Securities Industry Association

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October 15, 1997

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

RE: SEC Release No. 34-38993; File No. SR-NASD-97-35 -- NASD Proposed Rule Change Relating to Non-Cash Compensation in Connection with the Sale of Investment Company Securities

Dear Mr. Katz:

The members of the Investment Company Committee (the "Committee") of the Securities Industry Association (the "SIA") wish to comment on SEC Release No. 34-38993; File No. SR-NASD-97-35, the proposed amendments to NASD Conduct Rule 2830 relating to the regulation of non-cash compensation arrangements (the "Proposed Amendment"). The Proposed Amendment seeks to amend NASD Conduct Rule 2830 as that rule relates to the regulation of non-cash compensation in connection with the sale of investment company securities.**1** Unlike earlier rule proposals,**2** which addressed both cash and non-cash compensation arrangements, the Proposed Amendment deals primarily with non-cash compensation arrangements.**3**

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 respond to the Proposed Amendment and commends the staffs of the Securities and Exchange Commission (the "SEC") and the National Association of Securities Dealers, Inc. (the "NASD") for their efforts to address the potential conflicts of interest that can arise from non-cash compensation arrangements in connection with the sale of investment company securities. Nevertheless, as described in more detail below, the Committee strongly questions the need for revision of the current Conduct Rule 2830 at this time. Accordingly, the Committee respectfully cannot support the Proposed Amendment.**4**

There Has Been No Evidence of Widespread Abuse Arising Out of the Use of Non-Cash Compensation

The current regulatory scheme, as it is structured under the NASD's Conduct Rules, sufficiently addresses the various potential conflicts of interest that confront member firms and their associated persons, including any potential conflicts that arise out of non-cash compensation arrangements. To the Committee's knowledge, there are no indications of wide-spread abuses regarding non-cash compensation in connection with the sale of any securities, including investment company securities.

Indeed, in an earlier release proposing similar amendments to the NASD's Conduct Rules, the SEC staff noted that the Investment Companies and Insurance Affiliated Member Committees of the NASD "did not find that the manner in which non-cash compensation is offered and paid to members and their associated persons indicates a level of supervisory problems similar to that present in connection with the sale of [direct participation program securities] which led the NASD to adopt a prohibition on non-cash compensation in connection with such securities in 1988."**5**

Similarly, in the "Tully Report," the Securities and Exchange Commission's Advisory Committee on Compensation Practices did not indicate that it had found abuses or problems relating to non-cash compensation arrangements.**6** Finally, the Investment Company Institute consistently has noted, in its written comments on various cash and non-cash compensation proposals, that it is not aware of any problems relating to cash and non-cash compensation arrangements. **7**

The Current Regulatory Structure Adequately Addresses Potential Conflicts

Notwithstanding the fact that there are no indications of abuse in the area of non-cash compensation arrangements, the Committee recognizes that the staffs of both the SEC and the NASD are concerned that non-cash and cash compensation arrangements may pose the potential for the loss of supervisory control over sales practices. However, the Committee feels strongly that the potential conflicts of interest in this area already are sufficiently addressed by the NASD's supervisory and suitability rules, which serve to prevent abuses from occurring.

One of the areas in which non-cash compensation arrangements may pose a potential conflict of interest relates to circumstances whereby one product is given preferential treatment over others through sales contests or other programs that award non-cash compensation to participants.**8** Theoretically, this conflict of interest may result in registered representatives making unsuitable recommendations or investments for customer accounts in order to earn a trip or other non-cash compensation. However, this analysis is far too simplistic and does not take into account the realities of the brokerage business or the measures that the Committee believes have prevented abuses of this type.

Under Conduct Rule 2310, a member firm is obligated to make only suitable recommendations or investments for customer accounts. Every registered representative is aware of this obligation, and every member firm has in place supervisory procedures designed to prevent unsuitable recommendations or investments from being made. For the most part, these procedures are effective, and the vast majority of investors receive suitable recommendations and investments. To the extent that unsuitable recommendations or investments may be made, these are infrequent and may or may not be the result of a non-cash compensation

arrangement. In any event, the internal compliance procedures of member firms and the enforcement programs of the NASD and the SEC adequately deal with these cases.**9** Accordingly, given the absence of a record of abuse relating to non-cash compensation arrangements, and given that the current NASD Conduct Rules adequately address any potential conflicts of interest with respect to non-cash compensation, it would be inappropriate for the NASD to adopt broad prohibitions of the type proposed.

