fines for violation of trading conduct and decorum policies established under CBOE Rule 6.20, and states that the specific dollar amount that may be imposed as fines thereunder will be distributed to the membership periodically. The Exchange has previously issued Regulatory Circular 95–37, which sets forth fines for most of the trading conduct and decorum policies established under Rule 6.20, but does not include fines for violation of the firm quote requirements of Rule 8.51, which are deemed to be violations of Rule 6.20(b).[2] Proposed Regulatory Circular 96–yy cures this omission for violations of the firm quote rule in the OEX crowd by setting forth the specific dollar amounts that may be imposed as summary fines for such violations. As noted above, the fines that may be imposed for refusal to take the other side of an OEX trade entitled to execution under the firm quote rule when directed to do so by Floor Officials range from $1,000 to $5,000, which places them at the high end of the scale under Rule 17.50. This is intended to remove any economic incentive for a market maker to refuse to obey the directions of Floor Officials to comply with firm quote requirements.

The Exchange believes that by clarifying the obligations of market makers and floor brokers in the OEX crowd under the firm quote rule and by specifying the fines that may be imposed for failure to honor these obligations, the proposed regulatory circulars will serve to promote just and equitable principles of trade and to protect investors and the public interest, in furtherance of the objectives of section 6(b)(5) of the Act.

*B. Self-Regulatory Organization's Statement on Burden on Competition*

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

*C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing rule change constitutes a stated policy with respect to the meaning, administration, or enforcement of an existing rule, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b–4 thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to the File No. SR–CBOE–96–31 and should be submitted by July 29, 1996.

For Commission, by the Division of Market Regulation, pursuant to delegated authority.[3]

Jonathan G. Katz,

*Secretary.*

[FR Doc. 96–17251 Filed 7–5–96; 8:45 am]

**BILLING CODE 8010–01–M**

[2] See *supra* note 1.

[3] 17 CFR 200.30–3(a)(12).

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**[Release No. 34–37374; File No. SR-NASD–95–61]**

## Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Regulation of Cash and Non-Cash Compensation in Connection With the Sale of Investment Company Securities and Variable Contracts

June 26, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78s(b)(1), notice is hereby given that on December 22, 1995,[1] the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD proposes to amend NASD Rules 2820 and 2830 (formerly Article III, Sections 29 and 26 of the Rules of Fair Practice) to revise existing rules applicable to the sale of investment company securities and establish new rules applicable to the sale of variable contracts.[2] Below is the text of the proposed rule change. Proposed new language is italicized; proposed deletions are in brackets.

Rules of the Association

Conduct Rules

* * * * *

Variable Contracts of an Insurance Company

Rule 2820.

* * * * *

Definitions

(b)

* * *

*(3) The terms ''affiliated member'', ''cash compensation'', ''non-cash compensation'' and ''offeror'' as used in paragraph (h) shall have the following meanings:*

*''Affiliated Member'' shall mean a member which, directly or indirectly, controls, is controlled by, or is under common control with a non-member company.*

*''Cash compensation'' shall mean any discount, concession, fee, service fee, commission, loan or override received in connection with the sale and distribution of variable contracts. ''Non-cash compensation'' shall mean any form of compensation received in*

[1] On June 14, 1996, the NASD filed Amendment No. 1 with the Commission. Amendment No. 1 addresses the relationship of the proposed rule change to industry initiatives concerning compensation practices, expands the scope of the proposed rule change to govern all sales targets, whether or not previously specified and replaces the term ''variable contract securities'' with the term ''variable contract.'' *See* Letter from John M. Ramsay, Deputy General Counsel, NASD to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (June 14, 1996).

[2] *NASD Manual*, Rules of the Association, Conduct Rules (CCH), Rules 2820, 2830.

*connection with the sale and distribution of variable contracts that is not cash compensation, including but not limited to merchandise, gifts and prizes, and payment of travel expenses, meals and lodging.*

*''Offeror'' shall mean an insurance company, a separate account of an insurance company, an adviser to a separate account of an insurance company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.*

* * * * *

*Member Compensation*

*(h) In connection with the sale and distribution of variable contracts:*

*(1) Except as described below, no associated person of a member shall accept any compensation, cash or non-cash, from anyone other than the member with which the person is associated. This requirement will not prohibit arrangements where a non-member company pays compensation directly to associated persons of the member, provided that:*

*(a) the arrangement is agreed to by the member;*

*(b) the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or ''no-action'' letter issued by the Securities and Exchange Commission that applies to the specific fact situation of the arrangement;*

*(c) the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of NASD rules; and*

*(d) the recordkeeping requirement in subparagraph (h)(2) is satisfied.*

*(2) Except for items as described in subparagraphs (h)(3)(a) and (b), a member shall maintain records of all compensation, cash and non-cash, received by the member or its associated persons from offerors. The records shall include the names of the offerors, the names of the associated persons, the amount of cash, the nature and, if known, the value of non-cash compensation received.*

*(3) No member or person associated with a member shall directly or indirectly accept any non-cash compensation offered or provided to such member or its associated persons, except as provided in this provision. Notwithstanding the provisions of subparagraph (h)(1), the following items of non-cash compensation may be accepted:*

*(a) Gifts to associated persons of members that do not exceed an annual amount per person fixed periodically by the Board of Governors[3] and are not preconditioned on achievement of a sales target.*

*(b) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of impropriety and is not preconditioned on achievement of a sales target.*

*(c) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:*

*(i) the recordkeeping requirement in subparagraph (h)(2) is satisfied;*

*(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other non-cash compensation arrangement permitted by paragraph (d);*

*(iii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;*

*(iv) the payment or reimbursement is not applied to the expenses of guests of the associated person; and*

*(v) 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 permitted by paragraph (d).*

*(d) 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 member's or non-member's non-cash compensation arrangement, if it includes variable contracts, is based on the total production of associated persons with respect to all variable contracts distributed by the member;*

*(ii) the non-cash compensation arrangement requires that the credit received for each variable contract security is equally weighted;*

*(iii) 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*

*(iv) the recordkeeping requirement in subparagraph (h)(2) is satisfied.*

*(e) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in paragraph (d).*

*(4) No person associated with a member shall accept any cash compensation offered or provided to such person that is preconditioned on such person achieving a sales target, except that the following arrangements are permitted:*

*(a) Cash compensation arrangements preconditioned on the achievement of a sales target 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 member's or non-member's arrangement, if it includes variable contracts, is based on the total production of associated persons with respect to all variable contracts distributed by the member;*

*(ii) the arrangement requires that the credit received for each variable contract security is equally weighted;*

*(iii) 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 arrangement; and*

*(iv) the recordkeeping requirement in subparagraph (h)(2) is satisfied.*

*(b) Contributions by a non-member company or other member to a cash compensation arrangement preconditioned on the achievement of a sales target between a member and its associated persons, provided that the arrangement meets the criteria in paragraph (a).*

Investment Companies

Rule 2830

* * * * *

(b)

[(1) ''Associated person of an underwriter,'' as used in paragraph (l), shall include an issuer for which an underwriter is the sponsor or a principal underwriter, any investment adviser to such issuer, or any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such underwriter, issuer, or investment adviser.] *The terms ''affiliated member'', ''cash compensation'', ''non-cash compensation'', and ''offeror'' as used in paragraph (l) shall have the following meanings:*

*''Affiliated Member'' shall mean a member which, directly or indirectly, controls, is controlled by, or is under*

[3] *The current annual amount fixed by the Board of Governors is $100.*

*common control with a non-member company.*

*''Cash compensation'' shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan, or override received in connection with the sale and distribution of investment company securities.*

*''Non-cash compensation'' shall mean any form of compensation received in connection with the sale and distribution of investment company securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, and payment of travel expenses, meals and lodging.*

*''Offeror'' shall mean an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.*

* * * * *

[Dealer concessions]

[(l)(1) No underwriter or associated person of an underwriter shall offer, pay or arrange for the offer or payment to any other member in connection with retail sales or distribution of investment company securities, any discount, concession, fee or commission (hereinafter referred to as ''concession'') which:]

[(A) is in the form of securities of any kind, including stock, warrants or options;]

[(B) is in a form other than cash (e.g.. merchandise or trips), unless the member earning the concession may elect to receive cash at the equivalent of no less than the underwriter's cost of providing the non-cash concession: or]

[(C) is not disclosed in the prospectus of the investment company. If the concessions are not uniformly paid to all dealers purchasing the same dollar amounts of securities from the underwriter, the disclosure shall include a description of the circumstances of any general variations from the standard schedule of concessions. If special compensation arrangements have been made with individual dealers, which arrangements are not generally available to all dealers, the details of the arrangements, and the identities of the dealers, shall also be disclosed.]

[(2) No underwriter or associated person of an underwriter shall offer or pay any concession to an associated person of another member, but shall make such payment only to the member.]

[(3)(A) In connection with retail sales or distribution of investment company shares, no underwriter or associated person of an underwriter shall offer or pay to any member or associated person, anything of material value, and no member or associated person shall solicit or accept anything of material value, in addition to the concessions disclosed in the prospectus.]

[(B) For purposes of this subparagraph (3), items of material value shall include but not be limited to:]

[(i) gifts amounting in value to more than $50 per person per year.]

[(ii) gifts or payments of any kind which are conditioned on the sale of investment company securities.]

[(iii) loans made or guaranteed to a non-controlled member or person associated with a member.]

[(iv) wholesale overrides (commissions) granted to a member on its own retail sales unless the arrangement, as well as the identity of the member, is set forth in the prospectus of the investment company.]

[(v) payment or reimbursement of travel expenses, including overnight lodging, in excess of $50 per person per year unless such payment or reimbursement is in connection with a business meeting, conference or seminar held by an underwriter for informational purposes relative to the fund or funds of its sponsorship and is not conditioned on sales of shares of an investment company. A meeting, conference or seminar shall not be deemed to be of a business nature unless: the person to whom payment or reimbursement is made is personally present at, or is en route to or from, such meeting in each of the days for which payment or reimbursement is made; the person on whose behalf payment or reimbursement is made is engaged in the securities business; and the location and facilities provided are appropriate to the purpose, which would ordinarily mean the sponsor's office.]

[(C) For purposes of this subparagraph (3), items of material value shall not include:]

[(i) an occasional dinner, a ticket to a sporting event or the theater, or comparable entertainment of one or more registered representatives which is not conditioned on sales of shares of an investment company and is neither so frequent nor so extensive as to raise any question of propriety.]

[(ii) a breakfast, luncheon, dinner, reception or cocktail party given for a group of registered representatives in conjunction with a bona fide business or sales meeting, whether at the headquarters of a fund or its underwriter or in some other city.]

[(iii) an unconditional gift of a typical item of reminder advertising such as a ballpoint pen with the name of the advertiser inscribed, a calendar pad, or other gifts amounting in value to not more than $50 per person per year.]

[(4) The provisions of this paragraph (l) shall not apply to:]

[(A) Contracts between principal underwriters of the same security.]

[(B) Contracts between the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.]

[(C) Compensation arrangements of an underwriter or sponsor with its own sales personnel.]

*Member Compensation*

*(l) In connection with the sale and distribution of investment company securities:*

*(1) Except as described below, no associated person of a member shall accept any compensation, cash or non-cash, from anyone other than the member with which the person is associated. This requirement will not prohibit arrangements where a non-member company pays compensation directly to associated persons of the member, provided that:*

*(a) the arrangement is agreed to by the member;*

*(b) the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or ''no-action'' letter issued by the Securities and Exchange Commission or its staff that applies to the specific fact situation of the arrangement;*

*(c) the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of NASD rules; and*

*(d) the recordkeeping requirement in subparagraph (l)(3) is satisfied.*

*(2) No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.*

*(3) Except for items described in subparagraphs (l)(5)(a) and (b), a member shall maintain records of all compensation, cash and non-cash, received by the member or its associated persons from offerors. The records shall include the names of the offerors, the names of the associated persons, the amount of cash, the nature and, if known, the value of non-cash compensation received.*

*(4) No member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made*

*available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus. Prospectus disclosure requirements shall not apply to cash compensation arrangements between:*

*(a) principal underwriters of the same security; and*

*(b) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.*

*(5) No member or person associated with a member shall directly or indirectly accept any non-cash compensation offered or provided to such member or its associated persons, except as provided in this provision. Notwithstanding the provisions of subparagraph (l)(1), the following items of non-cash compensation may be accepted:*

*(a) Gifts to associated persons of members that do not exceed an annual amount per person fixed periodically by the Board of Governors*[4] and are not preconditioned on achievement of a sales target.

*(b) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.*

*(c) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:*

*(i) the recordkeeping requirement in subparagraph (l)(3) is satisfied;*

*(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other non-cash compensation arrangement permitted by paragraph (d);*

*(iii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;*

*(iv) the payment or reimbursement is not applied to the expenses of guests of the associated person; and*

*(v) 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 permitted by paragraph (d).*

*(d) 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 member's or non-member's non-cash compensation arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member;*

*(ii) the non-cash compensation arrangement requires that the credit received for each investment company security is equally weighted;*

*(iii) 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*

*(iv) the recordkeeping requirement in subparagraph (l)(3) is satisfied.*

*(e) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in paragraph (d).*

*(6) No person associated with a member shall accept any cash compensation offered or provided to such person that is preconditioned on such person achieving a sales target, except that the following arrangements are permitted:*

*(a) Cash compensation arrangements preconditioned on the achievement of a sales target 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 member's or non-member's arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member;*

*(ii) the arrangement requires that the credit received for each investment company security is equally weighted;*

*(iii) 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 arrangement; and*

*(iv) the recordkeeping requirement in subparagraph (l)(3) is satisfied.*

*(b) Contributions by a non-member company or other member to a cash compensation arrangement preconditioned on the achievement of a sales target between a member and its associated persons, provided that the arrangement meets the criteria in paragraph (a).*

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

*(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

(a) Purpose of Proposed Rule Change

Introduction

The NASD is proposing to amend Rule 2820 (''Variable Contracts Rule'') and Rule 2830 (''Investment Company Rule'') to establish new rules applicable to the sale of variable contracts and revise existing rules applicable to the sale of investment company securities.

