

## COMMENT LETTER

September 26, 1997

# Comment Letter on Revised NASD Noncash Compensation Proposal, September 1997

September 26, 1997

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: File No. SR-NASD-97-35

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> is writing to comment on the revised proposed amendments to NASD Conduct Rule 2830 relating to noncash compensation paid in connection with the sale of investment company securities.<sup>2</sup> The Institute generally supports the proposal. As discussed below, however, the Institute recommends that the NASD: (1) reinstate a provision that would restrict the payment of certain cash incentives directly to persons associated with a member; and (2) revise the proposal to permit members to create inhouse incentive programs that focus on a broad investment objective or category (as opposed to including all investment company securities sold by the member). In addition, we have comments on the provision concerning attendance at training or education meetings and minor, technical suggestions on the ability to make contributions to permissible inhouse incentive programs and on the proposed implementation of the amendments.

## Cash Incentive Payments to Associated Persons

The current NASD proposal is substantially similar to an earlier version of the proposal on which the Commission solicited public comments in July 1996.<sup>3</sup> The 1996 proposal, however, contained a provision that would have prohibited the receipt by persons associated with a member of cash compensation preconditioned on the achievement of a sales target unless certain conditions similar to those proposed for noncash compensation incentive programs were met. The 1996 Release stated that the provision was "intended to ensure that offerors do not circumvent the noncash incentive prohibition through the offering of cash incentives directly to associated persons" and that it was "consistent with

the NASD's intention to prohibit incentives that act as point-of-sale inducements that could influence the advice of a salesperson."<sup>4</sup>

According to the 1997 Release, several commenters on the 1996 proposal expressed concerns about the potentially broad impact that the provision unintentionally might have. The 1997 Release states that the NASD's Investment Companies Committee and its Insurance Affiliated Committee "agreed with the commenters that the language of the incentive-based cash compensation provision was capable of being interpreted broadly and voted unanimously to either amend the incentive-based cash compensation provision to clarify its intended scope or delete the provision in its entirety." It indicates that NASD staff subsequently decided to delete the provision and to explore the nature of cash compensation arrangements separately by issuing a Request for Comment on cash compensation issues. For the reasons discussed below, the Institute urges the NASD to revise the provision to clarify its intended scope rather than abandoning it altogether.

The Institute believes that it remains important to address the concern that led the NASD to include the cash incentive provision in the 1996 proposal, i.e., that in the absence of such a provision, it might be possible to circumvent the proposed restrictions on noncash compensation. In our view, payments to individual registered representatives, whether cash or noncash, present potentially greater conflicts of interest than do payments to a broker-dealer firm.<sup>5</sup> Such payments to individuals, regardless of their form, also create the potential to undermine an NASD member's supervisory control over its associated persons. For these reasons, cash incentives paid directly to associated persons of a member should be treated the same as noncash incentives paid directly to associated persons.<sup>6</sup> In both cases, it is appropriate to impose substantive restrictions, as the NASD has proposed with respect to noncash incentive payments.

## **Scope of Inhouse Incentive Programs**

The proposed amendments would impose certain conditions on permissible inhouse incentive programs, including that a noncash compensation arrangement that includes investment company securities must be based on the total production of associated persons with respect to all investment company securities distributed by the NASD member. In a supplemental comment letter on the 1996 proposal, the Institute recommended that the proposal be revised to permit inhouse incentive programs where the compensation is based on sales of investment company securities within a designated broad investment objective or category, rather than all investment company securities sold by the member.<sup>7</sup> We continue to support such a change, which would allow members to tailor their incentive programs to meet their clients' needs.

## **Attendance at Training and Education Meetings**

The proposal excludes from the general prohibition on noncash compensation payments or reimbursement for training and education meetings held by an NASD member or a mutual fund for the purpose of educating associated persons of the member, provided certain conditions are met. One of the conditions is that an associated person's attendance at such meetings must be approved in advance by the member and cannot be "preconditioned by the member on the achievement of a sales target" or any other incentive pursuant to a permissible inhouse noncash compensation program. The 1997 Release states that the prior approval requirement "is intended to ensure that the member does not treat a training or education meeting as a noncash incentive item."<sup>8</sup>

The release further explains that this condition is not intended "to prevent a member from designating persons to attend a meeting held by the member or by an offeror to recognize past performance or encourage future performance, so long as attendance at the meeting is not earned through a member's inhouse sales incentive program, through the sales incentive program of a member's nonmember affiliate, or through the achievement of a sales target."<sup>9</sup> The Institute wishes to emphasize its support for this explanation. As the NASD correctly recognizes, determining attendance at these meetings is a critical component of members' supervisory control over their associated persons.<sup>10</sup> The above-cited explanation of the prior approval condition affirms that NASD members will maintain an appropriate degree of flexibility to determine attendance at training and education meetings, within parameters that are consistent with the overall purposes of the rule amendments.