Industry Best Practices

As noted above, NASD Conduct Rule 2310 requires a member's associated persons to have a reasonable grounds for believing that the recommended security is suitable for the customer, thereby preventing, among other things, a member firm's associated person from recommending a particular product to earn credit in a non-cash compensation arrangement. Further, the industry generally has addressed potential conflicts and product favoritism by adopting procedures and practices designed to prevent such conflicts and favoritism. As set forth in the Tully Report, some of the industry's "best practices" are those that do not favor one product over others. For example, some of the best practices as set forth in the Tully Report include paying substantially similar commissions to associated persons for proprietary and non-proprietary products within a product group and sales contests based only on broad measures rather than on a single product.**10** While the Tully Report indicated that this last practice did not in itself eliminate the potential for conflict, the Committee believes that coupled with the overlay of Rule 2830 and supervisory requirements, the potential for conflict is greatly reduced if not eliminated.

In 1996, the SIA issued a list of "Compensation Practices," which represent recommendations of the Committee on Compensation Practices.**11** These recommendations include substantially similar payments for proprietary and non-proprietary products and the prohibition of single product sales contests. During the course of preparing this comment letter, members of the Committee met on several occasions and discussed industry practices with respect to product favoritism. These industry practices illustrate that many member firms have adopted, either voluntarily or pursuant to NASD Rule 2310, procedures and safeguards designed to prevent the types of potential conflicts that the Proposed Amendment is designed to prevent. Coupled with a member firm's responsibility to supervise its associated persons under Conduct Rule 3010, Rule 2310 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 non-cash compensation arrangements, do not result in unsuitable investments for customer accounts.

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The Committee strongly believes that by addressing only one potential conflict of interest (*i.e.,* non-cash compensation arrangements), as it relates to one specific type of security, (*i.e.,* investment company securities), the NASD will be abandoning its long-standing, broad-spectrum approach to regulation of member firms that has been so successful in the past. By promulgating rules specifically attempting to address each and every potential conflict, the NASD would be preventing member firms from tailoring to each firm's particular business needs procedures designed to protect the interests of customers and address potential conflicts of interest.

If the Proposed Amendment is adopted, it could discourage member firms from offering a wide variety of investment company securities due to the burden arising out of the need for member firms to implement procedures to ensure compliance with the detailed requirements of the Proposed Amendment. This result would be harmful to investors, who benefit from having a wide selection of investment companies from which to choose. Consequently, the Committee strongly urges the SEC and the NASD to abandon consideration of the Proposed Amendment.**12** If, however, despite the lack of evidence of abuse, the staffs of the SEC and/or the NASD feel that the potential for conflict is too great as it relates to the sale of investment company securities, then the SEC and/or the NASD staffs should address any potential conflicts under the suitability and supervision requirements to ensure that the conflicts are dealt with appropriately. Providing guidance in the form of a Notice to Members on how to prevent abuses that may arise from non-cash compensation arrangements under these requirements would be an appropriate response to the potential conflicts in this area.

Of course, the Committee would be happy to meet with members of the NASD staff to discuss industry practices and best practices as they relate to avoiding potential conflicts of interest associated with the sale of investment company securities and to issue recommendations as to what revisions, if any, should be made to the Conduct Rules to address those potential conflicts.

The Committee appreciates the opportunity to comment on the Proposed Amendment. Should members of the SEC or NASD staff wish to discuss any of the foregoing with the Committee, please contact the undersigned at 212/848-1715 or Michael Udoff, the SIA 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.
Janice Mitnick, Attorney, SEC Division of Market Regulation
Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, Inc.
Barry P. Barbash, Director, SEC Division of Investment Management
Joan Conley, Secretary, NASD Regulation, Inc.
Members of the Investment Company Committee

Footnotes:

1 The Proposed Amendment also addresses revisions to Rule 2820 relating to the regulation of non-cash compensation in connection with the sale of variable contracts, which are identical in most respects to the proposed amendments to Rule 2830. The SIA's comments are applicable, as appropriate, to the proposed revisions to Rule 2820.

2 *See* SEC File No. SR-NASD-95-61; NASD Notice to Members 96-68.

3 The Committee is aware that the NASD has solicited comments with respect to regulation of cash compensation arrangements in NASD Notice to Members 97-50. The Committee separately will provide comments to the NASD in response to that Notice.

4 Although the Committee strongly opposes amending the current NASD Rule 2830, it does have specific comments to some of the proposed revisions as set forth in the Proposed Amendment. Those comments are set forth in Appendix A to this letter.

5 *See* SEC Release No. 34-37374, File No. SR-NASD-95-61 (June 26, 1996).

6 *See* The Report of the Committee on Compensation Practices, April 10, 1995 (the "Tully Report"). The Report is commonly referred to as the "Tully Report" after the Committee's Chairman, Daniel P. Tully.

7 *See* 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.

8 Provided that sales contests do not favor one product over another, or give unfair advantage to proprietary products, the Committee believes that sales contests can be a useful tool in promoting sales and servicing customers if they are conducted within the confines of current NASD rules.