Generally, the proposed rule change would: (1) Adopt definitions of the terms ''affiliated member,'' ''cash compensation,'' ''non-cash compensation'' and ''offeror''; (2) prohibit, except under certain circumstances, associated persons from receiving any compensation, cash or non-cash, from anyone other than the member with which the person is associated; (3) require that members maintain records of compensation received by the member or its associated persons from offerors; (4) with respect to the Investment Company Rule, prohibit receipt by a member of cash compensation from the offeror unless such arrangement is described in the current prospectus; (5) retain the prohibition, only with respect to the Investment Company Rule, against a member receiving compensation in the form of securities; (6) prohibit, with certain exceptions, members and persons associated with members from accepting, directly or indirectly, any

[4] The current annual amount fixed by the Board of Governors is $100.

non-cash compensation in connection with the sale of investment company securities and variable contracts; and (7) prohibit, with certain exceptions, a person associated with a member from accepting, directly or indirectly, any cash compensation in connection with the sale of investment company securities and variable contracts.

The exceptions from the non-cash compensation prohibition would permit: (1) Gifts of up to $100 per associated person annually; (2) an occasional meal, ticket to a sporting event or theater, or entertainment for associated persons and their guests; (3) payment or reimbursement for training and education meetings held by a broker-dealer or a mutual fund or insurance company for associated persons of broker-dealers, as long as certain conditions are met; (4) in-house sales incentive programs of broker-dealers for their own associated persons; (5) sales incentive programs of mutual funds and insurance companies for the associated persons of an affiliated broker-dealer; and (6) contributions by any non-member company or other member to a broker-dealer's permissible in-house sales incentive program.

The exceptions from the cash compensation prohibition would permit: (1) In-house sales incentive programs of broker-dealers for their own associated persons; (2) sales incentive programs of mutual funds and insurance companies for the associated persons of an affiliated broker-dealer; and (3) contributions by any non-member company or other member to a broker-dealer's permissible in-house sales incentive program.

## Background

The proposed rule change is the latest in a series of NASD determinations designed to control the use of non-cash compensation in connection with a public offering of securities. Previous rule filings amending the NASD's rules established restrictions on non-cash compensation in connection with transactions in direct participation program securities (''DPPs''), real estate investment trusts (''REITs''), and corporate debt and equity offerings.

When the DPP rule was first proposed, commenters urged that if non-cash incentives were inappropriate in connection with the sale of DPPs, they are also inappropriate in connection with the sale of investment company securities and variable contracts. However, the NASD recognized that DPP and investment company securities are treated differently in many regulatory areas including marketing standards, advertising rules, net capital requirements, fidelity bonding, corporate finance requirements, membership in SIPC, qualification examination requirements and the application of the Investment Company Act of 1940 (''1940 Act''). Similarly, variable contracts are also subject to a separate scheme of regulation under the NASD's advertising rules and corporate financing requirements, net capital requirements, fidelity bonding, membership in SIPC, qualification examination requirements, and are regulated under the 1940 Act. In 1992, the NASD submitted to the SEC proposed rule change SR-NASD–92–36 which proposed recordkeeping and disclosure requirements on the receipt of non-cash compensation in connection with the sale of investment company securities and variable contracts. As a result of SEC staff concerns regarding that proposal, the NASD withdrew SR-NASD–92–36 in April 1994.

In developing the proposed rule change, the Investment Companies and Insurance Affiliated Member Committees of the NASD (the ''Committees'') have considered the current environment in which investment company securities and variable contracts are sold. The Committees did not find that the manner in which non-cash compensation is offered and paid to members and their associated persons indicates a level of supervisory problems similar to that present in connection with the sale of DPPs which led the NASD to adopt a prohibition on non-cash compensation in connection with such securities in 1988. The Committees believe, however, that the increased use of non-cash compensation for the sale of investment company securities and variable contracts heightens the potential for loss of supervisory control over sales practices and increases the possibility for perception of impropriety, which may result in a loss of investor confidence. The Committees determined, therefore, that the adoption of limitations on non-cash compensation for the sale of investment company securities and variable contracts is appropriate at this time.

The NASD is aware of a broad range of cash compensation practices by which investment company securities and variable contract issuers or their affiliates provide either incentives or rewards to individual broker-dealers and their registered representatives for selling the issuers' products. The NASD believes that the increased use of such practices, which create an incentive to favor one product over another, may compromise the ability of securities salespersons to render advice and services that are in the best interests of customers.

The NASD issued Notice to Members 94–14 (March 1994), reminding members, among other things, of prospectus disclosure obligations regarding their acceptance of cash and non-cash compensation for the sale of investment company products, and Notice to Members 95–80 (September 26, 1995), reminding members, among other things, that recommendations of investment company securities must be suitable given the investor's investment objectives and not based on incentives received by a registered representative.

Given the recent proliferation of such compensation practices and dramatic increase of public interest in the purchase of investment company securities and variable contracts, the NASD believes it is appropriate to adopt limitations on non-cash compensation and certain types of incentive-based cash compensation for the sale of investment company securities and variable contracts.

A complete discussion of the background of the proposed rule change is set forth in NASD Special Notice to Members 94–67 (''NTM 94–67''), attached to this filing as Exhibit 2, and in an addendum containing background information (referenced in NTM 94–67), attached to this filing as Exhibit 3. These documents are available to the public from the NASD's Office of General Counsel.

## Description of the Proposed Rule Change

The current requirements of paragraph (l) of the Investment Company Rule regulate the disclosure and form of dealer concessions between principal underwriters and retail dealers of investment company securities. These provisions prohibit dealer concessions in the form of securities, require that members be able to elect to receive cash in lieu of the receipt of non-cash compensation, and prohibit the payment of concessions directly to associated persons of a member. The provisions also set forth requirements with respect to the disclosure of compensation arrangements between underwriters and dealers in the investment company's prospectus.[5]

[5] In Notice to Members 94–14 (March 1994), the NASD clarified the obligations of members in complying with the compensation disclosure requirements for investment companies in Subsection 26(l)(1)(C) to Article III of the Rules of Fair Practice. See also Notice to Members 94–41 (May 1994).

With respect to the regulation of variable contracts, the requirements of Rule 2820 currently do not contain similar provisions regulating dealer concessions. Thus, the proposed amendments to the Investment Company Rule would modify current requirements and the proposed amendments to the Variable Contracts Rule would establish new requirements that address compensation arrangements between an offeror and any member participating in the distribution of the company's securities. The discussion below addresses each proposed provision in the Investment Company Rule and its counterpart in the Variable Contracts Rule.

*Definitions*

*Affiliated Member*—The NASD is proposing to adopt a definition of the term ''affiliated member'' for both the Investment Company and Variable Contracts Rules to include a member which, directly or indirectly, controls, is controlled by, or is under common control with a non-member company. The term is used in the sections of the proposed rule change which address incentive compensation arrangements in order to identify a common type of relationship existing in the investment company securities and variable contracts industries whereby a non-member owns or controls one or more subsidiary broker-dealer member firms used for underwriting and/or wholesale and retail distribution services.

*Cash Compensation*—As proposed to be defined in the Investment Company Rule, this term would include any discount, concession, fee, service fee, commission, asset-based sales charge, loan or override received in connection with the sale and distribution of investment company securities. This term would encompass compensation arrangements currently covered under the Investment Company Rule in subparagraph (l)(1), as well as asset-based sales charges and service fees as currently defined in subparagraph (b)(9) of the Investment Company Rule. As a result, the proposed new term would apply to all compensation arrangements that would be covered under the current provisions of the Investment Company Rule, with the addition of asset-based sales charges and service fees. The Variable Contracts Rule's proposed definition of cash compensation would have a similar scope with respect to the sale of variable contracts, but does not include asset-based sales charges in recognition of the different structure of compensation arrangements with respect to such products.

*Non-Cash Compensation*—This definition is proposed to be identical in applicability for both the Investment Company and Variable Contracts Rules and would encompass any form of compensation received by a member in connection with the sale and distribution of investment company securities and variable contracts that is not cash compensation, including, but not limited to, merchandise, gifts and prizes, and payment of travel expenses, meals and lodging. Thus, the definition of ''non-cash compensation'' encompasses payments of cash to reimburse costs incurred by a member or person associated with a member in connection with travel, meals and lodging. Certain of the proposed rule language is drawn from the current provisions of subparagraph (l)(3)(B) of the Investment Company Rule which identifies items of material value.

*Offeror*—The NASD is proposing to define the term ''offeror'' in the Investment Company Rule to include an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person of such entities, and in the Variable Contract rule to include an insurance company, a separate account of an insurance company, an adviser to a separate account of an insurance company, a fund administrator, an underwriter and any affiliated person of such entities. With the exception of ''fund administrator,'' the enumerated entities included in the proposed definition of ''offeror'' in the Investment Company Rule are currently included in the definition of ''associated person of an underwriter,'' which is proposed to be deleted.[6] That definition encompasses the issuer, the underwriter, the investment advisor to the issuer, and any affiliated person of such entities.[7] The term ''affiliated person'' in the proposed definition of ''offeror'' is defined in accordance with Section 2(a)(3) of the 1940 Act. The term ''underwriter'' is defined in Section 2(a)(40) of the 1940 Act and is intended to refer to the principal underwriter through which the investment and insurance company distributes securities to participating dealers for sale to the investor.

The NASD does not believe that the inclusion of ''fund administrator'' in the definition of ''offeror'' in the proposed rule is overbroad as a result of the fact that affiliates of fund administrators would now be included in the definition of offeror. Affiliates of fund administrators are most likely entities already specified in the definition of ''offeror,'' the definition of which is further circumscribed by the requirement that payments of cash or non-cash compensation be made in connection with the sale of investment company securities or variable contracts.

The adoption of this new definition of offeror would change the applicability of paragraph (l) of the Investment Company Rule and paragraph (h) of the Variable Contract rule from focusing on the distribution relationship of the principal underwriter to the retail dealers to focusing on the distribution relationship of the offeror to any participating broker-dealer firm.

Regulation of the Receipt of Cash and Non-Cash Compensation

*Introduction*—The NASD is proposing to adopt as paragraph (l) of the Investment Company Rule (replacing the current provisions of that section) and paragraph (h) of the Variable Contracts Rule new provisions governing the receipt of cash and non-cash compensation by members and associated persons of members. The proposed amendments would apply to both variable annuity and variable life products under the Variable Contracts Rule. With respect to the Investment Company Rule, the proposed amendments would apply to sales of securities of an investment company registered under the 1940 Act. Thus, the proposed rules would apply to sales of securities by a face-amount certificate company, a unit investment trust, and open-end and closed-end management companies.[8]

The preamble to the new rules provides that such compensation must be received ''in connection with the sale and distribution'' of investment company securities or variable contracts, as applicable. The preamble is intended to clarify that the provisions only relate to cash and non-cash compensation received in connection

[6] There are no current similar terms in the Variable Contracts Rule.

[7] The term is significantly different from the term ''person associated with a member'' as used throughout the NASD's rules and regulations. Any reference to persons associated with an NASD member firm is defined by the definition of ''person associated with a member'' or ''associated person of a member'' in Article I, Section (m) to the NASD By-Laws.

[8] Closed-end management companies also are regulated under The Corporate Financing Rule in Rule 2710 and currently are subject to the prohibition on non-cash compensation contained in subparagraph (c)(6)(ix) thereof. Rule 2710(b)(8)(C) provides an exemption from compliance with Section 44 for securities of investment companies registered under the 1940 Act, except for securities of a closed-end management company as defined in Section 5(a)(2) of the 1940 Act.

with the sale and distribution of the security covered by the rule, but not to other forms of payment that are not for sales and distribution activities.

*Subparagraphs 2820(h)(1) and 2830(h)(1): Limitation on Receipt of Compensation by Associated Persons, and Exception from Limitations*—The NASD is proposing in new subparagraph (l)(1) of the Investment Company Rule and new subparagraph (h)(1) of the Variable Contract rule to generally prohibit a person associated with a member from accepting any compensation from any person other than the member with which the person is associated. The provision is based on current subparagraph (l)(2) of the Investment Company Rule.

An exception from this general prohibition is proposed which would allow the receipt of commissions by an associated person directly from a non-member if the arrangement is agreed to, and the amount of commission determined, by the member, the receipt is treated as compensation received by the member for purposes of NASD rules, the recordkeeping requirement in the proposed rule change is satisfied, and the member relies on an appropriate rule, regulation, interpretive release or applicable ''no-action'' or exemptive letter issued by the Commission or its staff. It would only be necessary for a member to obtain from the Commission an interpretation or no-action position in the event that no current rule, regulation, interpretive release, or no-action or exemptive letter applied to the member's fact situation. Also, the proposed rule change clarifies that the member must treat such direct payments to associated persons as compensation in order to ensure that the member views such payments in the same manner as payments made directly to the member for purposes of NASD rules and posts such payments to the member's books.

The proposed exception is particularly intended to recognize current practice, commonly referred to as insurance networking, which relies on certain Commission interpretations or staff no-action letters that permit, under limited circumstances, associated persons to receive compensation for the sale of variable annuity products from an insurance company or licensed insurance agency.[9] The exception reflects the view of the Commission in Securities Exchange Act Release No. 8389 (August 29, 1968) that, under certain circumstances, such commission payments to associated persons may be made by an insurance company or insurance agency acting on behalf of a broker-dealer.[10]

Although the need to recognize such direct payments arose in connection with the sale of variable contract products, the Investment Company Rule includes the same exception in order to recognize Commission staff no-action positions that permit direct payments by certain non-members to associated persons of broker-dealers for the sale of investment company shares.[11]

*Subparagraph 2830(l)(2): Securities as Compensation*—The NASD is proposing to retain as new subparagraph (l)(2) of the Investment Company Rule the provision currently in subparagraph (l)(1)(A) that prohibits members and associated persons of members from receiving compensation in the form of securities of any kind. The Variable Contracts Rule does not contain this prohibition, as the prohibition is intended to reflect circumstances that are limited to the sale of investment company securities.

*Subparagraphs 2820(h)(2) and 2830(l)(3): Recordkeeping Requirement*—The NASD is proposing to adopt as new subparagraph (l)(3) of the Investment Company Rule and subparagraph (h)(2) of the Variable Contracts Rule the general requirement that members maintain records of all compensation, cash and non-cash, received from offerors. The records must include the names of the offerors, the names of the associated persons, and the amount of cash and the nature and, if known, the value of non-cash compensation received.

With respect to the requirement that the actual value of non-cash compensation be recorded, if it is known, the NASD believes that the value of a non-cash item is usually not known where unaffiliated third parties contribute to a training and education program sponsored by a member. In this case, it would be appropriate to only include a description of the nature of the non-cash item of compensation. In comparison, the value of non-cash items provided by member firms and/or their affiliates is generally readily known or determinable.

