

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40206; File Nos. SR-MCC-98-01 and SR-MSTC-98-01]

Self-Regulatory Organizations; The Midwest Clearing Corporation; the Midwest Securities Trust Company; Order Approving Proposed Rule Changes Relating to the Structure and Composition of the Board of Directors

July 15, 1998.

On February 9, 1998, the Midwest Clearing Corporation ("MCC") and the Midwest Securities Trust Company (MSTC) filed proposed rule changes with the Securities and Exchange Commission ("Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and on February 25, 1998, amended the proposed rule changes. Notice of the proposals was published in the **Federal Register** on April 22, 1998.² For the reasons discussed below, the Commission is approving the proposed rule changes.

I. Description

The proposed rule changes amend MCC's and MSTC's by-laws in order to reflect the cessation of their securities clearing and depository services³ and to streamline the structure and composition of their board of directors in order to remain consistent with the changes recently made by the Chicago Stock Exchange, Incorporated ("CHX").⁴

The proposed rule changes reduce the number of directors from 27 to 24 and realign the classes for both MCC and MSTC. The directors are still divided into three classes, but the size and composition will be adjusted as follows. At the 1998 annual election, class I will be reduced by two directors. At the 1999 annual election, class II will be reduced by four directors. At the 2000 annual election, class III will be reduced by one

director, and class II will be increased by one director. The board of directors will also be increased by three additional "non-industry" directors by the 1999 annual election to serve for staggered terms so as to balance the classes as determined by the nominating committee.⁵

II. Discussion

Section 17A(b)(3)(F)⁶ of the Act requires that the rules of a clearing agency be designed to protect investors and the public interest. The Commission believes that the change in the composition of MCC's and MSTC's board of directors should help MCC and MSTC to better protect investors and the public interest. As a result of the modifications to the boards, there will be fifty percent representation of non-industry directors on MCC's and MSTC's board of directors. If carefully selected, non-industry directors should bring diverse experience to the boards and thus enable MCC and MSTC to better perform their self-regulatory obligations.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposals are consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule changes (File Nos. SR-MCC-98-01 and SR-MSTC-98-01) be and hereby are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁷

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40214; File No. SR-NASD-97-35]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change Filed 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

July 15, 1998.

I. Introduction and Background

On May 7, 1997,¹ the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")² and Rule 19b-4 thereunder³ to amend NASD Conduct Rules relating to the regulation of non-cash compensation in connection with the sale of investment company securities and variable contracts.

Over the past years, the SEC, the investing public and the securities industry have raised concerns about actual and potential conflicts of interest in the retail brokerage business. Responding to these concerns, in May

¹ 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. A final amendment, Amendment No. 4, was filed on December 2, 1997. 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 were incorporated into and published in the **Federal Register** notice of the proposed rule change. See Securities Exchange Act Release No. 38993 (August 29, 1997), 62 FR 47080 (September 5, 1997). Amendment No. 2 made technical changes to Amendment No. 1. See letter from John Ramsay, NASD Regulation to Katherine A. England, Assistant Director, 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. These two technical amendments do not need to be published for comment. Amendment No. 4 was filed on December 2, 1997. See letter from John Ramsay, NASD Regulation to Katherine A. England, Assistant Director, Commission Amendment No. 4 responds to comment letters received by the Commission in response to its notice of the filing and solicitation of comment. It is a technical amendment and therefore not subject to notice and comment. NASD Regulation's response is discussed in detail in Section III of this approval order.

² 15 U.S.C. 78s(b)(1).

³ 17 CFR 240.19b-4.

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 39872 (April 14, 1998), 63 FR 19991 (File Nos. SR-MCC-98-01 and SR-MSTC-98-01).

³ Securities Exchange Act Release No. 36684 (January 5, 1995), 61 FR 1195 (File Nos. SR-MCC-95-04, SR-MSTC-95-10) (order approving proposed rule changes relating to the withdrawal of the Chicago Stock Exchange, Incorporated from the clearance and settlement and securities depository businesses, conducted principally through its subsidiaries, MCC and MSTC).

