The Commission, therefore, has determined to permanently approve, on an accelerated basis, the proposed rule change permitting a CHX specialist to autoquote in increments as determined by the specialist from time to time.[5]

The Commission believes it is reasonable for the CHX to determine that for competitive reasons it will not continue to require its specialists to maintain a minimum quotation size of 1000 shares in certain Nasdaq/NM securities when Nasdaq market makers' in those securities are permitted a minimum quotation size, for proprietary quotes, of 100 shares.[6] The Commission notes, however, that it has not approved the NASD Pilot on a permanent basis nor has it determined that it should continue past December 31, 1997.[7] The Commission is, therefore, approving the CHX proposal on a pilot basis equal to the limitations of the Nasdaq market makers; 50 securities and until December 31, 1997. Because Nasdaq market makers have been quoting a minimum of 100 shares for the 50 Nasdaq/NM securities in the NASD Pilot since January, 1997, the Commission is approving this part of the proposal on an accelerated basis to allow CHX specialists to also reduce the minimum quotation size in those 50 Nasdaq/NM securities.

The Commission is deferring approval of the proposal to permit CHX specialists to reduce the quotation minimum in an additional 100 Nasdaq/NM securities until comments on the proposal are received and the Commission takes action on the NASD's proposal to expand the NASD Pilot by 100 securities.[8]

For the foregoing reasons, the Commission finds good cause for approving the proposed rule change, in part, prior to the thirtieth day after date of publication of notice of filing thereof in the **Federal Register**.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[9] that the proposed rule change (SR–CHX–97–3) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[10]

Jonathan G. Katz,

Secretary.

[FR Doc. 97–23601 Filed 9–4–97; 8:45 am]

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[5] The increment used by the specialists for autoquoting, however, must be an increment that is available for quotation on the exchange by all members.

[6] *See* Securities Exchange Act Release No. 38156 (January 10, 1997), 62 FR 2415 (January 16, 1997), order approving reduction in the minimum quotation size for Nasdaq market makers in fifty Nasdaq/NM securities (''NASD Pilot''). A list of the 50 Nasdaq/NM securities is located on the Nasdaq web site (www.nasdaq.com).

[7] *See* Securities Exchange Act Release No. 38851 (July 18, 1997), 62 FR 39565 (July 23, 1997), approving the extension of the NASD Pilot for a minimum quotation size of 100 shares in 50 Nasdaq/NM securities until December 31, 1997.

[8] *See* Securities Exchange Act Release Nos. 38513 (April 15, 1997), 62 FR 19369 (April 21, 1997); 38872 (July 24, 1997), 62 FR 40879 (July 30, 1997), (notices of request to expand the number of Nasdaq/NM securities to 150).

[9] 15 U.S.C. § 78s(b)(12).

[10] 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–38993; File No. SR–NASD–97–35]

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

August 29, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1], and Rule 19b–4[2] thereunder, notice is hereby given that on May 7, 1997,[3] the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] On July 15, 1997, the NASD filed Amendment No. 1 to the proposed rule change. On July 23, 1997, the NASD filed Amendment No. 2 to the proposed rule change. On August 28, 1997, the NASD filed Amendment No. 3 to the proposed rule change. Amendment No. 1 made several changes to the proposed rule language and the rule filing. *See* letter from John Ramsay, Deputy General Counsel, NASD Regulation, Inc. (''NASD Regulation'') to Katherine A. England, Assistant Director, Commission, dated July 11, 1997. The changes made by Amendment No. 1 are incorporated into and published in this notice. Amendment No. 2 makes a technical change to Amendment No. 1. *See* letter from John Ramsay, NASD Regulation to Katherine A. England, Commission, dated July 22, 1997. Amendment No. 3 states that the NASD Board of Governors has reviewed the proposed rule change and that no other action by the NASD is necessary for Commission consideration of the rule proposal. *See* letter from John Ramsay, NASD Regulation to Katherine A. England, Commission, dated August 27, 1997.

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

The NASD is filing a proposed rule change to NASD Conduct Rules 2820 and 2830 relating to the regulation of non-cash compensation in connection with the sale of investment company securities and variable contracts. Below is the text of the proposed rule change. Proposed new language is italicized; proposed deletions are in brackets.

Conduct Rules

2820. Variable Contracts of an Insurance Company

(a) Application.

Unchanged.

(b) Definitions.

(1)–(2) Unchanged.

(3) The terms ''affiliated member,'' ''compensation,'' ''cash compensation,'' ''non-cash compensation'' and ''offeror'' as used in paragraph (h) of this Section 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.

''Compensation'' shall mean cash compensation and non-cash compensation.

''Cash compensation'' shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override, or cash employee benefit received in connection with the sale and distribution of variable contracts.

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

''Offeror'' shall mean an insurance company, a separate account of an insurance company, an investment company that funds a separate account, any adviser to a separate account of an insurance company or an investment company that funds a separate account, 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.

(c)–(g).

Unchanged.

(h) Member Compensation.

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 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)(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 as described in subparagraphs (h)(4) (A) and (B), a member shall maintain records of all compensation 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 or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Notwithstanding the provisions of subparagraph (h)(1), the following non-cash compensation arrangement are permitted:

(A) Gifts 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 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 (h)(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 incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (h)(4)(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 subparagraph (h)(4)(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 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)(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 subparagraph (h)(4)(D).

* * * * *

2830. Investment Company Securities

(a) Application.

Unchanged.

(b) Definitions.

(1) [''Associated person of an underwriter,'' as used in paragraph (1), 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,'' ''compensation,'' ''cash compensation,'' ''non-cash compensation'' and ''offeror'' as used in paragraph (l) of this section 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.

''Compensation'' shall mean cash compensation and non-cash compensation.

''Cash compensation'' shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit 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, 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.

(2)–(10) Unchanged.

* * * * *

(c)–(k).

Unchanged.

* * * * *

(l) [Dealer Concessions] *Member Compensation.*

[(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

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

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 paragraph (l)(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 paragraph (l)(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 subsection (1) 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.]

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 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 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 or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Notwithstanding the provisions of subparagraph (l)(1), the following non-cash compensation arrangements are permitted:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors[5] *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 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 incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (l)(5)(D);

(iii) the location is appropriate to the purpose of the meeting, which shall

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

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 subparagraph (l)(5)(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 subparagraph (l)(5)(D).

* * * * *

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. NASD Regulation 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

Introduction

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

Generally, the proposed rule change would: (1) Adopt definitions of the terms ''affiliated member,'' ''compensation,'' ''cash compensation,'' ''non-cash compensation,'' and ''offeror''; (2) prohibit, except under certain circumstances, associated persons from receiving any compensation 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, with respect to the Investment Company Rule, against a member receiving compensation in the form of securities; and (6) prohibit, with certain exceptions, members and persons associated with members from directly or indirectly accepting or paying any non-cash compensation in connection with the sale of investment company and variable contract securities.

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 comparable entertainment; (3) payment or reimbursement for training and education meetings held by a broker-dealer or a mutual fund or insurance company for the purpose of educating 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.

Background

The proposed rule change is the latest in a series of NASD proposals designed to control the use of non-cash compensation in connection with a public offering of securities. Previous rule amendments established restrictions on non-cash compensation in connection with transactions in direct participation program securities, real estate investment trusts, and corporate debt and equity offerings.

