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Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, D.C. 20006-1506

RE: NASD Notice to Members 07-12: "Harmonization" of NASD Rule 3010(g) with New York Stock Exchange Standards and Practices

April 6, 2007

Dear Ms. Sweeney:

We greatly appreciate the opportunity to share our views on proposed amendments to NASD Rule 3010(g) in the first "harmonization" of the NYSE rules with NASD rules. ACLI is a national trade association with 373 members that account for 93 percent of the industry's total assets, 91 percent of life insurance premiums, and 95 percent of annuity considerations.

Many of our member companies offer and distribute variable annuities through affiliated and independent broker-dealers. Over 50% of the NASD's 659,202 registered representatives work for broker-dealers affiliated with life insurance companies. The initiative would have a significant and negative impact on our industry.

Overview of Proposal

In Notice to Members 07-12, the NASD invited comment on proposed amendments to NASD Rule 3010 (g), which defines the terms "Office of Supervisory Jurisdiction" and "Branch Office" in the NASD supervision rule. The notice explains that the NASD and the New York Stock Exchange (NYSE) "announced a plan to work jointly to harmonize their rulebooks in an effort to eliminate duplicative rules and streamline regulation." The proposed Rule 3010 amendments are the SROs' first endeavor in the harmonization project.

Because the NYSE rules do not contain a definition of OSJ, the NASD would eliminate this definition from NASD Rule 3010. The NASD notes that the amendment will "prevent locations from being classified as branch offices under Rule 3010(g) where the only activity being conducted is principal review and approval of research reports." As part of this endeavor, the NASD has also proposed the creation of several new definitions, including "supervisory branch office," a "limited supervisory branch office," "non-supervisory branch office" and "non-branch office."

The notice indicates that joint NYSE-NASD committees reviewed all the collective NASD and NYSE rules involving sales practices, supervision, financial and operational obligations, registration, qualifications and continuing education requirements to bring the two organizations' rulebooks "into line." The notice explained that the proposal is a "critical step toward ending duplication and reducing regulatory inefficiency." The notice also explains that the NASD and the NYSE announced a plan on November 28, 2006, to consolidate operations into a new organization that will be the single SRO for all broker-dealers. The harmonization project, therefore, will remain a continuing priority for the SROs.

Summary of Position

As a matter of principle, the life insurance industry fully supports streamlined self-regulatory rules, and the elimination of duplicative standards or practices. We strongly recommend that NYSE and NASD rule "harmonization" include all broker-dealers' interests, especially in light of the antitrust challenges inherent in the merger of the NASD and the NYSE.

The rule harmonization process should elicit broad input from all types of broker-dealers. Balanced, equitable rules should take priority over harmonization benefiting a small minority of the SROs' collective members. Rule harmonization should not inflict disproportionate burdens on any segment of the SROs' membership.

As the inaugural rule harmonization, the proposal will set an important conceptual and procedural tone for many future targets of the harmonization project. Unfortunately, the initiative fails in several fundamental respects, and presents a worrisome harbinger of merged NYSE-NASD rules. It will be critical for the NASD to conduct the formidable process of rule harmonization in an even-handed, well-executed manner. The project can, and should, be done correctly.

Statement of Position

Broker-dealers have established compliance procedures, training materials and supervisory responsibilities based on the NASD's definitions of OSJ, and branch office, and non-branch location. While the creation of new definitions of "limited supervisory branch office," and "non-supervisory branch office" may appear simply cosmetic in nature, they will disrupt substantial enterprise-wide compliance procedures, training practices and supervisory responsibilities for broker-dealers affiliated with life insurers. Compliance manuals, office designations and management procedures will face substantial change.

Likewise, the elimination of the OSJ definition will impose significant transitional and logistical burdens. Transformational systems costs will be large under the proposal, especially for firms operating out of numerous, small and geographically dispersed locations. One of our members, for example, distributes its products through 9,000 registered representatives that primarily operate out of one and two person offices. The impact on companies facing these logistics will be immense. Similarly, the definition of branch office was substantially revised in 2005, transforming to a numerical definitional threshold from a longstanding functional threshold. This revised branch office definition consumed extensive resources in adjustment, supervision, training, compliance procedures, and management. The proposed modifications to the branch office definition

so rapidly after its substantial overhaul will inflict substantial unnecessary burdens and expenses. The definitional changes will have an uncharted impact on complying with broker-dealer books and records requirements under the Securities Exchange Act of 1934. None of these issues appear to have been considered in the proposed amendment.

