to inform investors of certain concessions, in addition to the charges already required to be disclosed in the prospectus, that dealers receive to promote specific products.

Conduct Rule 2830 does not contain a definition of "special compensation arrangement," and members have interpreted the term differently. In some instances, issuers have taken the position that cash compensation arrangements with individual dealers do not constitute "special" compensation arrangements where such arrangements are available to all dealers upon request, and therefore do not have to be disclosed in the prospectus with the required specificity. This interpretive ambiguity has resulted in a wide array of disclosure practices by issuers regarding special cash compensation, ranging from specific to very general disclosure or, in some cases, no disclosure.

NASD Rules for variable products do not contain any requirements regarding prospectus disclosure of cash compensation arrangements.[4]

Recent NASD Initiatives

In 1994, NASD Regulation requested member comment on proposed rules that would have more closely regulated non-cash compensation arrange-

ments and sales promotion awards involving trips, merchandise and other prizes, for the sale of mutual funds and variable contracts (Non-Cash Proposal).[5] While the Non-Cash Proposal generally was aimed at enhancing supervisory control and reducing "point-of-sale" influences inherent in non-cash incentives, it also restated the current requirement in NASD Rules to disclose in the prospectus all "cash compensation" and "special cash compensation" arrangements for the sale of mutual funds. "Cash compensation" was proposed to be defined as "any discount, concession, fee, service fee, commission, asset-based sales charge, loan, or override received in connection with the sale and distribution of investment company securities." "Special cash compensation" was not defined.

When the Non-Cash Proposal was published by the Securities and Exchange Commission (SEC) for public comment,[6] it contained an additional provision that proposed to require that certain cash compensation credit for the sale of mutual funds and variable products be equally weighted. This provision was intended to prevent members from paying out non-cash awards in the form of cash, thereby circumventing the non-cash provisions. However, some commenters, primarily insurance-affiliated broker/dealers, stated that such a requirement appeared to mandate equal treatment of all forms of cash compensation. In particular, the commenters were concerned that the proposed rules would restrict the ability of member firms and their affiliated insurance companies to pay higher commissions or offer higher incentives for their proprietary products. Further, the commenters underscored the difficulties in trying to identify which compensation practices would qualify as cash or non-cash compensation for purposes of the proposed rule and to what extent those practices provided significant incentives for salespersons to sell one product over another. As a result of these comments, the Board of Directors of NASD Regulation approved the deletion of the provision requiring equal credit for certain cash compensation incentives. On May 6, 1997, NASD Regulation resubmitted the Non-Cash Proposal to the SEC without the incentive cash compensation provision.

The Tully Report

In May 1994, an industry committee chaired by Merrill Lynch Chairman Daniel P. Tully (the Committee) was formed at the request of SEC Chairman Arthur Levitt to address concerns regarding conflicts of interest in the brokerage industry. The Committee's mandates were to review industry compensation practices for registered representatives (RRs) and branch managers, identify actual and perceived conflicts of interest for RRs and branch managers, and identify the "best practices" used in the industry to eliminate, reduce or mitigate such conflicts. The Committee issued its report on April 10, 1995 (Tully Report).[7] Among some of the "best practices" identified were (i) paying a portion of RR compensation based on client assets in the account, regardless of transactional activity; (ii) prohibiting sales contests, or permitting contests based only on broad measures, rather than on single products; and (iii) paying identical commissions to RRs for proprietary and non-proprietary products within a product category, so that, with respect to the products in the same category, RRs are less motivated at point-of-sale by incentives.[8] Generally, the Tully Report's findings and conclusions reflected a growing concern that the securities industry should more closely align the interests of brokerage firms and RRs to those of their customers and should encourage long-term relationships between firms and RRs and their customers.

Discussion

Types Of Arrangements

NASD Regulation is aware of a broad range of cash compensation practices by which investment company and variable contract issuers, distributors, underwriters, investment advisers or affiliates of these entities (Offerors) provide various payments, incentives, rewards or value-added services to retail broker/dealers or their RRs in exchange for selling, promoting, or carrying the Offeror's products. Some of these payments (sometimes referred to as "revenue sharing") are paid to the broker/dealer and generally remain at the entity level to cover firm costs; other payments, such as differential commission payouts, are passed on to RRs and raise more directly the point-of-sale issues associated with the payment of differential compensation for proprietary products and sales contests.