In developing the proposed rule change, the staff and NASD Regulations's Investment Companies Committee, the Insurance Affiliated Member Committee, and the Variable Insurance Products Committee (a successor to the Insurance Affiliated Committee) (collectively, the ''Committees'') have considered the current environment in which investment company and variable contract securities are sold. The NASD believes that the increased use of non-cash compensation for the sale of investment company and variable contract securities heightens the potential for loss of supervisory control over sales practices and increase the perception on inappropriate practices, which may result in a loss of investor confidence. The NASD also believes that the increased use of non-cash compensation creates significant point-of-sale incentives that may compromise the requirement to match the investment needs of the customer with the most appropriate investment product. The NASD determined, therefore, that the adoption of limitations on non-cash compensation is appropriate at this time.

In 1992, the NASD submitted to the Commission 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 and variable contract securities. As as result of Commission staff concerns regarding the proposal, the NASD withdrew SR–NASD–92–36 in April 1994. In March 1995, the NASD submitted SR–NASD–95–10 to the Commission, which proposed substantive prohibitions on the receipt of non-cash compensation in connection with sale of investment company and variable contract securities. The NASD withdrew that proposal in 1995. In December 1995, the NASD submitted to the Commission proposed rule change SR–NASD–95–61, which proposed substantive prohibitions regarding non-cash compensation and incentive-based cash compensation in connection with the

sale of investment company and variable contract securities. SR–NASD–95–61 was published by the Commission for public comment on July 8, 1969.[6]

SR–NASD–96–51 raised significant issues among commenters regarding the nature and treatment of certain incentive-based cash compensation arrangements, in particular those cash compensation arrangements of insurance-affiliated member firms. NASD Regulation has prepared a summary of the comments, which is attached as Exhibit A. Most of the commenters opposed the proposed provisions to regulate incentive-based cash compensation. In response to the commenters, the NASD determined to delete those provisions proposing to impose substantive prohibitions regarding incentive-based cash compensation. Therefore, the NASD has withdrawn SR–NASD–95–61 and has replaced it with this proposed rule change, which does not contain provisions imposing substantive regulations on the receipt of cash compensation arrangements.

Nevertheless, the NASD is aware of a broad range of cash compensation practices by which investment company and variable contract issuers or their affiliates provide various incentives and rewards to individual broker-dealers and their registered representatives for selling the issuers' products. NASD staff believes that various cash incentive compensation practices, which create an incentive to favor one product over another, also may compromise the ability of securities salespersons to render advice and services that are in the best interests of customers. The NASD has determined to solicit comment pertaining to these issues before proposing any new rules to require either disclosure or substantive regulation of cash compensation for the sale of investment company and variable contract securities. Accordingly, the NASD intends to issue a Request for Comment that would inquire primarily about the nature of various cash compensation arrangements and structures within the mutual fund and variable product industries, the potential harms and benefits of such arrangements and structures, and the appropriate regulatory approach to such arrangements and structures.[7] The Request for Comment will explore issues such as: (1) The nature of various cash compensation arrangements, particularly within the mutual fund and variable product industries (such as ''revenue sharing'' and payments of differential compensation for proprietary versus non-proprietary products); (3) the current best practices being followed by each industry regarding cash compensation arrangements; (3) the potential harms and benefits of such arrangements; and (4) the appropriate regulatory approach to such arrangements (such as disclosure versus substantive prohibitions).

In addition, the Request for Comment will explore the general applicability of such issues mentioned above across all product lines to address broader issues regarding compensation practices, including disparate compensation practices in general, how fare NASD rules regarding incentive-based compensation should reach, the effects at point-of-sale of incentive-based compensation in general, and which regulatory approaches, if any, would be appropriate in addressing disparate compensation practices.

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 may 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.[8]

With respect to the regulation of variable contract securities, the requirements of the Variable Contract Rule 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 address 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 Contract Rules to include a member that 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 that address incentive compensation arrangements in order to identify a common type of relationship existing in the investment company 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.

''Compensation'': For ease of reference in appropriate paragraphs of the proposed rules, the NASD is also proposing to include in the Variable Contracts Rule and the Investment Company Rule a new definition of ''compensation'' to mean ''cash compensation and non-cash compensation,'' and to amend the appropriate paragraphs in the proposed rule language accordingly.

''Cash Compensation'': As proposed to be defined in both the Investment Company and Variable Contracts Rules, this term would include any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the sale and distribution of investment company securities or variable contracts. This term would encompass compensation arrangements currently covered under the Investment Company Rule in subparagraph (l)(1), to Conduct Rule 2830 as well as asset-based sales charges and service fees as currently defined in subparagraphs (b) (8) and (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 proposed new term also includes cash employee benefits to make clear that certain payments of ordinary employee benefits as part of an overall compensation package are not included in the definition of non-cash compensation.

[6] Release No. 34–37374 (June 26, 1996), 61 FR 35822 (July 8, 1996.)

[7] The NASD issued a Notice to Members regarding the regulation of payment and receipt of cash compensation incentives in August 1997. The comment period expires on October 15, 1997. *See* NASD Notice to Members 97–50 (August 1997).

[8] 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 subparagraph (l)(1)(C) to Conduct Rule 2830. *See also* NASD Notice to Members 94–41 (May 1994).

''Non-Cash Compensation'': This definition is proposed to be identical in applicability to both the Investment Company and Variable Contract Rules, and would encompass any form of compensation received by a member in connection with the sale and distribution of investment company and variable contract securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging. Thus, the definition of ''non-cash compensation'' encompasses reimbursement for costs incurred by a member or person associated with a member in connection with travel, meals and lodging.

''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 Contracts Rule to include an insurance company, a separate account of an insurance company, an investment company that funds a separate account, any advisor to a separate account of an insurance company or an investment company that funds a separate account, 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.[9] The definition of the term ''associated person of an underwriter'' in the Investment Company Rule, which is proposed to be deleted, encompasses the issuer, the underwriter, the investment advisor to the issuer, and any affiliated person of such entities.[10] 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 reference the principal underwriter through which the investment and insurance company distributes securities to participating dealers for sale to the investor.

Regulation of the receipt of cash and non-cash compensation. Introduction—The NASD is proposing to adopt as paragraph (l) to 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 non-cash compensation by members and associated persons of members. The proposed amendments would be applicable to both variable annuity and variable life products under the Variable Contracts Rule. With respect to the Investment Company Rule, the proposed amendments would be applicable to sales of securities of an investment company registered under the 1940 Act. Thus, the proposed rules would be applicable to sales of securities by a face-amount certificate company, a unit investment trust, and open-end and closed-end management companies.[11]

The preamble to the new rules provides that such compensation must be received ''in connection with the sale and distribution'' of investment company or variable contract securities, as applicable. The preamble is intended to clarify that the provisions relate only to cash and non-cash compensation received in connection with the sale and distribution of the security covered by the rule, but not to other forms of payment that are not related to sales and distribution activities.

Subparagraphs (l)(1) and (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 Contracts Rule generally to 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 that would allow the receipt of compensation by an associated person directly from a non-member company if: the member agrees to the arrangement, 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, interpretive letter or applicable ''no-action'' letter issued by the Commission or its staff that applies to the specific fact situation of the arrangement. Also, the proposed rule change treats 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 reflect those situations where Commission interpretations permit direct payments by the insurance company to associated persons as a ''ministerial service'' or because state insurance law prohibits payments of commissions on variable products to a broker-dealer.[12] The exception reflects the view of the Commission staff that under certain circumstances such commission payments to associated persons may be made by a life insurance company acting on behalf of a subsidiary broker-dealer.[13] The NASD also notes that the Commission has issued a number of ''no-action'' letters permitting, among other things, associated persons of members to receive compensation for the sale of variable contract products from a license corporate insurance agent acting on behalf of one or more insurance companies.[14]

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

[10] 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.