⁴ Securities Exchange Act Release No. 39759 (March 6, 1998), 63 FR 14153 (order approving a proposed rule change relating to the structure and composition of CHX's board of governors). Historically, the MCC's and MSTC's board of directors have been the same as the CHX's board of governors. As a result of these changes, half of MCC and MSTC's boards will be "non-industry" directors as defined in CHX's constitution.

⁵ Class I will consist of seven directors, class II will consist of seven directors, and class III will consist of eight directors.

⁶ 15 U.S.C. 78q-1(b)(3)(F).

⁷ 17 CFR 200.30-3(a)(12).

1994, an industry committee chaired by Merrill Lynch Chairman Daniel P. Tully ("Tully Committee") was formed at the request of SEC Chairman Levitt to address concerns regarding conflicts of interest in the brokerage industry. The Tully Committee reviewed industry compensation in connection with the sale of all forms of securities for associated persons of members, identified conflicts of interest inherent in such practices, and identified "best practices" used in the industry to eliminate or reduce such conflicts of interest. A report was subsequently issued by the Tully Committee in April 1995 (the "Tully Report").⁴ NASD Regulation, a wholly owned subsidiary of the NASD, believes this proposed rule change is consistent with the characteristics of "best practices" identified in the Tully Report to the extent that the proposal helps to better align the interests of associated persons, broker-dealers and investors with respect to investment company securities and variable contracts.

The proposal 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 changes 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.⁵ In December 1995, the NASD filed with 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 investment company and variable contract sales. SR-NASD-95-61 was published by the Commission for comment on July 8, 1996,⁶ SR-NASD-95-61 raised significant issues among comments regarding the nature and treatment of certain incentive-based cash compensation arrangements, in particular those cash compensation arrangements of insurance-affiliated

member firms. Most of the commenters opposed the proposed provisions to regulate incentive-based cash compensation, stating among other things, that the provisions pertaining to cash compensation were over-broad in their scope. In response to the commenters, NASD Regulation chose to delete those provisions proposing to impose substantive prohibitions regarding incentive-based cash compensation. The NASD therefore withdrew SR-NASD-95-61 and replaced it with the filing approved herein, SR-NASD-95-35, which does not contain provisions imposing substantive regulations on the receipt of cash compensation arrangements.⁷

II. Summary Description of the Proposed Rule Change

In general, the terms of the rule change would 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. Limited exceptions to this general prohibition allow an associated person to receive payment from persons other than his or her NASD member firm where the compensation is approved by the member, or compensation received by the associated person is treated as compensation received by the member for purposes of NASD rules.

New record keeping provisions of the proposed rule change would require that members maintain records of any compensation, cash or non-cash, received by the member or its associated person from offerors. NASD Investment Company Rule 2830, as amended, would prohibit receipt by a member of

cash compensation from the offeror unless such arrangement is described in the current prospectus. NASD Investment Company Rule 2830 prohibitions against a member receiving compensation in the form of securities would be retained. The amendments would prohibit, moreover, 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 prohibitions 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 of reimbursement for training and educational meetings held by a broker-dealer or 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 fund 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 proposed rule amendments would define the terms "affiliated member," "compensation," "cash compensation," "non-cash compensation," and "offeror." NASD Regulation is proposing to adopt a definition of the term "affiliated member" for both the Investment Company Rule, Rule 2830, and the Variable Contract Rule, Rule 2820, 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 which 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 for underwriting and/or wholesale and retail distribution services.

For ease of reference in appropriate paragraphs of the proposed rules, NASD Regulation 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

⁴ See Report of the Tully Committee on Compensation Practices, April 10, 1995.

⁵ See e.g., order approving proposed rule change relating to the offering on non-cash sales incentives as inducement to sell interests in direct participation programs. Securities Exchange Act Release No. 26185 (October 14, 1988), 53 FR 41262 (October 20, 1988). See also order approving proposed rule change to prohibit NASD members and associated persons from accepting non-cash compensation in connection with the sale of real estate investment trust, and debt or equity corporate offerings. Securities Exchange Act Release No. 26186 (October 14, 1988), 53 FR 41265 (October 20, 1988).