The recordkeeping requirement is not applicable to two types of *de minimis* non-cash compensation allowable under subparagraphs (l)(5)(a) and (b) of the Investment Company Rule and subparagraphs (h)(3)(a) and (b) of the Variable Contracts Rule, discussed more fully below under the exceptions to the prohibition on non-cash compensation.

*Subparagraph 2830(l)(4): Prospectus Disclosure of Cash Compensation*—The NASD is proposing to adopt as new subparagraph (l)(4) in the Investment Company Rule the requirement currently in subparagraph (l)(1)(C) that prohibits the acceptance of cash compensation by a member from an offeror unless such compensation is disclosed in a prospectus. In the case where special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members to distribute the securities, the disclosure shall include the name of the recipient member and the details of the special arrangements. The provision has been modified to reference only ''cash compensation'' because non-cash compensation is proposed to be prohibited in a manner that would not require disclosure of any such non-cash compensation.[12]

The proposed rule change includes two exceptions from the prospectus disclosure requirement in the Investment Company Rule. The two exceptions in paragraphs (a) and (b) track the language in current subparagraphs (l)(4)(A) and (B) of the Investment Company Rule, with minor language changes for clarification. These two provisions provide an exception from disclosure for compensation arrangements between: (1) Principal underwriters of the same security; and (2) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment. By their terms, these provisions describe arrangements that would not trigger the proposed recordkeeping requirements.

The NASD is not proposing to amend the Variable Contracts Rule to adopt a similar prospectus disclosure

[9] *See, e.g., Wiley, Rein & Fielding* (Oct. 16, 1991); *Traditional Equinet* (Jan. 8, 1992).

[10] Securities Exchange Act Rel. No. 8389 states that the Commission would not recommend enforcement action where the insurance company makes payments directly to its life insurance agents who are also persons associated with the insurance company's subsidiary broker/dealer, so long as: (1) Such payments are made as a purely ministerial service and properly reflected on the books and records of the broker/dealer; (2) a binding agreement exists between the insurance company and the broker dealer that all books and records are maintained by the insurance company as agent on behalf of the broker/dealer and are preserved in conformity with the requirements of Rules 17a-3 and 17a-4 under the Act; (3) all such books and records are subject to inspection by the Commission in accordance with Section 17(a) of the Act; and (4) the subsidiary broker/dealer has assumed full responsibility for the securities activities of all persons engaged directly or indirectly in the variable annuity operation.

[11] *See Chubb Securities Corporation* (Nov. 24, 1993) (financial institutions were permitted to make commission payments to dual employees of the financial institution and a broker-dealer).

[12] *See supra* n. 5.

requirement. Unlike the Investment Company Rule, there is currently no provision in the Variable Contracts Rule requiring disclosure of compensation received by NASD members in connection with the distribution of variable contracts. Arrangements by insurance companies for compensating salespersons for variable contract sales are generally part of a total compensation package based on the sale of non-securities insurance products as well as variable contracts. Further, the Securities Act of 1933 and rules adopted thereunder do not require such disclosure in the prospectus for variable life and annuity products. As a result, there is no practice for disclosure of any item of compensation in connection with variable life and annuity products, such as commissions and expense reallowances. The NASD believes that insurance companies would be required to make significant modifications to their automated systems in order to separate in some manner compensation for sales of securities products from total compensation for all insurance products. The NASD has determined, therefore, that before proposing new rules to require the disclosure of all cash compensation for the sale of variable contracts, more information should be gathered regarding the different kinds of compensation that are paid to broker-dealers for the sale of variable contracts and the form of any required disclosure. The NASD intends to gather such information in the course of conducting a general study of cash compensation practices in connection with investment company securities and variable contracts, as more fully set forth below.

*Subparagraphs 2830(l)(5) and 2820(h)(3): Prohibition on Non-Cash Compensation*—The NASD is proposing to adopt as new subparagraph (l)(5) of the Investment Company Rule and new subparagraph (h)(3) of the Variable Contracts Rule a general prohibition, with certain exceptions, on the receipt of non-cash compensation. The new provisions would prohibit a member or person associated with a member from directly or indirectly accepting any non-cash compensation offered or provided to such member or its associated persons unless such non-cash compensation is permitted under the provisions. Implicit in the prohibition on the ''acceptance'' of non-cash compensation is the requirement that a member may not make a payment of compensation to another member and its associated persons that results in a violation of the rule by the recipients.

The proposed rule change contains several exceptions from the general prohibition on the receipt of non-cash compensation.

*Subparagraphs 2820(h)(3)(a) and (b) and 2830(l)(5)(a) and (b):* The NASD is proposing to adopt exceptions that would permit an associated person to accept from a person other than its member-employer: (1) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors, which is currently $100 per person; and (2) an occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of propriety. These provisions are based on the current provisions of subparagraph (l)(3)(B) of the Investment Company Rule. The latter exception has been revised from the current language of the Investment Company Rule to reflect that entertainment for associated persons will usually include a spouse or guest of the person and that payment for a guest is permissible, but adds cautionary language that the entertainment should not be ''so frequent nor so extensive as to raise any question of propriety.'' Since such gifts and entertainment are considered non-cash items, they are not required to be disclosed in the prospectus. Additionally, these two forms of non-cash compensation are specifically excepted from the recordkeeping requirement of the proposed rules.

The proposed provisions would require that the receipt of such non-cash items not be preconditioned on the achievement by the associated person of a sales target. This language replaces the current requirement in subparagraph (l)(3)(B)(v) of the Investment Company Rule that entertainment ''not be conditioned on sales of shares of investment companies.'' The revised language is intended to clarify that such gifts and entertainment are permitted to be provided as recognition for past sales or as encouragement for future sales, but shall not be part of an incentive program or plan which requires that the recipient reach a sales goal as a prior condition to receive the entertainment or gift.

The proposed exceptions for $100 gifts and entertainment permits the continuation of long-established, normal business practices, while preventing an investment or insurance company from providing the gift or entertainment as part of a non-cash sales incentive program. The exceptions also recognize that the NASD has not detected or been aware of any history of abuses in connection with the receipt of such items of compensation by associated persons of a member firm in connection with the sale of investment company securities or variable contracts.

*Subparagraphs 2820(h)(3)(c) and 2820(l)(5)(c):* The NASD is proposing an exception to the prohibition on non-cash compensation for training and education meetings in subparagraph (l)(5)(c) of the Investment Company Rule and subparagraph (h)(3)(c) of the Variable Contracts Rule. The proposed exception would, under certain conditions, permit payment or reimbursement by offerors in connection with meetings held by the offeror or by a member for the purpose of training or education of associated persons of a member.[13] It is not unusual for offerors to pay for such meetings in order to discuss their products and to reimburse certain expenses related to the member's meeting in exchange for the opportunity to make a presentation to the associated persons of the member on a particular training or education topic.

This provision is intended to continue to permit members and offerors to hold training or education meetings for associated persons of one or more members, where an offeror or a number of offerors pay for or reimburse the expenses of the meeting. Because investment company securities and variable contract products are continuously offered, it is particularly important that associated persons receive education opportunities with respect to the investment company securities and variable contract industries generally, updates on any portfolio changes or structural changes to a current product, and explanations of new products.

Since the proposed prospectus disclosure provision requires disclosure of cash compensation only, the proposed exception would not trigger the disclosure requirements because the payment or reimbursement of expenses by an offeror for a member's training and education meeting is considered to be non-cash compensation. The proposed exception would, however, continue to be subject to the prohibition on an associated person accepting any compensation from anyone other than its member-employer.

The NASD anticipates that the agenda of a bona fide training or education

[13] A member holding a training or education meeting for its associated persons (in comparison to the associated persons of another member) would not be required to comply with this provision if the member does not receive a payment or reimbursement from an offeror for the expenses of the meeting. In this event, the member would not be prohibited from permitting offerors to make a presentation at the meeting.

meeting will reflect the business purpose of the meeting. In order to establish circumstances that will encourage such a business purpose, the NASD is proposing that the exception for training or education meetings be available only if five conditions are met, which conditions are intended to ensure that the meeting is for the purpose of training and education and is not, in fact, a prohibited non-cash sales incentive trip or entertainment. The first condition is that the payment or reimbursement by offerors in connection with such meetings is subject to the proposed recordkeeping requirement in subparagraph (l)(3) of the Investment Company Rule and subparagraph (h)(2) of the Variable Contracts Rule in order that information on such payments and reimbursements is in the records of the member and, therefore, capable of examination and regulatory oversight by the NASD.

The second condition is that associated persons must obtain the member's prior approval to attend the meeting. It is anticipated that members will establish a procedure so that their records reflect that appropriate approval has been provided to associated persons in connection with such meetings. This provision assists members in maintaining supervisory control over their associated persons. Moreover, the second condition also requires that attendance by the member's associated persons may not be based by the employer-member on the achievement of a sales target or any other non-cash compensation arrangement that is permitted in reliance on paragraph (d) of the proposed rule. That provision would permit non-cash compensation arrangements between a member and its associated persons or between a non-member company and its sales personnel who are associated persons of an affiliated member, as more fully discussed below. This condition is intended to ensure that the member does not treat a training or education meeting as a non-cash incentive item. The provision is not, however, 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 in-house sales incentive program or through the sales incentive program of the member's non-member affiliate or through the achievement of a sales target.

The third condition is that the location of the meeting must be appropriate to its purpose. A showing of appropriate purpose is demonstrated where the location is the office of the offeror or the member, or a facility located in the vicinity of such office. In order to address meetings where the attendees are from a number of offices in a region of the country, the meeting location may be in a regional location.

The fourth condition is that the payment or reimbursement by an offeror must not be applied to the expenses of guests of the associated person.

The fifth and final condition is that the payment or reimbursement by the offeror must not be conditioned by the offeror on the achievement of a sales target or any other non-cash arrangement permitted by proposed subsection (l)(5)(d) of the Investment Company Rule or proposed subsection (h)(3)(d) of the Variable Contracts Rule. This requirement is intended to ensure that the offeror making the payment or reimbursement does not participate in any manner in a member's decision as to which associated persons will attend a member's or offeror's meeting.

The fifth condition should be compared to the second provision that prohibits a member from basing the associated person's attendance at a training or education meeting on achievement of a sales target or a permissible in-house non-cash incentive arrangement. Taken together, the second and fifth conditions are intended to clarify that attendance at a training or education meeting by an associated person is permitted to be approved by a member as a recognition for past sales or as an encouragement for future sales, but shall not be part of a member's or offeror's incentive program or plan which requires that the recipient or the member reach a sales goal as a prior condition to attending the training or education meeting.

*Subparagraphs 2820(h)(3) (d) and (e) and 2830(l)(5) (d) and (e):* The NASD is proposing to adopt for the Investment Company Rule and the Variable Contracts Rule exceptions from the prohibition on non-cash compensation that will permit: (1) Non-cash compensation arrangements between a member and its associated persons, (2) non-cash compensation arrangements between a non-member company and its sales personnel who are associated persons of an affiliated member, and (3) contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons.

The three permissible arrangements are subject to four conditions. The conditions that must be met are that: (1) The member's or non-member's non-cash compensation arrangement, if it includes investment company or variable product securities, must be based on the total production of associated persons with respect to all investment company or variable product securities distributed by that member, (2) the credit received for each investment company or variable product security must be equally weighted, (3) no unaffiliated non-member company or other unaffiliated member may directly or indirectly participate in the member's or non-member's organization of a permissible non-cash compensation arrangement; and (4) *the member must maintain records of all compensation, cash and non-cash, received by the member or its associated persons from offerors.* However, the applicability of the total production and equal weighting requirements to variable contract securities does not require that variable annuity and variable life products be combined in the same incentive arrangement. Because of the substantially different commission structure of each product, the NASD intends that subparagraph (h)(3)(d) of the Variable Contracts Rule apply to each variable contract product type—variable annuity or variable life.

The NASD believes that the proposed rule change distinguishes between non-cash incentives that act at the *point-of-sale* to the investor and those that do not. Point-of-sale non-cash incentive programs reward associated persons only if they sell a certain number of shares of a specific investment company securities or variable contract. Such incentive programs by an offeror or a member will affect the point-of-sale relationship of associated persons with the investor because they influence the salesperson to sell a specific investment company securities or variable contract or the products of only one offeror. In addition, point-of-sale non-cash incentives offered by third-parties to the associated persons of a member firm have the potential to undermine the supervisory control of the member over the sales practices of its associated persons.

The phrase ''point-of-sale incentives'' is intended to distinguish between different sales incentive structures on the basis of the potential impact of the sales incentive on the recommendation of the associated person at the point of sale to the customer. Where a sales incentive is structured as a ''point-of-sales incentive,'' the associated person's recommendation of a specific product is motivated by the prospect of receiving the sales incentive rather than the desire to match the investment needs of the customer with the most appropriate investment product. An example of this is an incentive program that will

provide a trip to an exotic location or a cash bonus to an associated person who sells $X million of ABC mutual fund over a three-month period. Such an incentive would have the effect of influencing an associated person to recommend ABC mutual fund over its competitors to customers. In comparison, an incentive program without a point-of-sale impact would be a program organized by the employer broker-dealer of an associated person that would provide for the same trip to the exotic location or a cash bonus for the sale of $X million of mutual fund products, with the sale of all mutual fund products being equally-weighted. In this case, the incentive program should not impact the point-of-sale recommendation of the associated person, who would focus on matching the appropriate investment needs of the customer in order for the associated person's recommendation to result in a sale.

The NASD's proposed rule change, therefore, limits non-cash sales incentives to situations where such non-cash incentives do not contain the potential to impact the point-of-sale recommendation by an associated person to a customer or to undermine the supervisory control of the member firm with respect to its associated persons.

The NASD is proposing to eliminate the point-of-sale impact of non-cash sales incentives on the sales practices of an associated person with respect to the sale of investment company securities and variable contracts by prohibiting third-party non-cash sales incentive programs and by requiring that all securities of the product type be included in the member's (or its affiliate's) in-house incentive program and be equally weighted. The proposed rule change, therefore, would prohibit a third-party offeror from conducting a non-cash sales incentive program for associated persons of member firms, as such programs only provide incentives that will act at the point-of-sale to influence a salesperson to sell the proprietary products of the offeror and have the potential to undermine the supervisory control of the member with respect to its associated persons, thereby increasing the possibility for a perception of impropriety which may result in a loss of investor confidence. The proposed rule change would, however, continue to permit non-cash incentive programs by a member for its associated persons or by an insurance or investment company for the associated persons of an affiliated member, under the four conditions discussed more fully below. The NASD determined that, in both cases, the non-cash compensation arrangement is internal to the employer-employee relationship and, therefore, does not raise the supervisory concerns that are present in the compensation arrangements between a non-member and the associated persons of unaffiliated broker-dealers selling its product.

