

## COMMENT LETTER

August 8, 2005

# ICI Comment Letter on NASD Compensation Proposal, August 2005

August 5, 2005

Ms. Barbara Z. Sweeney  
Office of Corporate Secretary  
NASD  
1735 K Street, NW  
Washington, DC 20006-1500

Re: Notice to Members 05-40 Relating to Sales Contests and Non-Cash Compensation

Dear Ms. Sweeney:

The Investment Company Institute<sup>1</sup> supports proposed NASD Rule 2311 governing sales contests and the payment and receipt of non-cash compensation.<sup>1</sup> Prohibiting sales contests for specific products and extending restrictions on non-cash compensation to all products will promote the interests of investors. Consistent regulatory treatment of similar arrangements across all products makes sense because concerns about potential conflicts exist regardless of the type of product. It also addresses concerns that singling out some products (e.g., investment company securities) for more stringent regulatory treatment puts them at a competitive disadvantage.

The Institute recommends that the NASD revise the rule to:

- Avoid unintentionally prohibiting certain non-cash compensation arrangements that are currently permitted under NASD Rule 2830(I)(5)(D);
- Replace a subjective standard that would be used to determine the permissibility of certain non-cash compensation arrangements with an objective standard; and
- Continue to permit outside contributions to a non-cash compensation arrangement.

In addition, we recommend that the NASD clarify its intent to continue to apply applicable existing interpretive positions under the new rule, provide a sufficient compliance period, and take steps to avoid inconsistent interpretations by its examination staff. These comments are discussed below.

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## **Permissible Non-Cash Compensation Arrangements**

According to the Notice, the NASD believes that proposed Rule 2311 is “largely consistent with the current non-cash compensation rules applicable to investment company securities . . .,” with the exception of some changes made to improve the rule’s clarity and members’ understanding of the rule. As drafted, however, Rule 2311 appears unintentionally to prohibit some non-cash compensation arrangements that current rules permit.

The problem occurs, in part, because of the interaction between the provisions of Rule 2311 governing sales contests and those governing non-cash compensation. The rule prohibits “sales contests,” which are defined 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 type of security.” The definition excludes any contest that meets certain criteria, including that the contest is based on total production of the associated persons and the member retains specified records.

The rule also prohibits non-cash compensation arrangements, with three exceptions.<sup>3</sup> As a result, where a contest qualifies for the exclusion from the definition of “sales contest,” but involves a non-cash prize, the prize must fall into one of these three categories. Similarly, a non-cash compensation arrangement that does not involve a contest must fall into one of the three categories. Thus, for example, the rule does not permit a member to reward its top producing wholesalers with a \$1,000 set of golf clubs because this does not fit within any of the permitted types of non-cash compensation.

By contrast, Rule 2830(I)(5)(D) permits non-cash compensation arrangements between a member and its associated persons, provided that the arrangement meets certain criteria.<sup>4</sup> It does not restrict the nature or amount of non-cash compensation involved, so long as the required criteria are met. The Institute believes that Rule 2311 similarly should permit in-house non-cash compensation arrangements, whether involving a contest or not, that meet specified conditions, including that the arrangement is based on total production of all types of securities sold by the member and the member complies with recordkeeping requirements.

We believe this is consistent with the NASD's intent in proposing Rule 2311. The Notice states that the definition of sales contest would permit broker-dealers to hold a contest among associated persons that is based on their total production on the sale of all securities, provided certain records are kept. It further states that "by permitting contests that are based on an associated person's total production, the rule also would allow cash bonuses to registered representatives who attained a higher total production across all securities."<sup>5</sup> While this example involves cash compensation, we do not believe that the NASD intends to prohibit an identical contest that involves a non-cash prize. Indeed, it appears that, in proposing Rule 2311, the NASD is attempting to address the Institute's longstanding concern that it is inappropriate, as a matter of policy, for the NASD rules to determine whether an arrangement is permissible based solely on whether the compensation involved is in the form of cash or non-cash.<sup>6</sup>

