

January 26, 2001

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-00-38 - Application of Rules of the Association and Interpretive Materials thereunder to Certain Exempted Securities; Response to Comments

Dear Ms. England:

NASD Regulation, Inc. (“NASD Regulation”) hereby responds to the comment letters received by the Securities and Exchange Commission (“Commission” or “SEC”) in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-00-38, regarding the application of the NASD rules and interpretive materials to certain exempted securities.¹

SR-NASD-00-38 represents a technical amendment to NASD rules, essentially codifying in proposed Rule 0116 the long-standing application of NASD rules to exempted securities, except municipal securities, pursuant to the authority provided under the Government Securities Act Amendments of 1993 (“GSAA”).² Among the NASD rules that apply to exempted securities is Rule 2820(g), concerning non-cash compensation.

NASD Regulation requested accelerated approval of the proposed rule change pursuant to Section 19(b)(2) of the Securities Exchange Act of 1934 (the “Exchange Act”). However, the Commission received two letters, both from trade organizations, opposing the granting of accelerated approval, and requesting the SEC to provide a public comment period.³ The Commission published the

¹ Exchange Act Release No. 43370, File No. SR-NASD-00-38 (September 27, 2000), 65 Fed. Reg. 59240 (October 4, 2000). The public comment period announced in the *Federal Register* expired on October 19, 2000.

² Government Securities Act Amendments of 1993, Pub. L. No. 103-202, § 1(a), 107 Stat. 2344 (1993).

³ See letter from Carl B. Wilkerson, Chief Counsel, Securities, American Council of Life Insurers (“ACLI”), to Jonathan G. Katz, Secretary, Commission, dated August 4, 2000; and letter from David A. Winston, Vice President, Government Affairs, National Association of Insurance and Financial Advisors (“NAIFA”), to Jonathan G. Katz, Secretary, Commission, dated August 30, 2000.

proposal in the *Federal Register* and received two comment letters, both of which opposed the proposal.⁴ The comment letters regarding SR-NASD-00-38 are summarized by issue below.

Questions Concerning NASD Regulation's Authority to Apply its Rules to Group Variable Contracts

The definition of exempted securities, as provided in Section 3(a)(12) of the Exchange Act, includes group variable contracts. Nevertheless, commenters argue that the NASD lacks authority under the GSAA to apply its rules to group variable contracts, and that the application of NASD rules in this instance contravenes the limitations Congress created for self-regulatory organization ("SRO") rules when it amended Section 15A(b)(2), 15A(b)(6), 19(b) and 19(c) of the Exchange Act. According to commenters, the GSAA authorized the NASD to apply its rules to transactions in government securities only, which also are included within the definition of "exempted securities" under Section 3(a)(12) of the Exchange Act.

In asserting that *no* NASD rule should apply to group variable contracts, commenters attempt to re-open an issue that Congress settled in 1993 and question the NASD's exercise of its authority as previously approved by the SEC in 1996. This assertion by the commenters is not germane to the technical amendments represented by the proposed rule change. Nevertheless, we will respond again to it.

The GSAA amended Section 15A(f) of the Exchange Act to permit the application of rules of registered securities associations to all exempted securities, other than municipal securities. Subsequent to the enactment of the GSAA amendments, NASD Regulation filed proposed amendments with the SEC to implement this expanded sales-practice authority. The SEC requested public comment on the proposed amendments and approved them on August 20, 1996.⁵ NASD Regulation announced the SEC's approval in NASD Notice to Members 96-66 (October 1996).

Congress specifically excluded municipal securities from this grant of authority to the NASD. Congress, however, did not see fit to exclude group variable contracts. The assertion that group variable contracts are somehow unique because Congress *implicitly* excluded them, has no basis in the statute, in the legislative history, or in the SEC's adoption of the NASD's new rules four years ago. As the Commission concluded at that time, the NASD's proposal to impose its rules on "transactions in

⁴ See letter from Carl B. Wilkerson, Chief Counsel, Securities, ACLI, to Jonathan G. Katz, Secretary, Commission, dated October 17, 2000; and letter from David A. Winston, Vice President, Government Affairs, NAIFA, to Jonathan G. Katz, Secretary, Commission, dated November 13, 2000.

⁵ See Exchange Act Release No. 37588, File No. SR-NASD-95-39 (Aug. 20, 1996), 61 Fed. Reg. 44100 (August 27, 1996) ("Approving Release").

exempted securities other than municipals . . . is consistent with the purposes of the Act and the GSAA.’⁶

Proposed Rule Change is Anti-Competitive and Unnecessary

Commenters assert that the multiple, unnecessary layering of regulation caused by proposed Rule 0116 and the codification of Notice to Members 97-27 (May 1997)⁷ creates an anti-competitive burden contrary to the provisions of Sections 15(A)(b)(2), 15(A)(b)(6), 19(b) and 19(c) of the Exchange Act. Commenters further argue that the application of proposed Rule 0116 will reduce product choices for consumers and increase costs in the distribution of group variable contracts by salespersons who are NASD registered representatives, because of the costs associated with compliance with NASD rules. They assert that NASD members will be put at a competitive disadvantage.