⁶ See Securities Exchange Act Release No. 37374 (June 26, 1996), 61 FR 35822 (July 8, 1996).

⁷ See Securities Exchange Act Release No. 37374 (June 26, 1996), 61 FR 35822 (July 8, 1996). Notwithstanding its decision to bifurcate the regulation of cash and non-cash compensation in the instant filing, NASD Regulation has informed the Commission that it 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 Regulation staff continues to believe 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 interest of customers.

As a result of its continuing concerns regarding the appropriate regulatory response to cash compensation arrangements, in August 1997, NASD Regulation issued Notice to Members 97-50, which solicited comments pertaining to conflicts of interest arising from the payment of cash incentives. Among other things, Notice to Members 97-50 solicited comment as to whether cash compensation should be subject to disclosure versus substantive prohibitions.

appropriate paragraphs in the proposed rule language accordingly.

"Cash compensation," as proposed to be defined in the Investment Company and Variable Contract Rules, 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.

The "non-cash compensation" 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.

Finally, NASD Regulation 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. The term "offeror," as defined in the Variable Contracts Rule, would 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. 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. The term "affiliated person" in the proposed definition of "offeror" is defined in accordance with Section 2(a)(3) of the 1940 Act.⁸ The term "underwriter" is defined in Section 2(a)(40) of the 1940 Act.⁹ It is intended to reference the principal underwriter through which the investment and insurance company distributes securities to participating dealers for sale to the investor.

III. Amendment No. 4 and NASD Regulation's Response to Comments Received on the Proposal

The Commission received letters from eight commenters regarding the proposed rule change.¹⁰ Two of the commenters generally supported the proposal with modifications. Four of the commenters opposed the proposal, and two of the commenters requested clarification regarding certain aspects of the proposal, but did not assert an opinion as to their general support of opposition to the proposal. NASD Regulation responded to the issues raised by the commenters in a letter dated December 2, 1998.¹¹ This response letter is discussed below in addition to a description of the amendments to the proposal that were made as a result of comments received from the Commission's notice of the proposal and solicitation of public comment.

A. The Bifurcation of the Regulation of Non-Cash and Cash Compensation

M Financial, Banc One, Merrill Lynch, and the SIA expressed the

opinion that it would be imprudent and potentially confusing to introduce substantive regulations regarding non-cash compensation prior to fully evaluating the answers to the questions regarding cash compensation raised by NASD Regulation in Notice to Members 97-50. In responding to these commenters, NASD Regulation notes that since the late 1980s, the NASD, with the support of its Investment Company and Insurance Affiliated Committees, has focused on crafting a rule to address non-cash compensation practices that create particularly strong point-of-sale incentives and supervisory problems for member firms. NASD Regulation believes the proposed rule change, which has the general support of the industry, is appropriate to address these issues and need not be linked to cash compensation issues, which raise much broader and more complicated concerns.

The ICI urged NASD Regulation to reinstate the cash incentive provision in the earlier proposal SR-NASD-95-61 to prevent cash payments directly to individuals, because such payments create the potential to undermine an NASD member's supervisory control over its associated persons. In response, NASD Regulation explains that the intended purpose of the now deleted cash incentive provision was to prevent the monetizing of non-cash compensation. NASD Regulation determined to delete the cash incentive provision in response to comments, primarily from insurance affiliated members, that the provision was over-broad, and to solicit comments in Notice to Members 97-50 on cash compensation issues. The potential of payments to individuals to undermine an NASD member's supervisory control over its associated person has always been a major concern that the proposed rule change has attempted to address. Thus, paragraph (h)(1) and (l)(1) of the proposed rule change, which were also contained in predecessor versions, with limited exceptions prohibit individual associated persons from accepting any compensation, cash or non-cash, from anyone other than the member with which the person is associated.

The ICI noted that in connection with the discussion of the implementation period of the proposed rule change, NASD Regulation states that the requirement that "[w]ith respect to the non-cash and cash sales incentive provisions, no new sales incentive programs may be commenced after the effective date" is incongruent with the removal of the cash sales incentive provision and needs to be clarified. NASD Regulation agrees with this

⁸ 15 U.S.C. 80a-2(a)(3).

