

NASD Notice to Members 98-75

SEC Approves Rule Change Relating To Non- Cash Compensation For Mutual Funds And Variable Products

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Executive Summary

On July 15, 1998, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD[®]) Rules 2820 (Variable Contracts Rule) and 2830 (Investment Company Rule) that regulate non-cash compensation arrangements for the sale and distribution of variable contracts and investment company securities. Generally, the amendments adopt new definitions, impose recordkeeping requirements, and limit the manner in which members can pay or accept non-cash compensation. The amendments are effective January 1, 1999, under the implementation plan described below.

Questions concerning this *Notice* may be directed to R. Clark Hooper, Executive Vice President, Office of Disclosure and Investor Protection, NASD Regulation, Inc. (NASD RegulationSM), at (202) 728-8325, and Robert J. Smith, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Discussion Background

The amendments are the latest in a series of NASD Regulation proposals designed to control the use of non-cash compensation in connection with a public offering of securities. Previous rule amendments established restrictions on non-cash compensation in connection with transactions in direct participation program securities (DPPs), real estate investment trusts (REITs), and corporate debt and equity offerings.

The amendments are the final product of a process that began over 10 years ago and involved several versions of the rules published in various *Notices to Members* and submitted to the SEC. In developing

the amendments, the staff and NASD Regulation's Investment Companies Committee, the Independent Dealer/Insurance Affiliate Committee, and the Variable Insurance Products Committee considered the current environment in which investment company and variable contract securities are sold.

NASD Regulation believes that the increased use of non-cash compensation for the sale of variable contracts and investment company securities heightens the potential for loss of supervisory control over sales practices and increases the perception of inappropriate practices, which may result in a loss of investor confidence. NASD Regulation also believes 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. NASD is continuing to examine and develop an approach to the payment of certain types of cash compensation that may raise similar issues.¹

Description

Prior to the amendments, the Variable Contracts Rule did not contain provisions regarding non-cash compensation and the Investment Company Rule generally required disclosure in the prospectus of non-cash compensation arrangements. Thus, the amendments establish new requirements in the Variable Contracts Rule and modify current Investment Company Rule requirements.

Definitions

Affiliated Member: The term "affiliated member" has been adopted for both the Variable Contracts and Investment Company Rules to include a member that, directly or

indirectly, controls, is controlled by, or is under common control with a non-member company. The term reflects a common type of relationship existing in the variable contracts and investment company industries whereby a non-member is affiliated through ownership or control with one or more broker/dealer member firms used for underwriting and/or wholesale and retail distribution services.

Compensation: For ease of reference in appropriate paragraphs of the amendments, a new definition of "compensation" has been included to mean "cash compensation and non-cash compensation."

Cash Compensation: For both the Variable Contracts and Investment Company Rules, this term is defined to include any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the sale and distribution of investment company and variable contract securities. The new term also includes cash employee benefits to make clear that certain payments of ordinary employee benefits as part of an overall compensation package are not included in the definition of non-cash compensation or governed under the non-cash provisions.

Non-Cash Compensation: This term is identical in applicability in both the Variable Contracts and Investment Company Rules and encompasses any form of compensation received by a member in connection with the sale and distribution of variable contracts and investment company securities that is not cash compensation, including, but not limited to, merchandise, gifts and prizes, travel expenses, meals, and lodging.

Offeror: The term "offeror" in the Variable Contracts Rule is defined as an insurance company, a separate account of an insurance company, an investment company that funds a separate account, any adviser to a separate account of an insurance company or an investment company that funds a separate account, a fund administrator, an underwriter and any affiliated person of such entities, and in the Investment Company Rule as an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person of such entities. The term "affiliated person" in the definition of "offeror" is defined in accordance with Section 2(a)(3) of the Investment Company Act of 1940 (1940 Act). The term "underwriter" is defined in Section 2(a)(40) of the 1940 Act and is intended to reference the underwriter through which the investment or insurance company distributes securities to participating dealers for sale to the investor.

