

## COMMENT LETTER

May 23, 2014

# ICI Files Comment Letter on FINRA Review of Its Non-Cash Compensation Rule (pdf)

May 23, 2014 Marcia E. Asquith Office of the Corporate Secretary FINRA 1735 K Street, NW Washington, DC 20006-1506 Re: Retrospective Rule Review, FINRA Notice 14-15 (April 2014) Dear Ms. Asquith: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on FINRA Rule 2830(l)(5), relating to non-cash compensation arrangements involving investment company securities (the “non-cash compensation rule”), which FINRA is considering as part of its retrospective rule review. <sup>2</sup> FINRA is to be commended for conducting this review, which seeks comment on whether this rule and others are meeting their intended investor protection objectives by reasonably efficient means. According to its Notice, among other things, FINRA seeks input on whether the non-cash compensation rule has effectively addressed the problems it was intended to address and members’ experiences with implementation of the rule, including any ambiguities or compliance challenges. We commend FINRA for undertaking a retrospective review of its rules to determine whether certain rules

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$16.8 trillion and serve more than 90 million shareholders. <sup>2</sup> See FINRA Requests Comment on the Effectiveness and Efficiency of its Gifts and Gratuities and Non-Cash Compensation Rules, FINRA Notice 14-15 (April 2015) (the “Notice”). FINRA’s retrospective rule review also includes a review of FINRA Rule 5110(h), which governs non-cash compensation arrangement involving corporate underwritings, including those of closed-end funds. To the extent relevant to its review of Rule 5110(h), we respectfully request that FINRA additionally consider the comments in this letter regarding Rule 2830(l)(5) in connection with that review. Marcia E. Asquith May 23, 2014 Page 2 or rule sets are meeting their intended investor-protection objectives through reasonably efficient means. As discussed in more detail below, we recommend that FINRA strongly consider replacing the provisions in the rule’s current exemptions that require the categorization of expenses as “entertainment” or “training” with a more principles-based provision. In the event FINRA determines to retain these two elements of the rule in their current form, we recommend that it address certain related compliance challenges. We also recommend that FINRA revise the nominal gift provision in the rule to ensure that it reflects, on an ongoing basis, a current sense of the amount of gifts that would be considered nominal. We hope that our comments assist FINRA in its review of the rule. I.

BACKGROUND ON RULE 2830(I)(5) FINRA Rule 2830(I) governs member compensation relating to investment company securities. Subdivision (5) of the rule governs members' non-cash compensation arrangements. In general, it prohibits any member, or person associated with a member from, directly or indirectly, accepting or making payments or offers of payments of any non-cash compensation except as permitted in the rule. The non-cash compensation that is permitted under the rule consists of: (1) nominal gifts, including logo items; (2) occasional meals, tickets to a sporting event or the theater, or comparable entertainment; (3) payment or reimbursement by offerors in connection with training meetings; and (4) sales contests.<sup>3</sup> Each of these exceptions is predicated on the member satisfying certain criteria. In addition, the last two exceptions are conditioned on the member maintaining records of all compensation received by the member or its associated persons from offerors. These records must include the name of the offeror, the names of the associated persons, and the nature and value of any non-cash compensation received. Rule 2830(I)(5) was the result of a ten-year project of FINRA's predecessor (the NASD) to control the use of non-cash compensation in connection with a public offering of securities. As the NASD explained in 1998 when announcing the SEC's approval of the new rule, NASD Regulation believes that the increased use of non-cash compensation for the sale of variable contracts and investment company securities heightens the potential for loss of supervisory control over sales practices and increases the perception of inappropriate practices, which may result in a loss of investor confidence. NASD Regulation also believes that the increased use of non-cash compensation creates significant point-of-