[11] Closed-end management companies are also subject to the prohibition on non-cash compensation contained in the Corporate Financing Rule in Conduct Rule 2710.

[12] The exception is not, however, restricted to these situations, but is intended to be available in any situation where a member relies on any appropriate rule, regulation, interpretive release or applicable ''no-action'' position issued by the Commission that applies to the specific fact situation of the arrangements.

[13] *See* Release No. 34–8389 (August 29, 1968) (''Distribution of Variable Annuities by Insurance Companies, Broker-Dealer Registration and Regulation Problems under the Securities Exchange Act of 1934''). The Commission stated that no question will be raised by Commission staff regarding an arrangement where a life insurance company makes commission 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; (4) all such books and records are subject to inspection by the Commission in accordance with Section 17(a) of the Act; and (5) the subsidiary broker-dealer has assumed full responsibility for the securities activities of all persons engaged directly or indirectly in the variable annuity operation.

[14] *See* no-action letters issued by Division of Market Regulation, Commission to *Traditional Equinet* (January 8, 1992) and *Mariner Financial Services* (December 16, 1988). The Traditional Equinet and Mariner Financial Services letters requesting Commission no-action include references to other Commission no-action letters.

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 no-action letters that permit an insurance company to establish a commission account as a ministerial service to make payments of commission overrides for sales of insurance and investment company securities products.[15] Moreover, the language of the proposed provision in the Investment Company and Variable Contract Rules permits such direct payments by any ''non-member company'' in order to recognize that any entity may be permitted to make such payments.[16]

Subparagraph (1)(2): Securities as Compensation—The NASD is proposing to retain as new subparagraph (1)(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 NASD is also proposing a similar provision as subparagraph (2) to paragraph (h) of Rule 2820.

Subparagraphs (l)(3) and (h)(3): Recordkeeping Requirement—The NASD is proposing to adopt as new paragraph (l)(3) of the Investment Company Rule and paragraph (h)(3) of the Variable Contracts Rule the general requirement that members must 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 include only 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 requirement in the proposed rule to maintain a record of the ''nature'' of the non-cash compensation received requires that the member disclose, in addition to the names of the offerors and the names of the associated persons, whether the non-cash compensation is paid in connection with a sales incentive program or a training and education meeting. The NASD further expects such records to retain all information necessary to determine that the rule is being complied with. Thus, for example, with respect to non-cash compensation received by a member for a training and education meeting, it would be expected that the records would include information demonstrating that the requirements of a training and education meeting were complied with, including the date and location of the meeting, the fact that attendance at the meeting is not conditioned on the achievement of a previously specified sales target, the fact that payment is not applied to the expenses of guests of associated persons of the member, and any other information required to enable NASD Regulation to determine compliance with the rule.

The recordkeeping requirement is not applicable to two types of *de minimis* non-cash compensation allowable under subparagraphs (l)(5) (A) and (B) to the Investment Company Rule and subparagraphs (h)(4) (A) and (B) of the Variable Contracts Rule, discussed more fully below under the exceptions to the prohibition on non-cash compensation.

Subparagraph (l)(4): Prospectus Disclosure of Cash Compensation—The NASD is proposing to adopt a new subparagraph (l)(4) in the Investment Company Rule a requirement 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. This requirement is similar to the current requirement in subparagraph (l)(1)(C) of the Investment Company Rule to disclose all compensation in the prospectus, but has been modified to reference only ''cash compensation'' because non-cash compensation is proposed to be prohibited in a manner that would obviate the need for disclosure of any such non-cash compensation.

The proposed rule change includes two exceptions from the prospectus disclosure requirement in the Investment Company Rule. The two exceptions in new subparagraphs (l)(4) (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 that utilizes such security as its underlying investment. By their terms, these provisions describe arrangements that would not trigger the proposed recordkeeping requirements.

The NASD will reconsider the appropriateness of prospectus disclosure in light of the Commission's recent initiatives for simplified prospectus disclosure as well as the responses to NASD's publication of a Request for Comment on cash compensation issues.[17]

Subparagraphs (l)(5) and (h)(4): Prohibition on Non-Cash Compensation—The NASD is proposing to adopt as new subparagraph (l)(5) to the Investment Company Rule and new subparagraph (h)(4) to the Variable Contracts Rule a general prohibition, with certain exceptions, on the receipt of non-cash compensation in connection with the sale and distribution of investment company and variable contract securities. The new provision would prohibit a member or person associated with a member from directly or indirectly accepting or making payments or offers of payments of any non-cash compensation, unless the payment is specifically excepted. The proposed rule change contains several exceptions from the general prohibition on the receipt of non-cash compensation.

Subparagraphs (l)(5) (A) and (B) and (h)(4) (A) and (B): The NASD is proposing to adopt exceptions that would permit an associated person to accept from a person other than his or her member-employer: (1) gifts that do not exceed an annual amount per person, currently $100 per person, fixed periodically by the Board of Governors; 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

[15] *See, e.g.*, no action letter issued by the Division of Market Regulation, Commission to Commission to *The Mutual Benefit Life Insurance Company* (December 20, 1984), and other Commission no-action letters cited herein.

[16] *See* no action letter issued by Division of Market Regulation, Commission to *Chubb Securities Corporation* (November 24, 1993).

[17] *See supra* note 7.

provisions of subparagraphs (l)(3)(B)(i) and (C)(i) of the Investment Company Rule. Since such gifts and entertainment are considered non-cash items, they are not required to be disclosed in the prospectus. In addition, 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 subsection (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 that requires that the recipient reach a specific sales goal as a prior condition to receive the entertainment or gift.

The proposed exceptions for $100 gifts and entertainment are intended to permit the continuation of long-established, normal business practices, involving benefits with relatively small value such that they are unlikely to impact overall compensation incentives. The exceptions also recognize that NASD Regulation 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 or variable contract securities.

Subparagraphs (l)(5)(C) and 29(h)(4)(C): The NASD is also proposing an exception to the prohibition on non-cash compensation for training and education meeting. This exception is contained in subparagraph (l)(5)(C) of the Investment Company Rule and subparagraph (h)(4)(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.[18] It is not unusual for offerors to pay for such meetings in order to discuss their products and to reimburse certain expenses related to meetings held by members 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. Since investment company and variable contract products are continuously offered, it is particularly important that associated persons receive education opportunities with respect to the investment company 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 only requires disclosure of cash compensation, 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 NASD anticipates that the agenda of a bona fide training or education 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 subject to five conditions that are intended to ensure that the meeting is held for the purpose of training and education and is not, in fact, a prohibited non-cash sales incentive.

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)(3) of the Variable Contracts Rule. This provision is designed to ensure that information on such payments and reimbursements is maintained in the records of the member and, therefore, capable of examination and regulatory oversight by NASD Regulation.

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 provisions 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 incentives that would otherwise be permitted under subparagraphs (l)(5)(D) or (h)(4)(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, through the sales incentive program of a 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 subparagraphs (l)(5)(D) or (l)(4)(D) of the proposed 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 and the second provision, which prohibits a member from basing the associated person's attendance at a training or education meeting on achievement of a previously specified sales target or a permissible in-house non-cash incentive arrangement, collectively are intended to clarify that

[18] 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 any event, the member would not be prohibited from permitting offerors to make a presentation at the meeting.

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, but shall not be part of a member's or offeror's incentive program or plan that requires that the recipient or the member reach a sales goal as a prior condition to attending the training or education meeting.