Regulation Of Cash And Non-Cash Compensation Arrangements

Introduction: The amendments adopt as paragraph (h) of the Variable Contracts Rule and paragraph (l) of the Investment Company Rule (replacing the current provisions of that section) new provisions governing the payment and receipt of non-cash compensation by members and associated persons of members. Under the Variable Contracts Rule, the amendments apply to the sale and distribution of both variable annuity and variable life products; under the Investment Company Rule the amendments apply to the sale and distribution of investment company securities registered under the 1940 Act.

Subparagraphs (h)(1) and (l)(1): Limitation on Receipt of Compensation by Associated Persons,

and Exception from Limitations: Subparagraph (h)(1) of the Variable Contracts Rule and (l)(1) of the Investment Company Rule prohibit a person associated with a member from accepting any compensation from any person other than the member with which the person is associated.

An exception from this general prohibition permits the receipt of compensation by an associated person from a non-member company if the member agrees to the arrangement, the receipt is treated as compensation received by the member for purposes of NASD rules, the recordkeeping requirement in the proposed rule change is satisfied, and, the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or applicable "no-action" letter issued by the SEC or its staff that applies to the specific fact situation of the arrangement.

The exception reflects the view of the SEC as expressed in Securities Exchange Act Rel. No. 34-8389 (August 29, 1968) that, under certain circumstances, such commission payments to associated persons may be made by a life insurance company acting on behalf of a subsidiary broker/dealer.² The SEC has issued a number of "no-action" letters permitting, among other things, associated persons of members to receive compensation for the sale of variable contract products from a licensed corporate insurance agent acting on behalf of one or more insurance companies.³ The Investment Company Rule includes the same exception in order to recognize SEC no-action letters that permit an insurance company to establish a commission account as a ministerial service to make payments of commission overrides for sales of insurance and investment company securities products.⁴

Subparagraphs (h)(2) and (l)(2): Securities as Compensation: New subparagraphs (h)(2) of the Variable Contracts Rule and (l)(2) of the Investment Company Rule prohibit members and associated persons of members from receiving compensation in the form of securities of any kind. This prohibition is similar to a prior requirement in the Investment Company Rule.

Subparagraphs (h)(3) and (l)(3): Recordkeeping Requirement: New subparagraphs (h)(3) of the Variable Contracts Rule and (l)(3) of the Investment Company Rule require that members maintain records of all compensation, cash and non-cash, received from offerors. The records must include the names of the offerors, the names of the associated persons, and the amount of cash and the nature and, if known, the value of non-cash compensation received.

NASD Regulation expects records regarding the "nature" of non-cash compensation received to disclose whether the non-cash compensation was received in connection with a sales incentive program or a training and education meeting. Thus, for example, records for a training and education meeting should include information demonstrating that the requirements of a training and education meeting were complied with, including the date and location of the meeting, the fact that attendance at the meeting is not conditioned on the achievement of a previously specified sales target, the fact that the payment is not applied to the expenses of guests of associated persons of the member, and any other information required to enable NASD Regulation to determine compliance with the rule.

The recordkeeping requirement does not apply to two types of de minimis non-cash compensation allowable under subparagraphs (h)(4)(A) and

(B) of the Variable Contracts Rule and (l)(5)(A) and (B) of the Investment Company Rule, discussed more fully below under the exceptions to the prohibition on non-cash compensation.

Subparagraph (l)(4): Prospectus Disclosure of Cash Compensation: New subparagraph (l)(4) in the Investment Company Rule prohibits members from accepting cash compensation from offerors unless such compensation is disclosed in a prospectus. In the case where special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members to distribute the securities, the disclosure must include the name of the recipient member and the details of the special arrangements. This requirement is similar to the prior requirement in subparagraph (l)(1)(C) of the Investment Company Rule to disclose all compensation in the prospectus, but has been modified to reference only "cash compensation" because non-cash compensation is prohibited in a manner that would obviate the need for disclosure of any such non-cash compensation.