The exception permitting a non-member affiliate to grant non-cash incentives to the associated persons of its affiliated broker-dealer for the sale of investment company securities and variable contracts recognizes the practice that is particularly present in the life insurance industry of a non-member insurance company holding a non-cash sales incentive program for its sales personnel who are also associated persons of the non-member's affiliated broker-dealer. Such sales persons are dual-licensed to sell non-securities insurance products and variable contracts. It is particularly a common practice for a member's parent life insurance company to award ''points'' for the sale of all insurance products—including securities—toward attendance at the insurance company's annual ''leadership conference.'' [14] Moreover, the exception recognizes that, as a practical matter, an insurance company or investment company affiliated with a broker-dealer is in a position through intra-corporate transfers to contribute to and through its relationship to affect the structure of its affiliated broker-dealer's in-house incentive program.

The permissible in-house non-cash arrangements by a member or its affiliate are subject, moreover, to the first two conditions which are intended to ensure that a non-cash sales incentive earned by a member's associated person is on a delayed basis and does not influence the associated person's point-of-sale relationship with the investor. The first two conditions require that a member's or its affiliate's non-cash sales incentive program, if it includes investment company securities or variable contracts, must be based on the total production of associated persons with respect to the sale of all investment company securities or variable contracts distributed by that member and the credit received for the sale of each investment company security or variable contract must be equally weighted.

The NASD believes that the intent of first two conditions, by focusing on total production and equal weighting rather than point-of-sale incentives, is to align the interests of associated persons, broker-dealers and investors. Thus, the proposed provisions would allow for sales incentive programs based on such measures as overall gross production, new accounts opened or assets under management. Such measures are not precluded by the proposed rule language and are based on the same intent to align the interests of associated persons, broker-dealers and investors. The concept of total production, for example, is not necessarily restricted to total sales production, but could include total activity in investment company securities, thus allowing for incentive contests based on assets gathered or assets maintained under management.[15]

In proposing the second condition requiring equal weighting, the NASD recognizes that differential payouts at all levels is common industry practice and that current methods for determining contest credits vary, including measurements based on gross production to the firm or net commissions to the associated person. The NASD believes that either practice, as well as other arrangements, would be acceptable so long as the concept of ''equal weighting'' is met and not skewed by disparate commission, payout or reallowance structures for individual products. The condition of equal weighting requires a good faith effort by a member to comply and the test of whether a particular equal weighting methodology is acceptable is whether the contest is still skewed toward a particular product or products.

It is believed that these requirements will ensure that members and their affiliates selling proprietary investment company securities and variable contracts products do not structure in-house non-cash arrangements that are biased in favor of their proprietary products or any one specific product.

A member's or its affiliate's non-cash compensation arrangement is also subject to the restriction that no unaffiliated non-member entity (usually an offeror) or another member can participate directly or indirectly in the member's or its affiliate's organization of a permissible non-cash sales incentive program. This provision is intended to ensure that third-party offerors are not involved in and do not influence the organization of a permissible non-cash sales incentive program by a member or a member's affiliate. The restriction on participation is not, however, intended to prevent a

[14] As set forth above, arrangements by insurance companies for compensating salespersons for variable product sales are generally part of a total compensation package based on the sale of non-securities insurance products as well as variable contracts.

[15] *See* Report of the Committee on Compensation Practices, April 10, 1995 (''Tully Report''), at 13.

non-member company from making a presentation on its products at a member's or its affiliate's in-house sales incentive meeting at the member's or affiliate's request.

Finally, the non-cash incentive program of a member or its affiliate for a member's associated persons is also subject to the recordkeeping requirements of the proposed rule. Thus, in the case where the member or its associated persons is in receipt of payments or non-cash sales incentives from its affiliated entity, such payments or non-cash sales incentives must be recorded on the books and records of the member firm.

The NASD is also proposing in subparagraph (l)(5)(e) of the Investment Company Rule and subparagraph (h)(3)(e) of the Variable Contracts Rule that any non-member entity (usually an offeror) or another member continue to be permitted to contribute to any *member's* in-house non-cash sales incentive program, so long as: (1) The in-house program is based on total production of the investment company securities or variable contract products; (2) each sale receives equal weighting; (3) no entity (other than a member's affiliate) directly or indirectly participates in the member's organization of its permissible non-cash incentive compensation program; and (4) the member maintains records of such contributions. This provision is intended to permit third-party offerors, and their affiliates, to contribute to the non-cash incentive program of a member in order to benefit the associated persons of the member that sell the offeror's securities.[16] The proposed rule change does not similarly permit third party entities to make contributions to the non-cash incentive program of an affiliate of a member because such non-member affiliates are not subject to the recordkeeping requirements of the proposed rule change. Thus, contributions by third parties for a non-cash incentive program for associated persons of a member firm may be made only directly to the member.

*Relationship of the In-House Non-Cash Incentive Exceptions for Members and Their Affiliates to the Training or Education Exception:* The NASD believes that training/education meetings are important to the investment company/variable contract industries and it is, therefore, important that the NASD's rules continue to permit such meetings. The structure of the training or education provision permits members to recognize high producers by attendance at such meetings, but prohibits a member from requiring achievement of a specified sales target or any other in-house non-cash arrangement to attend the meeting. Since the proposed rule change would permit members and their affiliates to have an in-house non-cash incentive program for sales of investment company securities and variable contracts (and offerors may contribute to such in-house incentive programs), it is important to clarify the difference between attending a training/education meeting as a permissible ''recognition'' and attending it as an impermissible ''non-cash sales incentive program.'' The issue arises only where a member is in receipt of any payment or reimbursement for the costs of a meeting or a third-party offeror (or any of its affiliates) pays for any of the costs of a meeting which is attended by associated persons of a member.[17] One clear demarcation is that any meeting held by a member or its affiliate only for the member's associated persons (where contributions are made by a third-party offeror) may be covered either by the exception for in-house non-cash incentives or the exception for a training and education meeting, whereas any meeting held by a third-party offeror must comply with the training/education requirements (because a *third-party* offeror cannot conduct a non-cash incentive program).

*Subparagraphs 2820(h)(4) and 2830(l)(6): Prohibition on Certain Types of Incentive-Based Cash Compensation*—The NASD is proposing to adopt as new subparagraph (l)(6) of the Investment Company Rule and new subparagraph (h)(4) of the Variable Contracts Rule a prohibition, with certain exceptions, on the receipt of incentive-based cash compensation. The new provision would prohibit a person associated with a member from directly or indirectly accepting any cash compensation preconditioned on the achievement of a sales target offered or provided to such person or the member with the person is associated, unless such compensation is permitted under the provision. Implicit in the prohibition on the ''acceptance'' of such incentive-based cash compensation is the requirement that a member may not make a payment of compensation to another member and its associated persons that results in a violation of the rule by the recipients.

The inclusion of this provision for the prohibition of incentive-based cash compensation is intended to ensure that offerors do not circumvent the non-cash incentive prohibition through the offering of cash incentives directly to associated persons. This is consistent with the NASD's intention to prohibit incentives that act as point-of-sale inducements that could influence the advice of a salesperson. The cash incentive prohibition is focused only on cash sales incentive contests that could be used by offerors to reward associated persons of a broker-dealer for the sale of a particular investment company or variable contract security and does not encompass payments at the entity-broker-dealer level that are not passed on to the associated person. Thus, the focus of the prohibition does not include other cash revenue-sharing arrangements intended to be covered by the NASD's study of cash compensation practices, as more fully set forth below. In particular, the proposed provision would not prohibit the practice of paying higher sales charges for reaching increasing sales targets. Also, it is important to note that payments of cash compensation that would be permitted under this provision would not be subject to the proposed disclosure provisions above.

The proposed rule change contains exceptions from the prohibition on the receipt of incentive-based cash compensation.

*Subsections 26(l)(6) (a) and (b) and 29(h)(4) (a) and (b):* The NASD is proposing to adopt for the Investment Company Rule and the Variable Contracts Rule exceptions from the prohibition on incentive-based cash compensation that, consistent with the non-cash sales incentive prohibition, will permit: (1) Compensation arrangements between a member and its associated persons; (2) compensation arrangements between a non-member company and its sales personnel who are associated persons of an affiliated member; and (3) contributions by a non-member company or other member to a cash compensation arrangement between a member and its associated persons.

The three permissible arrangements are subject to four conditions. The conditions that must be met are that: (1) The member's or non-member's compensation arrangement, if it includes investment company or variable product securities, must be based on the total production of associated persons with respect to all investment company or variable product securities distributed by that member; (2) the credit received for each investment company or variable product security must be equally weighted; (3)

[16] The provision would also permit a member's affiliate to contribute to the member's in-house non-cash incentive program.

[17] *See supra* note 12.

no unaffiliated non-member company or other unaffiliated member may directly or indirectly participate in the member's or non-member's organization of a permissible compensation arrangement; and (4) the member must maintain records of all compensation, cash and non-cash, received by the member or its associated persons from offerors.

Finally, as with proposed provisions for non-cash compensation arrangements above, the applicability of the total production and equal weighting requirements to variable contract securities does not require that variable annuity and variable life products be combined in the same cash incentive arrangement. Again, because of the substantially different commission structure of each product, the NASD intends that subparagraph (h)(4)(a) of the Variable Contracts Rule apply to each variable contract product type—variable annuity or variable life.

In order to fully understand the applicability of the proposed rule change with respect to training or education meetings and in-house non-cash incentive programs, a chart and five narrative examples are included as Exhibit 5. Copies of these documents are available to the public from the NASD.

*Relationship of the Proposed Rule Change to the Tully Report:* The Tully Report reviewed industry compensation practices in connection with the sale of all forms of securities for associated persons of members, identified conflicts of interests inherent in such practices and identified the ''best practices'' used in the industry to eliminate, reduce, or mitigate such conflicts of interest. The rule change proposed herein is limited to addressing certain compensation issues only in connection with the sale of investment company securities and variable contracts. The NASD believes that the proposed rule change is consistent with the characteristics of ''best practices'' identified in the Tully Report in that the requirements in the proposed rule for the receipt of non-cash and cash incentives eliminates the point-of-sale impact of such incentives on the sales practices of an associated person, thereby helping to align the interests of associated persons, broker-dealers and investors with respect to the sale of investment company securities and variable contracts.

Separate from the proposed rule change, however, the Board of Directors of NASD Regulation, Inc. (''NASDR'') has agreed that NASDR, acting through its standing committees, should review the Tully Report recommendations and determine what initiatives, if any, the organization should undertake. NASDR will be collecting the views of the Committees later this year for consideration by the NASD National Business Conduct Committee (''NBCC'').

Proposed Implementation of New Rules

The NASD is proposing that the amendments to the Investment Company and Variable Contracts Rules be implemented in the following manner. The proposed rule change will be effective on the date stated in a Notice to Members announcing Commission approval, which Notice will be issued no later than 60 days after Commission approval. The date stated is the date of the issuance of that Notice. As of that date, members will be required to comply with the proposed rule change. With respect to the non-cash and cash sales incentive provisions, no new sales incentive programs may be commenced after the announced effective date. Sales incentive programs that are currently on-going on the date of effectiveness will be permitted to continue for a period not to exceed six months following the announced effective date. Thus, during the six-month implementation period, no new incentive programs may commence and sales may continue to be applied to existing incentive programs. However, non-cash and cash sales incentives earned by associated persons will be permitted to be received for a period not to exceed twelve months following the expiration of the six-month implementation period in the next calendar year after approval of the amendments by the SEC. Thus, during the calendar year 1996, members and their associated persons would be permitted to receive non-cash sales incentives earned prior to January 1, 1996.

(b) Statutory Basis for Proposed Rule Change

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6)[18] of the Act, which require that the Association adopt and amend its rules to promote just and equitable principles of fair trade, and generally provide for the protection of investors and the public interest in that the proposed rule change is designed: (1) To adopt new regulations with respect to the sales of variable contracts in Rule 2820 that will regulate the direct payment of compensation to associated persons by persons other than the member with which a person is associated, establish recordkeeping requirements, and regulate the receipt of non-cash compensation by members and their associated persons; (2) amend current regulations with respect to the sale of investment company securities in Rule 2830 that will clarify the circumstances under which associated persons may receive direct payments of compensation from persons other than the member with which a person is associated with, establish recordkeeping requirements, retain current disclosure requirements and a prohibition on the receipt of securities as compensation, and regulate the receipt of non-cash compensation by members and their associated persons and the receipt of cash incentives by associated persons. Moreover, the proposed rule change is designed to minimize the point-of-sale impact of non-cash sales incentives on the recommendations of associated persons to their customers with respect to the sale of investment company securities and variable contracts and eliminate any potential that third party non-cash incentives may undermine the supervisory control of the member with respect to their associated persons, which would increase the possibility for the perception of impropriety which may result in a loss of investor confidence.

*(B) Self-Regulatory Organization's Statement on Burden on Competition*

Comments received on the proposed rule change in response to NTM 94–67 raised a number of concerns regarding the potential discriminatory impact of the proposed rule change as published for comment on issuers of investment company securities and variable contracts and on members not affiliated with an issuer. Because the rule change proposed for comment in NTM 94–67 has been significantly amended to address the arguments of comments with respect to its discriminatory impact, the NASD's discussion of the proposed rule change's burden on competition is set forth below in connection with the comments received on the proposed rule change. On the basis of the discussion set forth below in connection with the comments received, the NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

*(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

The proposed rule change was published for comment in NTM 94–67. 43 comments were received in response thereto. Of the 43 comment letters

[18] 15 U.S.C. § 78o–3.

received, 25 were supportive of the overall goal of the proposed rule change to more closely regulate incentive compensation arrangements, 8 were opposed, and 10 were neither explicitly for nor against the proposal. The rule change published for comment did not include the proposed prohibition on the receipt of cash incentives by associated persons of a member.

