

Notice to Members

JUNE 2005

SUGGESTED ROUTING

Investment Companies
Legal & Compliance
Registered Representatives
Senior Management
Variable Contracts

KEY TOPICS

Sales Contests
Non-Cash Compensation

REQUEST FOR COMMENT

Sales Contests and Non-Cash Compensation

NASD Requests Comment on Proposal to Prohibit All Product-Specific Sales Contests and to Apply Non-Cash Compensation Rules to Sales of All Securities; *Comment Period Expires August 5, 2005*

Executive Summary

NASD currently restricts the payment and acceptance of non-cash compensation in connection with the sale of direct participation programs (DPPs), variable insurance contracts, investment company securities, and public offerings of real estate investment trusts (REITs) and other securities. NASD also prohibits internal non-cash sales contests in connection with the sale of variable insurance contracts or investment company securities unless they meet certain criteria, including that such contests are based on principles of total production and equal weighting. NASD proposes to expand the prohibitions of non-cash compensation to the sale and distribution of any security or type of security, rather than just those enumerated above. NASD also proposes to prohibit all product-specific cash and non-cash "sales contests" as defined by the proposed rule.

Questions/Further Information

Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, at (240) 386-4533; Joseph P. Savage, Associate Vice President, Investment Companies Regulation, at (240) 386-4534; or Philip A. Shaikun, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Action Requested

NASD encourages all interested parties to comment on the proposed rule change. Comments must be received by August 5, 2005. Members and other interested parties can submit their comments using the following methods:

- ♦ **Mail** comments in hard copy to the address below; or
- ♦ **Email** comments to pubcom@nasd.com.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

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

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication in the *Federal Register*.²

Background and Discussion

Current Rules Governing Non-Cash Compensation and Sales Contests

NASD rules generally prohibit members and their associated persons from directly or indirectly accepting or making payments or offers of non-cash compensation in connection with the sale of DPPs, variable insurance products, investment company securities, and the public offering of other securities, including REITs. These prohibitions are subject to certain exceptions that permit:

- (A) Gifts that do not exceed an annual amount per person fixed by the NASD Board of Governors (currently \$100) and are not preconditioned on achievement of a sales target;

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- (B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment that is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target;
 - (C) Payment or reimbursement by offerors³ in connection with meetings held by an offeror or by a member for the purpose of training or educating associated persons of a member, provided that the meeting meets certain criteria;⁴
 - (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 the arrangement meets certain criteria (discussed below);⁵ and
 - (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 requirements for a non-cash compensation arrangement between a member and its associated persons pursuant to sub-paragraph (D) (discussed below).

Under the provisions permitting non-cash compensation arrangements between a member and its associated persons, a member may hold an internal *non-cash* sales contest with respect to the sale of investment company securities or variable insurance products provided that the contest is based on total production and the credit for each type of security sold (e.g., investment company or variable insurance product) is equally weighted. While this exception excludes sales contests that award credit only for specific securities within a category, such as only awarding credit for sales of proprietary mutual funds, it does allow sales contests that award credit for all sales within a particular category of securities (e.g., all sales of mutual funds), subject to the total production and equal weighting requirements.

NASD believes that general prohibitions concerning payment or receipt of non-cash compensation should be extended beyond investment companies, variable insurance products, DPPs, and public offerings of securities such as REITs, as the conflicts underlying these prohibitions exist with respect to all securities. NASD also believes that product-specific sales contests—even those that conform to the total production and equal weighting requirements of the current non-cash rules—should be prohibited.

Extension of Non-Cash Compensation Prohibitions to All Securities

The proposal would eliminate the current non-cash compensation provisions—Rules 2710(i) (REITs and other publicly offered securities), 2810(c) (DPPs), 2820(g)(4) (variable contracts), and 2830(l)(5) (investment companies)—and replace them with a new Rule 2311, which would apply to the payment or receipt of non-cash compensation and the sponsoring or participation in any sales contest with respect to the sale or distribution of any security or type of security. Thus, for example, the restrictions on the payment of non-cash compensation that currently apply to investment company securities, variable insurance products, REITs, and DPPs also would apply to the sale of stocks, bonds, or other securities.

Under proposed Rule 2311, members and their associated persons would be prohibited from directly or indirectly accepting or making payments or offers of payments of any non-cash compensation, subject to certain exceptions. One such exception would permit gifts that do not exceed in value an annual amount per person established by the NASD Board of Governors (currently \$100) and that are not preconditioned on the achievement of a sales target. Another exception would permit an occasional meal, a ticket to a sporting event or the theater, or comparable entertainment that is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on the achievement of a sales target.

The proposal also would permit offerors⁶ and members to make payments or reimbursements of associated persons' expenses in connection with training or education meetings, provided that the meetings meet certain conditions.