⁹ 15 U.S.C. 80a-2(a)(40).

¹⁰ See letters to Jonathan Katz, Secretary, SEC from Banc One Corporation ("Banc One"), dated September 29, 1997; Investment Company Institute ("ICI"), dated September 26, 1997; M Financial Group ("M Financial"), dated September 30, 1997; Drinker Biddle & Reath ("Drinker Biddle"), dated, September 29, 1997; Merrill Lynch Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), dated October 1, 1997; Bruce Avedon, dated October 16, 1997; First Investors Corporation ("First Investors"), dated October 16, 1997; and the Securities Industry Association ("SIA"), dated October 16, 1997.

¹¹ See Letter from John Ramsay, Deputy General Counsel, NASD Regulation Inc., to Katherine England, Assistant Director, Division of Market Regulation, SEC, dated December 2, 1998.

observation and has thus made a technical amendment to the proposed rule change to delete the words "and cash" from the above cited statement.

B. Effective Date of Proposal

M Financial maintained that the proposed implementation plan interferes with the completion on ongoing commitments, and NASD Regulation should extend the "grace period" for completing on-going incentive programs. The proposal, M Financial argues, does not allow adequate time for insurers and broker-dealers to honor their commitments for programs that have already begun. Having taken this argument under advisement, NASD Regulation believes the proposed "grace period" is fair and will not unduly burden the completion of ongoing commitments, particularly since industry participants have been aware for some time of the proposed rule and the proposed grace period and, in many cases, have already begun to adjust accordingly.

C. In-house Compensation Plans

Merrill Lynch and the ICI urged that the proposed rule change be revised to permit in-house incentive programs where the compensation is based on sales of investment company securities within a designated broad investment objective or category, rather than all investment company securities sold by the member. NASD Regulation is of the opinion that it would be inappropriate to permit in-house incentive programs based on broad objectives or categories. Some members, NASD Regulation notes, may carry limited numbers of funds, or only one fund, for a given objective or category which, under the commenters' suggestion could result in sales incentive contests tied to one or a few funds, which would vitiate the purpose of the proposed rule.

D. Contributions of NASD Members to Non-NASD Member Compensation Arrangements

Drinker Biddle and the ICI maintained that, although the proposed rule change would permit a non-NASD member or other NASD member to contribute to a member's permissible in-house non-cash compensation arrangement, as currently drafted, it could be read to prohibit contributions by NASD members to non-cash compensation arrangements of non-NASD members, for example, banks. The commenters stated, moreover, that this is probably an unintended consequence of a revision to the prior proposal that not only prohibits an NASD member or person associated with a member from

accepting any non-cash compensation (subject to certain specified exceptions), but also prohibits members and associated persons from making payments or offers of payment of such compensation. Thus, the commenters recommended that the NASD clarify that an NASD member also could contribute to the non-cash compensation arrangements of a non-NASD member, such as a bank, provided that the arrangement complies with the requirements of the proposed rule change.

NASD Regulation agrees that members should not be prohibited from contributing to non-cash compensation arrangements of a non-member, provided that the arrangement complies with the conditions of the proposed rule. Thus, paragraph (h)(4)(E) of Rule 2820 is amended as follows: New language has been underlined.

"Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, or contributions by a member to a non-cash compensation arrangement of a non-member, provided that the arrangement meets the criteria in subparagraph (h)(4)(D)."

In addition, paragraph (1)(5)(E) of the proposed Rule 2830 is amended as follows:

"Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, or contributions by a member to a non-cash compensation arrangement of a non-member, provided that the arrangement meets the criteria in subparagraph (1)(5)(D)."