Deferral of Cash Compensation Issues

At the time the non-cash compensation proposal was published for comment company securities and variable contracts, and not with respect to disclosure of various forms of cash compensation. A number of commenters raised issues as to whether the requirements of the current Investment Company Rule and the proposed new Variable Contracts Rule would require disclosure of various forms of cash compensation arrangements (*e.g.*, ''revenue sharing'' and ''soft dollar'' arrangements) as ''special compensation'' or as ''cash compensation,'' that are increasingly being provided to members in connection with the sale of investment company securities and variable contracts. Other commenters expressed concerns regarding the possibility that members may provide a disparate cash payout to representatives with respect to sales of proprietary products.

A connected issue concerning the disclosure of such revenue sharing arrangements is whether such disclosed compensation is subject to the sales charge limitations of paragraph (d) of the Investment Company Rule. In a letter dated November 22, 1994, the Division of Investment Management of the SEC requested advice from the NASD as to whether the current disclosure requirements of the Investment Company Rule apply to such revenue sharing arrangements. Specifically, the SEC asked whether such cash compensation and revenue sharing arrangements are a ''discount, commission, fee or concession'' for purposes of paragraph (l) that are subject to disclosure and should be limited as ''sales charges described in the prospectus'' for purposes of paragraph 2830(d). In connection with the SEC's request, the NASD Board of Governors approved the proposed rule change to be filed with the SEC but agreed to defer resolution of the revenue sharing issues until a later date. The NASD believes that it should not attempt to determine the applicability of the proposed amendments to the variety of revenue sharing issues without first gathering information about the scope of revenue sharing payments and also addressing jurisdictional questions. Thus, the NASD has deferred issues regarding revenue sharing arrangements until a study is conducted by NASD staff of members that engage in the sale of investment company securities and variable contracts in order to develop a greater understanding of the different forms of revenue sharing arrangements and to provide information for policy-making by the Committees. It is anticipated that, as a result of the study, the NASD will develop rule proposals with respect to the disclosure of revenue sharing items that will be filed with the SEC and published for comment prior to adoption. Therefore, the NASD will not address at this time issues raised by commenters in response to NTM 94–67 regarding special cash compensation, revenue sharing, soft dollar payments or certain other forms of cash compensation payments made in connection with the sale of investment company securities and variable contracts.

The discussion set forth below of the comments received on the proposed rule change includes the specific comments received with respect to revenue sharing and other cash compensation issues that will be covered by the NASD's study of such arrangements.

Original Proposal

In connection with the sale of investment company securities and variable contracts, the amendments as originally proposed would have: (1) Prohibited, with certain exceptions, members and persons associated with members from accepting any non-cash compensation from an offeror in connection with the sale of investment company securities and variable contracts; (2) prohibited associated persons from receiving any compensation from anyone other than the member with which the person is associated, unless permitted by the rule; (3) prohibited receipt by a member of cash compensation from the offeror unless such arrangement is described in the current prospectus; and (4) required that members maintain records of compensation received from offerors. The amendments also would have retained the prohibition, in connection with the sale of investment company securities, against a member receiving compensation in the form of securities from an offeror.

The exceptions from the non-cash compensation prohibition would have permitted: (1) In-house sales incentive programs of broker-dealers for their own associated persons; (2) sales incentive programs of investment companies and insurance companies for the associated persons of a broker-dealer subsidiary; (3) payment or reimbursement for training and education meetings held by a broker-dealer or an investment or insurance company for associated persons of broker-dealers; (4) gifts of up to $100 per associated person annually; and (5) an occasional meal, ticket to a sporting event or theater, or entertainment for associated persons and their guests.

As a result of member comments, the rule language of the proposed amendments published in NTM 94–67 was significantly modified by the Board of Governors. The following is a discussion of member comments in response to NTM 94–67.

General Comments

*Rationale for New Rules.* Certain commentators opposed to the proposed rule change questioned the necessity for the proposed rule given that both the Insurance Affiliated Members Committee and the Investment Companies Committee did not find that the manner in which non-cash compensation is offered and paid to members and their associated persons indicates a level of supervisory and compliance problems similar to those experienced by the DPP industry in the late 1980s (Massachusetts Mutual Life Insurance Co. (''MML''), New England Funds (''New England''), Wood Logan). One commentator (MML) requested that any final rules be accompanied by a clear and forthright explanation of the abuses which the proposed rules are attempting to correct. Another commentator stated that the possibility of the perception of impropriety is greater in the sale of investment company securities since such securities, unlike variable products, are not subject to state insurance regulation, and expressed concern about broadening the non-cash compensation rules to include variable products without any evidence of actual or potential abuse (ITT Hartford). The commentator expressed concern about extending non-cash prohibitions to variable products solely on the basis of a perception of impropriety.

There were 25 commentators in support of the proposed rule change that provided specific comments in favor of the proposal (ACLI, A.G. Edwards & Sons (''AG Edwards''), American Funds Distributors, Inc., Bridgeway, Calvert Securities Corp. (''Calvert''), Edwards & Angell, Equity Services, Inc., FNIC, Fidelity Investments, IAFP, ICI, IM&R, ML Stern & Co. (''ML Stern''), Mariner, Merrill Lynch, Mutual Service Corporation (''Mutual Service''),

Nuveen, PNMR, Prudential, Putnam Investments, Raymond James, State of New York, T. Rowe Price, Thornburg Securities (''Thornburg''), Titan). The NASD was urged to adopt a policy regarding the treatment of non-cash compensation that is applied ''more or less even-handedly'' across businesses within the securities industry. It was stated that the potential is present that the abuses identified by the NASD with respect to DPPs in the 1980s may occur with respect to investment company securities and variable contracts. It was pointed out that in many cases the same registered representatives that sell DPPs also sell investment company securities and variable contracts. It was argued that the perception of impropriety may lead to a loss of investor confidence. In this connection, it was pointed out that there had been recent unfavorable media coverage of non-cash incentives in the sale of investment company securities (Edwards & Angell).

Another commentator stated that the proposal will contribute to ethical business practices among registered representatives, instill a greater disclosure responsibility on sponsors and provide an enhanced regulatory effort for the protection of the consumer (Raymond James) and that the proposal on the whole is excellent and will serve to provide full and fair disclosure of all compensation to the public and necessary guidance to members as to acceptable forms of compensation (AG Edwards).

Other commentators stated that prohibiting non-cash compensation will strengthen the ability of member firms to supervise their registered representatives (Merrill Lynch) and that the entire investment community is best served by removing any incentive a registered representative may have to sell a particular product other than one for the clients' best interests (Thornburg). It was also stated that the proposal will provide NASD members with greater control over compensation offered to their registered representatives (Mutual Service). Finally, commentators stated that the proposal protects and enhances investor confidence (IAFP), and decreases the possibility, as well as the consumer's perception of, representatives' impropriety (Calvert).

*Other General Comments.* One commentator thought the proposed rules were unduly complicated and might unnecessarily penalize members who have creative compensation approaches (Mutual Service). The commentator stated that a simpler way to accomplish the objectives of the proposed rule change would be to require only that all compensation be disclosed in the prospectus, all cash compensation be paid to the member firm, and all incentive compensation be based on gross production of all products. As set forth above, the NASD will review the current forms of cash compensation received by members in connection with the sale of investment company securities and variable contracts in order to develop rules that will address disclosure of compensation in the prospectus. With respect to the second request that all cash compensation be paid to the member firm, there is a long history of SEC interpretive positions and no-action letters permitting third-parties to make direct payments of cash compensation to associated persons under certain circumstances. The NASD believes it is appropriate that the proposed rule change recognizes these SEC positions. With respect to the third comment, as set forth below, the NASD is revising the proposal published for comment to require that a member's or its affiliate's in-house incentive program must be based on total production of associated persons with respect to sales of investment company securities and variable contracts and that the credit received for the sale of each security is equally weighted. These provisions are discussed more fully below.

Another commentator requested general clarification on the relationship between Rules 2820 and 2830 (Fidelity). As stated in paragraph 2820(a), Rule 2820 applies to member's activities in connection with the sale of variable contracts in lieu of Rule 2830. Thus, variable contracts are regulated solely by Rule 2820—not Rule 2830.

*Relationship to Rules for Direct Participation Program Securities.* One commentator recommended that if the proposed rule with respect to non-cash sales incentives is adopted that the NASD implement conforming changes with respect to the NASD's rules for direct participation program securities in Rule 2810. It was stated that to regulate the DPP and investment company/variable contracts industries differently would give a competitive advantage to one over another (Edwards & Angell). Another commentator stated that Rule 2810(b)(4)(E) does not contain a similar carve-out for in-house compensation arrangements by affiliates of a broker-dealer and the proposed rule, if adopted, would therefore discriminate against broker-dealers which are not subsidiaries of an investment company or insurance company (Titan II).

The NASD's Direct Participation Programs Committee will review the proposed rule change in light of the current provisions of the non-cash incentive rule of Rule 2810.

Specific Comments

Definitions of Cash and Non-Cash Compensation

*Cash Compensation Definition.* In the explanation of the provisions of the proposed rule in NTM 94–67, the NASD stated that the proposed definition of ''cash compensation'' in paragraph (b)(7) of the Investment Company Rule ''encompasses cash compensation arrangements covered under the current provisions of the Investment Company Rule.'' One commentator stated that this description appears to be inconsistent with the proposed new definition of ''cash compensation,'' which includes, among other things, asset-based sales charges (Fidelity). The commentator suggested that the NASD either eliminate asset-based sales charges from the coverage of the definition or explain more clearly the reasons for its inclusion and the scope of its applicability. The commentator suggested that the NASD also explain the scope of the counterpart definition of cash compensation in subparagraph (b)(3) of the Variable Contracts Rule. The NASD believes that the definition of ''cash compensation'' in the Investment Company Rule should include coverage of ''asset based sales charges'' and that they are encompassed in the current Investment Company Rule as a ''fee.'' In comparison to the proposed definition in NTM 94–67, the term ''asset based sales charge'' has been deleted from the definition of ''cash compensation'' in the Variable Contracts Rule since there is no provision in the current Variable Contracts Rule for such charges.

One commentator urged that although the proposal appropriately places limits on non-cash compensation, the NASD should go further and only allow, with limited exceptions, the reallowed sales charges in the prospectus (Nuveen). The NASD believes it is appropriate to permit different forms of cash compensation, so long as such compensation arrangements are not contrary to the concepts of fairness and reasonableness under Article III, Section 1 of the NASD's Rules of Fair Practice—the NASD's basic ethical rule. In the course of conducting a study of cash compensation arrangements, the fairness and reasonableness of such arrangements will be considered.

*Non-Cash Compensation.* The definition of ''non-cash'' compensation in Subparagraphs (b)(7) of the Investment Company Rule and (b)(3) of

the Variable Contracts Rule includes payments of cash to reimburse members for the costs of travel, meals and lodging. One commentator stated that if cash payments are to be included within the term ''non-cash compensation,'' the term ''non-cash compensation'' should be recharacterized (MML). The NASD believes it is appropriate to treat cash payments for non-cash items as ''non-cash compensation,'' because the receipt of non-cash items of compensation should be regulated in the same manner regardless of whether the item is received or payment is made for the cost of the item.

However, the NASD believes that there is an issue of whether excess cash payments for training and education meetings meet the definition of non-cash compensation and will seek to clarify in its study on cash compensation whether payments exceeding actual reimbursements fit within the definition of non-cash compensation, and whether any such excess is received in connection with sale or distribution practices.

*Special Cash Compensation.* The proposed change does not contain a definition of the term ''special cash compensation'' that is used in the current and proposed disclosure provision of the Investment Company Rule (subparagraph (l)(4) of the Investment Company Rule) and the disclosure provision that was originally proposed in subparagraph (h)(3) of the Variable Contracts Rule. One commentator suggested, for purposes of the Variable Contracts Rule, defining the phrase as ''any cash compensation that exceeds the maximum compensation disclosed in the prospectus,'' which would enable a member to accept less than the maximum disclosed commission without having to force the disclosure in the prospectus of all members who were paid no more than the maximum commission (ITT Hartford).

As set forth above, the NASD has amended the proposed rule change to the Variable Contracts Rule to delete the disclosure provision. The NASD intends, nonetheless, to reconsider the definitions in the proposed rule change with respect to the Investment Company Rule and Variable Contracts Rule and the text of the disclosure provision being proposed herein with respect to the Investment Company Rule (including the requirement for disclosure of ''special compensation arrangements'') as a part of the study of cash compensation arrangements, referenced above.

Preamble—''In Connection With''

The preambles to the proposed rule change in the Investment Company Rule and the Variable Contracts Rule begin with the phrase ''In connection with the sale and distribution of investment company securities [variable contracts].'' Commentators stated that there is no guidance to illustrate the meaning of the phrase and requested NASD clarification as to the scope of the phrase and whether it applies to in-house non-cash compensation not intended to serve as a sales incentive such as, for example, compensation paid as a reward to phone representatives for a stellar attendance record or exceptional phone demeanor (MML, Nuveen, T. Rowe Price). Another commentator requested that the final rules clearly state what compensation arrangements are acceptable and suggested that language be incorporated in the final rule clarifying what specific types of compensation are unrelated to sales and distribution, and therefore not covered by the rules (New England).

One commentator identified various current investment company ''payment'' practices which are not tied to specified sales levels of the broker-dealer, but are intended instead to ''solidify the relationship between the broker-dealer and the mutual fund complex,'' such as when a mutual fund complex: (1) Gives '''unrestricted''' funds to some of the broker-dealers in its selling group; (2) Gives books to some of its broker-dealers on '''how to sell mutual funds''' for distribution to its registered representatives; (3) pays for the cost of preparing broker-dealer training materials; (4) pays for advertising in a broker-dealer's internal newsletter (MML). The commentator emphasized that a literal reading of the phrase could cover all of the above examples and, absent clarification, the phrase will be interpreted liberally by some firms and narrowly by others. The commentator recommended that the phrase be deleted in its entirety or clarified to ensure its uniform interpretation and implementation.

The NASD is aware that members and their associated persons receive compensation for the sale of non-securities products from insurance companies and receive other forms of payments from investment and insurance companies that are not for sales and distribution activities. The preamble is not intended to cover compensation and payment arrangements that are clearly not in connection with the sale and distribution of investment company securities or variable contracts. The extent to which any specific cash payments are considered to be made in connection with the sale of securities will be further considered and clarified as a result of the NASD's study of cash compensation arrangements, as set forth above.