Subparagraphs (l)(4)(A) and (B) provide an exception from disclosure for compensation arrangements between: (1) principal underwriters of the same security; and (2) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment. By their terms, these provisions describe arrangements that would not trigger the proposed recordkeeping requirements.

Subparagraphs (h)(4) and (l)(5): Prohibition on Non-Cash Compensation: New subparagraphs (h)(4) of the Variable Contracts Rule and (l)(5) of the Investment Compa-

ny Rule generally prohibit, with certain exceptions, a member or person associated with a member from directly or indirectly accepting or making payments or offers of payments of any non-cash compensation. There are several exceptions to the general prohibition that permit certain non-cash arrangements.

Subparagraphs (h)(4)(A) and (B) and (l)(5)(A) and (B): These provisions permit the payment and acceptance of gifts that do not exceed an annual amount, currently \$100 per person, and an occasional meal, ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of propriety. Since such gifts and entertainment are considered non-cash items, they are not required to be disclosed in the prospectus. In addition, these two forms of non-cash compensation are specifically excepted from the recordkeeping requirement of the proposed rules.

The provisions also require that the acceptance or payment of such non-cash items not be preconditioned on the achievement of a sales target. Thus, gifts and entertainment are permitted to be provided as recognition for past sales or as encouragement for future sales, but not as part of an incentive program or plan which requires that the recipient reach a specific sales goal as a prior condition to receive the entertainment or gift. These exceptions permit the continuation of long-established, normal business practices, involving benefits with relatively small value such that they are unlikely to impact overall compensation incentives.

Subparagraphs (h)(4)(C) and (l)(5)(C): These exceptions permit, under certain conditions, payment or

reimbursement by offerors in connection with meetings held by the offeror or by a member for the purpose of training or education of associated persons of a member. It is not unusual for offerors to pay for such meetings in order to discuss their products and to reimburse certain expenses related to meetings held by members in exchange for the opportunity to make a presentation to the associated persons of the member on a particular training or education topic. Since investment company and variable contract products are continuously offered, it is particularly important that associated persons receive education opportunities, updates on any portfolio changes or structural changes to a current product, and explanations of new products.

Payments for training or education meetings are subject to the record-keeping requirement in subparagraph (h)(3) of the Variable Contracts Rule and subparagraph (l)(3) of the Investment Company Rule. This provision ensures that information on such payments and reimbursements is maintained in the records of the member and, therefore, capable of examination and regulatory oversight by NASD Regulation.

Associated persons must obtain the member's prior approval to attend the meeting and the member may not base attendance on the achievement of a sales target or other incentives. Members should establish a procedure so that their records reflect that appropriate approval has been provided to associated persons in connection with such meetings. Although a member may not condition attendance at the meeting on the achievement of a sales target, this is not intended to prevent a member from designating persons to attend a meeting to recognize past performance or encourage future performance.

The location of the meeting must be appropriate to its purpose. A showing of appropriate purpose is demonstrated where the location is the office of the offeror or the member, or a facility located in the vicinity of such office. In order to address meetings where the attendees are from a number of offices in a region of the country, the meeting location may be in a regional location.

The payment or reimbursement by an offeror must not be applied to the expenses of guests of the associated person.

Finally, the payment or reimbursement by the offeror must not be conditioned by the offeror on the achievement of a sales target or any other incentive. This requirement is intended to ensure that the offeror making the payment or reimbursement does not participate in any manner in a member's decision as to which associated persons will attend a member's or offeror's meeting.

Subparagraphs (h)(4)(D) and (l)(5)(D): These provisions permit non-cash compensation arrangements between a member and its associated persons, and between a non-member company and its sales personnel who are associated persons of an affiliated member. In permitting such arrangements, NASD Regulation recognizes that in the life insurance industry, for example, non-member insurance companies may hold non-cash sales incentive programs for their sales personnel who are also associated persons of the non-member's affiliated broker/dealer and are licensed to sell both variable contract securities and non-securities insurance products. As a practical matter, an insurance company or investment company affiliated with a broker/dealer is in a position to contribute to and affect the structure of its affiliated broker/dealer's in-house incentive compensation program.