Such arrangements include:

a) differential commission payouts by an Offeror to retail broker/dealers, such as:

- cash awards or increased commission payouts for sales contests, in particular, contests that promote a single product of an Offeror over the short term;

- higher base commission payouts for the sale of proprietary products;

- bonus commissions on new business;

- excess commissions for the sale of particular products;

- renewal commissions for maintaining accounts with an Offeror;

• service commissions for ongoing customer and shareholder account service; and

• commission payments for large purchases of the Offeror's funds at net asset value by the broker/dealer's customers;

b) payments by an Offeror to retail broker/dealers in exchange for:

• carrying the Offeror's funds as one of the broker/dealer's "preferred" funds;

• conducting "due diligence" examination of an Offeror's products;

• placing the Offeror's ads in the broker/dealer's internal newsletter;

• allowing the Offeror to prepare the broker/dealer's training materials; and

• providing omnibus and subaccounting services to the broker/dealer's customers who have purchased the Offeror's funds; and

c) reimbursement by an Offeror to retail broker/dealers to cover business costs, such as:

• errors and omissions insurance;

• group life and health insurance;

• contributions to pension plans;

• agent and RR licensing fees;

• generation of sales leads;

• continuing education;

• office space, furniture and telephone bills;

• general marketing costs;

• training of an "equity" specialist; and

• management bonuses or "overrides" to wholesalers and supervisors.

Current Best Practices

The Tully Report identified current "best practices" of firms that are designed to align more closely the interests of firms and their RRs with their customers. The Tully Report assessed all firms, not just firms that exclusively sell mutual funds and variable products. According to the Report, many firms have adopted the practice of paying identical commissions for the sale of proprietary and non-proprietary products to ensure that RRs are indifferent to incentives when making recommendations. The Tully Report noted that some firms have adopted policies against sales contests of any kind; other firms permit contests but base them on broad measures rather than a single product. The Tully Report also noted that some firms have adopted practices of paying a portion of RR compensation based on client assets in an account regardless of transactional activity or deferring a portion of RR compensation for several years and linking payment to a good compliance record. At least one firm adopted the practice of linking a portion of compensation for the sale of variable products to certain customer satisfaction measures, such as the RR's product knowledge and responsiveness to customer needs.

The Tully Report noted in particular that, where differential compensation practices were still in place, there was generally no disclosure of extra compensation RRs receive for the sale of particular products. For example, there was generally no disclosure of the extra incentives associated with sales contests or the sale of proprietary products. The Tully Report concluded that knowledge of such practices may lead to better decision-making by clients and that full disclosure of such practices may reduce the potential for conflict and abuse.[9]

The Need For Additional Public Comment On Cash Compensation Issues

Some commenters to the Non-Cash Proposal asked whether disclosure should apply equally to similar compensation arrangements for the sale of variable products. Other commenters expressed concerns regarding the impact of the Non-Cash Proposal on disparate payout of commissions and compensation to representatives for the sale of proprietary products. Some commenters suggested that customers are not harmed by cash arrangements that do not involve deducting payments from customer purchases or fund assets and, therefore, that such payments should neither be disclosed nor regulated. Other commenters proposed that all "revenue sharing" cash compensation practices be either disclosed in the prospectus or prohibited.

Cash compensation arrangements of the types described above provide an array of economic resources from which distribution and marketing costs for mutual funds and variable products are financed. NASD Regulation has historically not attempted to regulate the internal compensation arrangements of member firms and their RRs. However, NASD Regulation recognizes that the compensation arrangements described above in some cases may create incentives to inappropriately favor one product over another. Such arrangements may provide point-of-sale or other incentives that could compromise proper customer suitability determinations or otherwise create a perception that a member's interests might not, in some circumstances, be fully aligned with the interests of customers. NASD Regulation seeks comment on the appropriate regula-

tory approach regarding the participation by members and their associated persons in cash compensation arrangements described above.

General Approaches

One approach might be to mandate disclosure of all cash compensation arrangements. As noted above, although NASD Conduct Rule 2830 currently prohibits principal underwriters of investment company shares from making cash and non-cash payments to NASD members selling such shares unless the payments are disclosed in the prospectus, the current content and scope of disclosure varies widely. A disclosure approach to cash compensation is also consistent with the NASD's long-standing practice to not substantively regulate the internal compensation arrangements of member firms and their RRs.

Investors may find that information on cash compensation arrangements would be important in determining whether an RR's particular product recommendation was influenced by such arrangements. Yet some of the cash compensation arrangements described above may be of so little interest to investors or so far removed from any effective point-of-sale influence that disclosure of such information would not serve a significant customer protection or other regulatory purpose.

A disclosure approach would seem to require, at a minimum, a determination of what kind of information would need to be disclosed (*e.g.*, only those cash compensation arrangements that raise significant point-of-sale conflicts, such as sales contests, rather than entity-level, revenue sharing arrangements) and with what specificity, where the disclosure would occur (*e.g.*, prospectus, statement of additional information, a separate document), when it would occur (*e.g.*, at point of sale), and who would provide it (*e.g.*, Offerors, selling dealers, RRs).

Another approach might be to impose substantive requirements on cash compensation arrangements — for example, limiting or prohibiting payments of differential compensation. Imposing substantive requirements to pay the same commissions to RRs for proprietary and non-proprietary products, for example, would attempt to ensure that RRs are indifferent to incentives when making recommendations and sales. Similarly, it may be appropriate for NASD Regulation to prohibit differential compensation in connection with the offer and sale of "multiple class" funds. A multiple class fund is an open-end investment company that issues two or more classes of securities representing interests in the same investment portfolio. Each class may vary with respect to expenses for distribution, administration and shareholder services. Certain classes may be more appropriate for a particular investor (*e.g.*, Class A shares for a long-term investment). To the extent that compensation arrangements with respect to various classes might differ, a prohibition of differential compensation arrangements with respect to multiple class funds might better ensure that the form of compensation would not unduly influence an RR's recommendation of a class.