First, the member would have to maintain records of all such payments or reimbursements, including the names of the associated persons who attended, and the amounts of the payments or reimbursements.

Second, the associated persons would have to obtain the member's prior approval to attend the meeting and attendance or reimbursement of expenses could not be preconditioned on the achievement of a sales target. The proposal would explicitly define the term "preconditioned on the achievement of a sales target" (which also relates to the gift and entertainment exceptions above) as meaning an arrangement pursuant to which associated persons understand in advance that they must achieve either a dollar-denominated goal for selling any security or type of security or a goal of finishing within a group of top sellers of a security or type of security. The definition would state that a training or education meeting shall not be considered preconditioned on the achievement of a sales target if a member or an offeror designates persons to attend the meeting to recognize past performance or to encourage future performance, provided that associated persons do not understand in advance that receipt of compensation in connection with the meeting requires achievement of a sales target.

Third, the location would have to be appropriate to the purpose of the meeting, which the proposal would define as a United States office of the offeror or member holding the meeting, a facility located in the vicinity of such office, a U.S. regional location with respect to meetings of associated persons who work within that region or, with respect to meetings dealing with REITs or DPPs, a U.S. location at which a significant asset of the program is located.

Fourth, consistent with past staff interpretations, the proposed rule would explicitly permit only reimbursement for training, education, meals, lodging, and transportation of the associated person.⁷ Consequently, the proposed rule would make clear that in a training and education meeting, the offeror or member firm could not pay for or provide reimbursement for entertainment or for the expenses of guests of attendees.⁸

NASD believes that these provisions are largely consistent with the current non-cash compensation rules applicable to investment company securities, variable insurance products, DPPs, and REITs. However, NASD has made some changes to these provisions to improve their clarity and members' understanding of the rules. NASD requests comments as to whether these changes make the rules clearer.

Prohibition of Product-Specific Sales Contests

While proposed Rule 2311 expands many of the non-cash compensation provisions to all types of securities, NASD also is proposing to eliminate the current exception for product-specific sales contests. Specifically, the proposal would ban all "sales contests," which are defined as "any contest among associated persons for cash or non-cash prizes that is preconditioned on the achievement of a sales target within a defined period of time with respect to the sale or distribution of any security or any type of security." The meaning of "preconditioned on the achievement of a sales target" is discussed above.

NASD views any sales contest that favors one security (e.g., a proprietary investment company) or one type of security (e.g., investment companies or stocks) as having the potential to create an incentive to engage in sales conduct unrelated to the best interests of customers. Consequently, the ban on sales contests would prohibit "stock of the day" and similar promotions. It also would prohibit increased bonuses or "President's Club" memberships that are awarded for the sale of specific securities or types of securities within a defined period of time.

The definition of sales contest would permit broker-dealers to hold a contest among its associated persons that is based on their total production on the sale of all securities, provided certain records were kept. By permitting contests that are based on an associated person's total production, the rule also would allow cash bonuses to registered representatives who attained a higher total production across *all* securities. The member would be required to maintain records of those contests, including the criteria for awarding prizes and the names of the associated persons who participate in them.

NASD specifically seeks comment on the proposed definition of “sales contest.” Does it adequately address those compensation arrangements that create inappropriate incentives, without prohibiting legitimate forms of compensation?

The proposal also would eliminate a current provision that permits non-member companies or other members to contribute to a non-cash 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 it meets the requirements for such arrangements (such as the total production and equal weighting standards). NASD requests comment on whether there is any need to retain this provision in some form, given that the proposal would ban product-specific sales contests.

NASD does not intend these changes to cover different sales load structures or ongoing differential cash payouts among various products. Thus, for example, a member would be permitted to sell fund families that pay higher sales loads (e.g., a fund that pays a highest sales load of 5.75 percent of the purchase price) than other fund families that the member sells (e.g., funds whose highest sales loads are 4.5 percent). Likewise, for example, the rule would not apply to a member that, on an ongoing basis, pays out to associated persons 80 percent of commissions earned from the sales of proprietary products but only pays out 60 percent of commissions earned from the sale of non-proprietary products. The regulatory treatment of these so-called “differential compensation” arrangements is the subject of SEC rulemaking.⁹

Endnotes

- 1 See *Notice to Members 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 The term “offeror” generally refers to issuers, sponsors, advisers to issuers or sponsors, underwriters and their affiliates. See Rules 2710(i)(1)(C), 2810(c)(1)(C), 2820(b)(3)(E) and 2830(b)(1)(E).
- 4 Generally, training and education meetings must meet the following requirements:
 - i) the member must maintain certain records of these meetings, including the names of the offerors involved, the names of the associated persons attending the meetings, and the nature and value of the non-cash compensation received;
 - ii) the associated persons must obtain the member's prior approval to attend the meeting and attendance is not preconditioned by the member on achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (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 persons; 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 paragraph (D).

