

MEMO# 9186

August 20, 1997

NASDR REQUESTS COMMENT ON CASH COMPENSATION

1 NASD Notice to Members 97-50 (August 1997). [9186] August 20, 1997 TO: DIRECT MARKETING COMMITTEE No. 20-97 MARKETING POLICY COMMITTEE No. 25-97 SALES FORCE MARKETING COMMITTEE No. 20-97 RE: NASDR REQUESTS COMMENT ON CASH COMPENSATION

NASD Regulation, Inc. ("NASDR") is soliciting comment on how the payment and receipt of various forms of incentive-based cash compensation for the sale and distribution of investment company and variable contract securities should be regulated. A copy of the Notice is attached,¹ and it is summarized below. The Notice notes that NASD Conduct Rule 2830 currently requires disclosure of cash and non-cash payments to NASD members in fund prospectuses. In the case of "special compensation arrangements," which are not generally made available to all dealers, more detailed disclosure, including the identity of particular dealers, is required. The Notice acknowledges, however, that Rule 2830 does not define "special compensation arrangements" and that different issuers interpret the term differently. As indicated in the Notice, the SEC previously solicited comment on an NASDR proposal to restrict non-cash compensation arrangements (e.g., those involving trips and merchandise). That proposal restated the NASD rules regarding prospectus disclosure requirements for cash compensation arrangements. It also would have treated certain cash incentive arrangements similar to non-cash compensation. The Notice states, however, that this latter provision has been dropped from the proposal as resubmitted to the SEC. The Notice notes that there exists a broad range of cash compensation practices, which are grouped into three general categories: (1) differential commission payouts to retail broker/dealers; (2) payments to retail broker/dealers in exchange for a variety of services, such as carrying a fund as a "preferred fund" or providing subaccounting services; and (3) reimbursement to retail broker/dealers to cover business costs, such as, for example, insurance, licensing fees, and office expenses. The Notice notes that the Tully Report on compensation practices covered some of these practices, although it was not limited to sales of investment company shares. The Notice states that NASDR believes that certain cash compensation practices could create incentives to inappropriately favor one product over another, which could compromise customer suitability determinations or create a perception that a broker's interests might not, in some circumstances, be fully aligned with those of its customers. The Notice discusses three general approaches to regulating cash compensation arrangements. The first would be through disclosure. This raises questions such as which information should be disclosed, in which documents should the disclosure be made, and who should make the disclosure (e.g., the fund or the dealer). A second approach would involve substantive standards, such as limiting payments of different compensation. (In this regard, the Notice discusses multiple class funds in particular.) A

third approach would be to treat cash compensation as a sales practice issue and attempt to regulate it by, for instance, providing more guidance on broker's suitability requirements. In addition to generally requesting comments on the nature of various cash compensation arrangements, their harms and benefits, and the appropriate regulatory approach, the Notice asks a series of specific questions, including whether such arrangements raise specific investor protection concerns, which types of arrangements may warrant substantive regulation, and whether individual investors are interested in disclosure of these arrangements. Comments on NASDR's request for comment must be submitted by October 15, 1997. Barry E. Simmons Assistant Counsel Attachment (in .pdf format)

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