To avoid unintentionally prohibiting non-cash compensation arrangements similar to those that are currently permitted, and consistent with the NASD's proposal to prohibit arrangements based on sales of a single security or type of security, the Institute recommends that the NASD revise Rule 2311 by adding a new subsection (b)(4), as follows:

(4) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

(i) the arrangement is based on the total production of all associated persons with respect to all securities distributed by the member;

(ii) the arrangement requires that the credit received for each security is equally weighted;<sup>7</sup>

(iii) the member maintains records of all such arrangements, including the criteria for awarding compensation and the names of the associated persons who participate in the arrangements.

## **Definition of "Preconditioned on the Achievement of a Sales Target"**

Consistent with existing restrictions on non-cash compensation, the proposed rule will prohibit arrangements that are "preconditioned on the achievement of a sales target." The NASD proposes to define this phrase, in part, to mean "an arrangement pursuant to which associated persons understand in advance that they must achieve either a dollar denominated goal for selling any security or type of security or a goal of finishing within a defined number of top sellers of a security or type of security. (Emphasis added.) The rule further provides that a training or education meeting will not be "preconditioned on the achievement of a sales target" if, among other things, "associated persons do not understand in advance that the receipt of compensation in connection with the meeting requires achievement of a sales target." (Emphasis added.)

The Institute supports the NASD's intent to clarify the meaning of its rule language. At the same time, we are concerned that the proposed definition establishes a subjective standard that will make compliance impractical, if not impossible. It is unclear how NASD members or other offerors will be able to determine, and document, what associated persons "understand" at a given point in time. For example, if a broker-dealer has awarded the

same non-cash compensation reward to top producers for two years in a row, would the use of this same reward for top producers in the third year be considered “preconditioned on the achievement of a sales target”? The Institute believes that the answer should be no, provided that the broker-dealer did not communicate its plans to its associated persons beforehand, including any threshold for being considered a top producer or other criteria to qualify for the reward.

As currently drafted, the rule holds a member responsible for any erroneous, subjective impressions of its associated persons. We are also concerned that any determination regarding what associated persons understand will be subject to second-guessing (e.g., in an NASD examination). NASD examiners might draw a different conclusion, for example, about associated persons’ understanding regarding the non-cash compensation arrangement described above. Enforcement of the proposed standard would be difficult, too, because of its subjective nature.

To avoid these problems, we recommend that the NASD revise its proposed definition of “preconditioned on the achievement of a sales target” to establish a more specific and objective standard that turns on information communicated to associated persons. We recommend that the definition be revised as follows:

(5) ‘Preconditioned on the achievement of a sales target’ shall mean an arrangement pursuant to which associated persons understand in advance that they must achieve either a dollar-denominated goal for selling any security or type of security or a goal of finishing within a defined number of top sellers of a security or type of security. A training or education meeting An arrangement shall not be considered preconditioned on the achievement of a sales target if a member or an offeror designates persons to attend the meeting designs the arrangement to recognize past performance or to encourage future performance, provided that associated persons do not understand in advance that the receipt of compensation in connection with the meeting requires achievement of a sales target the member or offeror does not disclose to associated persons in advance the dollar-denominated sales goal or defined number of top sellers that will qualify.

Our proposed revision clarifies that an otherwise permissible arrangement will not be considered “preconditioned on the achievement of a sales target” if the specific criteria on the basis of which associated persons are selected to qualify are not disclosed to associated persons in advance. In addition, it extends this clarification to all permissible arrangements under the rule, rather than limiting it to training or education meetings.

## **Regional Meetings**

Unlike Rule 2830(l)(5)(C)(iii), the proposed rule would limit attendance at regional meetings to those associated persons “who work within that region.” This restriction seems unduly limiting. There is nothing inherently improper about an associated person attending a training or education meeting outside his or her region. Indeed, it would seem wholly appropriate for associated persons in one region to interact at training or educational sessions with their colleagues in other regions. Also, depending on individual circumstances, it may be more convenient for an associated person to attend a training session in another region.