E. Proposed Prospectus Disclosure

Three commenters objected to the prospectus disclosure requirements regarding certain compensation arrangements. Specifically, Banc One stated that the proposal to require additional detailed disclosure in a current prospectus regarding special cash compensation arrangements, including the names of individual members engaged in such arrangements, is unnecessary. Merrill Lynch and the SIA noted that the current rule provides that "[n]o underwriter or associated person of an underwriter shall * * * pay * * * any * * * concession * * *" which is not disclosed in the prospectus, whereas the proposed rule would be revised to state "[n]o member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus." These commenters expressed the opinion that the proposed

rule would inappropriately shift the burden of ensuring that such disclosure appears in the prospectus from underwriters to NASD member dealers, who are unable to write or control the disclosure contained in an investment company's prospectus. The SIA maintained, moreover, that the disclosure requirement 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.

In responding to the comments objecting to the proposed prospectus disclosure, NASD Regulation notes that the prospectus disclosure requirement in the proposed rule change is similar to the current prospectus disclosure requirement, but the proposed rule change applies only to cash compensation. Rule 2830 currently requires disclosure of all compensation, including non-cash compensation, paid or offered to be paid by an underwriter or its associated person in connection with the sale of investment company securities. By contrast, the proposed rule change governs the conduct of NASD members who accept payments in connection with investment company securities. Specifically, the proposed rule change prohibits NASD members from accepting any cash compensation from an offeror that is not described in the current prospectus of the investment company.

As to the concern that the proposed rule change inappropriately shifts the burden for disclosure from offerors of funds to NASD member dealers, NASD Regulation points out that the proposed rule changes does not impose a specific prospectus disclosure requirement on the dealer-member; rather, the rule prohibits the "acceptance" by a member of cash and special cash compensation unless disclosed in the prospectus. Finally, NASD Regulation has stated in the proposed rule change that it will reevaluate prospectus disclosure in light of the SEC's recent initiatives for a simplified prospectus.

F. Proposed Definitions

The SIA suggested modifications to several of the proposal's definitions. Specifically, it maintained the "affiliated member" definition is too narrow and should be modified to include arrangements where member firms and fund groups are affiliated through ownership, but are not under common control. NASD Regulation believes expanding the definition of affiliated member would expand the universe of non-members that could

sponsor a non-cash arrangement under sub-paragraphs (h)(4)(D) of rule 2820 and (1)(5)(D) of Rule 2830 to non-members that have only a business or investment interest, rather than a control interest, in a member. Subparagraphs (h)(4)(D) and (1)(5)(D), as explained in Amendment No. 4, were intended in part to give member firms and their parent insurance company or mutual fund control over the sponsorship and organization of a non-cash arrangement, and to limit that control to such relationships.

The SIA also suggested modifications to the definition of service fee. It stated that service fees are payments for continuing investor services and, as such, should be excluded from the definition of "cash compensation." NASD Regulation, in response, asserts that it understands that "service fees" may serve myriad purposes and has intentionally drafted a broad definition of "cash compensation" to address the various forms and ways in which such compensation may be paid.

Noting that the definition of "offeror" would pick up any party that has a five percent ownership arrangement with an investment company, including an investor owning more than five percent of a fund, the SIA stated that the definition is overly broad and the term should be more narrowly defined. As explained by NASD Regulation, the definition of offeror was broadly drafted to address those entities that may function as offerors of cash or non-cash compensation in connection with the sale and distribution of investment company and variable contract securities. NASD Regulation believes that it is very unlikely that an investor could or would act in such capacity.

Finally, one commenter, Bruce Avedon, requested that NASD Regulation expressly clarify its position that the definition of "cash compensation," as amended in Rule 2820, does not include fees and reimbursement for reasonable travel expenses paid to directors of life insurance companies for attending board of directors' meetings. In response to this request for clarification, NASD Regulation notes that directors' fees are not paid pursuant to the sale and distribution of securities, and it therefore considers such fees to be outside the purview of the new rule.

G. Training and Education Exceptions

The SIA requested specific clarification that an issuer that is an affiliate of a member firm could provide compensation for training and education programs under the provisions of (1)(5)(C) of Rule 2830, as

well as under the provisions of (1)(5)(D). Proposed paragraph (1)(5)(C), as interpreted by NASD Regulation, would permit an issuer that is an affiliate of a member firm to provide payment or reimbursement for a training and education meeting held by the member, as long as the five conditions under (1)(5)(C) are satisfied. Proposed paragraph (1)(5)(D), as interpreted by NASD Regulation, does not address training and education meetings.