Subparagraphs (l)(5) (D) and (E) and (h)(4) (D) and (E): The NASD is proposing to adopt 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: (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 contract 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 recordkeeping requirements must be satisfied. 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 structures that presently apply in the case of each product, the NASD intends that the equal weighting requirement would apply separately to variable annuity and variable life products.

The proposed rule change is intended, in part, to address non-cash compensation that acts as a significant incentive at the point-of-sale to the investor. Such non-cash incentive programs, in addition to creating the potential to undermine the supervisory control of the member over its associated person sales practices when offered by third parties, also may motivate salespersons at the point-of-sale to recommend a specific product on the basis of the incentive rather than a desire to meet the investment needs of the customer.

The NASD's proposed rule change, therefore, attempts to limit non-cash sales incentives regarding the sale of one investment company security over another or one variable contract security over another 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 person' sales of these products.

The proposed rule change is designed 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 and variable contract securities by prohibiting third-party non-cash sales incentive programs and by requiring that all securities of the same 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, in that such programs provide incentives at the point-of-sale to influence a salesperson to sell the proprietary products of the offeror to the exclusion of other products and have the potential to undermine the supervisory control of members with respect to their associated persons. 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. This provision is based on a determination that non-cash compensation arrangements that are internal to the employer-employee relationship do not raise the same supervisory concerns that are present in the compensation arrangements between a non-member and the associated persons of unaffiliated broker-dealers selling its product.

As noted above, another exception permits a non-member affiliate to grant non-cash incentives to the associated persons of its affiliated broker-dealer, subject to the same conditions described above. Particularly in the life insurance industry, non-member insurance companies may hold non-cash sales incentive programs for their sales personnel who are also associated persons of the non-member's affiliated broker-dealer and are licensed to sell both non-securities insurance products and variable contract securities. It is common practice, for example, 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.'' [19] 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 compensation program.

The permissible in-house non-cash arrangements by a member or its affiliate are subject, moreover, to the first two conditions described above (that the program is based on total production and credit for different products is equally weighted). These conditions help to ensure that a non-cash sales incentive earned by a member's associated person is received on a delayed basis and does not influence the associated person's point-of-sale relationship with the investor. 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.[20]

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 compensation credits vary, including measurements based on gross production to the firm or net commissions to the associated person. Either practice, as well as other arrangements, would be acceptable under the proposed rule so long as the concept of ''equal weighting'' is met and not skewed by disparate commission, payout or re-allowance structures for individual products. It is believed that these requirements will ensure that

[19] 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 contract securities.

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

members and their affiliates selling proprietary investment company and variable contracts products do not structure in-house non-cash arrangements that are biased in favor of any one specific product or proprietary products as a group.

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 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, 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)(4)(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, subject to the same four conditions identified above. 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.[21] 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 only be made directly to the member.

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.[22] 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 incentives address the point-of-sale impact of such incentives on the sales practices of an associated person, thereby helping to better align the interests of associated persons, broker-dealers and investors with respect to the sale of investment company securities and variable contracts.

The NASD recognizes, however, that this proposal does not address many significant issues raised by that report and, as noted, will seek public comment on the appropriate regulatory treatment of other types of compensation arrangements. Nonetheless, the NASD believes that this proposal should not be delayed by consideration of these other compensation issues in that this proposal addresses non-cash arrangements that have been generally identified and regarded as potentially abusive practices.

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 date will be no later than 60 days after Commission approval. 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 on-going on the date of effectiveness would 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 could commence, although sales could be applied to existing incentive programs. Non-cash and cash sales incentives earned by associated persons would be permitted to be received for a period not to exceed twelve months following the expiration of the six-month implementation period.

Statutory Basis

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require that 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 contract securities in Rule 2820 of the NASD Conduct Rules to regulate the direct payment of compensation to associated persons by persons other than the member with which a person is associated with, to establish recordkeeping requirements; and to regulate the receipt of non-cash compensation by members and their associated persons; and (2) to amend current regulations with respect to the sale of investment company securities in Rule 2830 of the NASD Conduct Rules to 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, to establish recordkeeping requirements, to retain current disclosure requirements and a prohibition on the receipt of securities as compensation, and to regulate the receipt of non-cash compensation by members and their 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 and variable contract securities and eliminate any potential that third-part 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 that may result in a loss of investor confidence.

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

The NASD does not believe that the proposed rule change will result in any burden on competition that is not

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

[22] *See supra* note 20.

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 has not been published for member comment. However, SR–NASD–95–61 was published by the Commission for comment on July 8, 1996.[23] SR–NASD–95–61 requested public comment on amendments to Rules 2820 and 2830 of the NASD's Conduct Rules that, among other things, would have prohibited the acceptance, directly or indirectly, of non-cash compensation, with certain exceptions, and would have also prohibited the acceptance, directly or indirectly, of cash compensation preconditioned on achieving a sales target (incentive-based cash compensation provision), with certain exceptions. The exceptions to the incentive-based cash compensation provision would have permitted members to accept cash compensation preconditioned on achieving a sales target so long as the compensation, among other things: (1) was based on total sales of all investment company or variable contract securities offered; and (2) required that the credit received for each investment company or variable contract security sold carries equal weight in structuring the compensation arrangement.

The Commission received comment letters from 30 commenters, 7 of whom were supportive, 18 of whom were opposed, and 5 of whom were neither for nor against the proposal. A summary of the comments is attached as Exhibit A. Most of the commenters were insurance-affiliated members that distributed proprietary variable insurance products of their parent insurance companies and also offered some non-proprietary variable insurance products to accommodate their customers. In addition to ordinary sales commissions, sales of proprietary products often generate other incentive-based cash compensation such as contributions from the parent insurance company to its sales agents' pension plan, health insurance plan, 401(k) plan, and similar fringe benefits. Most commenters regarded the total sales and equal credit requirements of the incentive-based cash compensation provision as very problematic, and stated that the requirements appear to mandate equal treatment of incentive compensation paid for both proprietary and non-proprietary products. Commenters stated that there is not enough profit margin built in to non-proprietary products to fund equal compensation. The commenters also stated that it would be too difficult operationally and practically to implement such an equal treatment system. The commenters also stated that the internal differential compensation practices of member firms ought not to be regulated by the NASD.

The Investment Companies Committee (''ICC''), at its meeting on October 2, 1996, and the Insurance Affiliated Committee (''IAC''), at its meeting on October 8, 1996, reviewed and discussed the comment letters. Both Committees concluded that the incentive-based cash compensation provisions in SR–NASD–95–61 were generally intended by the NASD to prohibit the circumvention of the non-cash prohibition by monetizing the non-cash payment, and were not intended to regulate broader compensation and recognition programs of insurance companies. However, both Committees also agreed with the commenters that the language of the incentive-based cash compensation provision was capable of being interpreted broadly and voted unanimously to either amend the incentive-based cash compensation provision to clarify its intended scope or delete the provision in its entirety.

In subsequent discussions, NASD staff determined to delete the incentive-based cash compensation provision in its entirety. In addition, because of the complexity of issues regarding the variety of cash compensation arrangements in the mutual fund and variable products industry, and the need to explore the nature of these arrangements more thoroughly, NASD staff also determined to solicit the Committees' views on the publication of a Request for Comment requesting general comments on cash compensation issues.[24]

The ICC, at its meeting on February 11, 1997, and the Variable Insurance Products Committee (''VIPC''), a successor to the IAC, at its meeting on February 24, 1997, both agreed with the views of NASD staff and voted unanimously to amend the proposal by deleting the cash compensation provision and to issue the Request for Comment on cash compensation issues.