The Notice does not any explanation of the basis for this limitation. In the absence of a compelling reason for including the limitation, we recommend eliminating it.

## **Contributions to a Non-Cash Compensation Arrangement**

The NASD proposes to eliminate a provision in the current rules that permits non-member companies or other NASD members to contribute to a non-cash compensation arrangement between a member and its associated persons, or members to contribute to a non-cash compensation arrangements of a non-member. We recommend retaining the provision. Notwithstanding the proposed ban on product-specific sales contests, there still could be situations in which it would be appropriate and desirable to permit outside contributions to non-cash compensation arrangements. For example, a fund wholesaler could offer to sponsor a well-known speaker or sports figure to appear at a conference held by a member for its associated persons.

We are not aware of any concerns or abuses in this area under current rules that would warrant eliminating the flexibility permitted by the current rule. Accordingly, we believe that the NASD should continue to permit outside contributions to permissible non-cash compensation arrangements in order to preserve flexibility without diminishing investor protection.

## **Interpretive Positions**

According to the Notice, like Rule 2830(I)(5), Rule 2311 is not intended to cover differential sales load structures or ongoing differential cash payments among various securities products. The Institute agrees that the rule should not extend to these arrangements inasmuch as they involve neither sales contests nor non-cash compensation. We recommend that the NASD reconfirm its intent in any notice to members concerning adoption of the rule.

We further recommend that the NASD clarify that it will interpret other aspects of the new rule consistently with Rule 2830(I)(5), as discussed below.

## **Promotional Items of Nominal Value**

Like Rule 2830(I)(5)(A), proposed Rule 2311 will permit broker-dealers and their associated persons to receive gifts from offerors that do not exceed \$100 per person annually so long as such gifts are not preconditioned on the achievement of a sales target. The NASD has interpreted Rule 2830(I)(5)(A) to exclude promotional items of nominal value that display the offeror's logo, such as golf balls, shirts, towels, and pens.<sup>8</sup> While the Notice is silent on this issue, we recommend that the NASD apply the existing interpretation to Rule 2311.

Similarly, the Institute recommends that the NASD clarify that, under Rule 2311, members and their associated persons attending training and education meetings may continue to receive promotional items of nominal value that display an offeror's logo. While the receipt of such items is currently permitted, Rule 2311 appears to prohibit them at training and education meetings. This is because Rule 2311(b)(3)(D) limits payment or reimbursement in connection with a training or education meeting to only those expenses of an associated person that are related to "training, education, meals, lodging, and transportation."<sup>9</sup> Inasmuch as these de minimis items have not been found to raise conflict of interest concerns, we recommend that the NASD revise Rule 2311(b)(3)(D) as necessary to continue to permit members and their associated persons to receive promotional items of nominal

value at training and education meetings.

#### Arrangements Limited to a Specific Division

NASD also should clarify that Rule 2311 will not prohibit non-cash arrangements that are limited to a specific division of a broker-dealer, such as an institutional sales division that offers only certain products. As noted in NTM 99-55, Rule 2830(I)(5) currently permits such an arrangement so long as it is “based on the entire universe of products that the specific division is authorized to sell and otherwise complies with the equal weighting and total production requirements” of the rule. [Arrangements Limited to a Specific Division](#)

NASD also should clarify that Rule 2311 will not prohibit non-cash arrangements that are limited to a specific division of a broker-dealer, such as an institutional sales division that offers only certain products. As noted in NTM 99-55, Rule 2830(I)(5) currently permits such an arrangement so long as it is “based on the entire universe of products that the specific division is authorized to sell and otherwise complies with the equal weighting and total production requirements” of the rule. [10](#) A similar standard should apply under proposed Rule 2311.