The permissible non-cash arrangements are subject to four conditions: (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) the recordkeeping requirements must be satisfied.

The total production and equal weighting requirements address the danger that non-cash incentive programs may motivate salespersons at the point-of-sale to recommend a specific product on the basis of the incentive rather than a desire to meet the investment needs of the customer. The total production and equal weighting requirements are intended to limit the impact of non-cash sales incentives at point-of-sale.

Regarding the condition for equal weighting, NASD Regulation recognizes that methods for determining compensation credits could vary, including measurements based on gross production to the firm or net commissions to the associated person. Either practice, as well as other arrangements, such as new accounts opened or assets under management, would be acceptable so long as the concept of "equal weighting" is met and not skewed by disparate commission, payout, or reallowance structures for individual products.

Because of the substantial differences in design, purpose, cost structure, commission payouts, and target audience for variable annuity and

variable life products, NASD Regulation has determined that the total production and equal weighting requirements may apply separately to variable annuity and variable life products, and they do not need to be combined in the same incentive arrangement.

Regarding the third condition, NASD Regulation recognizes that non-cash arrangements are sometimes structured directly between offerors and salespersons, away from the supervisory purview of the broker/dealer. Thus, under the third condition, the non-cash compensation arrangement is subject to the restriction that no unaffiliated non-member entity (usually an offeror) or another member can participate directly or indirectly in the member's or its affiliate's organization of a permissible non-cash sales incentive program. This provision is intended to ensure that third-party offerors or other broker/dealers do not influence, or in effect control, the organization of a permissible non-cash sales incentive program. This restriction is not, however, intended to prevent third-party offerors or other members from making a presentation on its products at a member's or its affiliate's in-house sales incentive meeting.

Finally, under the fourth condition, payments or non-cash sales incentives are subject to the recordkeeping requirements.

Subparagraphs (l)(5)(E) and (h)(4)(E): These provisions permit a non-member entity (usually an offeror) or another member to contribute to a member's in-house non-cash sales incentive program, and a member to contribute to a non-cash arrangement of a non-member, subject to the same four conditions identified above. These provisions are intended to permit third-party offerors and other members to contribute to the non-cash incentive program of a

member involving variable contracts or investment company securities in order to benefit the associated persons of the member that sell the securities. These provisions also permit members to contribute to non-cash compensation programs of non-members, such as banks, for example, involving variable contracts or investment company securities.

Proposed Implementation Of New Rules

The amendments to the Variable Contracts and Investment Company Rules are implemented in the following manner. The amendments are effective on January 1, 1999. As of that date, members' new sales incentive programs must comply with the amendments. Existing sales incentive programs that are ongoing as of January 1, 1999, may continue under previous rules for a period not to exceed six months following January 1, 1999. Thus, during the six-month implementation period, sales could be applied to existing incentive programs under previous rules, and new incentive programs as limited by the new amendments could commence. Finally, non-cash sales incentives or awards earned by registered representatives under existing programs would be permitted to be received by the registered representative for a period not to exceed 12 months following the expiration of the six-month implementation period.

Text Of Amendments To Rules 2820 And 2830

(Note: New language is underlined; deletions are bracketed.)

Rule 2820. Variable Contracts of an Insurance Company

(a) No change

(b) Definitions

(1) - (2) No change

(3) The terms "affiliated member," "compensation," "cash compensation," "non-cash compensation" and "offeror" as used in paragraph (h) of this Section shall have the following meanings:

"Affiliated Member" shall mean a member which, directly or indirectly, controls, is controlled by, or is under common control with a non-member company.

"Compensation" shall mean cash compensation and non-cash compensation.

"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 and distribution of variable contracts.

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

"Offeror" shall mean an insurance company, a separate account of an insurance company, an investment company that funds a separate account, any adviser to a separate account of an insurance company or an investment company that funds a separate account, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.