Finally, the SIA requested clarification that condition (v) of provision (1)(5)(C), which specifies that payment or reimbursement by an offeror for a permissible training and education program cannot be preconditioned by the offeror on the achievement of a sales target, does not preclude payment by an offeror to a training or education program aimed at the member's top producers during a given time period, or payment by a fund to a training or education program aimed at the member's top producers.

As explained in Amendment No. 4 to the proposal, condition (ii) of subparagraph (h)(4)(C) of Rule 2820 and (1)(5)(C) of Rule 2830 states that attendance by the member's associated persons at a training and education meeting must, among other things, not be preconditioned on the achievement of a sales target. In connection with this condition, NASD Regulation stated in the proposed rule and reiterated in response to comment letters, that the condition is not, however, intended to prevent a member from designating persons to attend a meeting 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.

Consistent with this reasoning, as explained by NASD Regulation, condition (v) of Paragraph (1)(5)(C) would not prevent payment of reimbursement by an offeror for a training or education program aimed at the member's top producers during a given time period, or payment by a fund to a training or education program aimed at the member's top producers, so long as payment 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 preconditioned on achieving a sales target.

IV. Conclusion

After carefully considering all comments received and the NASD's

response to comments, the Commission has determined that the proposed rule change should be approved. The Commission believes that the amendment is responsive to commenters' concerns. Indeed, in its consideration of the views and opinions expressed by commenters and the NASD's response, the Commission is of the opinion that the NASD proposal, as amended, complies with the requirements of the statute. Although further steps could be taken, and the NASD is considering future action regarding cash compensation arrangements, the Commission believes that the measured steps taken in the proposal are consistent with the Act.

While some commenters urged that NASD Regulation defer action on the proposal until it addresses the issue of cash compensation, the NASD has taken considerable steps over the past decade to address concerns raised by non-cash compensation arrangements, and, accordingly, the Commission believes it is appropriate for the NASD to address non-cash compensation arrangements at this time, while continuing to consider the most appropriate regulatory approach to cash compensation arrangements made in connection with mutual fund and variable contract sales.

The Commission expects that future proposals by NASD Regulation to address the issue of cash compensation will be consistent with the prospectus disclosure principles that the Commission set forth in amended Form N-1A. These principles include a focus on information central to investment decisions and avoidance of detailed highly technical disclosure that discourages investors from reading the prospectus or obscures essential information about an investment in a fund.¹² In the release adopting amendments to Form N-1A, the commission noted its belief that if its fund disclosure initiative are to have their intended effect, all parties involved in the disclosure process—funds, their legal counsels and other advisors, the Commission and its staff, and other regulators and their staff—should act consistently with the basic disclosure principles that serve as the cornerstone of the initiative.

The Commission believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹³ which require in pertinent part that the Association adopt and amend its rules to promote just and

¹² See Investment Company Act Release No. 23064 (March 13, 1998), 63 FR 13916 (March 23, 1998).

¹³ 15 U.S.C. 78o-3.

equitable principles of trade, prevent fraudulent and manipulative acts and practices, and generally provide for the protection of investors and the public interest. Specifically, the proposed rule change is designed to reduce point-of-sale impact of non-cash sales incentives that may compromise the duty of registered representatives to match the investment needs of customers with the most appropriate investment product. The Commission believes the proposal appropriately recognizes that the interest of those giving investment advice and those seeking investment advice can diverge where non-cash compensation exists as an incentive to sell specific investment products.

Accordingly, the proposed rule change is designed to limit compensation arrangements that may threaten the mutuality and harmony of interest between firms, their representatives, and the investing public. To that end, the proposal addresses direct and perceived conflicts of interest stemming from non-cash compensation arrangements, such as contests offering lavish trips and expensive prizes and gifts for the sale of investment company and variable contract securities. Investor confidence in the operation of the securities markets is in turn bolstered as a consequence of the removal of such conflicts of interest.