The “harmonization” in Rule 3010(g) principally benefits 200 wire-house broker-dealers within the total NASD population of 5,200 broker-dealers. The 5,000 NASD broker-dealers who are not NYSE members do not face duplicate rule books or disparate SRO rule definitions. Likewise, broker-dealers that are not NYSE members do not typically have locations exclusively limited to supervision and review of research reports. Consequently, the proposed amendment principally benefits a select minority of NASD broker-dealers, and would impose collateral burdens on a vast majority of NASD broker-dealers. That is inexcusable, particularly as the NYSE-NASD merger moves forward.

In any administrative rulemaking, benefits must be carefully balanced against burdens. Competitive and economic impacts should be thoroughly identified and justified. The NASD rule proposal does not appear to have quantified the impact of the rule “harmonization” on the many broker-dealers who will incur substantial systems and compliance costs retrofitting the new categories of broker-dealer offices. We understand that the NASD did not elicit input from substantive committees, such as the independent distributor committee, on the proposal.

The NASD did not appear to have considered or coordinated the impact of the proposed definitional changes on parallel state securities laws and regulations, which could cause multiple, disparate state and federal categories for broker-dealer offices and locations. The proposed amendments will impose significant operational and compliance costs on broker-dealers. Even worse, the proposal provides no benefit to broker-dealers that are not NYSE members. These factors are not properly addressed in the Notice to Members.

NASD Notice to Members 07-12 initially had a nominal comment period of approximately 21 days. Given the importance of harmonized rules in the merged SRO and the absence of any emergency circumstances, such a short comment period is completely unreasonable and would be unlikely to elicit broad, balanced input. The merged SRO should strive to have sufficiently long comment periods of at least 75 days on non-emergency rulemaking.¹

¹ The special time burdens confronting regulated industries and large organizations in digesting regulatory proposals were explicitly recognized by the Administrative Conference of the United States in its publication entitled *A Guide to Federal Agency Rulemaking*, which observes:

The 60-day period established by Executive Order 12044 for significant regulations (and no longer in effect unless adopted by agency rule) is a more reasonable *minimum* time for comment. However a longer time may be required if the agency is seeking information on particular subjects or counter-proposals from regulated industry. *“Interested persons” often are large organizations and they need time to coordinate and approve an organizational response or to authorize expenditure of funds to do the research needed to produce informed comments.* See, *A Guide to Federal Agency Rulemaking* (1983) at 124 (emphasis added). ACLI opposed NASD’s request for automatic approval of SRO rule changes in 2001, and the SEC did not grant the NASD’s request. ACLI’s letter appears at <http://sec.gov/rules/proposed/s70301/wilkers1.htm> .

Missing Competitive and Economic Impact Analysis

The NASD's proposal contains no economic impact statement, and does not quantify the burdens on broker-dealers. These are important considerations in evaluating the initial SRO harmonization project. The merged SROs must provide information on competitive and economic impact so that the SEC can properly execute unequivocal statutory duties to screen SRO initiatives for anticompetitive effect. The SEC cannot create the analysis on its own initiative. It is incumbent on the SRO to fully develop and deliver this information, as explained below.

When it amended the Exchange Act in 1975, Congress specifically charged the SEC with the responsibility to evaluate competitive burdens of SRO rules and rule changes. The Senate report on the legislation stated that:

Sections 6(b)(8), 19(b) and 19(c) of the Exchange Act would *obligate* the Commission to review existing and proposed rules of the self-regulatory organizations and to abrogate any present rule, or to disapprove any proposed rule, having the effect of a competitive restraint it finds to be neither necessary nor appropriate in furtherance of a legitimate regulatory objective.²

Section 23(a) of the Exchange Act was also added in 1975, and requires the SEC to consider the anti-competitive effects of rule changes, and to balance any impact against the regulatory benefit to be obtained.³ Similarly, Sections 15A(b)(6) and (9) of the 1934 Act require the SEC to evaluate carefully the competitive impact of proposed SRO rules and amendments.

The Securities Act Amendments of 1975 significantly expanded the SEC's oversight and regulatory powers concerning SRO rules, and specifically directed the SEC to carefully evaluate competitive factors in exercising its SRO oversight. Importantly, Congress did not intend to confer general antitrust immunity on SRO rulemaking that was subject to the SEC's oversight review.⁴

The antitrust immunity created by Congress contemplates active oversight by the SEC in executing its responsibilities to ensure consistency with the securities laws, and to blunt the anticompetitive behavior inherent in self-regulatory conduct. Otherwise, a Congressional grant of substantial regulatory authority to private organizations without

²S. Rep. 94, 94th Cong., 1st Sess. (April 14, 1975) at 12.

³*Id.* at 12.