(c) - (g) No change

(h) Member Compensation

In connection with the sale and distribution of variable contracts:

(1) Except as described below, no associated person of a member shall accept any compensation from anyone other than the member with which the person is associated. This requirement will not prohibit arrangements where a non-member company pays compensation directly to associated persons of the member, provided that:

(A) the arrangement is agreed to by the member;

(B) the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or "no-action" letter issued by the Securities and Exchange Commission that applies to the specific fact situation of the arrangement;

(C) the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of NASD rules; and

(D) the recordkeeping requirement in subparagraph (h)(3) is satisfied.

(2) No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.

(3) Except for items as described in subparagraphs (h)(4)(A) and (B), a member shall maintain records of all compensation received by the member or its associated persons from offerors. The records shall include the names of the offerors, the names of the associated persons, the amount of cash, the nature and, if known, the value of non-cash compensation received.

(4) 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. Notwithstanding the provisions of subparagraph (h)(1), the following non-cash compensation arrangements are permitted:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors* 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) the recordkeeping requirement in subparagraph (h)(3) is satisfied;

(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (h)(4)(D);

(iii) 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;

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

(v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (h)(4)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

(i) the member's or non-member's non-cash compensation arrangement, if it includes variable contracts, is based on the total production of associated persons with respect to all variable contracts distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each variable contract is equally weighted;

(iii) 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

(iv) the recordkeeping requirement in subparagraph (h)(3) is satisfied.

(E) 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 that the arrangement meets the criteria in subparagraph (h)(4)(D).

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

2830. Investment Company Securities

(a) No change

(b) Definitions

(1) ["Associated person of an underwriter," as used in paragraph (1), shall include an issuer for which an underwriter is the sponsor or a principal underwriter, any investment adviser to such issuer, or any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such underwriter, issuer, or investment adviser.] The terms "affiliated member," "compensation," "cash compensation," "non-cash compensation" and "offeror" as used in paragraph (l) of this section shall have the following meanings:

"Affiliated Member" shall mean a member which, directly or indirectly, controls, is controlled by, or is under common control with a non-member company.

"Compensation" shall mean cash compensation and non-cash compensation.

"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 and distribution of investment company securities.

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

"Offeror" shall mean an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated per-

son (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.

(2)- (10) No change

(c) - (k) No change

(l) [Dealer Concessions] Member Compensation

[(1) 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:]

[(A) is in the form of securities of any kind, including stock, warrants or options;]

[(B) is in a form other than cash (e.g., merchandise or trips), unless the member earning the concession may elect to receive cash at the equivalent of no less than the underwriter's cost of providing the non-cash concession: or]

[(C) 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) No underwriter or associated person of an underwriter shall offer or pay any concession to an associated person of another member, but

shall make such payment only to the member.]

[(3)(A) In connection with retail sales or distribution of investment company shares, no underwriter or associated person of an underwriter shall offer or pay to any member or associated person, anything of material value, and no member or associated person shall solicit or accept anything of material value, in addition to the concessions disclosed in the prospectus.]

[(B) For purposes of this paragraph (1)(3), items of material value shall include but not be limited to:]

[(i) gifts amounting in value to more than \$50 per person per year.]

[(ii) gifts or payments of any kind which are conditioned on the sale of investment company securities.]

[(iii) loans made or guaranteed to a non-controlled member or person associated with a member.]

[(iv) wholesale overrides (commissions) granted to a member on its own retail sales unless the arrangement, as well as the identity of the member, is set forth in the prospectus of the investment company.]

[(v) payment or reimbursement of travel expenses, including overnight lodging, in excess of \$50 per person per year unless such payment or reimbursement is in connection with a business meeting, conference or seminar held by an underwriter for informational purposes relative to the fund or funds of its sponsorship and is not conditioned on sales of shares of an investment company. A meeting, conference or seminar shall not be deemed to be of a business nature unless: the person to whom payment or reimbursement is made is personally present at, or is en route to or from, such meeting in each of the

days for which payment or reimbursement is made; the person on whose behalf payment or reimbursement is made is engaged in the securities business; and the location and facilities provided are appropriate to the purpose, which would ordinarily mean the sponsor's office.]

