

**Securities Industry Association**

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October 15, 1997

Ms. Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006

RE: NASD Notice to Members 97-50

Regulation of Payment and Receipt of Cash Compensation Incentives

Dear Ms. Conley:

The members of the Investment Company Committee (the "Committee") of the Securities Industry Association (the "SIA") wish to comment on NASD Notice to Members 97-50 (the "Notice") relating to the regulation of payment and receipt of cash compensation for the sale and distribution of investment company securities.¹

Introduction

The SIA is comprised of more than 780 securities firms throughout North America, collectively accounting for approximately 90 percent or \$100 billion of securities firms' revenues and employing more than 350,000 individuals. These firms manage the accounts of more than 50 million investors directly.

The Committee appreciates the opportunity to comment on the Notice and commends the staff of the National Association of Securities Dealers, Inc. (the "NASD") for its efforts in addressing the potential conflicts of interest that can arise in the sale of investment company securities.

General Comment

Before responding to the specific comments set forth in the Notice, the Committee would like to take this opportunity to comment on the success of the current regulatory structure. Over the past several years, in connection with a number of various initiatives to regulate the payment and receipt of cash compensation, cash compensation arrangements have been intensely scrutinized. While most agree that payment and receipt of cash compensation could lead to *potential* conflicts of interest, there has been no evidence of wide-spread abuses regarding cash compensation in connection with the sale of securities, including investment company

securities. Neither the NASD, the members of the Securities and Exchange Commission's Advisory Committee on Compensation Practices (which issued the Tully Report), nor the Investment Company Institute have found widespread problems relating to the payment or receipt of cash compensation relating to the sales of securities. 2

This lack of systemic abuse leads the Committee to believe that the current regulatory structure, whereby all potential conflicts of interest are addressed using a broad-spectrum approach, is working well. To the extent that the potential for conflicts of interest in connection with the payment and receipt of cash compensation have increased in recent years due to the complexity of the marketplace, those potential conflicts can adequately be addressed by providing additional guidance under the NASD Conduct Rules as those rules relate to suitability regulation and supervision. The alternative approach of imposing specific, detailed regulation governing each and every potential conflict is overly burdensome, difficult to regulate and not the best use of regulatory and member firm resources.

Specific Comments

The members of the Committee have the following responses to the specific requests for comment posed by the staff of the NASD in the Notice.

The Committee recognizes that the payment and receipt of cash compensation in connection with the sale of securities (including, but not limited to, investment company securities) may pose the potential for conflicts of interest. However, these potential conflicts historically, and successfully, have been addressed through the NASD Conduct Rules relating to suitability regulation and supervision rather than through detailed, substantive regulation.

Because member firms vary widely in size and services offered, a compensation arrangement at one firm may encourage the common interests of investors, salespersons and the member firm, while a similar arrangement in another firm may discourage the common interests of those parties. For example, a compensation arrangement between a firm and an investment company may encourage the common interests of investors, salespersons and the firm if the investment company is a smaller, lesser-known issuer seeking to provide additional compensation to members and/or their associated persons in order to encourage them to learn more about the issuer's products. Such an arrangement can be beneficial to investors, because these may be products that will help them meet their investment objectives. The arrangement also can benefit salespersons, because they can learn about, and be trained with respect to, a product line about which they otherwise may not be knowledgeable. The arrangement can help them to conduct the due diligence necessary to help their customers make informed and suitable investment decisions. The arrangement also can be beneficial to investors and member firms, by encouraging the firms to offer a product it may not otherwise have offered. The Committee believes that cash compensation arrangements can offer important and legitimate benefits to investors, salespersons and member firms alike.

One compensation practice that needs clarification relates to service fees. Because service fees represent payments for continuing investor services, such fees should not be viewed as "cash compensation." Service fees, which help provide investor services, encourage portability of investment company shares, allowing investors to move their fund holdings from an account with one member firm to an account with another member firm. To the extent that regulation of

service fees as cash compensation leads to an increased compliance burden on member firms, such a burden could lead member firms to reduce the number of funds available to investors. Such a result would not be in the best interests of investors.

One of the areas in which cash compensation arrangements may pose a potential conflict of interest relates to point-of-sale "product favoritism," whereby one product is given preferential treatment over others through cash compensation arrangements. However, this potential for conflict is adequately and appropriately addressed through the current regulatory scheme, and the industry's voluntary efforts, and NASD substantive regulation needlessly would stretch both the NASD's and member firms' resources, resources that are better utilized in other areas.

NASD Conduct Rule 2310 requires a member's associated persons to have reasonable grounds for believing that the recommended security is suitable for the customer, thereby prohibiting, among other things, a member firm's associated person from recommending a particular product in order to benefit from an incentive arrangement. The industry generally has addressed potential conflicts and product favoritism by voluntarily adopting procedures and practices designed to prevent such conflicts and favoritism and to ensure that customers are given only suitable recommendations. An example of how the industry has addressed these potential conflicts is by adopting procedures relating to multi-class investment companies whereby supervisory sign-off is required before certain investors who are eligible for sales charge waivers in one class can purchase another class of shares with higher expenses. Another example is member firms structuring cash compensation arrangements so that the cash incentives are not passed on to the sales persons, but rather are retained at the member firm level. The NASD traditionally has not regulated payments of this type and should not begin to do so now.