3 Our comments are limited to the first three of these exceptions. Marcia E. Asquith May 23, 2014 Page 3 sale incentives that may compromise the requirement to match the investment needs of the customer with the most appropriate investment product.<sup>4</sup> The rule took effect on January 1, 1999. It has not been substantively revised since then, making it ripe for FINRA's retrospective rule review. II. THE ENTERTAINMENT AND TRAINING EXCEPTIONS As noted above, Rule 2830(I)(5) permits the payment of non-cash compensation in connection with (1) occasional meals, tickets to a sporting event or the theater, or comparable entertainment (the "entertainment" exception in Subdivision 2830(I)(5)(B)) and (2) meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member (the "training" exception in Subdivision 2830(I)(5)(C)). It is not always clear whether an event should fall within the entertainment exception or the training exception, thereby presenting compliance challenges for members. To address such ambiguities and challenges without compromising the customer-protection purpose of the rule, we recommend that FINRA consider a new principles-based approach to these two exceptions as discussed below. A. Conditions for Claiming these Exceptions The criteria for reliance on the entertainment and training exceptions differ. The entertainment exception is conditioned on the permitted entertainment events not being (1) so frequent nor so extensive as to raise any question of propriety and (2) preconditioned on achievement of a sales target. The training exception, on the other hand, is conditioned on five criteria. These are: (1) records of the event must be maintained pursuant to Rule 2830(I)(3); (2) associated persons must obtain the member's prior approval to attend and attendance cannot be preconditioned on reaching a sales target or other incentive; (3) the location must be appropriate to the purpose of the meeting; (4) guests' expenses may not be reimbursed; and (5) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement. Through guidance, FINRA has explained that holiday parties, receptions, and other local events where local transportation and dinner may be provided to associated persons by offerors (and which are not organized for training or educational purposes) must be treated under either the entertainment exception or under the nominal gifts provision (subsection (A)), described

below).<sup>5</sup> FINRA also has allowed offerors to reimburse a registered representative's "prospecting trip" expenses, including travel, 4 See NASD Notice to Members 98-75 (September 1998) (the "1998 Notice") at p. 1. 5 See Questions and Answers Relating to Non-Cash Compensation Rules, NASD Notice 99-55 (July 1999) ("Notice 99-55") at Question 13. Marcia E. Asquith May 23, 2014 Page 4 lodging, meals, the cost of renting meeting spaces or rooms, and the cost of producing marketing materials to promote investment company sales.<sup>6</sup>

**B. Ambiguities and Compliance Challenges Associated with these Exceptions** As mentioned above, in practice, it is not always clear whether non-cash compensation paid or received in connection with an event is subject to the entertainment or training exception. For example, events might involve training during the day, but also have entertainment in the evening (e.g., a group dinner with entertainment or an outing following a day of training). We note that the five conditions included under the training exception are silent regarding any entertainment expenses associated with a training event. As a result, events that blend training with entertainment raise confusion regarding a variety of issues including, for example, the amount of training that must occur for it to qualify for the training exception. Also, in connection with such events, it is uncertain whether a member is expected to either (1) divide the expenses associated with the event into two component parts for purposes of the rule (i.e., the training portion of the event would fall within the exception for training and the social portion of the meeting would fall within the exception for entertainment) to avoid an allocation of entertainment invalidating a member's reliance on the training exception, or (2) determine that it is appropriate to treat the value of the entertainment as part of the permitted training non-cash compensation. Similarly, the relationship between the "prospecting trip" guidance and the training exception oftentimes causes confusion. To our knowledge, neither the rule nor FINRA's guidance definitively resolve this relationship, thereby leaving it up to each member's individual determination. While we may presume that the exception for prospecting trips may be more limited in terms of the number of retail broker-dealers or registered representatives involved in such trips, we are unable to find that distinction or any meaningful distinction between a prospecting trip and a training event in FINRA's rules or guidance.<sup>7</sup> Since there do not appear to be any conditions attached to non-cash compensation paid in connection with a prospecting trip – so long as the trip is, in fact, a "prospecting trip," which is not defined – it would seem that a member would opt to treat such trip as meals and entertainment rather than as a training or education trip. 6 See Notice 99-55 at Questions 14 and 15. 7 According to the Release, "The NASD believes that a 'road show' or seminar for investors is not the same as a training or education meeting that is intended only for associated persons of member firms nor is it a non-cash sales incentive trip that was intended to be prohibited by the proposed rule. Thus, it appears appropriate to interpret the proposed rule to not prohibit reimbursements of the expenses of members for road shows for the benefit of investors." Release at p. 35839. We note that, with respect to the business conducted by mutual fund underwriters, the prospecting trips may involve hosting intermediaries that the underwriter hopes to enlist as fund distributors. There is nothing in the text of the rule that indicates that the prospecting trip or road trip exception is limited to trips involving retail investors. Marcia E. Asquith May 23, 2014 Page 5 We appreciate that Rule 2830(l)(5) was designed both to protect investors from inappropriate influences or conflicts of interest that may impact a broker-dealer's recommendation of a particular mutual fund and to ensure that compensation arrangements do not undermine the supervisory control of the member firm with respect to its associated persons. We question whether the rule's current design and component parts remain necessary to address FINRA's concerns.