⁴See, Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. Rev. 475 (1984) at 504 [the SEC has an obligation in reviewing SRO conduct to "weigh the competitive impact in reaching regulatory conclusions"]. See also Linden, *A Reconciliation of Antitrust Law with Securities Regulation: the Judicial Approach*, 45 GEO. Wash. L. Rev (1977); Johnson, *Application of Antitrust Laws to the Securities Industry*, 20 SW. L.J. (1966); Note, *The Application of Antitrust Laws to the Securities Industry*, 10 WM. & Mary L. Rev. (1968).

federal regulatory oversight would violate the constitutional prohibition against the delegation of legislative powers.

The antitrust threshold in the 1934 Act is not an optional procedure. The legislative history unequivocally highlighted that thorough review of competitive burdens is mandatory in SRO rulemaking:

This *explicit obligation* to balance, against other regulatory criteria and considerations, the competitive implications of self-regulatory [actions].... The Commission's obligation is to weigh competitive impact in reaching regulatory conclusions.... [and] disapprove any proposed rule, having the effect of a competitive restraint if finds to be neither necessary nor appropriate in furtherance of a legitimate regulatory objective.⁵

In order for SEC review to provide immunity for self-regulatory conduct, the review must be active, and must result in a ruling by the SEC that is judicially reviewable.⁶ Section 25 of the 1934 Act states that the SEC's actual findings are conclusive if supported by substantial *evidence*, and that its decisions should be overturned only if "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law, the excess of statutory jurisdiction, authority, or limitations, or short of statutory right, or without observance of procedures required by law." The proposed rule amendments fail the statutory safeguards to competition set forth above.

The SEC Chairman and several SEC Commissioners recently reemphasized the critical importance of identifying and addressing the costs and benefits of rulemaking.⁷ The SEC Chairman has directed the SEC's "General Counsel's Office to carry out a 'top-to-bottom' review of our process for assessing the economic ramifications of our rulemakings."⁸ The NASD should strive for nothing less.

In a different context, former SEC Chairman Levitt emphasized the importance of reviewing the impact of rulemaking on competition when he stated:

In response to the National Securities Markets Improvement Act of 1996 (NSMIA), the Commission has rededicated itself to considering how rules affect

⁵ S. Rep. 94, 94th Cong., 1st Sess. (April 14, 1975) at 13 [emphasis added]. Congress noted that SROs are "quasi-public organizations, not private clubs." *Id* at 29. Accord, 121 Cong. Rec. 10728, 10756 (Apr. 17, 1975)

⁶ See note 4 *supra*.

⁷ See, speeches by SEC Chairman Cox and Commissioners Atkins, Casey, and Nazareth at the PLI SEC Speaks Conference (Feb. 9, 2007) that can be found, respectively at <http://www.sec.gov/news/speech/2007/spch020907cc.htm>, <http://www.sec.gov/news/speech/2007/spch020907psa.htm>, <http://www.sec.gov/news/speech/2007/spch020907klc.htm>, and <http://www.sec.gov/news/speech/2007/spch020907aln.htm> .

⁸ See comments of Commissioner Atkins at <http://www.sec.gov/news/speech/2007/spch020907psa.htm> .

competition, efficiency, and capital formation as part of its public interest determination. Accordingly, the Commission intends to focus increased attention on these issues when it considers rulemaking initiatives. In addition, the Commission measures the benefits of proposed rules against possible anti-competitive effects, as *required* by the Exchange Act.⁹

Conclusion

The inaugural NYSE-NASD rule harmonization is regrettably deficient. The need for the amendment has not been properly justified. The rule's economic and competitive impact has not been quantified. The NASD's substantive committees were not involved in the rule's development. The burdens of the rule were not balanced against its benefits. Notwithstanding the NASD's earnest statements¹⁰ that the interests of *all* broker-dealers would be fairly represented in the merged SRO, the first "critical step" in "ending duplication and reducing regulatory inefficiency" stumbled in favor of a select group to the detriment of a much larger group of broker-dealers.

Anticompetitive consequences in the merged NYSE-NASD do not appear to have been considered in the initiative. The proposed amendments provide benefit to NYSE broker-dealers only, while imposing significant operational and compliance costs on broker-dealers that are not NYSE members. This is an inadequate foundation for rulemaking governing broker-dealers competing under different business models and in different markets. The amendments to Rule 3010(g) should be frozen until these matters are fully addressed.