See Rules 2710(i)(2)(C), 2810(c)(2)(C), 2820(g)(4)(C) and 2830(l)(5)(C).

- 5 Under Rules 2820 and 2830, non-cash compensation arrangements between a member and its associated persons or, in the case of variable contracts, between a non-member company and its sales personnel who are associated persons of an affiliated member, generally must meet the following requirements:

- i) the member's or non-member's non-cash compensation arrangement is based on the total production of associated persons with respect to all securities within a specific category (such as mutual funds, variable annuities, or variable life insurance) distributed by the member;
- ii) the non-cash compensation arrangement requires that the credit received for each security is equally weighted;
- ii) 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 record keeping requirements of the non-cash rules are satisfied.

See Rules 2820(g)(4)(D) and 2830(l)(5)(D). Rules 2710 and 2810 permit non-cash arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement. See Rules 2710(i)(2)(D) and 2810(c)(2)(D).

- 6 The proposal would modify the definition of "offeror" depending upon the type of product that is the subject of the training or education meeting. The modified definition is based upon the current definitions of "offeror" in Rules 2710, 2810, 2820, and 2830.
- 7 See "Non-Cash Compensation – Training or Education Meetings," NASD Regulatory & Compliance Alert 13 (Summer 2000), available at http://www.nasd.com/rca/summer_00; Letter from Mary L. Schapiro, President, NASD (March 7, 2001), available at http://www.nasd.com/schapiro_030701.
- 8 The staff has interpreted the training or education meeting exception "as an event that is first and foremost intended to provide training or education to an associated person. Any training meeting should occupy substantially all of the work day." "Non-Cash Compensation – Training Or Education Meetings," NASD Regulatory & Compliance Alert 13 (Summer 2000).
- 9 See SEC Rel. No. 33-8544 (Feb. 28, 2005), 70 Fed. Reg. 10521 (Mar. 4, 2005).

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ATTACHMENT A

Proposed rule text.

2311. Non-Cash Compensation and Sales Contests

(a) Definitions

(1) "Compensation" shall mean cash compensation and non-cash compensation.

(2) "Cash compensation" shall mean any, discount, concession, fee, service fee, commission, asset-based sales charge, loan, override, cash employee benefit or cash prize received in connection with the sale and distribution of any security or type of security.

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

(4) "Offeror" shall mean:

(A) with respect to a training or education meeting concerning variable contracts, 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;

(B) with respect to a training or education meeting concerning investment company securities not sold through variable contracts, an investment company, an adviser to an investment company, 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; and

(C) with respect to a training or education meeting concerning any other type of security, an issuer, sponsor, an adviser to an issuer or sponsor, an underwriter and any affiliated person of such entities.

(5) "Preconditioned on the achievement of a sales target" shall mean an arrangement pursuant to which associated persons understand in advance that they must achieve either a dollar-denominated goal for selling any security or type of security or a goal of finishing within a defined number of top sellers of a security or type of security. A training or education meeting shall not be considered preconditioned on the achievement of a sales target if a member or an offeror designates persons to attend the meeting to recognize past performance or to encourage future performance, provided that associated persons do not understand in advance that the receipt of compensation in connection with the meeting requires achievement of a sales target.

(6) "Sales contest" shall mean any contest among associated persons for cash or non-cash prizes that is preconditioned on the achievement of a sales target within a defined period of time with respect to the sale or distribution of any security or type of security. The term "sales contest" shall not mean any contest among associated persons that is based upon the total production of the associated persons for all types of securities, provided that the member maintains records of all such contests, including the criteria for awarding prizes and the names of the associated persons who participate in such contests.

(b) Restrictions on Non-cash Compensation and Sales Contests.

No member or person associated with a member shall sponsor or participate in any sales contest or directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except the following:

(1) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors¹ and are not preconditioned on achievement of a sales target.

(2) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment that is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(3) Payment or reimbursement by offerors or members 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:

(A) the member maintains records of all such payments or reimbursements, including the names of the offerors, the names of the associated persons who attended, and the amount of the payment or reimbursement;

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

(B) 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;

(C) the location is appropriate to the purpose of the meeting, which shall mean a United States office of the offeror or the member holding the meeting, or a facility located in the vicinity of such office, or a United States regional location with respect to meetings of associated persons who work within that region or, with respect to meetings dealing with real estate investment trusts or direct participation programs, a United States location at which a significant asset of the program is located;

(D) the payment or reimbursement applies only to training, education, meals, lodging and transportation for associated persons, and is not applied to the expenses of guests of associated persons, or to the entertainment of associated persons; and

(E) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target.