Yet it may be difficult to define "differential compensation" for these purposes. For example, how would NASD Regulation or its members treat different streams of compensation payments for the sale of different funds? How would different compensation arrangements for different types of funds (*e.g.*, international funds and municipal bond funds) be resolved?

Moreover, existing commission-based compensation systems may reflect legitimate business considerations that derive from a competitive market. For example, smaller, less-known issuers may want to provide additional compensation to members and their RRs in order to encourage them to learn more about their products and how those products can help customers meet their investment objectives. The imposition by NASD Regulation of rules requiring similar commission structures could be viewed as anti-competitive and inconsistent with the NASD's purpose under the Securities Exchange Act of 1934 to promulgate rules that "...are designed to promote just and equitable principles of fair trade...remove impediments to and perfect the mechanism of a free and open market...and are not designed to...impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by [the NASD's] members...."[10]

Another approach might be to regard cash compensation arrangements that create conflicts of interest as fundamentally a sales-practice issue. 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. It may be possible to provide more detailed guidance concerning the applicability of the suitability requirements to differential compensation arrangements. Such detailed guidance might not anticipate all of the circumstances under which compensation arrangements can be conducted according to the varied and evolving business practices of our members, however.

Because of the significant interest in cash compensation arrangements and how such arrangements ought to be regulated, NASD Regulation is soliciting comment on (i) the nature of various cash compensation arrange-

ments within the mutual fund and variable product industries as described above (such as "revenue sharing" and payments of differential compensation for proprietary vs. non-proprietary products), (ii) the potential harms and benefits of such arrangements, and (iii) the appropriate regulatory approach to the arrangements (including imposing disclosure requirements or substantive prohibitions, or regulating the arrangements under existing NASD sales practice rules).

Solicitation Of Comments

1. Do cash compensation arrangements as described above raise specific investor protection concerns? Do these arrangements in general encourage or discourage aligning the common interests of investors, salespersons and firms? Are there other compensation practices not identified above that should be regulated?

2. Do cash compensation arrangements create sufficiently strong "point-of-sale" incentives to warrant substantive regulations regarding their use? Would the answer to the question vary depending on whether such incentives are retained at the firm level or passed on to individual salespersons? Would the answer to the question vary depending on whether an arrangement, such as a sales contest, is designed to promote the sale of a particular product?

3. If cash compensation arrangements warrant substantive regulations, what would be the appropriate form of such regulations? Should such arrangements generally be prohibited or permitted within certain guidelines? Should guidelines require equal weighting of cash compensation credit when offered as part of a sales contest, reflecting a similar requirement for non-cash incentives in the Non-Cash Proposal?

4. Is it more appropriate to require disclosure of cash compensation arrangements rather than substantive regulation? Should disclosure be provided in the prospectus and/or some other document? What information and level of detail should be included? Should the responsibility for providing the disclosure fall on the Offeror, the retail broker/dealer and/or the salesperson? Are current NASD prospectus disclosure rules for mutual funds sufficient to require disclosure of cash compensation arrangements? Should the NASD's rules regarding variable products require similar disclosure?

5. Are individual investors concerned about and interested in disclosure of the cash compensation arrangements described above? What investor protection purposes are served when such information is made available to investors? Rather than substantive regulation or disclosure, is it more appropriate to address concerns regarding cash compensation arrangements under existing NASD sales practice rules, such as rules regarding suitability requirements?

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Endnotes

[1] *See* subparagraph (l)(1)(C) to NASD Conduct Rule 2830. This provision states in part: "No underwriter or associated person of an underwriter shall offer, pay, or arrange for the offer or payment to any other member, in connection with retail sales or distribution of investment company securities, any discount, concession, fee or commission (hereinafter referred to as "concession") which:..is not disclosed in the prospectus of the investment company. If the concessions are not uniformly paid to all dealers purchasing the same dollar amounts of securities from the underwriter, the disclosure shall include a description of the circumstances of any general variations from the standard schedule of concessions. If special compensation arrangements have been made with individual dealers, which arrangements are not generally available to all dealers, the details of the arrangements, and the identities of the dealers shall also be disclosed."

[2] *Id.*

[3] Under SEC Rules, front-end, asset-based and deferred sales charges are required to be disclosed in the fund's prospectus fee table.

[4] *See* NASD Conduct Rule 2820.

[5] *See Special Notice to Members 94-67* (August 22, 1994).

[6] Securities Exchange Act Rel. No. 37374 (June 26, 1996); 61 FR 35822 (July 8, 1996).

[7] *See* Report of the Committee on Compensation Practices, April 10, 1995.

[8] *See* Tully Report, pp. 12-13.

[9] *See* Tully Report, p. 23.

[10] 15 U.S.C. § 78o-3.

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