The proposal facilitates, moreover, the ability of NASD members to execute compliance and supervisory responsibilities by restricting the potential for third-party non-cash incentives to undermine the supervisory control of an NASD member with respect to its associated persons. An NASD member is thus assisted in its efforts to create unbiased compensation plans that are arranged with the approval of, and administered and recorded by, the member firm. The Commission believes greater supervisory and compliance control of compensation structures of associated persons will enhance the ability of NASD members to implement policies and procedures to ensure that registered representative compensation structures align the interests of the firm, the registered representative, and the investor.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that File No. SR-NASD-97-35 be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40213; File No. SR-NASD-98-36]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change and Amendment 1 Thereto Relating to At-Large Industry Members of the National Adjudicatory Council

July 15, 1998.

I. Introduction

On May 12, 1998, the National Association of Securities Dealers, Inc., ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder² to amend the By-Laws of NASD Regulation, Inc. ("NASD Regulation") to permit one or more Industry members of the National Adjudicatory Council ("NAC")³ to serve as at-large Industry members of the NAC. By letter dated May 19, 1998, the Association filed Amendment 1 to the proposed rule change.⁴ The proposed rule change and Amendment 1 were published for comment in the **Federal Register** on June 11, 1998.⁵ No comments were received. This order approves the proposal.

II. Description of the Proposal

Currently, the NASD Regulation By-Laws authorize the NASD Regulation Board to appoint a NAC of 12 to 14

¹ 15 U.S.C. 78s(b)(1) (1994).

² 17 CFR 240.19b-4 (1997).

³ The functions of the NAC include hearing appeals and conducting reviews of disciplinary proceedings, statutory disqualification proceedings, and membership proceedings; reviewing offers of settlement; reviewing exemptions granted or denied by staff; and making recommendations to the Board on policy and rule changes relating to securities business and sales practices and enforcement policies, including policies with respect to fines and other sanctions. See Article V, Section 5.1 of the NASD Regulation By-Laws.

⁴ See Letter from T. Grant Callery, General Counsel, NASD, to Katherine England, Assistant Director, SEC, dated May 19, 1998. Several additional non-substantive textual changes were also provided by telephone call on June 2, 1998. Telephone call between Alden Adkins, General Counsel, NASD Regulation, and Mandy Cohen, Attorney, SEC.

⁵ Securities Exchange Act Release No. 40062 (June 3, 1998), 63 FR 32033.

members, and require that the number of Non-Industry members equal or exceed the number of Industry members.⁶ Thus, the NAC generally will consist of six or seven Industry members, depending on the size of the Board. The By-Laws also require that beginning in 1999 and thereafter, all Industry members represent a geographic region.⁷ Industry members must be nominated by a Regional Nominating Committee and may be challenged for the nomination.⁸ The Regional Nominating Committees then nominate their candidates to the National Nominating Committee, which makes the final determination as to the nominees who are presented to the NASD Regulation Board for appointment to the NAC.⁹

The proposed rule change would permit the Board to designate up to two NAC Industry members who would not be subject to the regional nominating process; instead, these members would be designated as at-large Industry members of the NAC. The number of at-large Industry members could vary from year-to-year depending on the total number of Industry seats on the NAC and the number of regions selected by the Board. For example, if the Board determined that there should be a 12- or 13-member NAC (which would include six Industry seats) and five regions, then the Board could designate one at-large Industry member. If the Board determined that there should be a 14-member NAC (which would include seven Industry seats) and five regions, then there could be two at-large Industry members. If the number of Industry seats and the number of regions were equal, then there would be no at-large Industry seats that year. Thus, given the limitation on the size of the NAC and the number of Industry seats, the proposed rule change would allow zero, one, or two at-large Industry members in any given year.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of Section 15A(b)(6) of the Act,¹⁰ which provides, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in

⁶ Article V, Section 5.2 of the NASD Regulation By-Laws.

⁷ *Id.*

⁸ Article VI of the NASD Regulation By-Laws.

⁹ Article VII, Section 9 of the NASD By-Laws; Article VI, Section 6.25 of the NASD Regulation By-Laws.

¹⁰ 15 U.S.C. 78(b)(6).

¹⁴ 17 CFR 200.30-3(a)(12).