**C. A New Principles-Based Approach to the Entertainment and Training Exceptions** We recommend that as part of its current initiative, FINRA take a fresh look at

its provisions governing non-cash compensation paid in connection with entertainment and training events and consider whether, in light of other FINRA reforms in the intervening years, it remains necessary to require members to allocate non-cash compensation pursuant to these categories. In particular, we note that when the rule was first adopted in 1998, NASD had one suitability standard – Article III, Section 2, which required a member, in recommending a security to a customer, to have “reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.” Today, FINRA’s suitability rule, Rule 2111, is far more comprehensive and robust. The rule now defines three component parts of a member’s suitability obligation (i.e., reasonable-basis, customer- specific, and quantitative suitability), it extends a member’s suitability obligation to recommendations involving investment strategies, and it requires a member or its associated person to obtain sufficient information to assess the customer and the customer’s investment profile. These enhancements to FINRA’s suitability rule should diminish FINRA’s concerns with non-cash compensation arrangements compromising a member’s duty to match the investment needs of the customer with the most appropriate investment products. Also, with respect to FINRA’s concern regarding undermining the supervisory control of a member firm with respect to its associated persons, when Rule 2830(l)(5) was adopted, there was not as much rigor and formality around FINRA members’ supervisory control procedures and systems as there is today.<sup>8</sup> Today’s more formal requirements include, among others: FINRA Rule 3110, which requires each member to have a supervisory system; FINRA Rule 3120, which requires each member to have a supervisory control system; and FINRA Rule 3130, which requires every member to designate a chief compliance officer and have its chief executive officer (or its equivalent) certify annually that, among other things, the member has in place processes to establish, maintain, review, test, and modify its written compliance policies and written supervisory procedures that are reasonably designed to achieve compliance with applicable securities laws, rules, and regulations.

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Article III, Section 27 governed a member’s supervisory activities. It required each member to: establish and maintain a system to supervise the activities of its registered representatives; have written supervisory procedures; designate a principal to carry out supervisory responsibilities; designate offices of supervisory jurisdiction as appropriate; and conduct an annual interview or meeting with each registered representative at which compliance matters are discussed. Marcia E. Asquith May 23, 2014 Page 6 We respectfully submit that the reforms that have been instituted through these various new rules may sufficiently address many of the concerns underlying the entertainment and training provisions. As a result, there may no longer be a compelling need to address such concerns by specifically requiring members to categorize events as either entertainment, training, or a prospecting trip. Instead, for example, FINRA could take a more principles-based approach that instead requires members to have compliance policies and procedures relating to their payment of non-cash compensation that are reasonably designed to avoid: (1) improperly influencing a broker-dealer or its associated person at the point of sale; (2) conflicts of interest that might impact recommendations by the broker-dealer or its associated persons; and (3) any conduct that might have the potential for undermining a member’s supervisory controls of the member firm with respect to its associated persons. FINRA also might require members, in such policies and procedures, to establish limits on the types and amounts of non-cash compensation that they receive (or pay, as appropriate) on an annual basis. Consistent with other FINRA rules,<sup>9</sup> each member that pays non-cash compensation might also be required to review its policies and procedures in this area on an ongoing basis and adjust them as necessary to ensure they continue to fulfill their intended purpose. While we are not advocating that FINRA necessarily propose a rule

containing each of these elements, we believe that, as part of its retrospective rule review project, FINRA should explore whether a principles-based approach to its concerns with non-cash compensation arrangements could ensure the protection of investors without requiring members to categorize their receipt or expenditure of non-cash compensation. A new principles-based approach along the lines of what we suggest might be one such alternative worthy of further consideration.

### III. SPECIFIC ISSUES WITH THE CURRENT RULE'S EXCEPTIONS

In the event FINRA elects to maintain the rule's current structure, rather than taking a new principles-based approach, we recommend that it resolve – through revisions to the rule or otherwise – several ambiguities with the current rule's exceptions, which are discussed below.

