

**MEMO# 23568**

June 19, 2009

## **FINRA Proposes Changes To The NASD's Compensation Rule As Part Of Its Rule Consolidation Process; Call To Be Held June 30th**

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TO: SEC RULES COMMITTEE No. 39-09  
SMALL FUNDS COMMITTEE No. 11-09  
BROKER/DEALER ADVISORY COMMITTEE No. 33-09  
ETF ADVISORY COMMITTEE No. 17-09 RE: FINRA PROPOSES CHANGES TO THE NASD'S  
COMPENSATION RULE AS PART OF ITS RULE CONSOLIDATION PROCESS; CALL TO BE HELD  
JUNE 30TH

As part of its continuing process to consolidate the rules of the NASD and NYSE, FINRA has published for comment a new FINRA Rule 2341, which will replace existing NASD Rule 2830 that, among other things, governs members' cash and non-cash compensation arrangements. [\[1\]](#) As proposed, Rule 2341 will track the language of NASD Rule 2830, with the exception of certain proposed revisions, including new disclosure requirements, that are summarized below.

Comments on the proposal are due to FINRA by Monday, August 3rd. The Institute will hold a conference call on Tuesday, June 30th at 2 p.m. Eastern to discuss FINRA's proposal. If you plan to participate on the call, please let Ezella Wynn know by email ([ewynn@ici.org](mailto:ewynn@ici.org)) no later than Friday, June 26th. If you are unable to participate in the call but have comments on the draft letter, please provide them to Tami Salmon prior to the call by phone (202-326-5825) or email ([tamara@ici.org](mailto:tamara@ici.org)).

## **FINRA's Proposed Revisions**

The vast majority of the proposed revisions relate to disclosure of the member's cash compensation arrangements, particularly any "special" arrangements. FINRA has, however, also proposed revisions to the recordkeeping requirements relating to non-cash compensation, as well as a new provision relating to exchange traded funds.

### **Cash Compensation Arrangements - Special Arrangements**

Rule 2830 would change the terminology used in new FINRA Rule 2341 for cash compensation. Instead of requiring prospectus disclosure of "cash compensation," the new rule would require the disclosure of standard "sales charges or service fee arrangements." With respect to those members that receive greater sales charges or service fees than are ordinarily paid in connection with sales – which are referred to as "special sales charges or service fee arrangements" – the new rule would impose additional disclosure requirements. In particular, any member that, within the previous 12 months, has received from an offeror any form of cash compensation, other than sales charges or service fees disclosed in the prospectus fee table, must disclose:

- That information about a fund's fees and expenses may be found in the fund's prospectus;
- If applicable,
  - That the firm received cash payments from offerors in addition to the standard sales charges and service fees disclosed in the prospectus;
  - The nature of such payments received in the last 12 months; and
  - A list of offerors making such payments listed in descending order of payments received; and
- Either: (1) provide a reference to a Web page or toll-free phone number containing updated information, which must be updated at least every six months or (2) if the firm elects not to do (1), it must disclose updated information to investors in writing every six months.

#### *Timing of Required Disclosure of Special Arrangements*

The above disclosure that is required in connection with special compensation arrangements must be updated semi-annually and provided in writing to both existing and new customers. Existing customers must be provided the disclosure the later of 90 days after the rule becomes effective or at the time of the customer's next purchase of mutual fund shares (unless the next purchase is an automatic investment); new customers must receive it either at the time of establishing an account with the member or the member's "clearing broker" or, if an account is not established, by the time of the customer's first purchase of shares.

Proposed Supplementary Material .01, "Cash Compensation," would clarify that the term "cash compensation," as used in the new rule includes revenue sharing payments without regard to whether they are based on the amount of mutual fund assets held by the member's customers, the member's sales of the mutual fund's securities, or any other payment related to the sales and distribution of the fund's securities. Proposed Supplementary Material .02, "Special Sales Charge of Service Fee Arrangements," would define "special sales charge or service fee arrangement" as "an arrangement under which a member received greater sales charges or service fees than other members selling the same investment company securities." As explained in this Supplementary Material, this might include a portion of gross charges paid the member that are not paid to other members and cash payouts in addition to the regular commission paid by the offeror. Generally speaking, "a member should assume it has entered into a special sales charge or service fee arrangement if it is receiving sales charges or service fees in addition to the standard dealer reallowance or commission described in the [fund's] prospectus, unless the prospectus is clear that this additional compensation is being paid to all members that sell the [fund's shares]."

The Supplementary Material also clarifies that special arrangements require two levels of prospectus disclosure: (1) the [standard] sales charges and service fees paid to the member and (2) the details of any special sales charge or service fee arrangement with the member and the identity of the member. Also, this additional disclosure is required "even if an offeror would have made the same arrangements available to other members had they requested it." The provisions of Supplementary Material .02 will supersede all prior guidance under existing NASD Rule 2830 that relates to the disclosure of cash compensation arrangements

### **Non-Cash Compensation arrangements**

The only change proposed in the new rule to the substance of the non-compensation provisions in NASD Rule 2830 relate to the recordkeeping requirements. In particular, subdivision (l)(3) of proposed Rule 2341 (p. 20 of Attachment A), will require members to include in their records the value of all non-cash compensation received from offerors. Currently, the value need only be recorded "if known." According to FINRA, deleting the "if known" condition will make this provision "more consistent" with the non-cash compensation recordkeeping requirements. FINRA notes that firms could estimate in good faith the actual value of non-cash compensation received if a receipt or other similar documentation assigning a value is not available.

### **Exchange Traded Funds**

A new subsection (o) would be added to the rule expressly clarifying that nothing in the new rule shall be deemed to prohibit the trading of ETFs in the secondary market at prices other than the ETF's current net asset value, provided that all such transactions are consistent with applicable SEC rules and orders. This provision would define an ETF as a fund registered under the Investment Company Act of 1940 that has either (1) received an exemptive order from the SEC permitting the trading of its shares at prices other than a

current NAV or (2) is operating in a manner consistent with SEC rules applicable to funds or trusts that trade in the secondary market.

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**endnotes**

[1] See *FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Investment Company Securities*, FINRA Regulatory Notice 09-34 (June 2009). The Notice is available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119013.pdf>. Appendix A to the Notice consists of proposed Rule 2431, which is presented as NASD Rule 2830 with redlining to show how the new rule would revise the provisions of the existing rule.

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