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. 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 at 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 File No. SR–NASD–97–35 and should be submitted by September 26, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[25]

Jonathan G. Katz,

Secretary.

Exhibit A—NASD's Summary of Comments Received in Response to the Publication of SR–NASD–95–61

Background

SR–NASD–96–51 requested public comment on amendments to Rules 2830 and 2820 of the NASD's Conduct Rules (formerly, Article III, Sections 26 and 29, respectively, of the NASD Rules of Fair Practice) that would revise existing rules applicable to the sale of investment company securities (''Investment Company Rule'') and

[23] SR–NASD–95–61 contained a summary of comments in response to the publication by the NASD of Notice to Members 94–67 (August 22, 1994). Those comments, and the NASD's response thereto, are not reproduced in this rule filing, but are contained in the Commission's publication of SR–NASD–95–61. *See supra* note 6.

[24] *See supra* note 7.

[25] 17 CFR 200.30–3(a)(12).

establish new rules applicable to the sale of variable contract securities (''Variable Contracts Rule''). Generally, the proposed rule change would, in connection with the sale and distribution of investment company securities and variable contracts: (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) required 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 in 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 non-cash compensation in connection with the sale of investment company and variable contract securities; 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 and variable contract securities.

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.

The Commission received comment letters from the following commentators:

1. American Council of Life Insurance
2. American Council of Life Insurance
3. American Funds Distributors, Inc.
4. American General Securities Incorporated
5. Banc One Corporation
6. BMA Financial Services, Inc.
7. Carillon Investments, Inc.
8. Cigna Financial Advisors, Inc.
9. Cova Financial Services Life Insurance Company
10. The Equitable Life Assurance Society of the United States
11. First Investors Corporation
12. Investment Company Institute
13. John Hancock Mutual Life Insurance Company
14. John Hancock Mutual Life Insurance Company
15. Locust Street Securities, Inc.
16. Merrill Lynch, Pierce, Fenner & Smith Incorporated
17. M Financial Group
18. The Minnesota Mutual Life Insurance Company
19. The Minnesota Mutual Life Insurance Company
20. MML Investors Services, Inc.
21. National Life of Vermont
22. The New England
23. The Princor Financial Services Corporation
24. Security Benefit Life Insurance Company
25. Sunset Financial Services, Inc.
26. The Union Central Life Insurance Company
27. Walnut Street Securities
28. WS Griffith and Co., Inc.
29. Investment Company Institute
30. SAFECO Life Insurance Company

Of the 30 commenters, 7 were supportive (Comments 2, 3, 5, 10, 12, 16, 29), 18 were opposed (Comments 4, 6, 7, 8, 11, 13, 14, 18, 19, 20, 21, 23, 24, 25, 26, 27, 28, 30), and 5 were neither for nor against the proposal (Comments 1, 9, 15, 17, 22).

General Comments

Those commenters supporting the proposed rule generally applauded the efforts of the NASD and the Commission to provide consistent rules for the sale of investment company securities and variable annuity contracts, supported sensible regulatory enhancements that facilitate the ability of members to execute compliance and supervisory responsibilities, recognized that certain non-cash practices may raise the perception of impropriety and potentially undermine the confidence of investors, such as contests offering lavish trips and expensive prizes, and supported initiatives reasonably targeted to reducing or eliminating potential conflicts of interest in these situations. Some of these commenters, however, also stated that additional work is necessary to ensure that the proposed rules adequately meet the needs expressed and are not overbroad (Comments 2, 3, 5, 10, 12, 16).

The most common general criticism, primarily from insurance-affiliated members distributing proprietary products through the career agency system, was that the proposed rules appear to mandate equal treatment of both proprietary and non-proprietary commission payments and/or cash and non-cash compensation arrangements for the sale of variable products and mutual funds. According to the commenters, this would, among other things, restrict the ability of member firms and their affiliated insurance companies to pay higher commissions for their proprietary products, give an unfair advantage to broker-dealers that do not manufacture their own variable products, lead to the sale of only proprietary variable products, lead to the sale of only fixed insurance products, produce an anti-competitive environment, cause the demise of the traditional insurance career agency system, and conflict with the current practice of treating career agents under IRS rules as ''statutory employees'' when selling proprietary products and ''independent contractors'' when selling non-proprietary products, thus requiring fundamental changes to the compensation structure within parent life insurance companies who continue to offer proprietary and non-proprietary variable insurance contracts (Comments 4, 8, 10, 11, 13, 14, 17, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28).

Specific Comments

Conflicts of Interest

Point of Sale Incentives

Some commenters stated that the proposed rule overemphasized point-of-sale conflicts (Comments 10, 14, 17, 27). One commenter disputed that non-cash incentives are currently influencing a salesperson's product recommendation at the point of sale and stated that therefore the need for the proposed changes does not exist (Comment 27). Another commenter stated that there is little in a proprietary sales force distribution model that distributes an overwhelmingly proprietary product

line, particularly variable insurance products, that seems to raise the prospect of meaningful point-of-sale conflicts, and that if the proposed rules regulate the manner in which non-cash incentives are awarded in situations which don't present a significant conflict of interest, they represent in inappropriate and unwarranted regulatory intrusion into the internal compensation arrangements between a member and its associated persons (Comment 10). Two commentators stated that point-of-sale incentives for variable products are mitigated by the fact that agents selling variable insurance products, as compared to mutual funds, tend to receive a higher percentage commission on premium payments in the early years and to have a greater expectation of future premium payments that will result in additional compensation in subsequent years (Comment 14), and that since a portion of the registered representative's compensation remains dependent upon the continuance of the policy in force, the agent has an intrinsic motivation to place an appropriate and suitable product at inception (Comment 17).

Disclosure

Other commenters argued that the dangers of conflicts of interest at point-of-sale can be addressed through disclosure (Comments 11, 17). One commenter noted that the Commission Release did not suggest that any actual abuses have occurred that justify such substantive regulation of in-house incentive programs, and stated that even assuming that in-house incentive programs favoring proprietary products created the ''possibility'' of a conflict of interest, there is no explanation in the Commission Release why disclosure of possible conflicts would not be sufficient to cure the problem (Comment 11). Another commenter stated that complete prospectus disclosure of the terms of any kind of incentive compensation would provide the customer with complete notice of the incentives, is a far better solution to NASD concerns regarding consumer protection, and would accomplish the NASD's goals without the unintended market impact the proposed rules will have (Comment 17).

Supervision

Other commenters thought conflicts of interest could be properly addressed through supervision (Comments 6, 8). One commenter stated that the proposed rules are too restrictive and specific, and do not adequately recognize the success of members in existing control over their associates and managing their control environments in a manner that sensibly balances legitimate business objectives and potential conflicts of interest (Comment 8). The same commenter further stated that, unlike direct participation program markets in the 1980s, members are effectively managing the supervisory issues associated with the sale of investment company securities and variable contracts, and therefore the proposed rules will have a negative impact on these industries without concomitant benefit. The commenter stated that the Commission should return the proposed rule to the NASD with the suggestion that it be revised to eliminate most of the specific limitations on conduct, and instead emphasize (a) reliance on members to properly control perceived conflicts of interest, and (b) changes (if any) necessary to enable the NASD to supervise the performance of members in exercising such control (Comment 8).