#### A. The Entertainment Exception

The condition in the entertainment exception that the entertainment not be “so frequent nor so extensive as to raise any question of propriety” presents both ambiguities and compliance challenges for our members' principal underwriters.<sup>10</sup> Mutual fund underwriters utilize wholesalers and regional distributors to both encourage retail broker-dealers and other intermediaries to offer and sell their funds' shares to investors and to educate retail broker-dealers regarding the fund complex and its funds' features. The underwriters also provide support services for the broker-dealers distributing their funds, such as broker-use only, marketing, and educational materials. Such underwriters and their wholesalers

<sup>9</sup> See, e.g., FINRA Rule 3130, discussed above. <sup>10</sup> Rule 2830((b)(1)(E) defines the term “offeror” to include a fund underwriter and any affiliated person. Marcia E. Asquith May 23, 2014 Page 7 interact with a variety of FINRA member firms including wirehouses, platforms, and national, regional, and local broker-dealers of all sizes, which differ in their views regarding what is permitted under this provision. Some broker-dealers interpret the words “not so frequent nor so extensive as to raise any question of propriety” very liberally; others very conservatively. Such differences in interpretation may vary depending on the type of intermediary (e.g., wirehouse v. platform) and whether the broker-dealer is a national, regional, or local firm. For example, some broker-dealers implement the rule by limiting the amount that an underwriter can spend on each representative each year. Others broker-dealers have no such dollar limit. Not surprisingly, what might raise questions of propriety in a large urban center, might be significantly different from what raises questions of propriety in a smaller, less urban location. And yet, our members that serve as national underwriters and that deal with a variety of broker-dealers throughout the United States must have compliance policies and procedures that accommodate the disparate practices among the broker-dealers that distribute their shares. The lack of clearly defined standards that can be utilized nationwide and among a variety of types of broker-dealers makes compliance with the rule quite challenging.

#### B. The Training Exception versus the Entertainment Exception

As noted above, due to the variety of types of events sponsored or offered by members or offerors, it is not always clear whether non-cash compensation relating to such events should fall under the training or entertainment exception. This issue arises in connection with at least three different types of events: “blended” events (as discussed above); events sponsored by a variety of firms; and the provision of meals and drinks to certain associated persons by an offeror in connection with training events. We recommend that FINRA provide greater guidance regarding the treatment of non-cash compensation in each of these circumstances.

##### 1. Blended Events

If FINRA elects not to address blended events through a principles-based rule, as discussed above, we recommend that it provide guidance regarding how the training and entertainment exceptions apply to them. In particular, we would like FINRA to clarify, for those events that involve both a training and an entertainment component, the amount of training that must occur for the event to qualify as a training event and how the entertainment portion of the event is to be treated for purposes of the rule.

##### 2. Multi-Sponsor Events

We understand that it is not uncommon for

industry events to be sponsored by a number of offerors or underwriters. Such events may include “big name” entertainment and involve hundreds of registered representatives from a variety of firms. The rule is unclear regarding how members are to Marcia E. Asquith May 23, 2014 Page 8 treat these and other similar events under this rule. In addition to the fact that these multi-sponsor events may raise issues associated with blended events, they also raise issues in terms of how the “lavish” standard in Rule 2830(l)(5)(B) applies to the allocation of expenses among the various sponsors and attendees. To address this uncertainty, it would be helpful for FINRA to clarify whether the rule’s standard of proprietary applies to the event overall regardless of the number of sponsors or attendees or whether, instead, sponsors are expected to make some type of per-attendee computation to make this determination. Currently, the lack of guidance regarding such events leaves each FINRA member to determine independently how to categorize such an event under the rule.

3. Meals and Drinks The third type of event occurs when, for example, in connection with an industry training conference, an offeror treats certain representatives of a member firm to a meal or drinks. This circumstance differs from the blended event scenario discussed above because not all persons involved in the training event may be invited for the meal or drinks. Under the current rule, it is uncertain whether the sponsor should characterize these expenses as training or entertainment.

C. The Treatment of Guests’ Expenses Under the Exceptions As noted above, the exception for training contains five conditions, including that guests’ expenses may not be reimbursed. As part of its retrospective rule initiative, we recommend that FINRA consider the continued relevance of this condition. While we presume that this condition may have been intended to avoid paying the expenses of family members accompanying an associated person to an event (thereby indirectly compensating the associated person), our members report that, today, it is not uncommon for the “guest” to be a financial professional, attorney, or accountant that works with the associated person or its clients to advise clients on financial matters. Paying a guest’s expenses in such circumstances seems wholly appropriate as it would not appear to result in the type of indirect compensation to the associated person that raises regulatory concerns. FINRA should consider revising the rule’s prohibitions to accommodate such reimbursement as a legitimate educational expense. Another issue relating to rule’s prohibition on paying the expenses of guests arises in connection with meals offered as part of a training event. In particular, members are uncertain whether the training exception prohibits a guest from attending or partaking in, for example, breakfasts or lunches that are provided to all training event attendees. We would welcome FINRA clarifying this issue. Also, in connection with a blended event involving both training and entertainment, our members request greater clarity regarding whether an offeror is permitted to pay for guests’ expenses at the social portion of the meeting even if it is prohibited from doing so for the training portion of the meeting (if this is the case).