9 The NASD has not hesitated in bringing disciplinary proceedings against member firms and/or their associated persons for related suitability issues. *See, e.g., District Business Conduct Committee District No. 3 v. Robert L. DenHerder,* Complaint No. C3B950031 (Jan. 21, 1997) (associated person violated Conduct Rule 2310 for recommending mutual fund purchases in a different fund family when the customer could have purchased shares in a fund with similar investment objectives with a fund family in which he already was invested, without incurring a sales charge).

10 The Tully Report also described as a best practice the prohibition of certain non-cash compensation arrangements. The Committee believes that while such a practice may be appropriate in some instances, the decision of whether to prohibit non-cash compensation arrangements should remain with the particular member firm.

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

12 If the SEC and/or the NASD nonetheless determine to go forward with the Proposed Amendment, the Committee urges the staff to delay further consideration of the Proposed Amendment until such time as the NASD staff has received comments on Notice to Members 97-50 (seeking comments on cash compensation arrangements), as cash and non-cash compensation arrangements are so closely related. Such delay would ensure the that these related issues can be addressed in a coordinated manner.

APPENDIX A

SPECIFIC COMMENTS ON THE PROPOSED RULE AMENDMENTS

Although the Committee feels that any potential conflicts of interest arising out of non-cash compensation arrangements should be addressed through the current structure of supervision and regulation of suitability, the Committee wishes to provide specific comments on certain aspects of the Proposed Amendment.

Prospectus Disclosure

The Proposed Amendment, while primarily dealing with non-cash compensation arrangements, also contains a provision, 2830(l)(4), that would prohibit NASD members from accepting cash compensation in connection with the sale of investment company securities absent specific prospectus disclosure.**1**

Traditionally, prospectus disclosure has been regulated by the SEC. As noted in the Tully Report, the SEC's regulation in this area has been effective: "For over sixty years [the SEC] has sought, within the limits of its authorization, to maintain an environment in which people can invest without risk of fraud or deception, *in which information flows freely among all participants*, and in which healthy competition leads to greater service and lower costs for all concerned" (emphasis added).**2** In its continuing efforts to ensure that investors receive accurate disclosure that is meaningful, the SEC currently is seeking to simplify prospectus disclosure, as the Proposed Amendment release acknowledges. **3**

It would be inconsistent with the SEC's proposal on prospectus disclosure, and confusing for members, if the NASD mandated additional disclosure at a time when the SEC is trying to streamline prospectus disclosure. Further adding to the confusion is the fact that, while the Proposed Amendment deals only with non-cash compensation (and the NASD at this time separately is seeking comments on cash compensation arrangements), there is a provision in the Proposed Amendment relating to prospectus disclosure of cash compensation arrangements. Accordingly, the Committee believes it would make more sense for the NASD to delay consideration of cash compensation prospectus disclosure at this time.

The Committee supports general prospectus disclosure, as regulated by the SEC, 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. Rule 2830 currently prohibits underwriters or associated persons of underwriters from *paying to any member*, in connection with the sale of investment company securities, any concession that is not disclosed in the prospectus of the investment company.**4** The provisions of the Proposed Amendment relating to prospectus disclosure of cash compensation arrangements in connection with the sale of investment company securities would shift the burden from those parties who control the disclosure that is made in the prospectus - issuers and underwriters - to parties that have no control over the disclosure process - selling dealer members - by prohibiting member firms from accepting any payment that is not disclosed.

One of the primary problems with this shifted burden is that, while it may be reasonable to expect a broker-dealer to monitor disclosure relating to the investment companies for which it serves as principal underwriter, it is unreasonable to expect a retail broker-dealer selling fund shares to be responsible for disclosure in each fund's prospectus. As the Committee noted in its response to the NASD's earlier request for comments on similar amendments as detailed in NASD Notice to Members 96-68, full service brokerage firms often sell a large number of

different funds.**5** Shifting the disclosure responsibility to member firms would place an oppressive burden on members' compliance efforts. In this era of high volume mutual fund sales, where a full-service brokerage firm may offer hundreds (or in some cases, thousands) of funds from dozens of complexes, monitoring prospectus disclosure for each fund would be unduly burdensome, if not impossible.

Even if member firms adequately could monitor disclosure, if improper disclosure is found, the member firms have no authority to compel proper disclosure. Thus, the Proposed Amendment could result in a member firm's being held responsible for accepting compensation that has not been adequately disclosed in a fund's prospectus under circumstances where the member has little or no control over the content of the prospectus.

The Committee would like to emphasize that, while it supports general prospectus disclosure, it is opposed to either point-of-sale disclosure and/or detailed and specific prospectus disclosure. As the Committee has specified in more detail in its comments to NASD Notice to Members 97-50, mandating point-of-sale disclosure would be confusing to investors and mandating specific disclosure of special compensation arrangements would conflict with the SEC's disclosure simplification initiative.