## **Contributions to Permissible Inhouse Incentive Programs**

The proposal would permit a nonNASD member or other NASD member to contribute to a member's permissible inhouse noncash compensation arrangement. As currently drafted, however, the proposal could be read to prohibit contributions by NASD members to noncash compensation arrangements of nonNASD members (e.g., banks). The Institute believes this is an unintended consequence of a revision to the 1996 proposal that not only prohibits an NASD member or person associated with a member from accepting any noncash compensation (subject to the specified exceptions), but also prohibits members and associated persons from making payments or offers of payments of such compensation. We recommend that the NASD make clear that an NASD member also could contribute to a nonNASD member's noncash compensation arrangement, provided that it complies with the rule amendments.

## **Proposed Implementation of Rule Amendments**

The Commission's release describes how the NASD proposes to implement the amendments to Rule 2830 once they are approved by the Commission. It indicates that the amendments will become effective on a date stated in a Notice to Members, which will be no more than 60 days after Commission approval. The release states that, "[w]ith respect to the non-cash and cash sales incentive provisions, no new sales incentive programs may be commenced" after the effective date. It further states that ongoing programs on the effective date could continue for no more than six months after the effective date (i.e., sales could continue to be applied to those programs). In addition, "non-cash and cash sales incentives" earned by associated persons could be received for up to twelve months following the implementation period.

To minimize potential confusion, the Institute recommends that the Commission's adopting release and the NASD Notice to Members announcing the effective date of the amendments clarify that the above references to sales incentive programs are limited to sales incentive programs that would not be permissible under the proposed rule amendments.<sup>11</sup> For example, presumably NASD members may commence sales incentive programs that comply with the rule amendments after the effective date.

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Thank you for considering our comments on the proposed amendments to NASD Conduct

Rule 2830 relating to noncash compensation arrangements. The Institute wishes to reiterate its concern about the very short period (21 days) provided for public comment on this important rule change proposal.<sup>12</sup> As noted previously, the proposal will have a widespread impact on participants in the brokerage and investment company industries. We urge the Commission to provide longer comment periods for significant regulatory proposals by self-regulatory organizations in the future, to ensure that all interested parties have the opportunity to provide meaningful input.

If you have any questions or need additional information, please call me at (202) 326-5815 or Frances Stadler at (202) 326-5822.

Sincerely,

Craig S. Tyle  
Vice President and Senior Counsel

Attachment

cc: Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission

R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, Inc.

#### **ENDNOTES**

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,642 open-end investment companies ("mutual funds"), 443 closed-end investment companies, and 11 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.206 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

2 SEC Release No. 34-38993 (August 29, 1997), 62 Fed. Reg. 47080 (September 5, 1997) ("1997 Release").

3 SEC Release No. 34-37374 (June 26, 1996), 61 Fed. Reg. 35822 (July 8, 1996) ("1996 Release").

4 1996 Release at p. 35832.

5 The Institute will be writing separately to the NASD in response to its request for comment regarding regulation of cash compensation arrangements. Those comments will focus on cash compensation payments to broker-dealer firms.

6 We understand that, as a practical matter, it is unusual for cash compensation payments to be made directly to associated persons, because of the general prohibition on paying any concession to an associated person of another member.

7 Letter from Craig S. Tyle, Vice President and Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 19, 1996. A copy of that letter is attached to this letter.

8 1997 Release at p. 47087.

9 Id.The 1996 Release included identical language at p. 35830.

10 For example, the 1997 Release states that the provision requiring a member's approval to attend a meeting "assists members in maintaining supervisory control over their associated persons." 1997 Release at p. 47087.

11 As noted above, the discussion of the proposed implementation of the rule amendments refers to the "non-cash and cash sales incentive provisions" and to "non-cash and cash sales incentives." Although we recommend earlier in this letter that the cash sales incentive provisions be reinstated, if our recommendation is not adopted, any references to implementation of the cash sales incentive provisions should be deleted.

12 See Letter from Craig S. Tyle, Vice President and Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 30, 1996.

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