

MEMO# 11225

September 7, 1999

NASDR REQUEST FOR COMMENT ON PROPOSED SALESPERSON COMPENSATION RULES

1 NASD Notice to Members 99-81 (September 1999) ("Notice"). 2 NASD Notice to Members 97-50 (August 1997). The Institute recommended at that time that NASDR continue to regulate cash compensation paid to broker-dealer firms through written disclosure requirements. We suggested that fund prospectuses be required to include general disclosure about cash compensation arrangements, and that broker-dealer firms be required to provide general written disclosure about cash compensation arrangements to investors before or when they purchase fund shares. 3 See NASD Notice to Members 98-75 (September 1998). [11225] September 7, 1999 TO: BOARD OF GOVERNORS No. 58-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 28-99 SEC RULES COMMITTEE No. 63-99 UNIT INVESTMENT TRUST COMMITTEE No. 19-99 RE: NASDR REQUEST FOR COMMENT ON PROPOSED SALESPERSON COMPENSATION RULES

NASD Regulation, Inc. has issued a Notice to Members requesting comment on three rule proposals relating to salesperson compensation.¹ The proposals include: (1) a rule prohibiting the payment of higher payout ratios to salespersons for the sale of proprietary investment company products; (2) a rule prohibiting single security sales contests; and (3) a rule requiring disclosure of accelerated payout arrangements for salespersons who change firms. The Notice indicates that these proposals are intended to address three practices identified as problematic in the 1995 report of an industry committee on compensation practices, known as the Tully Report. The Notice also discusses certain related NASD initiatives, including a 1997 Notice to Members soliciting comments on cash compensation issues relating to the sale and distribution of investment company securities² and the amendments to the non-cash compensation rules adopted last year.³ A copy of the Notice is attached, and the proposals are summarized below. Comments on the proposals must be filed with NASDR by October 29th. If there are issues you would like the Institute to consider addressing in its comment letter, please contact Frances Stadler by phone at (202) 326-5822 or by e-mail to frances@ici.org or Tami Reed by phone at (202) 326-5825 or by e-mail to tamara@ici.org by September 24th. Payment of Differential Cash Compensation NASDR's proposal would amend Rule 2830 to prohibit the payment of a higher percentage of gross dealer concessions to representatives for the sale of proprietary investment company securities than the percentage provided on the same dollar amount of non-proprietary investment company securities with similar investment objectives. The Notice explains that the current proposal is limited to investment company products because "the importance of mutual funds to retail investors may make differential payouts involving investment company products of particular concern." Comments are requested,

however, on the extent to which the restrictions should apply to other kinds of products. The Notice also solicits comments on various other issues including, for example: (1) whether differential compensation arrangements should instead be addressed through a disclosure approach and, if so, how that should work; (2) what business reasons exist for providing differential compensation to representatives; and (3) whether it is more appropriate to address concerns regarding compensation arrangements under existing NASD sales practice rules, such as rules regarding suitability requirements and/or through additional supervisory procedures. Single Security Sales Contests NASDR also proposes a new rule to prohibit all single security sales contests. According to the Notice, the proposed rule "is intended to prohibit all such contests that could improperly influence the advice of a representative." The Notice indicates that the proposed rule does not prohibit a sales contest "involving a type or family of securities, such as mutual funds. . . ." The Notice also explains the relationship of the proposed rule to the NASD's recently amended non-cash compensation rules. In particular, while the non-cash compensation rules generally prohibit the payment of non-cash compensation through sales contests, they do not regulate contests that result in cash awards. Moreover, in contrast to the proposed rule, they only apply to investment companies and variable products. The Notice requests comments on several questions including, for example: (1) the prevalence and features of sales contests today; (2) whether, instead of the proposed rule, NASDR should require disclosure of sales contests to investors; and (3) whether existing NASD rules (such as suitability requirements) adequately cover the type of potential misconduct that the proposed rule addresses. Accelerated Payouts The third rule proposal is designed to address a practice under which, as part of an incentive package, representatives who move from one NASD member firm to another receive higher commission payouts for a short, specified period of time (e.g., three to six months or a year). The proposed rule would require that when a registered representative transfers to a new firm, that firm must disclose in writing the existence and general nature of the compensation arrangements to customers whose accounts are being transferred. In addition, the new firm would have to provide this written disclosure to new customers as long as the higher payout arrangement is in effect. The Notice states that the specific compensation formula or amount paid to the representative would not need to be disclosed. Comments are requested on a number of issues concerning the practice of accelerated payouts, the details of the rule proposal, and possible alternatives. General Questions The Notice concludes with several general questions about the regulation of compensation practices, including: whether the burden of compliance with the proposed rules will be significant and whether the costs of compliance will outweigh potential benefits to investors; whether, instead of the specific requirements proposed, NASDR should require that customers receive a general disclosure statement that explains how representatives are compensated, including both cash and non-cash compensation arrangements; and whether there are other compensation practices that should be addressed in addition to, or instead of, the three practices identified above. Frances M. Stadler Deputy Senior Counsel Attachment