[(C) For purposes of this paragraph (l)(3), items of material value shall not include:]

[(i) an occasional dinner, a ticket to a sporting event or the theater, or comparable entertainment of one or more registered representatives which is not conditioned on sales of shares of an investment company and is neither so frequent nor so extensive as to raise any question of propriety.]

[(ii) a breakfast, luncheon, dinner, reception or cocktail party given for a group of registered representatives in conjunction with a bona fide business or sales meeting, whether at the headquarters of a fund or its underwriter or in some other city.]

[(iii) an unconditional gift of a typical item of reminder advertising such as a ballpoint pen with the name of the advertiser inscribed, a calendar pad, or other gifts amounting in value to not more than \$50 per person per year.]

[(4) The provisions of this subsection (1) shall not apply to:]

[(A) Contracts between principal underwriters of the same security.]

[(B) Contracts between the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.]

[(C) Compensation arrangements of an underwriter or sponsor with its own sales personnel.]

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

(1) Except as described below, no associated person of a member shall accept any compensation from any one other than the member with which the person is associated. This requirement will not prohibit arrangements where a non-member company pays compensation directly to associated persons of the member, provided that:

(A) the arrangement is agreed to by the member;

(B) the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or "no-action" letter issued by the Securities and Exchange Commission or its staff that applies to the specific fact situation of the arrangement;

(C) the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of NASD rules; and

(D) the recordkeeping requirement in subparagraph (l)(3) is satisfied.

(2) No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.

(3) Except for items described in subparagraphs (l)(5)(A) and (B), a member shall maintain records of all compensation received by the member or its associated persons from offerors. The records shall include the names of the offerors, the names of the associated persons, the amount of cash, the nature and, if known, the value of non-cash compensation received.

(4) No member shall accept any cash compensation from an offeror

unless such compensation is described in a current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus. Prospectus disclosure requirements shall not apply to cash compensation arrangements between:

(A) principal underwriters of the same security; and

(B) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.

(5) 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. Notwithstanding the provisions of subparagraph (l)(1), the following non-cash compensation arrangements are permitted:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors* 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.

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

(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) the recordkeeping requirement in subparagraph (l)(3) is satisfied;

(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (l)(5)(D);

(iii) 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;

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

(v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (l)(5)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

(i) the member's or non-member's non-cash compensation arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each investment company security is equally weighted;

(iii) 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

(iv) the recordkeeping requirement in subparagraph (l)(3) is satisfied.

(E) 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 that the arrangement meets the criteria in subparagraph (l)(5)(D).

Endnotes

¹ See *NASD Notice to Members 97-50* (August 1997).

² In Securities Exchange Act Rel. No. 34-8389, the SEC stated that no question will be raised by the staff regarding an arrangement where a life insurance company makes commission payments directly to its life insurance agents who are also persons associated with the insurance company's subsidiary broker/dealer, so long as: (1) such payments are made as a purely ministerial service and properly reflected on the books and records of the broker/dealer; (2) a binding agreement exists between the insurance company and the broker/dealer that all books and records are maintained by the insurance company as agent on behalf of the broker/dealer and are preserved in conformity with the requirements of Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934; (3) all such books and records are subject to inspection by the Commission in accordance with Section 17(a) of the Exchange Act; and (4) the subsidiary broker/dealer has assumed full responsibility for the securities activities of all persons engaged directly or indirectly in the variable annuity operation.

³ See *Traditional Equinet* (Pub. Avail. January 8, 1992); and *Mariner Financial Services* (Pub. Avail. December 16, 1988), which include references to other SEC no-action letters in the in-coming letters requesting the SEC no-action position.

⁴ See *The Mutual Benefit Life Insurance Company* (Pub. Avail. January 21, 1985) and other SEC no-action letters cited therein.

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