In addition, commenters assert that variable contracts marketed and distributed by life insurance companies are not the source of market conduct or sales practice abuses and, therefore, should be free from regulation by the NASD. In this regard, commenters claim that group variable contracts are adequately regulated by other federal and state regulations. According to one commenter, qualified plans are regulated by ERISA, state insurance laws, disclosure standards administered by the Department of Labor, federal crime statutes, and federal sentencing guidelines. This commenter contends that many aspects of these federal and state provisions are analogous to standards embodied in NASD rules and, therefore, regulation by NASD Regulation is unwarranted.

As stated above, proposed Rule 0116 simply is codifying authority that was previously granted to NASD Regulation by the SEC in 1996 and is not proposing that the NASD’s authority be expanded. Further, application of the NASD’s sales practice rules to group variable contracts is consistent with the application of such rules to other types of exempted securities and will protect investors and promote the integrity of markets generally. Sales of group variable contracts raise similar investor protection issues as sales of other types of securities products, such as individual variable annuities, variable life insurance and mutual funds, and NASD rules must apply to sales of these products by NASD members and associated persons.

⁶ Approving Release at 44113.

⁷ Notice to Members 97-27 clarified that the expanded sales practice authority authorized in the Approving Release applies to members and their associated persons who sell or distribute group variable contracts and other securities exempted under the Exchange Act, other than municipal securities.

Moreover, the commenters arguments are contradictory, in that they assert that the application of NASD rules would both impose *new* burdens that are anti-competitive, and standards that are *redundant* of other laws, such as ERISA and state insurance laws. Both obviously cannot be the case. While certain of the federal and/or state regulations may require plan sponsors to act as a fiduciary and for the benefit of plan participants and beneficiaries, the scope, focus and concern of NASD rules differ significantly from these regulatory schemes. For example, NASD rules require registered representatives to perform a thorough suitability analysis when making a recommendation to a customer and require that adequate disclosures be made to customers concerning group variable contracts. NASD rules also restrict certain uses of non-cash compensation where such non-cash compensation can create significant point-of-sale incentives that may compromise the requirement to match the investment needs of the customer with the most appropriate investment product. In addition, members are subject to extensive supervisory requirements and must supervise activities by their registered representatives relating to group variable contracts.

Commenters also state that the application of the NASD's sales practice rules has led the insurance industry to adopt non-uniform practices since 1997. The commenters contend that salespersons of NASD members will face different levels of compensation compared to salespersons outside of the NASD jurisdiction. NASD Regulation does not believe that potentially differing compensation structures is a valid reason not to regulate conduct by NASD members and associated persons.

Rule 2820(g) does not apply to Group Variables Because it was not Specifically Enumerated in Notice To Members 96-66 (October 1996)

Commenters assert that NASD Rule 2820(g) (the "non-cash compensation rule")⁸ was not expressly enumerated in NASD Notice to Members 96-66, which, among other things, sets forth a list of those NASD rules that apply to members' transactions in exempted securities (other than municipal securities). The commenters contend that, because NASD Rule 2820(g) was not specifically included in the 1996 listing of NASD rules applicable to exempted securities, the non-cash compensation rules do not apply to sales of group variables products. In effect, commenters are requesting that the NASD not apply its non-cash compensation rule to sales of group variable products and allow its members to pay and receive these forms of compensation for the sale of group variable annuities, even though such payments are not permissible for sales of individual variable annuity and variable life products.

⁸ Rule 2820(g) limits the manner in which members may pay or accept non-cash compensation in connection with the sale or distribution of variable contracts.

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At the time the NASD identified those NASD rules that would apply to exempted securities (other than municipal securities), Rule 2820(g), the non-cash compensation rule, had not been adopted, and therefore was not listed as one of the provisions applicable to exempted securities. However, since the adoption of Rule 2820(g), NASD Regulation staff consistently has interpreted the provision to apply to group variable contracts.

Separate Contests for Group Variable Products

Commenters argue that, if NASD Rule 2820(g) is applicable to group variable contracts, then separate sales contests should be permitted for both group variable contracts as a whole and for different categories of or types of group variable contracts because of the differences in design, purpose, cost structure, commission payouts and target audience for group variable products. Commenters contend that group variable products are targeted only to Fortune 500 companies and firms have separate sales forces or divisions that specialize in different types of group variable contracts.

NASD Regulation believes that the concerns raised by commenters regarding separate sales contests raises interpretive questions under Rule 2820(g), which would need to be addressed based on a specific factual scenario.

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In conclusion, NASD Regulation believes that proposed Rule 0116 should be adopted to codify the NASD's application of its conduct rules to exempted securities, other than municipal securities. The application of these sales practice rules and regulations is an existing requirement for members and the purpose of this proposed rule change is to codify existing requirements in a specific NASD rule.

If you have any questions, please feel free to contact Stephanie Dumont, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Very truly yours,

Jeffrey S. Holik
Vice President and
Acting General Counsel

cc: Yvonne Fraticelli