Unlevel Playing Field/Discriminatory Impact

Variable Versus Fixed Insurance Products

Some commenters stated that the proposed rules create an unlevel playing field between sellers of variable contracts and sellers of traditional fixed life insurance products. (Comments 4, 14, 17). One commenter stated that since companies which only sell traditional fixed insurance products are free to provide whatever non-cash compensation they wish, the unintended result of the proposed rules may be that insurance companies with affiliated broker-dealers will request that variable contracts offered by non-affiliated companies be removed from broker-dealers' list of approved products (Comment 4). Another commenter stated that if the proposed rules are adopted, many insurance companies will limit their cash and non-cash incentive compensation programs to sales of non-variable insurance products and registered reps interested in the incentives offered by a particular compensation program may encourage the investor to purchase the non-variable product irrespective of whether that product is the most suitable (Comment 14). Another commenter stated that this unintended skewing does not occur in investment company securities since investment companies do not have any unregistered funds (Comment 17).

Discrimination Against Smaller Issuers and Independent Insurance Agencies

One commenter stated that the proposed rules will place small fund groups which distribute through their own in-house sales forces at a serious economic disadvantage since they will be required to give unaffiliated groups equal access to their distribution systems without having to share the high costs or maintaining such systems (Comment 11). Small fund groups with captive sales forces will clearly suffer because they will probably not have the clout to demand fees for shelf space, and their only alternative may be to take unaffiliated funds off their shelves altogether (Comment 11). If such fund groups could not recover the costs of training in-house sales representatives by ''encouraging'' them to sell house-brand products, they would have little incentive to invest in such training in the first instance (Comment 11).

Another commenter stated that as the rules are presently written, insurance companies that have affiliated broker-dealer may implement and use non-cash compensation incentives to reward their captive brokerage agents while non-cash compensation for independent agents is prohibited, which unfairly discriminates against the independent agent, the independent broker-dealer, and issuers who distribute their products through independent broker-dealers (Comment 17). Thus, captive agents have opportunities with regard to compensation that independent agents do not, which skews the marketplace toward a limited line of products from a single issuer, which may not be in the client's best interest (Comment 17).

Proprietary Versus Non-Proprietary Products

Many commenters stated that the proposed rules, by requiring insurance-affiliated firms to ''equally credit'' sales of all third party products, will force insurance-affiliated firms selling primarily proprietary products to either deny its registered reps access to third-party products, sell such products at a loss, or pay lower commissions for proprietary products (Comments 10, 13, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28). Following are selected excerpts from commenters.

(a) ''Preconditioned on achieving a sales target'' and ''equal credit.''

One commenter stated that virtually all broker-dealer commission schedules provide for banded commissions, i.e., for all sales between $0 and $X, the commission is 40%; for all sales between $X and $Y the commission is 45%. Thus, all commissions are ''preconditioned on a person achieving a sales target'' (Comment 20). The commenter argues that therefore, proposed subparagraph (h)(4) to Rule 2820, which provides that ''no person

associated with a member shall accept any cash compensation that is preconditioned on such person achieving a sales target,'' literally prohibits registered representatives from accepting commissions for their sales unless the commission schedule falls within a specified exception of the rule. The same commenter further argued that subparagraph (h)(4) would mandate that an insurer include within its overall compensation plan not only compensation from sales of the variable contracts which it issues but also compensation from the sales of all the variable contracts which may be distributed by its registered representatives in its affiliated broker-dealer. The commenter concluded that firms with proprietary products will be unable to comply with the ''equal treatment'' mandate of the proposed rules and be forced to limit products to only their proprietary products, which would eliminate the incentive that issuers now have to improve their product design and/or administration so as to allow them to pay out higher total compensation. Thus, any superior profit margins that an issuer may achieve would be used not to provide incentives for further sales of that product but to supplement compensation on non-proprietary products or inferior proprietary products. The commenter stated that the proposed rules, if adopted without further clarification, would be inconsistent with long-standing insurance regulatory practices, and give an unfair competitive advantage to broker-dealers that do not manufacture their own products (Comment 20).

Another commenter stated that the proposed rules require a member firm which offers incentive-compensation on proprietary products to provide comparable incentives in connection with the sale of non-proprietary products, and the most likely means to do so will be to reduce the base commissions (i.e., the non-incentive compensation) paid to registered representatives for the sale of non-proprietary products. These savings in base commission costs (i.e., the additional portion of the dealer concession retained by the member firm) will then be used to provide incentive compensation on non-proprietary products at the same level as on proprietary products. Registered representatives would therefore have an even greater incentive to offer proprietary products given the even greater disparity in base compensation payable between proprietary and non-proprietary products. Such an outcome is also inconsistent with the stated intention of the proposal. The simplest means by which a member firm may comply with the proposed rules is to eliminate all non-proprietary products from its list of products (Comment 19).

Another commenter stated that if a captive dealer could no longer provide incentive programs to its own reps which focused on proprietary products, it would be faced with the unfortunate choice of becoming strictly captive or being less able to earn a return on the traditionally greater investment they have made in their reps, as the benefit of that investment unintentionally accrues partly to outside product providers (Comment 21).

Another commenter stated that if the rules are adopted sales contests will be held only to promote those products whose issuers have the resources to finance multiple contests or who sell through captive agents. This situation creates an advantage for large issuers with the ability to finance the contest of multiple broker-dealers (Comment 24).

Another commenter stated that the proposed rules will have the opposite effect than what is contemplated. The proposed rules will require many companies to make wholesale changes in their compensation plans and in the systems that support these plans, which will cost millions of dollars. Instead, many companies may decide to disallow the sale of ''non-proprietary'' products, in effect limiting the registered rep to one fund family and one variable annuity contract (Comment 25).

(b) Anti-competitive effect.

One commenter stated that because some members might only offer proprietary products, clients of such member firms would have a limited number of products from which to choose unless those clients were willing to shop around among various brokers, which would have a negative effect on competition (Comment 13).

Another commenter stated that because the resulting response by many insurance company broker-dealers with proprietary mutual funds, variable annuities, and variable life insurance will be to reduce or eliminate availability of non-proprietary products, investors will be subject to fewer objective investment recommendations, less portfolio diversification, and recommendations of other possible non suitable products not affected by the proposal, e.g., fixed annuities and and/or permanent insurance policies (Comment 23).

Another commenter stated if the proposed rules take effect, a number of firms will out of necessity be forced to only offer so-called proprietary products. This would severely limit the choice of products being offered to the prospective purchaser by a particular registered representative and necessitate the potential purchaser of a product to go through the time consuming process of having to visit a number of registered representatives (Comment 28).

(c) Effect on ''statutory employee'' compensation and ''career agent'' system.

One commenter stated that although the proposed subparagraphs sections (h)(4) and (1)(6) would appear to mandate the equal treatment of both proprietary and non-proprietary commission payments for variable products and investment companies, the Internal Revenue Code makes this virtually impossible for insurance-affiliated companies utilizing the career agency system. For such companies, the commission and recognition programs for their proprietary variable insurance and annuity products are integrated into the overall compensation plans for its career agents. In accordance with Section 3121(d)(3) of the Internal Revenue Code, payment of commissions of these proprietary variable insurance products to full-time career agents is treated as W–2 income to statutory employees. Typically, such commissions also generate contributions from the parent insurance company to the career agent's pension plan, health insurance plan, 401(k) plan, and similar fringe benefits. Payments made to career agents for sales of non-proprietary products are, however, treated as 1099 income paid to independent contractors. Accordingly, non-proprietary products commissions are not, and cannot be, incorporated into overall compensation plans (Comment 20).

