

VIA ELECTRONIC MAIL

August 5, 2005

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary
NASD, Inc.
1735 K Street, NW
Washington DC 20006-1500

Dear Ms. Sweeney:

The Financial Services Institute¹ (Institute) appreciates the opportunity to comment on NASD Notice to Members 05-40, a proposal to prohibit all product-specific sales contests and to apply existing non-cash compensation rules to all securities. The proposal would create a new Rule 2311 to replace current non-cash compensation rules.

The Institute supports the NASD's continuing efforts to enhance market integrity and protect investors by ensuring that the investment advice they receive is accurate and balanced. We agree that potential conflicts of interest should be fully disclosed and that compensation arrangements, including sales contests and non-cash compensation, should not differentiate among investment products. Nevertheless, we are concerned that the proposed new Rule 2311 would have disproportionately negative and burdensome implications for FSI member firms. We also believe the proposed rule would have the unintended consequence of eliminating or inhibiting much needed opportunities for education and training of registered representatives.

Background on Institute Members

The Institute was conceived in 2003 and launched in 2004 as an advocate for independent broker-dealers. Our members share similar business characteristics: They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products by "check and application"; take a comprehensive approach to their clients' financial goals and objectives; offer primarily packaged products such as mutual funds and fixed and variable insurance products; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives.

Our members' registered representatives are independent contractors, rather than employees of our member broker-dealers. These registered representatives are typically located in communities where they know their clients personally and provide investment advice to their clients on a face-to-face basis. Our members generally do not concentrate

¹ The Financial Services Institute, Voice of the Independent Broker-Dealer, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, which serve registered representatives who are independent contractors. The Institute has over 0101 member firms, with more than 124,000 registered representatives and over \$8.3 billion in Total Revenues.

their retail business on the sale of individual stocks and bonds; engage in active trading strategies; make markets; carry inventories; engage in investment banking services; or prepare and issue research to retail customers. We believe our members have a strong incentive to keep their clients' interests paramount because they take a comprehensive, holistic approach to their clients' financial needs and objectives.

Summary Comments

We have carefully reviewed and analyzed Notice to Members 05-40. Following are summaries of our comments, each of which will be discussed in more detail below:

In general, many of the problems with this proposal stem from the fact that some product manufacturers do not understand existing rules and are not subject to similar prohibitions. While broker-dealers work to educate registered representatives and product sponsors on the rules, there are still sponsors that continue to contact representatives directly with offers of inappropriate non-cash compensation. It would seem most effective to the industry if the NASD could work with the SEC to develop rules that apply across the industry. Application of these rules to broker-dealers alone also has anti-competitive effects. The rules do not apply to banks or to investment advisers. The NASD will need to clarify what existing interpretations to these rules will still be valid.

Here are specific issues we have identified in the proposal:

Extension of Non-Cash Compensation Prohibitions to All Securities

1. **Proposed definitions are not consistent with current definitions** - The Notice states that proposed Rule 2311 would replace 2820(g)(4) for variable contracts and the similar provisions for the other products with similar current rules. Nevertheless, the proposed rule contains definitions of "compensation," "cash compensation" and "non-cash compensation" that differ from the current provisions. It is not clear why these definitions are in the new proposed rule and not suggested as amendments to existing Rule 2820(b). There are other provisions in Rule 2820 that deal with compensation that do not appear to be changing. Having a different definition in the new rule could have some unintended consequences.
 - a. The definition of "cash compensation" is confusing and not consistent with prior NASD pronouncements. For example, NtM 03-54 proposed to include expense reimbursements in the definition, but that is not included in the latest proposal. The industry needs clarification on whether the cash compensation definition only applies in the context of sales contests. It is not unusual for broker dealers and offerors to reimburse registered representatives for legitimate business expenses, not in connection with any type of sales contest.
 - b. The existing preamble to Rule 2820(g) uses the terms "in connection with the sale and distribution of variable contracts". The proposed rule omits the current preamble because the phrase is included in the definitions of cash and non-cash compensation. The phrase is unclear and needs better definition. Theoretically, the phrase could be interpreted to apply to provision by offerors of training materials, advertising, and general revenue

sharing that is used for meeting purposes, etc. In proposing the existing rules, the NASD noted that clarification would be forthcoming, but has failed to provide it. This is important, because under the anti-fraud rules, that term is extremely broad, which should not be the case here.

- c. The term “security” needs definition, probably by reference to Section 3(a) of the Securities Exchange Act.
- d. “Pre-conditioned on the achievement of a sales target” – We generally applaud the clarification that is being given to this phrase. However, there are a couple of issues:
 - i. The new rule sets as the standard “associated persons understand in advance” that a goal must be achieved. This is a very subjective standard. A broker-dealer cannot control an associated person’s *understanding*, and someone’s *understanding* can change after the fact. A better standard would be one that focuses on the conduct of the broker-dealer, such as “an arrangement in which the broker-dealer sets a dollar-denominated goal or a goal of finishing within a defined number of top sellers in advance.” This approach would be more consistent with the idea that a broker-dealer can award past performance or encourage future performance and has control over the situation.
- e. “Sales Contest”
 - i. The term “incentive arrangement” may be clearer to the broker-dealers than “sales contest.” Many firms hold meetings that use production as a qualification or for reduced expenses.
 - ii. The definition uses the term cash or non-cash “prizes” and not compensation. Presumably, the same definition is intended, but this should be clarified.
 - iii. The definition of “sales contest” should not include any “contest” that does not involve the sale of a specific security. Such things as assets under management, opening of new accounts, etc., which are currently permitted, should continue to be allowed.
 - iv. Does the recordkeeping requirement supersede current rule 2820(g)(3)?