## President’s Club Memberships

According to the Notice, the new rule will prohibit increased bonuses or “President’s Club” memberships “that are awarded for the sale of specific securities or types of securities within a defined period of time.” We recommend that the NASD clarify that the rule will continue to permit the use of President’s Club memberships – involving cash or non-cash compensation – that are based on the total production of the sale of all securities provided certain records are kept.<sup>11</sup> We also recommend that the NASD clarify that the rule will continue to permit a sales contest based, for example, on the level of assets gathered or the number of new accounts opened over a defined period, so long as such arrangement is based on all assets gathered or all accounts opened – without regard to the type of assets or account – and the arrangement is not preconditioned on the achievement of a sale target as defined in the rule.

## Compliance

### Compliance Date

When the SEC approved the NASD’s non-cash compensation rule for investment companies in July 1998, the rule had an effective date of January 1, 1999. The NASD permitted members that had non-cash compensation arrangements in place to keep those arrangements in place until June 30, 1999, and permitted non-cash payments under those programs to continue until June 30, 2000. The Institute recommends that the NASD provide a similar compliance date and transition period for Rule 2311.

### Compliance Examinations

We understand that there have been instances in which the NASD’s examination staff has interpreted the existing non-cash compensation rules in ways that conflict with the NASD’s written interpretation of the rules (e.g., NTM 99-55) and that vary from field office to field office. In addition to clarifying how it intends to interpret Rule 2311, the Institute strongly recommends that the NASD train its examination staff in this area so that the staff does not take inconsistent positions when conducting examinations.

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The Institute appreciates the opportunity to express its support for the NASD's proposal. If you have any questions concerning these comments, please do not hesitate to contact the undersigned by phone at (202) 326-5825 or by email at [tamara@ici.org](mailto:tamara@ici.org).

Sincerely,

Tamara K. Salmon  
Senior Associate Counsel

cc: Thomas M. Selman, Senior Vice President  
Investment Companies/Corporate Financing  
NASD

Joseph P. Savage, Associate Vice President  
Investment Companies Regulation  
NASD

#### [Attachment](#)

#### **ENDNOTES**

1 The Investment Company Institute is the national association of the American investment company industry. [More information about the Institute](#) is attached to this letter.

2 See [Sales Contests and Non-Cash Compensation, NASD Notice to Members 05-40](#) (June 2005) (the "Notice").

3 The exceptions are: (1) gifts that do not exceed in value an annual amount per person established by the NASD Board of Governors (currently \$100) and that are not preconditioned on the achievement of a sales target; (2) an occasional meal, ticket to a sporting event or the theater, or comparable entertainment that is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on the achievement of a sales target; and (3) payments or reimbursements of associated persons' expenses in connection with training or education meetings, provided that the meetings meet certain conditions.

4 These conditions are: (1) the non-cash compensation arrangement, if it includes investment company securities, is based on the total production of all associated persons with respect to all investment company securities distributed by the member; (2) the arrangement requires that the credit received for each investment company security is equally weighted; (3) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and (4) the member or its associated person maintains records of the compensation received as required by the rule.

5 Notice at 5 (Emphasis added.).

6 The Institute previously urged the NASD to avoid creating such a distinction. See, e.g., [Letter from Craig S. Tyle](#), Vice President and Senior Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 26, 1997. The proposed definition of "sales contest" in Rule 2311, which refers to both forms of compensation, appears designed to provide consistent treatment.

[7](#) We note that, while proposed Rule 2311 would include a “total production” requirement, it would not require that each security considered for purposes of determining total production be equally weighted. We additionally recommend that the equal weighting condition of Rule 2830(l)(5)(D)(ii) be incorporated into Rule 2311.

[8](#) See Questions and Answers Relating to Non-Cash Compensation Rules, NASD Notice to Members 99-55 (July 1999) (“NTM 99-55”) at Question 17.

[9](#) Rule 2830(l)(5)(C) does not contain such a restriction.

[10](#) NTM 99-55 at Question 22.

[11](#) See pp. 2-3 above, concerning permissible non-cash compensation arrangements.

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