The SIA has issued recommendations as to its members' "best practices" with respect to compensation arrangements.³ Many of these recommendations have their genesis in the best industry practices that were set forth in the Tully Report and member firm implementation of the recommendations has been working to prevent potential conflicts of interest that can arise in connection with the sale of securities (including, but by no means limited to, investment company securities). These recommendations provide for, among other things, substantially similar payments to salespersons for sales of proprietary and non-proprietary products and the prohibition of single product sales contests.

Because the industry takes seriously potential conflicts of interest as they relate to the payment and receipt of cash compensation, substantive regulation in this area is unwarranted. Indeed, the current structure, whereby potential conflicts are managed through the suitability regulation and supervisory structure, works so well because the NASD has not attempted to micromanage member firm practices by promulgating rules governing each and every potential conflict. Rather, the current structure offers a workable construct that mandates the protection of customer interests, while allowing firms the flexibility to create the education and sales incentives that meet their business needs.

As indicated above, the Committee believes that the current regulatory structure is working and should not be altered. The NASD's Conduct Rules are designed not to specifically address every possible conflict of interest that can arise, but rather to provide broad, general investor protection guidelines that allow each firm to tailor its procedures to fit its particular business.

Coupled with a member firm's responsibility to supervise its associated persons, the suitability rule provides a regulatory structure that compels member firms to police their associated persons to ensure that potential conflicts of interest, including those that may arise under cash compensation arrangements, do not result in customers receiving unsuitable recommendations from associated persons of member firms.

The Committee supports general prospectus disclosure that alerts investors to payments made by investment companies or their principal underwriters to selling dealers in connection with the distribution of investment company shares. The Committee believes that general disclosure requirements relating to cash compensation arrangements is the correct approach. The current requirements appropriately place disclosure responsibility on issuers and underwriters, the parties that control the disclosure that is made in the prospectus.

The Committee is opposed to "special compensation arrangement" disclosure because it generally is burdensome and offers little benefit to investors because it often is confusing. Further, it would be inconsistent with the SEC's proposal on prospectus disclosure and confusing for members for the NASD to mandate additional in-depth disclosure of these arrangements at this time.⁴

It is the Committee's view that "point-of-sale" disclosure of special compensation arrangements that would be made by a member firm's associated person (*i.e.*, the salesperson) would require a heavy compliance effort while offering few benefits to investors. Salespersons often are not aware that there is a compensation arrangement in place between the member firm and the offeror, or if they are aware of the arrangement, are not familiar with the details (nor should salespersons necessarily be aware of the arrangement or the details). To require separate point-of-sale disclosure would only complicate the relationship between the salesperson and his or her customer and place undue prominence on the significance of the arrangement, especially in light of the fact that investors already receive disclosure in the form of prospectuses and confirmations in relation to sales of investment company securities.

Nevertheless, the Committee appreciates that it may be confusing for investors to read widely-divergent disclosure with respect to substantially the same cash compensation arrangements. Consequently, the Committee would encourage the NASD to provide guidance as to the types of disclosure relating to cash compensation that would be most helpful to investors. However, such guidance need not be promulgated in a rule, but rather could simply be offered in the form of a Notice to Members.

While the Committee believes that investors should be informed about cash compensation arrangements, it also believes that investors may be confused by disclosure that is too detailed or extensive. The real investor protection safeguards are found not primarily in the disclosure regulations, but in the NASD's sales practice and supervisory rules. As noted above, these rules compel member firms to implement practices and procedures that protect investors (and provide the NASD the necessary flexibility to monitor compliance with these practices and procedures) while at the same allowing each firm to tailor its program to its specific business needs.

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The Committee strongly believes that the current regulatory scheme relating to suitability

requirements and supervisory practices adequately addresses the potential conflicts of interest as they relate to the payment and receipt of cash compensation in connection with the sale of securities, including investment company securities. Substantive regulation of potential conflicts would be unworkable. If the NASD adopted substantive regulations regarding the payment and receipt of cash compensation, it would be abandoning the long-standing, broad-spectrum approach to regulation of member firms that has proven to be so successful in the past. In the absence of specific evidence of widespread abuse in this area, the adoption of detailed, substantive standards relating to cash compensation would be unjustified.

The Committee appreciates the opportunity to comment on the Notice. Should members of the SEC or NASD staff wish to discuss any of the foregoing with members of the Committee, or wish to meet with the Committee, please contact the undersigned at 212/848-1715 or Michael Udoff, the staff adviser to the Committee, at 212/618-0509.

Sincerely,

Lawrence H. Kaplan, Esq.
Chairman of the Investment Company Committee

Attachment

cc:

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

Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, Inc.

Barry P. Barbash, Director, SEC Division of Investment Management

Janice Mitnick, Attorney, SEC Division of Market Regulation

Members of the Investment Company Committee

Footnotes:

¹ The Notice also seeks comments relating to the regulation of cash compensation in connection with the sale of variable contracts. The SIA's comments are applicable, as appropriate, to the regulation of cash compensation in connection with the sale of investment company securities.

² See SEC Release No. 34-37374, File No. SR-NASD-95-61 (June 26, 1996); The Report of the Committee on Compensation Practices, April 10, 1995 (the "Tully Report"); Letter from Craig S. Tyle, Vice President and Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 30, 1996; Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Joan C. Conley, Office of the Secretary, NASD, dated October 3, 1994.

³ See SIA Best Practices: *A Guide for the Securities Industry* (November 1996).

⁴ See Investment Company Act Release No. 22528 (Feb. 27, 1997).