Subparagraphs 2820(h)(1) and 2830(l)(1)—The Ministerial Exception

Proposed subparagraph (l)(1) of the Investment Company Rule and proposed subparagraph (h)(1) of the Variable Contracts Rule would codify the so-called ''ministerial exception,'' which permits a non-member, under certain circumstances, to maintain a commission account as a ministerial service for a member and, on behalf of the member, pay commission checks directly to associated persons of the member.

One commentator stated that, contrary to the assertion in NTM 94–67 that the ministerial exception only recognizes either the conditions set forth in Securities Exchange Act Release No. 8389 or no-action positions on how to comply with conflicting requirements of state insurance and securities laws, there are additional no-action letters from the Commission authorizing other direct payment exceptions based on theories wholly different from either the ministerial exception or state law conflict (MML). The commentator requested modification of the proposed rules to explicitly recognize the existence and validity of such no-action letters. The commentator's recommendation was to add rule language to the end of subparagraphs (l)(1) of the Investment Company Rule and (h)(1) of the Variable Contracts Rule published for comment stating ''or where such payments are authorized by a no-action letter issued by the staff of the Securities and Exchange Commission.''

One commentator requested that the final rule clarify that an NASD member firm can rely on any no-action position or opinion of counsel without having to obtain its own no-action position in order to take advantage of the ministerial exception (NAVA). Another commentator stated that the ministerial exception should be allowed to be used in all states, regardless of whether a state law impediment exists (PNMR).

The NASD agrees that it was not the intention of the ministerial exception to limit the ability of a member to rely on any applicable SEC interpretations or no-action letters that would permit direct payment of commission checks to associated persons. At the same time, the NASD believes it is necessary to ensure that members rely only on SEC

positions that are issued (in comparison to telephone advice) and that are applicable to the specific fact situation under which such direct payments will be made. Thus, it should only be necessary for a member to obtain from the SEC an exemptive, interpretive or no-action letter in the event that no current rule, regulation, interpretive release, or no-action position that applies to the member's fact situation. Additionally, the NASD believes it is necessary to ensure that direct payments to associated persons are treated as payments directly to the member for purposes of NASD rules.

Therefore, the rule language set forth in subparagraphs (l)(1) and (h)(1) of the Investment Companies and Variable Contracts Rules, respectively, in NTM 94–67 has been revised to clarify that associated persons may be compensated by certain non-members provided: (1) The arrangement is agreed to and the amount of commission determined by the member; (2) the member relies on an appropriate rule, regulation, interpretation or applicable no-action or exemptive letter issued by the SEC or its staff; (3) the payments are treated as compensation received by the member for purposes of the rules of the NASD; and (4) the payments are subject to the proposed rule's recordkeeping requirements. The NASD also revised rule language to recognize the SEC staff's recent no-action letter to Chubb Securities Corporation that permits commission payments by financial institutions directly to associated persons of member firms under certain circumstances.[19]

The NASD does not believe it is appropriate, as recommended by one commenter, to amend the rule to recognize an opinion of counsel, standing alone, as the basis for a member's reliance on the ministerial exception. This position does not preclude a member from obtaining an opinion of counsel that the member has based its determination to permit direct payments by a third-party to its associated persons on an appropriate rule, regulation, interpretation, or no-action or exemptive letter of the SEC or its staff and that such rule, regulation, interpretation, or no-action or exemptive letter applies to the specific fact situation of the member.

Subparagraphs 2820(h)(2) and 2830(l)(3)—Recordkeeping Requirement

Subparagraph (l)(3) of the Investment Company Rule and subparagraph (h)(2) of the Variable Contracts Rule, proposed in NTM 94–67 require member firms to keep records, with certain exceptions, of all cash and non-cash compensation received from offerors.

One commentator suggested that the NASD should consider requiring member firms to file a brief report to the NASD on a standard form each time a program to provide incentives is adopted (Edwards & Angell). Unless specifically required otherwise by law, the NASD allows members to devise their own specific methods and procedures for maintaining various records required to be kept under the rules and regulations of the Association and the SEC. It is not believed necessary for the NASD to monitor compliance with the proposed rule change through such a filing method. The NASD will review member's compliance with the proposed prohibition on the receipt of non-cash compensation in the course of its normal examination of the records of member firms.

In order to avoid duplicative recordkeeping, another commentator suggested including an additional exception to the record keeping requirement to allow records of compensation to be kept on behalf of a member by a member's control person, such as, for example, the investment adviser of a no-load fund complex (T. Rowe Price). The proposed provision does not address the identity of the entity that maintains the member's records. The recordkeeping requirement proposed by the NASD is applicable to the member, regardless of the entity relied on by the member to maintain its records, and it is the obligation of the member to ensure that its records comply with all applicable rules. Any records maintained by a third-party entity for a member must be maintained in accordance with all applicable law and be immediately accessible for examination and other regulatory purposes.

Another commentator recommended that the NASD add the phrase ''by the member or its associated persons'' after the word ''received'' in the first sentence of the recordkeeping requirement subsections so that the requirement applies to compensation received by both members and associated persons (MML). The NASD agrees that the proposed rule should be clarified to indicate that the recordkeeping requirement applies to compensation received by members and associated persons and has modified the rule language in subparagraphs (l)(3) and (h)(2) of the Investment Company and Variable Contracts Rules, respectively, accordingly. This amendment is consistent with the proposed amendments to the ''ministerial'' exception permitting direct payments to associated persons.

Subparagraph 2830(l)(4)—Disclosure Requirements

The version of the proposed rule change published for comment in NTM 94–67 contained disclosure obligations in both the Investment Company Rule and the Variable Contracts Rule which required that all cash compensation arrangements, including special cash compensation arrangements, be specifically described in the prospectus, with the exception of, among other things, arrangements between a non-member company and its sales personnel who are associated persons of an affiliated member firm.

*The Proposed Disclosure Requirement for Variable Contracts.* Two commentators stated that any commission/compensation disclosure requirements should be applied equally to both investment company securities and variable annuities since the products are so similar in nature and there is no reasonable basis to do otherwise (Raymond James, New England). Another commentator stated the proposed requirement in the Variable Contracts Rule to disclose non-standard compensation in a variable contract prospectus would result in irrelevant and misleading compensation information and would be financially and functionally burdensome, especially during a period of rapid growth where the daily prospectus amendments could be required (PEN). Another commentator suggested deleting proposed subparagraph (h)(3) of the Variable Contracts Rule (Lincoln National).

Unlike the Investment Company Rule, there is currently no provision in the Variable Contracts Rule requiring disclosure of compensation received by NASD members in connection with the distribution of variable contracts. Arrangements by insurance companies for compensating salespersons for variable product sales are generally part of a total compensation package based on the sale of non-securities insurance products as well as variable contracts. As discussed above, the NASD believes that, before requiring disclosure of all cash compensation for the sale of variable product securities, more information should be gathered regarding the kinds of compensation that are included in payment for the sale of variable products and the form of any required disclosure. Further, regardless of the few comments received opposed to this provision in the Variable Contracts Rule, the NASD believes it is

[19] *Chubb Securities Corporation* (Nov. 24, 1993).

apparent from the lack of discussion in the comments that the full potential impact of the proposed disclosure provision in its entirety on the sale of variable contract products has not been fully understood by industry commenters. Therefore, the NASD has modified the language of the Variable Contracts Rule to delete the requirement for disclosure of cash compensation in subparagraph (h)(3) in the Variable Contracts Rule published for comment in NTM 94–67, pending the gathering of more information and industry input, and the Variable Contracts Rule has been renumbered accordingly.

*Discriminatory Impact of Exception for Payments to Sales Personnel.* A number of commentators indicated that the exception proposed in subparagraph (l)(4)(c) of the Investment Company Rule and subparagraph (h)(3)(c) of the Variable Contracts Rule in NTM 94–67 to the disclosure obligation requirement for proprietary issuers with captive sales forces was unduly burdensome for, and unfairly discriminatory against, member firms selling only ''non-proprietary'' products, anti-competitive, and/or misleading to a retail public expecting full disclosure (IM&R, FNIC, AG Edwards, Stern, Associated, Mariner, Mutual Service, Cadaret/Grant, Security Life, IAFP, LPL, Putnam, Titan II, PEN). The commentators emphasized that required disclosures should be the same whether the products are proprietary or non-proprietary, and that failure to require uniform disclosure not only frustrates any attempt to achieve a level playing field but also leads to recommendations to customers which are not objective or suitable. Other commentators stated that non-uniform disclosure requirements increases, rather than decreases, the possibility for the perception of impropriety (American Growth Fund Sponsors, Titan II, State of New York, Wood Logan). It was recommended that the exception be deleted. (IAFP, Titan II).

The NASD believes that the exception to which the commentators object was intended to clarify that, since any payments of cash compensation directly to associated persons under the ministerial exception are required to be disclosed in any event by the member employing the associated persons, such direct payments need not be disclosed twice, i.e., as part of the member's receipt of compensation from its affiliated offeror and separately as direct payments to associated persons by an affiliated offeror. The purpose of the exception was to avoid: (1) Duplicate disclosure of compensation received by members affiliated with an offeror; and (2) disclosure of the member's reallowance to associated persons when it is paid by an offeror affiliated with the member.

Because of the considerable confusion caused by the provision, proposed subparagraph (l)(4) of the Investment Company Rule was revised to delete the exception provision. At the same time, the ministerial exception (as set forth above) is proposed to be revised to make it clear that direct payments to associated persons are treated as compensation received by a member for purposes of NASD rules. Taken together, these changes clarify that direct payments to associated persons must be combined with any other compensation received directly by the member and are subject to the disclosure requirements of the proposed rule.

*Revenue Sharing Disclosure.* A number of commentators stated there is a growing practice of ''revenue sharing'' between investment company advisers and retail sellers of investment company shares, whereby the advisers, in either formal or informal agreements with the retailer, agree to pay fees to retailer members—over and above Rule 12b-1 fees—in exchange for, among other things, (1) The placement of the funds onto the retailer's ''preferred'' list, (2) the retailer agreeing to sell the fund's shares at all, (3) ''due diligence'' payments for a member's examination of an offeror's products, (4) inclusion of fund data in a member's computerized hypothetical system, and (5) access to a member's E-mail system (Wilmer/Cutler, State of New York, Nuveen).

One of the commentators stated that such practices are required to be disclosed under the proposed *and* existing language of paragraph (l) of the Investment Company Rule, and that the NASD should address this issue directly and immediately by clarifying and affirming that such arrangements must be disclosed in a fund's prospectus (Wilmer/Cutler). The commentator stated that such clarification is essential to fulfill the purpose of paragraph (l) of the Investment Company Rule and the larger goal of investor protection.

Another commentator noted that the NASD's definition of ''sales charges'' in subparagraphs (d)(1) and (2) of the Investment Company Rule seem sufficiently inclusive to reach and govern revenue sharing practices as well as non-cash compensation (State of New York). The same commentator stated that both principles of agency law and securities anti-fraud statutes and rules provide a basis for requiring brokers to disclose all financial and economic incentives in connection with a securities recommendation (State of New York). Finally, one commentator stated that such ''revenue sharing practices'' should be prohibited (Nuveen).

As more fully set forth above, the NASD will defer action on issues regarding revenue sharing and other cash compensation arrangements until a study conducted by NASD staff of members that engage in the sale of investment company securities and variable contract products in order to develop a greater understanding of the different forms of revenue sharing arrangements and to provide information to the NASD for policy making.

*Disclosure of Special Cash Compensation.* One commentator requested that specific details of special cash compensation arrangements, such as member names and amounts, should only be required to be disclosed where the standards for the receipt of such special cash compensation are not uniformly applicable (American Funds Distributors). Another commentator stated that the customers are not harmed by special cash compensation arrangements, since the limit of the customer's costs has already been disclosed in the prospectus, and suggested deleting proposed subparagraph (h)(3) of the Variable Contracts Rule (Lincoln National).

One commentator stated that the prospectus disclosure requirements would force issuers with non-proprietary sales forces to disclose in prospectuses the terms of each new selling agreement signed as soon as the agreement is signed, thus requiring prospectuses to be stickered sometimes as often as every week (Security Life). The commentator stated that the benefits of such a burden would be de minimis, and suggested that the proposed rule be redrafted to only require the disclosure, for both proprietary and non-proprietary firms, of the maximum amount of cash compensation.

As set forth above, the NASD will defer action on issues regarding special compensation arrangements until a study of cash compensation arrangements is conducted in order to develop a greater understanding of the different forms of special cash revenue sharing arrangements and to provide information to the NASD for policy making.

*Burden of Compliance.* One commentator objected to the proposed rule's disclosure requirements on the basis that it places the burden of compliance oversight for ensuring proper disclosure on individual member firms rather than on the funds and their

affiliated underwriter (Merrill Lynch). The commentator stated that this burden places each broker-dealer in the difficult position of having to independently evaluate the quality of fund disclosure, and recommended that the NASD either reaffirm the rule's current prohibition on underwriters and their associated persons from paying cash compensation that is not disclosed in the prospectus or, in the alternative, modify the rule language so that both broker-dealers and underwriters have responsibility for compliance with the proposed rule.

With respect to participating broker-dealers that are not the principal underwriter for an investment company, the language of the provision places the burden of ensuring adequate disclosure on each individual member only with respect to the compensation that the member is receiving.[20] Such a participating member does not have an obligation to ensure disclosure of compensation received by other member firms.

However, the principal underwriter is responsible for the disclosure of compensation with respect to all members with whom they have entered into dealer agreements. This obligation arises as a result of the disclosure requirements of SEC Registration Statement Form N–1A. In Notice to Members 93–12 (February 1993), in Question 35, the NASD stated that investment companies should provide disclosure in a manner sufficient for member firms to prove that they can sell the fund's shares in compliance with NASD rules. Because the principal underwriter enters into all dealer agreements, the principal underwriter must be responsible for ensuring adequate disclosure of the compensation received by all participating dealers.

*Treatment of Payments for Training or Education Meetings; Potential Discriminatory Impact.* Offerors from time to time hold and pay for training and/or educational meetings with different members to differing degrees, resulting in disparate payment levels to members. One commentator, assuming that such payments could be regarded as special cash compensation, stated that the NASD should clarify that such situations do not require any special prospectus disclosure (Prudential). Other commentators stated that if a non-proprietary fund family's contribution toward an unaffiliated broker-dealer's cost of a public seminar (i.e., training or education meeting) is considered cash compensation requiring prospectus disclosure, then such unaffiliated broker-dealers will be placed at a significant competitive disadvantage when marketing to the public compared to proprietary funds/firms which would not have to disclose such compensation under the proposed rule (FNIC, Stern).

