MEMO# 18965

June 22, 2005

NASD PROPOSAL ON SALES CONTESTS AND NON-CASH COMPENSATION

 [18965] June 22, 2005 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 23-05 SEC RULES COMMITTEE No. 40-05 SMALL FUNDS COMMITTEE No. 21-05 UNIT INVESTMENT TRUST COMMITTEE No. 9-05 RE: NASD PROPOSAL ON SALES CONTESTS AND NON-CASH COMPENSATION NASD has issued a Notice to Members seeking comment on proposed rule changes that would (1) expand current prohibitions on non-cash compensation to cover the sale and distribution of any security or type of security and (2) prohibit all product-specific cash and non-cash "sales contests," as defined by a proposed new rule.1 The Notice is summarized below. Comments on the proposal are due by August 5th. The Institute will hold a conference call on Thursday, June 30th at 3:30 p.m. Eastern time to discuss the proposal and our comment letter. Details regarding the call will be forthcoming by email. In the meantime, please provide any comments to Tami Salmon at 202/326-5825 or tamara@ici.org or to Frances Stadler at 202/326-5822 or frances@ici.org. The Notice describes current NASD rules prohibiting non-cash compensation, which apply only to specified products, including investment company securities. They provide a series of exceptions. One such exception permits an NASD member to hold an internal non- cash sales contest with respect to the sale of a single type of security, such as investment company securities, provided that the contest is based on total production and the credit for each type of security sold is equally weighted. Under NASD's proposal, a new rule (Rule 2311) would replace the existing non-cash compensation rules. It 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 of distribution of any security or type of security. Proposed Rule 2311 would contain several exceptions similar to those in the current non-cash compensation rules, with some changes intended to improve clarity and NASD members' understanding of the rules. 1 NASD Notice to Members 05-40 (June 2005) ("Notice"). The Notice is available on NASD's website at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014347.pdf. 2 Unlike the current rules, however, proposed Rule 2311 would ban all product-specific sales contests. The rule would define "sales contest" 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 Notice expresses NASD's view that any sales contest that favors one security (e.g., a proprietary investment company) or type of security (e.g., investment companies or stocks) has "the potential to create an incentive to engage in sales conduct unrelated to the best interests of customers." According to the Notice, the

definition of sales contest would permit broker-dealers to hold a contest based on total production on the sale of all securities, provided certain records were kept. In addition, it would allow the payment of cash bonuses to registered representatives who attained a higher total production across all securities. The Notice seeks comment on the proposed definition. The proposal also would eliminate an existing provision that allows non-member companies or other members to contribute to a non-cash arrangement between and member and its associated persons, or contributions by a member to a non-cash compensation arrangement of a non-member, provided that the contribution meets the requirements for such arrangements. Comment is requested on whether there is any need to retain this provision in some form. The Notice states that NASD does not intend the proposed changes to cover different sales charge structures or differential cash payouts among various products. It notes that the regulatory treatment of so-called “differential compensation” arrangements is the subject of SEC rulemaking. Frances M. Stadler Deputy Senior Counsel

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