The same commenter further stated that even if commissions from the sales of non-proprietary variable products could somehow be received by the parent insurance company, it would still be impractical to recognize them in the parent's compensation plans because such products are not manufactured by the proprietary issuer and there has been no opportunity to build appropriate margins into the products to cover certain distribution costs, particularly fringe benefit costs (Comment 20).

Another commenter further stated that the profit margins on third-party products are insufficient to fund the cost of providing ''equal credit'' toward all benefits having production eligibility criteria. As a result, if forced to provide equal credit for the sale of non-proprietary variable products, insurance-affiliated firms will be faced

with the Hobson's choice of either denying its registered representatives access to third-party products (to the ultimate detriment of its customers), or selling such products at a loss (Comment 10).

The same commenter stated that to the extent that the proposed rules bring within the definition of ''non-cash compensation'' (or otherwise purport to regulate as incentive-based cash compensation) items that traditionally have been viewed as point-of-sale incentives but instead as benefits customarily afforded in the context of an employer-employee relationship (e.g., health and disability income coverage, tuition reimbursement programs, etc.), the result will be regulation that is disruptive and unduly burdensome, again without meaningfully contributing to the protection of investors (Comment 10).

Another commenter stated that agent compensation is covered in collective bargaining agreements between insurance companies and career agents. If certain forms of compensation are no longer permitted with respect to variable products under the terms of the proposed rules, then collective bargaining agreements may have to be renegotiated (Comment 13).

Training and Education Limitations

Some commenters objected to the limitations imposed on training and education meetings (Comments 8, 20, 23, 24).

One commenter argued that, contrary to the requirements of the proposed rule, it is entirely appropriate to assess eligibility for training and education meetings based on achievement of sales targets. Offerors have a legitimate interest in limiting participation in such meetings to representatives whose sales activities reflects some minimal level of interest in the offeror's product. It is unreasonable without substantial justification to preclude offerors from targeting representatives who have exhibited an ability to market the offeror's product (Comment 8).

The same commenter also stated that the proposed rules should not impose artificial limits on ''appropriate locations'' for training and education meetings organized by offerors. Limiting ''appropriate'' to 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'' is unnecessary and too rigid (Comment 8).

Another commenter similarly stated that the limitations in the proposed rules concerning the locations of education/training meetings should be relaxed, not increased. The proposed rules mistakenly attempt to draw a link between the purpose of a meeting (i.e. education/training) and the location at which such meeting is conducted (i.e. office of the offeror or member). The commenter suggested that the largely irrelevant location requirements for education/training meetings be eliminated and replaced with a simple requirement that the broker-dealer be required to maintain documents (e.g. agendas, attendance lists, etc.) confirming the educational nature of the meeting (Comment 20).

Another commenter stated that, if the proposed rules are adopted, product issuers will have no control over the content of presentations made at training and education conferences. This shift in control of the sales conference from the issuer to the broker will result in the loss of an important forum for issuers to educate independent agents about the products they sell (Comment 24).

Implementation

Some commenters requested that the implementation period for the proposed rules be extended (Comments 11, 13, 15, 27, 28).

One commenter stated that the six-month grace period for implementing the rules is not long enough since many sales contests cover a full year or more than one year, and recommended grandfathering all contests commenced before the effective date of the rule (Comment 11).

Other commenters stated that proper implementation requires that contracts between offerors and member firms will have to be amended to include provisions assuring compliance with the new rules, systems will have to be updated to track compensation of total production, and, if repricing is involved, approval by state insurance departments may be necessary prior to implementation. Such issues could require up to 24 months to fully comply with the proposed rules (Comments 13, 15, 27, 28).

Recommendations

A few commenters suggested changes to the non-cash and cash incentive provisions of the proposed rules (Comments 2, 10, 16, 20, 22).

One commenter stated that the inclusion of subparagraph (h)(4), dealing with cash compensation matters, was confusing because the proposal and its release largely address non-cash compensation rule amendments (Comment 2). The commenter stated that it did not interpret subparagraph (h)(4) as an attempt to establish new procedures governing the receipt of cash compensation by associated persons of a broker-dealer, but as an effort to prevent circumvention of non-cash compensation practices by ''monetizing'' the compensation. The commenter stated that subparagraph (h)(4) could be construed to simply state that broker-dealers may not do indirectly what they are prohibited directly from doing in Rule 2820, and recommended the substitution of this concept for subparagraph (h)(4) (Comment 2).

Another commenter stated that the problems resulting from the equal weighting requirement can be addressed through the adoption of a *de minimis* exception to the provisions of subparagraphs (h)(3)(d) and (h)(4)(a) and through modifications to the definition of non-cash compensation (Comment 10). The commenter stated that the *de minimis* exception could be included as new subparagraph (h)(5) and would state in substance:

> The provisions of subparagraph (ii) of paragraphs (h)(3)(d) and (h)(4)(a) shall not apply to the production of associated persons with respect to variable contracts issued by a non-affiliate of the member to the extent that such variable contracts, in the aggregate, account for [an insubstantial percentage] of the total production of associated persons with respect to variable contracts; and further provided that the member does not actively promote such variable contracts to its associated persons nor permit the offeror of such variable contracts to do so. However, the member shall be required to provide such weight to the production in variable contracts issued by a non-affiliate as it determines, in good faith, best reflects the relative contribution of such production to the profitability of the member, taking into account the desirability of promoting, to the maximum extent practicable, parity in commissions between such product(s) and comparable products, if any, issued by an affiliate (Comment 10).

The commenter also recommended that the definition of non-cash compensation be revised to read as follows: ''Non-cash compensation'' shall mean any merchandise, gifts, prizes, payment of travel expenses, meals and lodging and all other similar items, including cash payments in lieu of any of the foregoing, received in connection with the sale and distribution of variable contracts.'' The commenter stated that, as so revised, the definition would be sufficiently broad so as to encompass those items of non-cash compensation that have traditionally been viewed as having the greatest potential for abuse. By including the phrase ''including cash payments in lieu of any of the foregoing,'' the definition

also would be sufficiently encompassing so as to prevent the abuse that subparagraph (h)(4) of the proposed rules was seemingly designed to address; namely that offerors might seek to ''monetize'' non-cash incentives to circumvent the provisions of the rule. However, the definition would not be so broad so as to unintentionally include items, like health insurance benefits, tuition reimbursement programs, etc., which traditionally have not been viewed as point-of-sale incentives (Comment 10).

One commenter strongly recommended that the proposed rules be amended by deleting Sections (h)(4) and (1)(6) in their entirety (Comment 20).

Another commenter suggested that: (1) the proposed incentive compensation requirements as they relate to proprietary/non-proprietary products be eliminated or revised; specifically, that the total production and equal weighting requirements might be applied separately to all proprietary products together; and, in any case, (2) an exemption be provided for companies for whom the amount of non-proprietary product sales is not material, i.e., a test of materially, or for whom the proprietary and non-proprietary products do not compete (Comment 22).

One commenter stated that the language relating to the inclusion of all investment company securities in incentive arrangements is over-broad and unduly restrictive (Comment 16). The commenter stated that an incentive arrangement which includes both a broad base of funds and funds of each fund family sold by the broker-dealer to an equal extent would meet the objectives of the proposed rules and recommended that the relevant language of proposed Rules 2830(I)(5)(d)(i) and 2830(I)(6)(a)(i) be changed to read as follows:

> The member's or non-member's [non-cash compensation] arrangement, if it includes investment company securities, must (a) include a broad range of investment company securities, (b) not discriminate within the range among investment companies included in the arrangement and (c) give equal weighting to the sale of all investment company securities included in the arrangement by the member (Comment 16).