Payments made by offerors for training and education meetings which meet all the requirements for training and education meetings set forth under subparagraphs (l)(5)(c) or (h)(3)(c) of the Investment Company and Variable Contracts Rules, respectively, are not required, as non-cash compensation, to be disclosed in the prospectus. Thus, there is no discriminatory impact on unaffiliated broker-dealers, as such firms are not required to disclose payments received as reimbursements for their costs in conducting a training or education meeting. Such payments will, however, along with other cash payments be reconsidered in connection with the NASD's study of the cash compensation arrangements in connection with the sale of investment company securities and variable contracts.

*Other Comments.* The proposed rule does not specifically address the payment practice of ''overcredits,'' which is a payment made by an offeror to a member firm over and above the reallowance in a full dealer reallowance offering. One commentator criticized the proposed rule for failing to require that the practice of awarding overcredits be included as a disclosure item (Thornburg). Such payments will, however, along with other cash payments be reconsidered in connection with the NASD's study of the cash compensation arrangements in connection with the sale of investment company securities and variable contracts.

Two commentators stated that the NASD exceeds its authority in mandating disclosure requirements which fall within the jurisdiction of the SEC (Cadaret/Grant, New England Funds). The NASD does not believe it exceeds its authority by imposing rules on its members with respect to disclosure of compensation or any other information to investors, so long as such disclosure requirements are not contrary to the rules and regulations of the SEC. The proposed disclosure requirements do not change, and do not attempt to change, in any way the existing prospectus disclosure requirements under the registration and disclosure provisions of the Securities Act of 1933 or the Investment Company Act of 1940.

Subparagraphs 2820(h)(3) and 2830(l)(5)—Prohibition on Non-Cash Compensation

*General Comments on Prohibition.* One commentator stated that the proposed prohibition on non-cash compensation as published for comment in NTM 94–67 ought not to prohibit an offeror from reimbursing a member firm for all or a portion of the expenses incurred in conducting a seminar for the benefit of potential investors, because no public policy interest is served by prohibiting such arrangements (AG Edwards). 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. Such payments will, however, along with other cash payments be reconsidered in connection with the NASD's study of the cash compensation arrangements in connection with the sale of investment company securities and variable contracts.

Another commentator suggested that an additional exemption be added from the prohibition on non-cash compensation for due diligence meetings sponsored and paid for by an offeror on behalf of selected registered representatives of the offeror's selling group broker-dealer who were invited by the offeror on the basis of the amount of assets generated or procured the reps for the offeror's funds (Thornburg). Such meetings, the commentator stated, are specifically for the purpose of clarifying detailed fund portfolio and investment information so that registered representatives will be able to answer sophisticated client queries concerning such matters. Due diligence meetings, as ''due diligence'' is referenced in Section 11 of the Securities Act of 1933, are attended by the due diligence personnel of a broker-dealer firm for the sole and narrow purpose of ensuring the adequacy and accuracy of the information in the offering document. Such meetings would be held at a location appropriate to the conduct of due diligence, such as the issuer's offices. NASD staff are not aware of such meetings in the investment company securities or variable contract context. The commenter's description of ''due diligence'' meetings does not comport with the narrow purpose of ensuring the adequacy and accuracy of

[20] The rule language states ''No member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company.''

the offering document. Instead, it appears that the meeting being described is a training and education meeting, which would be required to comply with the exception for training or education meetings. To the extent bona fide due diligence meetings are held, as may occur in the case of a new investment company, the proposed prohibition on non-cash sales incentives does not prohibit such meetings and the expenses related to such meetings are considered expenses of the offeror.

*De Minimis Exceptions.* One commentator stated that the protections contained in proposed subparagraph (l)(5) of the Investment Company Rule, which would prohibit members and their associated persons from accepting any non-cash compensation, are illusory since the proposed rule does not require any recordkeeping and accountability for the acceptance of *de minimis* gifts and entertainment in paragraphs (a) and (b) (State of New York). Another commentator suggested that these exceptions retain the current language of the Investment Company Rule which would require that such gifts and entertainment ''conditioned on sales of share'' to clarify that, contrary to the explanation in NTM 94–76 (p. 433), such gifts should not even be permitted as rewards, since rewards in effect invariably become a *de facto* sales incentive program (Nuveen).

The NASD agrees with the general premise of the commenters that any item of value given by an offeror to an associated person has some influence on that person. The issue is, however, whether the $100 gift exception and the entertainment exception provide for items of value that are sufficient to influence the sales practices of the recipient associated person. The exemptions for gifts and entertainment have long been in the Investment Company Rule and are particularly appropriate in the context of a continuously-offered security, when it should be anticipated that offerors will want to maintain a business relationship with associated persons of member firms. The NASD is not aware of any abuse of these exemptions and believes that they represent such a *de minimis* activity that they do not have the ability to undermine investor protection. The NASD has, nonetheless, amended the language of the first two exceptions to modify the phrase ''not preconditioned on achievement of a specified sales target'' to clarify that the sales target cannot be ''previously specified.'' The NASD believes that this requirement as well as the *de minimis* nature of the gift or entertainment proposed in subparagraphs (l)(5)(a) and (b) and (h)(3)(a) and (b) of the proposed rule change are sufficiently restrictive in scope and amounts to allay concerns that such gifts and gratuities may become substantial *de facto* incentive programs that have the potential to undermine investor protection.

Another commentator suggested deleting in its entirety the meals and entertainment exception since such *de minimis* payments have never posed serious non-cash compensation problems and the subjective language of the subsection makes it unenforceable (Titan). The proposed exception for meals and entertainment is drawn from the current language of the Investment Company Rule and has not previously presented an enforcement problem. While the requirement that such meals and entertainment be ''neither so frequent nor so extensive as to raise any question of propriety'' is subjective, it is believed that such a standard is not inconsistent with and is no more subjective than the Article III, Section 1 standard that members are required to ''observe high standards of commercial honor and just and equitable principles of trade'' which allows the NASD to take a broad regulatory approach on a case-by-case basis if necessary. It is believed that the proposed rule language provides sufficient specificity to put the membership on notice of the need to exercise appropriate discretion when relying on the exception.

One commentator stated that it is unclear whether the exceptions for $100 gifts and entertainment would be available if a fund sponsor makes such payments available to a broker-dealer in connection with the firm's internal sales campaign, which campaign is based on all of the firm's products during a specific period of time rather than specified sales targets for particular funds (MML). The NASD believes that this comment reflects the proposed structure of the rule change published for comment which would have prohibited third-party offerors from contributing to a member's in-house incentive program. Regardless of how the broker-dealer's in-house compensation program is structured, the exceptions for $100 gifts and entertainment cannot be combined with the member's in-house incentive program because the third-party offeror would be participating in the organization of the member's program which is proposed to be prohibited. As amended, the proposed rule change would permit, however, third-party offerors to make cash contributions to the member's in-house incentive program.

Another commentator suggested that the $100 gift exception be revised to replace the subsection's fixed dollar limitation with the language ''neither so frequent nor so extensive as to raise any question of propriety'' found in subparagraph (h)(4)(b) of the Variable Contracts Rule (ITT Hartford). The commentator reasoned that the standard of propriety is more appropriate than a fixed dollar limitation in the context of variable contracts. The $100 exemption is consistent with Article III, Section 10 of the Rules of Fair Practice which allows such gifts between a member and the personnel of another firm and with the Corporate Financing and DPP Rules which permit an issuer to provide up to $100 of non-cash sales incentives to associated persons annually in connection with the sale of corporate equities, real estate investment trusts, closed-end funds, debt, and DPP offerings.[21] The NASD believes it appropriate to provide a fixed dollar amount as proposed.

*Exception for Training and Education Meetings.* It was pointed out by commentators that a discrepancy may exist between the text of proposed subparagraph (l)(5)(c)(v) of the Investment Company Rule (which specifies that sponsors cannot contribute to the training/educational meetings if the payment or reimbursement is conditioned on sales or the promises of sales) and its counterpart in the Variable Contracts Rule, and the explanation of the subsection on page 434 in NTM 94–67, which appears to go further than the actual rule language in saying that members cannot condition attendance at their training meetings through satisfaction of in-house sales incentive requirements, regardless of whether they accept offeror contributions (MML, Mutual Service). Both commentators expect the literal rule language to govern, and one (MML) requested clarification of this expectation in the final release. Similarly, commenters stated that, contrary to the NASD's interpretation, example #4 in NTM 94–67 should *not* be interpreted as preventing a product sponsor from contributing to the expenses a member incurs for awarding a trip based on an in-house, total products sales contest (Calvert, LPL). Such sponsor contributions, one of the commenters argued (LPL), are payments for the opportunity to address and educate registered representatives, not rewards

[21] The SEC approved in Securities Exchange Act Release No. 35862 (June 19, 1995) a change to Rule 2710 that amended its non-cash incentive provision to change the gift exception from $50 to $100.

for product-specific sales performances. Another commenter stated that the proposed rule appears to prohibit certain fact-specific situations that ought not to be prohibited, such as a broker-dealer's incentive offer of a business development conference/meeting/trip to any of its associated persons (and guests) as an award for achieving a specific sales target (measured by either ''commissions earned'' or ''assets raised'') where the majority of the costs of the conference/meeting/trip are paid for by invited investment and insurance companies who also help to conduct some of the training and educational presentations (Raymond James). The commenter stated further that such incentive contests and their variants ought to be specifically exempted from the proposed rule's prohibitions since they satisfy the general intent of the proposed rules and help to increase the level of education and training in the fund industry. Finally, other commentators stated that the proposed non-cash restrictions would be detrimental to the variable product marketplace (NAVA) and variable product consumers and urged the NASD to amend its proposal to permit continued product sponsor support of legitimate educational and training seminars, without limitation on the methodology used by insurers to invite agent attendees (PEN).

The NASD believes that training/education meetings are important to the investment company/variable contract industries and it is, therefore, important that the NASD's rules continue to permit such meetings without problems of enforcing the non-cash incentive prohibition. It was anticipated when the training and education meeting exception was developed that members would recognize high producers by attendance at such meetings. Because members are permitted to have an in-house non-cash incentive program for sales of investment company securities and variable contract products (and offerors may contribute to such in-house incentive programs), it is important to appropriately clarify the difference between attending a training/education meeting as a permissible ''recognition'' and attending it as an impermissible ''non-cash sales incentive program.'' In order to prevent a member from combining a permitted in-house sales incentive program with a training/education meeting held by an offeror, the NASD has revised proposed subparagraphs (l)(5)(c)(ii) of the Investment Company Rule and (h)(3)(c)(ii) of the Variable Contracts Rule to specify that attendance of associated persons at bona fide training/education meetings must not be based by the member on achievement of a sales target or any other non-cash compensation arrangement permitted under paragraph (d) (which permits in-house non-cash arrangements by a member or its affiliate). When this requirement is taken together with the requirement that the offeror cannot condition its payment or reimbursement on sales or the promise of sales, these two requirements clarify that attendance at a training or education meeting by an associated person is permitted to be approved by a member as a recognition for past sales or as an encouragement for future sales, but shall not be part of a member's or offeror's incentive program or plan which requires that the recipient or the member reach a specific sales goal as a prior condition to attending the training or education meeting.

Other commentators suggested that the NASD should make explicit in the proposed rule language for subparagraph (l)(5)(c)(v) of the Investment Company Rule that attendance at a member's training meeting cannot be earned through a member's in-house product-specific sales incentive contest, but only through generic in-house sales criteria (FNIC, Stern). The NASD has, as set forth above, amended the training or education exception to clarify that attendance at any training or education meeting where a member's costs of the meeting are paid for or reimbursed by a third-party offeror cannot be earned through any in-house incentive contest—even though such contest is in compliance with the proposed rule. If a member holds a training or education meeting for its own associated persons and offerors or other third-parties pay or reimburse the costs of the meeting, the meeting must comply with the training or education meeting exception. If no third-party pays or reimburses the expenses of a member in connection with its internal training or education meeting, the meeting need not comply with the training or education exception as the member is not in receipt of non-cash compensation. Further, in the latter instance, the member is not prevented from inviting a third-party offeror to be a speaker at the meeting.

One commentator objected to having any limitations at all imposed on the ability of fund groups and product sponsors to participate, both financially and in terms of product content, in national or regional training, education and compliance meetings, particularly where the right to attendance at the meetings is earned by product sales (IM&R). The NASD disagrees with the position of the commentator and believes that it is appropriate to regulate the manner in which training or education meetings are held to ensure that such meetings are not prohibited non-cash incentive meetings.

Another commentator suggested that the NASD clarify that the limitations imposed for training and education meetings apply to an offering of new funds as well as existing funds (Prudential). The requirements for training or education meetings apply to any meeting considered a training or education meeting with respect to new or existing funds. As set forth above, however, investor seminars and bona fide due diligence meetings (which are more likely to occur in the case of a new fund) are not considered training or education meetings.

A commenter also stated that payment or reimbursement by offerors to members for the cost of educational meetings should be strictly limited to expenses actually incurred by the member in connection with the meeting, and that such payments not exceed the annual amount per person fixed periodically by the Board of Governors under proposed subparagraph (l)(5)(a) of the Investment Company Rule (Nuveen). The NASD is not proposing, at this time, to limit the payments for educational meetings to the expenses actually incurred by the member in connection with the meeting. Payments of a member's meeting expenses that exceed the costs of the meeting will, however, along with other cash payments be considered in connection with the NASD's study of the cash compensation arrangements in connection with the sale of investment company securities and variable contracts.

According to some commenters, the proposed rule's provision regarding the site for training and education meetings is excessively harsh and unrealistic, because it restricts site location to a specific region for non-affiliated broker-dealers while permitting a national brokerage firm to choose any location (Nike, Capital Analysts). Another commenter stated that the proposed rule language should be expanded to state that a national meeting may be held at a national location (Fidelity). Another commenter stated that since every location in the United States, or the world for that matter, could be viewed as a ''regional location,'' it is uncertain what regulatory purpose is served by putting such an ambiguous and virtually limitless requirement in the proposed rules (MML).

With respect to the first comment, without a restriction with respect to the

location of a training/education meeting, it is probable that offerors will compete for sales of their products on the basis of the location of the training/education meeting that they are willing to hold for associated persons of broker-dealers. Members, on the other hand, would be in a position to negotiate with offerors for reimbursement of expenses of training/education meetings in exotic locations on the basis of the sales they have generated. Thus, it appears important that a restriction be included with respect to the location of the meeting.