Marcia E. Asquith May 23, 2014 Page 9 D. The Nominal Gifts Exception Subdivision (l)(5)(A) of the rule, which is sometimes referred to as the “nominal gifts” exception, permits non-cash compensation arrangements involving “gifts that do not exceed an annual amount per person fixed periodically by [FINRA]” so long as they “are not preconditioned on achievement of a sales target.”<sup>11</sup> Since 1993, the maximum value of gifts or gratuities a member or its associated person may provide to another person each year has been fixed by FINRA at \$100.<sup>12</sup> In our view, this exception has effectively addressed the specific concerns it was designed to address – i.e., prohibiting lavish gifts and entertainment that may compromise members’ recommendations to investors. We recommend, however, that FINRA consider establishing – preferably in the rule – a process or formula by which the dollar limit in the rule is periodically updated. There is currently no requirement in the rule for FINRA to revisit the fixed amount and, as noted above, the rule’s current \$100 limit was established over 20 years ago, when \$100 likely reflected the costs of nominal gifts. Since

then, the amount has not been revised to adjust for inflation or increases in the consumer price index. Had the amount been adjusted solely on the basis of inflation, it would be closer to \$170. To ensure that the dollar limit reflects a current sense on an ongoing basis of the amount of gifts that, on an annual basis would be considered “nominal,” we recommend that FINRA consider revising the rule.<sup>13</sup> In particular, we recommend that the rule require FINRA, no less frequently than every five years, to revisit the annual amount of permissible gifts per person and make increases as warranted, taking into account the effect of inflation and other factors as appropriate.<sup>14</sup>

11 Prior to adoption of this rule, FINRA Rule Article III. Section 10, which governed Influencing or Rewarding Employees of Others, governed the giving of gift and gratuities. It prohibited members from giving anything of value, including gratuities “in excess of fifty dollars per individual per year to any person, principal, proprietor, employee, agent or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient . . .” 12 See Approval of Amendment Relating To the Payment of Gratuities or Anything Of Value by Members to Others, FINRA Notice 93-8 (January 1993). According to this notice, on December 28, 1992, the SEC approved an increase in the maximum value of gifts permitted under this exception from \$50 to \$100.

13 While our recommendation relates to Rule 2830(I)(5)(A), we note that FINRA is also considering FINRA Rule 3220, relating to Influencing or Rewarding Employees of Others, as part of its current retrospective rule review. We recommend that FINRA similarly consider amending Rule 3220 to provide for an automatic adjustment on a specified frequency of the rule’s \$100 gift limit. 14 Our recommended approach to build an adjustment into the rule is consistent with the approach taken by Congress in Section 418 of the Dodd Frank Wall Street Reform and Consumer Protection Act, which requires the SEC, at least every five years, to adjust for the effects of inflation the dollar threshold that is used to determine which clients may be treated as a “qualified client” under the Investment Advisers Act of 1940. Marcia E. Asquith May 23, 2014 Page 10 We additionally recommend that FINRA clarify two issues relating to this exception. The first is the treatment of “raffle” items under this exception. In particular, we request FINRA to specifically address whether a raffle is subject to the provisions of Rule 2830(I)(5) and, if so, whether a member must impose any conditions on the raffle, including limiting the value of the raffled item to the \$100 limit in this exception. If the raffled item is subject to the \$100 limit, we would appreciate FINRA clarifying whether the member offering the raffled item must keep a record of the winner of the raffle to ensure compliance with the rule. The second issue we would like FINRA to clarify is the treatment of charitable donations made to express sympathy for the passing of a business partner or a member of their immediate family. It would be helpful if FINRA clarified whether such contributions are subject to the rule’s monetary limit. ■ ■ ■ ■ ■

We again commend FINRA for undertaking its retrospective rule review and including Rule 2830(I)(5) in such review. We appreciate FINRA’s consideration of our comments as it begins this process and determines its next steps. If you have any questions concerning our comments or if we can be of any assistance to FINRA in this process, please contact the undersigned by phone (202-326-5825) or email (tamara@ici.org). Sincerely, /s/ Tamara K. Salmon Senior Associate Counsel