The same commenter disagrees with the manner in which the NASD proposes to accomplish prospectus disclosure of cash compensation. The commenter states that full service firms which neither act as underwriter for mutual funds sold to its clients nor control the issuer or underwriter of such funds, and thus have very limited ability, if any, to influence the contents of prospectuses, bear the burden adequate prospectus disclosure. Moreover, the proposed rules would place an extraordinary administrative burden on such firms by requiring continuous review of each funds prospectus to evaluate whether the cash compensation disclosure requirements of the proposed rules have been satisfied (Comment 16).

The commenter recommends, therefore, that the proposed amendments be modified to prohibit the ''underwriter'' from paying any cash compensation that is not disclosed in the fund prospectus, and would define the term ''underwriter'' to include ''any person which, directly or indirectly controls, in controlled by or is under common control with the underwriter.'' The commenter stated that this recommended change should accomplish the NASD's purpose of holding a person under its jurisdiction responsible for prospectus disclosure. In addition, because underwriters of investment company securities are generally under common control with the issuer of the investment company securities, it is much more likely that they can control or influence the disclosure contained in the fund's prospectus. Such an approach is consistent with Federal securities laws, which subjects underwriters to ''prospectus liability,'' but not broker-dealers acting as agent in the sale of securities (Comment 16).

Specific Commission Requests for Comments

The Commission Release contained requests for comment on four specific issues. The requests are restated below with a summation of the commenters' responses.

1. The proposed rule change would continue to permit an associated person to accept gifts if the total value does not exceed $100 and an occasional meal, a ticket to a sporting event or the theater, or comparable entertainment. Should members be required to keep records of such gifts or entertainment to enable the NASD to surveil effectively for abuse? The unanimous response of those commenters who answered this question was that, since such *de minimis* activity does not undermine a broker-dealer's supervisory control over registered representatives or create the appearance of impropriety, imposing recordkeeping requirements concerning these activities is not warranted (Comments 2, 3, 4, 5, 7, 8, 12, 16, 20, 23, 26, 27, 28).

2. The proposed rule change would permit a member or an associated 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. Are the recordkeeping requirements proposed by the NASD sufficient to support determinations of whether such meetings will be bona fide? Most commenters who responded felt that additional recordkeeping in this area was not needed (Comments 2, 3, 4, 7, 26, 27, 28).

Other commenters stated that the requirements were not sufficient (Comments 5, 8, 14). One commenter stated that such records should also include the identification of the nearest office of the member and should contain information relating to the agenda of the meeting in order to document the determination of a bona fide meeting (Comment 5). Another commenter stated that the recordkeeping requirement with respect to education and training meetings should be sufficient to indicate the substance of the meeting and to demonstrate that the location and related activities were appropriate (Comment 8). The commenter suggested that the following information, in addition to that required by the proposed rules, should be sufficient for these purposes: a description of the purpose of the meeting, a statement of the basis on which the member approved attendance at the meeting by the associated person (which would also evidence member approval), and a copy of the agenda of the education and training portion of the meetings (Comment 8). Finally, another commenter suggested that proposed rules are inadequate because they do not require records to be kept with respect to the location of such meetings (Comment 16).

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. 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. Some commenters who responded felt that when a broker-dealer conducts training and educational seminars with offeror participation it should not constitute non-cash compensation, because the broker-dealer is fully aware of the offeror's participation, because the broker-dealer's supervisory control is not diminished or undermined, because this is not typically an area of abuse, or because flexibility is needed to arrange meetings at locations convenient to attendees and within the budgets available (Comments 2, 7, 20, 23, 26, 27, 28).

Other commenters stated that mere offeror participation, as long as the offeror does not provide any monetary contributions, should not result in the meeting being treated as non-cash compensation (Comments 3, 4, 5, 8).

4. The Tully Committee identified the practice of payment of higher commission 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 proposed rule change would, however, prohibit a contest 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. Most commenters who responded stated that the proposed rule change should not cover ordinary compensation practices because the regulatory objectives cited in the proposed amendments are unrelated to the payment of commissions, such an approach would have anti-competitive implications, such an approach would delay the date of effectiveness of the proposed rules, or it would result in duplicative, overlapping regulation (Comments 2, 3, 6, 7, 8, 12, 13, 16, 23, 26, 27).

One commenter, however, stated that he could see barring differentials in cash compensation, since cash compensation is the strongest possible incentive (Comment 4). Another commenter stated that The Tully Committee's report on compensation practices voiced concern over possible conflicts of interest created by both higher commission payments for proprietary products and narrowly focused incentive sales contests. If such practices genuinely create conflicts of interest, the effect of the proposed rule change is to allow higher commissions to be paid year round under a general period. We fail to see the distinction. The ultimate issue for regulatory consideration should be suitability. Regulatory authorities should determine whether or not a conflict of interest is created by higher payments, regardless of the duration of the program and provide consistent proposals for rule changes accordingly (Comment 5).

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–38990; File No. SR–NASD–97–56]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Creation of New Rules 6900 Through 6970 or an Audit Trail System Owned and Operated by the National Association of Securities Dealers, Inc.

August 28, 1997.

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 August 25, 1997,[1] the National Association of Securities Dealers, Inc. (''NASD'') 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 NASD Regulation, Inc. (''NASDR''). 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

NASD Regulation is proposing new Rules 6900 through 6970 of the Conduct Rules of the NASD, relating to an audit trail system owned and operated by the NASD that is designed to capture order information reported by members for integration with The Nasdaq Stock Market, Inc. (''Nasdaq'') quote information and trade information reported to the Automated Confirmation Transaction Service (''ACT'') in order to provide the Association with an accurate time sequenced record of orders and transactions. Below is the text of the proposed rule change. Proposed new language is underlined.

[1] The proposal was originally filed on July 29, 1997, but was subsequently amended on August 25, 1997.

3110. Books and Records

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(c) Each member that acts as a market maker in an equity security quoted in the Nasdaq system shall record, with respect to each order for such security that is received and executed at its trading department, an identification of each registered person who executes the order.

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6900. Order Audit System

6910. Definitions

For purposes of the Rules 6900 through 6970:

(a) Terms shall have the same meaning as those defined in the By-Laws and other rules of the Association, unless otherwise specified.

(b) ''Association'' shall mean the National Association of Securities Dealers, Inc. and its two subsidiaries, NASD Regulation, Inc. and The Nasdaq Stock Market, Inc.

(c) ''Customer'' shall mean a person other than a broker or dealer.

(d) ''ACT'' shall mean the Automated Confirmation Transaction Service operated by Nasdaq, Inc.

(e) ''Index Arbitrage Trade'' shall mean an arbitrage trading strategy involving the purchase or sale of a ''basket'' or group of securities in conjunction with the purchase or sale, or intended purchase or sale, of one or more cash-settled options or futures contracts on index stock groups, or options on any such futures contracts in an attempt to profit by the price difference, as further defined in New York Stock Exchange Rule 80A.

(f) ''Order'' shall mean any oral, written, or electronic instruction to effect a transaction in a Nasdaq equity security that is received by a member from another person for handling or execution, or that is originated by a department of a member for execution by the same or another member, other than any such instruction to effect a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities.

(g) ''Order Audit System'' shall mean the automated system owned and operated by the Association that is designed to capture Order information reported by members for integration with trade information reported to ACT and quotation information disseminated by members in order to provide the Association with an accurate time sequenced record of orders and transactions.

(h) ''Program Trade'' shall mean a trading strategy involving the related purchase or sale of a group of 15 or