The Committee also is concerned that consideration of the cash-compensation disclosure that would be required by the Proposed Amendment is premature and confusing. The NASD has solicited industry comments with respect to the regulation of cash compensation arrangements, as announced in NASD Notice to Members 97-50. Moreover, the NASD has determined to defer proposed amendments regarding cash compensation until such time as it has evaluated comments received in response to Notice to Members 97-50. Consequently, it would be premature to include a prospectus disclosure requirement relating to *cash compensation* arrangements in the Proposed Amendment, which otherwise deals only with non-cash compensation arrangements. Because the NASD has determined to bifurcate proposed changes to cash and non-cash compensation regulation, the consideration of cash compensation disclosure is better suited to the cash compensation amendment proposals. Consequently, the Committee urges the NASD to delay consideration of cash compensation prospectus disclosure until such time as it amends the rules relating to cash compensation.

Definition Clarification

The Committee is concerned that some of the definitions contained in the Proposed Amendment are confusing and need clarification. For example, the term "affiliated member" is too narrowly defined and the term should be modified to include arrangements where member firms and fund groups are affiliated through ownership, but are not under common control. In addition, if the NASD determines to base this definition on the concept of control, it should provide guidance on the definition of control to be applied in this context.

Another term that needs clarification is the term "cash compensation." As set forth in the Proposed Amendment, the definition of "cash compensation" specifically includes service fees. However, the Proposed Amendment also specifies that compensation must be received "in connection with the sale and distribution" of securities. As traditional service fees are not the type of compensation the Proposed Amendment is intended to address, but rather are payments for continuing investor services, the term "service fees" should be deleted from the

definition of "cash compensation." Finally, the definition of "offeror" is overly broad and should be more narrowly defined. For example, as proposed, the definition would pick up any party that has a five percent ownership arrangement with an investment company, including an investor owning more five percent of a fund.

Training and Education Programs

With respect to the limitations on training and education programs, the Committee would like to note that the provisions of (l)(5)(C) and (l)(5)(D) of the Proposed Amendment preclude the use of sales targets. As a preliminary matter, the Committee would like to note that, provided other safeguards are in place, the use of sales targets are not necessarily detrimental to the interests of investors and can provide useful incentives for salespersons.

However, the Committee seeks clarification of certain provisions of the Proposed Amendment as they relate to the exclusion of certain training and education programs from the prohibition of non-cash compensation arrangements. First, the Committee would like clarification that an issuer that is an affiliate of a member firm could provide compensation for training and education programs under the provisions of (l)(5)(C), as well as under the provisions of (l)(5)(D). Affiliation does not automatically mean that entities are in cooperation with each other to sell fund shares, nor does it mean that cash flows can easily be shifted from one entity to another within a holding company structure. Clarification of this point would, therefore, level the playing field and promote competition among fund groups.

Second, the Committee seeks clarification of condition (v) of provision (l)(5)(C) of the Proposed Amendment. Provision (l)(5)(C) excludes payments by offerors for training and education programs from the prohibition on non-cash compensation arrangements provided five conditions are met. Condition (v) specifies that payment cannot be preconditioned by the offeror on the achievement of a sales target. The Proposed Amendment notes that this condition is intended to ensure that the offeror making the payment does not participate in any manner in a member's decision as to which associated persons will attend the training or education program. The Committee members seek confirmation that this condition would not preclude payment by an offeror to a training or education program aimed at the member's top producers during a given time period. Further, the Committee would like to confirm that under condition (v), a fund, whether affiliated with the member firm or not, could make a payment to a training or education program aimed at the member's top producers. For example, it is the Committee's view that an offeror, even if the offeror is a mutual fund, should be permitted to make payment toward a training program for a member's top 100 producers in a given year, so long as the top 100 producers are invited to attend no matter what their total sales were during the relevant year. This should be the case even if the program is offered annually.

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The members of the Committee would like to reiterate that they feel that revisions to Rule 2830 are unnecessary at this point, as the current regulatory structure is working to prevent any potential conflicts of interest that can arise in connection with the sale of investment company securities from harming the interests of customers. Nevertheless, the Committee members offer the comments set forth above should the NASD and SEC staffs determine to go forward with the Proposed Amendment.

Footnotes:

1 Non-cash compensation arrangements would not have to be disclosed in the prospectus because, if the Proposed Amendment were adopted, non-cash compensation arrangements would be prohibited in a manner that would obviate the need for disclosure of those arrangements.

2 Tully Report at 3.

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

4 If the NASD is concerned that current prospectus disclosure is confusing to investors, it could recommend uniform disclosure language or provide additional guidance on the interpretation of the current requirement.

5 *See* Letter from Lawrence H. Kaplan, Chairman of the SIA Investment Company Committee, to Joan Conley, Office of the Secretary, NASD, dated December 13, 1996.