Substantive rulemaking demands careful scrutiny and compelling justification. Without meaningful analysis of competitive and economic impact, SRO rulemaking fails the explicit Congressional mandate to weigh the anticompetitive effects of rule changes, and to balance any impact against the regulatory benefit to be obtained. Complacent practices do not provide sufficient rigor to protect against anticompetitive SRO behavior. Insufficient balancing of burdens and benefits has been a concern of life insurers in past NASD rulemaking.¹¹

⁹ See testimony of Arthur Levitt, SEC Chairman, concerning appropriations for fiscal year 1998 before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the House Committee on Appropriations (Mar 14, 1997), which appears at <http://www.sec.gov/news/testimony/testarchive/1997/tsty0497.txt>

¹⁰ See comments of NASD CEO Mary Shapiro before SEC on a consolidated NYSE and NASD (Nov. 28, 2006) at http://www.nasd.com/PressRoom/SpeechesTestimony/MaryL.Schapiro/NASDW_017978 [Consolidation of the SROs "will mean adopting a uniform set of rules *flexible enough to accommodate the different business models and sizes of firms that exist within the industry*" [emphasis added].

¹¹ Two examples, among others, illuminate our concern. The NASD recently implemented a rule amendment to (i) establish an annual "branch office processing fee" and (ii) waive the branch office registration fee for one office per NASD member per year. NASD asserted in its filing with the SEC that the rule change "will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act." Nothing in the NASD filing elaborated on the competitive burdens that would occur under the rule. The modifications had a profoundly disproportionate impact on broker-dealers affiliated with life insurers and burdened competition among broker-dealers.

In 2005, the NASD substantially overhauled the definition of the term "branch office" in Rule 3110, which was revised from a functional definition based on activities at the branch office to a numerical definition based solely on the number of salespersons in the office. As a result of the new branch office definition, many offices previously operating as non-branch locations were transformed into branch offices. For the life

NASD Chairman and CEO Mary Shapiro stated on March 26, 2007, that the NYSE-NASD consolidation will “reduce regulatory costs for *all* firms.”¹² Ms. Shapiro further noted that “when the new organization is in place and fully integrated, there will be a single set of rules adapted to firms of *all* sizes and business models.”¹³ Unfortunately, the proposed amendments to Rule 3010 (g) failed the noble aspirations of reduced regulatory costs for *all* through rules respecting broker-dealers of *all* sizes and business models. Ms. Shapiro also extolled a new NASD pilot program to analyze the impact of

insurance industry, thousands of locations were reclassified as branch offices. The impact on full service broker-dealers was insignificant because these groups historically operate out of large branch offices compared to the numerous one or two person locations common in the life insurance industry.

Quite simply, broker-dealers affiliated with life insurers are unique from full-service broker-dealers in operation and structure. As a result of these differences, the NASD's fee request imposed a significant and disproportionate economic and competitive burden on these broker-dealers that was neither discussed nor justified. Incidentally, the definitional rule change generated substantial new and recurrent revenue for NASD. Although the life insurance industry raised substantial concerns about the rule's anticompetitive burdens and revenues throughout the rulemaking, the NASD did not provide any competitive or economic impact statements regarding the initiatives. The NASD did not quantify how many offices would be affected by the change, estimate the burden of transformation, or discuss the new revenue that would inure to the NASD under the revised definition.

A copy of ACLI's comments on the branch office definition and its impact on the insurance industry can be found at <http://www.sec.gov/comments/sr-nasd-2006-065/nasd2006065-1.pdf> . ACLI has consistently brought its concerns to the SEC regarding anticompetitive NASD rule initiatives. See, e.g., <http://www.sec.gov/rules/proposed/s70301/wilkers1.htm> .

A second example occurs in NASD NTM 97-2, an interpretation applying its conduct rules to a registered representative's sale of *unregistered* variable life insurance or variable annuity contracts to qualified retirement plans. This interpretation conflicted with Congressional intent in the Government Securities Act Amendments of 1993, and was not approved by the SEC when it authorized expanded NASD sales practice authority over exempted government securities, as defined in Section 3(a)(12) of the 1934 Act. The limited expansion of authority was noticed for comment in NTM 94-62, and the SEC's approval was published in NTM 96-86. The SEC only approved authority to regulate the sale of unregistered *government* securities, not other categories of exempt securities. Nonetheless, the NASD asserted jurisdiction and applied its position in broker-dealer inspections and interpretive letters.

In 2002, the NASD subsequently sought to obtain SEC approval for its governance over these unregistered group variable life and annuity contracts in a Form 19b-4 petition for Approval of Proposed Rule Change applying NASD Conduct Rules to the Sale of Unregistered Securities. See File No. SR-NASD-00-38, Rel. No. 34-43370. ACLI filed an extensive letter of comment with the SEC on this action outlining the initiative's burden on competition and the NASD's lack of authority under the Government Securities Act Amendments of 1993 (GSAA). The legislative history under the GSAA specifically and exclusively referenced NASD jurisdiction over broker-dealer sales of unregistered government securities. It did not, however, make any reference to authority over unregistered variable contracts.