Restrictions on Non-Cash Compensation and Sales Contests

Prohibition on Product-Specific Sales Contests

The current rules relating to incentive programs permit incentives to be based on sales of a single type of product, subject to the condition that the products within the category be equally weighted. This makes sense, as decisions as to which manufacturer’s product should be sold to a particular customer should be based on factors other than incentive programs, and products within a specific category can be equally weighted.

The application of this rule across all products, however, does not make logical sense for the following reasons:

- The rationale presumes that a representative would sell a client one type of product instead of a different type of product based on an incentive program. Suitability rules already prohibit such practices, and the NASD has not demonstrated that this is, in fact, occurring within the industry as a direct result of current incentive programs.
- The NASD notes as part of its rationale for this proposal that it would prohibit “stock of the day” and similar promotions. These promotions could in any event be prohibited by application of the requirement of equal weighting to these securities that currently exists under the rules for variable contracts and other securities. In other words, one could not have a “stock of the day” promotion if all stocks were required to be considered.
- It is not clear from the proposal whether “commission specials” offered by sponsors would be prohibited.
- Not all representatives are qualified and registered to sell all products offered by a member. Would they be prohibited from participating in any “sales contest”?

In addition, prohibiting product-specific sales incentive programs would have anti-competitive effects in that single product broker-dealers would be permitted to hold sales incentive programs that general securities firms could not.

Elimination of Provision Permitting Non-Member and Other Member Contributions to Non-Cash Arrangements

Under current rules, the following arrangements are permissible, with certain limitations:

- Non-cash compensation arrangements between a broker-dealer and an affiliated offeror, such as an insurance company.
- Contributions by non-affiliated offerors as long as those offerors do not participate in the organization of the arrangement.
- A contribution by the member to non-member incentive programs, such as a broker-dealer’s contributing to a bank program.

The proposed rules would eliminate these arrangements.

Elimination of these exceptions to the non-cash compensation rules would have severe negative consequences. Many broker-dealers offer any number of meetings during the course of the year that provide important educational opportunities not otherwise available for independent contractor representatives. These education meetings may include an incentive component, in that they reward higher producing representatives by paying all or a portion of the costs of attending the meeting. In other circumstances, firms hold such education meetings for their top producers (who usually account for the vast majority of total sales). Because there are incentive aspects to attendance at these meetings, they may not qualify under the rules relating to training and educational meetings.

These meetings represent important opportunities to offer independent contractor representatives’ education and training in products, operations, technology, regulatory issues and any number of other topics important to the conduct of their business. They provide these individuals with opportunities to network and exchange ideas. These

opportunities would not be available to these representatives if they were forced to pay for such programs with their own funds.

Many independent broker-dealers would find it extremely difficult to pay for these meetings without sponsor/offerator participation. Although qualification for attendance at the meetings is often based on total production of all securities, various offerors contribute to the meetings through cash payments, provision of training materials, payment for industry and motivational speakers, provision of speakers on products, payment for meals and some entertainment, and other contributions.

It is difficult to rationalize how elimination of these meetings, which are seldom based on sales of a single product, would be in the public interest. It would appear that the public interest is, in fact, better served through these meetings because of their educational value to the sales force. Until the NASD changes the definition of "educational", we believe these meetings should be exempt from these rules.

Participation by Members in Non-Member Incentive Program - There is also no apparent reason for prohibiting broker-dealers from participating in non-member incentive programs, such as those offered by banks. If the NASD rules do not apply to those entities and there is nothing prohibiting those entities from engaging in incentive programs, there is no justification for prohibiting broker-dealers from participation through provision of speakers, or in other ways.

Training and Education

Section (b)(3) needs to be amended to make clear that the subsections do not apply to training and education meetings held by a member for its own associated persons. There is no reason to put restrictions on internal broker-dealer meetings that are not incentive based.

1. Location - No justification is given for limiting the location of a training and education meeting to the United States. Members and offerors with foreign locations or that are headquartered in foreign countries should be permitted to have appropriate training meetings in those locations. It is difficult to understand why Hawaii may be appropriate, but Toronto not. The NASD has traditionally stated that such meetings should not be held in "exotic" places. However, these meetings cannot be incentive based, nor can they be accompanied by entertainment, so it is not clear why location is important. The focus should be on the substance of the meeting and not the location.

The suggested limitation that regional meetings are limited to persons who "work within that region" is similarly without any rationale. At what point in time does a "region" have to be designated? Is there any reason why an East Coast offeror could not have a meeting for attendees across the nation in Chicago or Dallas for cost and convenience reasons?

2. Entertainment - If this is to be written into the rule, "entertainment" should be defined. Entertainment that is incidental to the meeting or meals (speakers, music, etc.) should be permissible.
3. "President's Clubs" - We believe that the NASD should look closer at the common structure of "President's Clubs". Today, these are focused on recognition of top selling representatives. In most cases there is not much, if any incentive, other than bragging rights. For example, many FSI member firms have "President's Clubs"

that have one or more of the following: the top producer receives a plaque, an ad slick, priority telephone and/or application processing, a special phone number to use that connects the representative with a knowledgeable staff member at the offeror, and a newsletter or other industry tool.

We appreciate the opportunity to share the views of our members with NASD on TNtM 05-40. We will be pleased to work with NASD staff to craft a rule that will protect investors without placing unnecessary burdens on our members. Please feel free to contact me at 770 980-8487 with any questions or to discuss further any of our comments.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Dale Brown", written in a cursive style.

Dale E. Brown, CAE
Executive Director and CEO