While the second commenter is correct that members with an international business are not subject to any location limitation, it is important to note that the agenda for such meetings must be appropriately focused on training and education. As a practical matter, certain business structures give a natural advantage to some members. It is believed that if the focus of the meeting is training or education, that the meeting is most likely to be within the 48 contiguous states.

The NASD determined not to include express limits on the location of national training and education meetings. The establishment of objective standards to limit national meetings would require precise definitions of the terms and phrases ''office of the offeror or member,'' ''facility located in the vicinity of such office,'' and ''regional location.'' Because members' business lines and distribution systems are structured in myriad and sometimes substantially dissimilar ways, especially with respect to physical location, precise definitions of such terms may deprive some members of the needed flexibility to structure their meetings. Thus, it would be very difficult to establish any objective geographical standards without avoiding what might appear to be discriminatory effects on certain members. The NASD believes that whether a particular location is appropriate for a training and education meeting will be dependant, to a significant extent, on the facts and circumstances of each situation.

Furthermore, the NASD believes that the limitations proposed for the nature of educational meetings in the proposed rule will discourage sponsors from holding training and education meetings in exotic places. Because the burden is now on members to show that a training and education meeting is bona fide, the NASD anticipates that members will generally avoid excessively expensive and lavish training and education settings that would be difficult to justify under the strictures of the proposed rule.

Another commenter suggested limiting issuer-sponsored trips to the corporate headquarters of the issuer for educational purposes only, and to substantiate the purpose of such trips with records of the meeting agendas (LPL). The NASD agrees with the comment that the purpose of training or education meetings should be substantiated by the member on the basis of the meeting agenda, but does not believe it necessary to limit meetings to the corporate headquarters.

*Exception for In-House Sales Incentives.* The major comments on the exceptions in the version of the proposed rule change in NTM 94–67 permitting in-house sales incentive arrangements argued that allowing direct payments by an affiliated offeror to a member's permissible in-house program discriminated between members that sell proprietary products and members that do not, and between investment/insurance companies with and without an affiliated broker-dealer. In particular, smaller members were concerned regarding the disparate impact of the sales incentive prohibition because the largest broker-dealers also generally sell proprietary products. Commenters also expressed particular concern regarding the ability of an affiliated investment company or insurance company (or other non-member affiliate, such as a bank) to contribute to a member's in-house incentive program, whereas non-affiliates were prohibited by the proposal from making similar contributions.

Two commentators stated that the reasons offered for the proposed rule change, namely, to prevent the increasing potential for loss of supervisory control and to preempt the possibility of perception of impropriety and loss in investor confidence, were less than compelling justifications for regulation that not only discriminates against certain firms but also encourages the sale of unsuitable products to the investing public (Security Life, Wood Logan). One commentator stated that the exception in NTM 94–67 permitting in-house non-cash compensation eviscerates the goal of aligning the salesperson's interest with the client's interest (State of New York). Commentators stated that proposed subparagraph (h)(5) of the Variable Contracts Rule in NTM 94–67, by allowing non-cash compensation programs for insurance companies with proprietary products and sales forces, creates an uneven playing field in favor of ''proprietary providers'' over ''independent providers'' and is anti-competitive (Skandia, Capital Analysts, Security Benefit, American Growth Fund Sponsors). Some commentators suggested either deleting subparagraph (h)(5) of the Variable Contracts Rule entirely or expanding it to allow independent providers to offer non-cash compensation programs on the same basis as proprietary providers (Skandia, PNMR).

The NASD was concerned about the disparate impact of the rule proposal that would result from a member firm with proprietary products conducting an in-house contest which includes direct or indirect economic support and funding through sales of its proprietary products, and was sympathetic to the comments of those members without proprietary products who argued that they would be unable to afford in-house contests without the economic support of outside issuers. In addition, the NASD was concerned regarding the potential disparate impact of the rule proposal on affiliated investment or insurance companies that did not have an affiliated member distributing their products and would not be permitted to contribute to the in-house incentive program of unaffiliated members.

The NASD focused on three provisions in subparagraphs (l)(6) and (h)(5) of the Investment Company and Variable Contracts Rules, respectively, as proposed in NTM 94–67. These are: (1) The language in the introduction which permitted a non-member (including offerors) to provide a sales incentive program for its salespersons that are associated persons of an affiliated broker-dealer; (2) paragraph (a) of subparagraphs (l)(6) and (h)(5) which required that the member's in-house incentive program must be multi-product type oriented or, for single product type firms, based on the gross production of the associated person; and (3) paragraph (b) of subparagraphs (l)(6) and (h)(5) which prohibited an unaffiliated non-member (including offerors) or other member from participating in and contributing to a member's in-house incentive program.

In general, the NASD determined that the goal of prohibiting non-cash incentives for the sale of a particular investment company's securities would not be compromised if non-member entities and other members are allowed to contribute to any member's in-house program, so long as restrictions are imposed on the structure of the in-house program. The NASD believes that the proposal should distinguish between incentives that act at the point-of-sale to influence the salesperson's recommendation to the investor and

incentives which do not have such effect. Non-cash incentive programs by an offeror that involve only a single product (regardless of whether the product is proprietary) affect the point-of-sale relationship with the investor and are more likely to influence the salesperson to sell a specific investment company's securities or variable contract. The NASD believes that contributions by a non-member to a member's in-house incentive program that includes all variable annuity or variable life or investment company products does not have the same ''incentive'' effect because the member's in-house incentive is a reward for total production—not for the sale of a specific variable annuity or variable life contract product or investment company security.[22]

The NASD has modified and restructured the provisions proposed in subparagraphs (l)(6) of the Investment Company Rule and (h)(5) of the Variable Contracts Rule in NTM 94–67. The subparagraphs have been renumbered in the proposed rule change as subparagraphs (l)(5)(d) and (e) and (h)(3)(d) and (e). Subparagraph (d) of the Investment Company Rule and of the Variable Contracts Rule permits all members and non-member affiliates of members to hold in-house incentive programs so long as certain conditions are met which are for the purpose of avoiding the point-of-sale impact of the incentives, and subparagraph (e) permits any non-member company and other member to contribute to, but not to hold or organize, a permissible in-house non-cash sales incentive program between a member and its associated persons so long as the same conditions for subparagraph (d) are met. By its limiting language, permissible contributions under subparagraph (e) may only be given to an in-house non-cash sales incentive program held by a member firm; such contributions may not be given to an in-house non-cash sales incentive program held by a non-member affiliate because the non-member affiliate is not required by NASD rules to maintain records of the receipt of such contributions.

With respect to the second condition on the structure of a member's or affiliate's in-house incentive program proposed in subparagraph (l)(6)(b) of the Investment Company Rule in NTM 94–67, two commentators observed that since almost all proprietary firms have investment company securities and cloned variable products, an incentive program could be based on just two product types, and recommended either deleting the exception for in-house sales entirely or changing the language of the provision to make in-house sales incentive programs available only if based on gross production of all products (FNIC, Stern). Another commentator recommended that the ''multi-product type'' condition be revised to make clear that the test is not satisfied by selecting one security of each product type, for example, a proprietary investment company and a proprietary variable product (Wood Logan).

The conditions applicable to the member's and its affiliate's permissible non-cash sales incentive programs in subparagraphs (l)(5)(d) and (e) of the Investment Company Rule and (h)(3)(d) and (e) of the Variable Contracts Rule were modified from those proposed in NTM 94–67 in the following manner: (1) The member's in-house non-cash incentive program, when it includes investment company securities or variable contracts, must include the total production of associated persons with respect to all investment company securities and variable annuity or life contracts distributed by the member, which modifies the ''multi-product type'' rule language in NTM 94–67; (2) the credit received for each variable contract (i.e., variable annuity or variable life) must be equally weighted, which is a new provision that was not included in the language of NTM 94–67; and (3) no non-member company or other member may directly or indirectly participate in the organization of a permissible non-cash compensation arrangement, which modified the corresponding provision in NTM 94–67 by deleting the words ''or contributes to'' in order to allow contributions to permissible non-cash programs by outside unaffiliated non-members or other members as long as their involvement is limited only to such contributions under new paragraph (e). The fourth requirement, the recordkeeping requirement, was not modified from the language of NTM 94–67.

The NASD believes that these changes to the non-cash compensation provisions proposed in subparagraphs (l)(5)(d) and (e) of the Investment Company Rule and subparagraphs (h)(3)(d) and (e) of the Variable Contracts Rule eliminate the point-of-sale impact of non-cash sales incentives on the sales practices of an associated person with respect to the sale of investment company securities and variable contracts by prohibiting third-party non-cash sales incentive programs and by requiring that all securities of the product type be included in the member's (or its affiliate's) in-house incentive program and be equally weighted. At the same time, the NASD believes that any potential discriminatory impact that is not in furtherance of the Act is addressed by permitting non-members and other members to contribute to a member's in-house incentive program.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. The Commission requests that, in addition to any general comments concerning whether the proposed rule change is consistent with Section 15A(b)(6) of the Act, commentators specifically address the following issues:

1. The proposed rule change would continue to permit an associated person to accept gifts from offerors if the total value of gifts from an offeror to an associated person does not exceed $100 per person per year and if such gifts are not preconditioned on meeting a sales target. Associated persons also could continue to accept an occasional meal, a ticket to a sporting event or the theater, or comparable entertainment from offerors if the entertainment is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on meeting a sales target. The NASD states that it is not aware of any abuse of these exemptions and believes that they represent such a *de minimis* activity that they do not have the ability to undermine investor protection. Should members be required to keep records of such gifts or entertainment to enable the NASD to surveil effectively for abuse?

2. The proposed rule change would permit a member or an associated

[22] *See supra* discussion explaining the NASD's rationale underlying the proposed non-cash compensation provisions in Subsections 26(l)(5) and 29(l)(3) of the Investment Company and Variable Contract Rules, respectively.

person to accept payment or reimbursement from an offeror for expenses incurred in connection with meetings held by the offeror for the purpose of training or educating associated persons of a member. Such meetings can be held at or near an office of the offeror or an office of the member or a regional location with respect to regional meetings)—a third-party offeror with a regional business may not conduct a meeting outside that region unless the member has a more widespread business. The provision would permit offerors to hold training meetings in resort locales if that offeror or the member has an office in that resort locale.

The NASD states that it ''believes that the limitations proposed for the nature of educational meetings in the proposed rule will discourage sponsors from holding training and education meetings in exotic places. Because the burden is now on members to show that a training and education meeting is bona fide, the NASD anticipates that members will generally avoid excessively expensive and lavish training and education settings.'' Are the recordkeeping requirements proposed by the NASD sufficient to support determinations of whether such meetings will be bona fide?

3. The NASD states in its filing that a member holding a training or education meeting for its associated persons would not be required to comply with the conditions imposed with respect to training and education meetings held by offerors or unaffiliated members ''if the member does not receive a payment or reimbursement from an offeror for the expenses of the meeting. In any event, the member would not be prohibited from permitting offerors to make a presentation at the meeting.'' The proposed rule change establishes three separate levels of regulation of training and education meetings depending upon whether a member or an offeror holds a training and education meeting and depending upon whether a member who holds a training and education meeting accepts reimbursement from an offeror.

a. If an offeror holds a training and education meeting, that meeting must comply with the training and education exception.

b. If a member holds training and education meeting, and accepts reimbursement from an offeror for certain expenses, the meeting must comply with either the training and education exception or the in-house sales incentive exception (permitting contributions by offerors).

c. If a member holds a training and education meeting for its own associated persons and accepts no reimbursement from offerors, the proposed rule change does not regulate that meeting because the meeting is not in connection with the sale or distribution of investment company/variable contract securities.

Commenters are asked to address whether a training and education meeting should constitute non-cash compensation subject to the proposed rule change if an offeror participates in organizing the meeting even though an identical meeting would not be subject to the proposed rule change if organized by the member for its own associated persons.

4. The Tully Committee identified the practice of payment of higher commissions to registered representatives for proprietary products than for non-proprietary products as an arrangement that can create conflicts of interest. The proposed rule change would not prohibit or regulate this practice. The NASD has stated that ''it has generally not been the practice for the NASD to regulate the internal compensation arrangements between a member and its associated persons.'' The proposed rule change would, however, prohibit contests granting cash awards if the contest gives greater weight to certain securities than others. Commenters are invited to address whether the proposed rule change should be extended to cover ordinary compensation practices in addition to incentive compensation practices.

Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by July 29, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30–3(a)(12).

Jonathan G. Katz,

*Secretary.*

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## SOCIAL SECURITY ADMINISTRATION

### Statement of Organization, Functions and Delegations of Authority

Notice is being given that two new chapters are being issued, Chapter TC, Office of the Chief Actuary and Chapter TE, Office of the Deputy Commissioner, Communications and that Chapter TA, Office of the Deputy Commissioner, Programs, Policy, Evaluation and Communications (TA) is being reissued.

Within the Deputy Commissioner, Programs, Policy, Evaluation and Communications notice is given that the Office of the Actuary (TAC); the Office of Communications (TAL); the Resources Management Staff (TAA–1); the Office Automation Support Staff (TAA–2); the Office of Program Coordination and Planning (TAB); the Office of Policy Analysis and Evaluation (TAQ); the Office of Policy (TAK); and the Office of Disclosure Policy (TAG) are abolished. Notice is also given of the establishment of the Office of Policy and Planning (TAR) and the Office of Program Support (TAS) and the retitling of the Office of Research and Statistics (TAN) as the Office of Research, Evaluation and Statistics.

Finally, notice is given that in the Office of Disability (TAE) the Office of Medical Evaluation (TAEA) is being abolished. The functions are being redistributed among the Office of the Associate Commissioner for Disability, the Division of Medical and Vocational Policy (TAEC) and the Federal Disability Determination Services (TAEB).

The new and reissued Chapters read as follows:

ADD new chapter

Chapter TC—Office of the Chief Actuary

TC.00 Mission
TC.10 Organization
TC.20 Functions

Section TC.00 *The Office of the Chief Actuary*—(Mission): The Office of the Chief Actuary (OCACT) plans and directs a program of actuarial estimates and analyses pertaining to the SSA-administered retirement, survivors and disability insurance programs and supplemental security income program and to projected changes in these programs. Evaluates operations of the