The life insurance industry commented extensively on the NASD's unauthorized expansion of jurisdiction and discussed the unwarranted and inequitable competitive burdens the action imposed. The NASD offered no analysis of competitive or economic impact in its filing on the matter. Like the branch office registration proposal, the SEC approved the NASD's request absent substantive information on competitive burdens. Like the branch office definitional change, the NASD's jurisdiction over unregistered variable contracts generated substantial new and recurrent revenue for NASD through enlarged FOCUS reports, and allowed broker-dealers to obtain a commission haircut on products not required to be registered as securities.

¹² SFFMA Compliance & Legal Division's 38th Annual Seminar, Phoenix AZ (Mar. 26, 2007), which can be found at http://www.nasd.com/PressRoom/SpeechesTestimony/MaryL.Schapiro/NASDW_018865 [emphasis added].

¹³ *Id.* [emphasis added].

NASD rules through a cost-benefit approach.¹⁴ As noted above, the life insurance industry strongly endorses a deliberative cost-benefit approach to NASD rulemaking. Such metrics would fulfill the unequivocal statutory responsibility to carefully evaluate the economic and competitive impact of SRO rules in the 1934 Act that protect against inherently anticompetitive conduct. Regrettably, the proposed amendments to Rule 3010 (g) do not implement the commendable cost-benefit aspirations advocated by Ms. Shapiro.

Fortunately, however, the rule harmonization process can be righted with a disciplined and balanced process that is inclusive of all broker-dealers' interests. As the first rule harmonization, the proposal can serve a critical role in establishing a rigorous, non-negotiable process for merged NYSE-NASD rulebooks that protects essential economic and competitive fundamentals. The merged SRO should serve fairly the interests of *all* 5,200 broker-dealers in the NASD membership, not just the 200 wire-house firms of the NYSE.

To ensure regulatory fairness respecting broker-dealers of *all* sizes and business models, we strongly recommend the following standards in every SRO rulemaking and harmonization:

- Early in every regulatory initiative, elicit the input of a balanced and fully representative delegation of the SROs' membership before a proposal crystallizes;
- Thoroughly quantify the regulatory need for all proposed rules and amendments;¹⁵
- Thoroughly quantify the economic and competitive impact of every regulatory action on broker-dealers of all types;
- Thoroughly explain the impact of new rulemaking on direct and indirect revenue for the SRO;
- Carefully balance the quantified regulatory need against the economic and competitive impact of all rules or amendments;
- In Notices to Members inviting comment, explain the purpose and rationale of proposed rule changes in a detailed and thorough fashion, similar to SEC releases on administrative rulemaking;
- Provide substantial comment periods of at least 75 days in all rule initiatives to elicit meaningful feedback, and avoid short comment periods or comment periods wrapped around holiday periods in all but emergency administrative actions;
- In Notices to Members inviting comment and in filings for SEC approval of SRO rulemaking, discuss in detail the competitive and economic impact of proposed actions on *all* broker-dealers and product categories;
- In filings for SEC approval of SRO rulemaking, provide detailed analysis and response to all comments filed with the NASD on the initiative; and,

¹⁴ *Id.*

¹⁵ To quantify regulatory need in a transparent and statistically significant manner, the NASD should immediately develop a comprehensive data base of disciplinary and enforcement actions classified according to violations over at least a five-year time period. The NASD currently does not have a data base of this nature, even though the source information is generated by the NASD. The construction of such a data base would complement the NASD's aspirations to operate a combined SRO that fairly treats broker-dealers of all sizes and business models based on meaningful cost-benefit techniques.

- Carefully limit administrative actions to areas over which the merged SRO has clear jurisdiction, and scrupulously avoid matters beyond the merged SRO's authority, such as attempting to define what is or is not a security.

To fully effectuate the antitrust laws, it will be incumbent on the merged NYSE-NASD SRO to execute rulemaking in the manner outlined above so that the SRO operates in a balanced manner reflecting the diverse universe of broker-dealers and the securities they distribute. The merged SRO should establish standardized procedures for the promulgation of all rules and rule amendments. We would be happy to work with the new SRO to develop uniform standards for administrative rulemaking. In the early stages of the merged SRO's existence, it will be critical to proceed in a deliberative fashion that is fair, equitable, and balanced.

We appreciate the opportunity to share our views on this important initial harmonization of NYSE and NASD rules. Please let me know if you have any questions, or would like to discuss our position further.

Sincerely,



Carl B. Wilkerson

Cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner