NASD Notice to Members 97-27

Application Of NASD Conduct Rules To Group Variable Contracts And Other Exempted Securities

Suggested Routing

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Executive Summary

On August 20, 1996, the Securities and Exchange Commission (SEC) approved amendments to the NASD® Conduct Rules (Conduct Rules) giving NASD Regulation, Inc. (NASD Regulation℠) expanded sales-practice authority over exempted securities. This *Notice* clarifies that this expanded sales-practice authority permits NASD Regulation to apply the Conduct Rules to members and their registered representatives who sell or distribute group variable contracts and other securities exempted under the Securities Exchange Act of 1934 (Exchange Act), other than municipal securities, and that such securities are now subject to the Conduct Rules.

Discussion

Background

Before enactment by Congress of the Government Securities Act Amendments of 1993 (GSAA),[1] NASD Regulation was statutorily precluded under the Exchange Act from applying the Conduct Rules to transactions in exempted securities as defined in Section 3(a)(12) of the Exchange Act.[2] The GSAA eliminated this statutory limitation, thus permitting NASD Regulation to apply the Conduct Rules to transactions in all exempted securities, except municipal securities.[3] 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. NASD Regulation announced the SEC's approval in *NASD Notice to Members 96-66* (NTM 96-66). The amendments announced in NTM 96-66 expanded the authority of NASD Regulation to apply the Conduct Rules to transactions in all exempted securities, except municipal securities.

While the primary focus of these changes was the application of sales-practice rules to government securities (one category of exempted securities under Section 3(a)(12) of the Exchange Act), they also applied to most other exempted securities under Section 3(a)(12), including interests in certain qualified retirement plans that use as funding vehicles variable life insurance and annuity contracts issued and distributed by life insurance companies (Group Variable Contracts).[4] When *NASD Notice to Members 94-62* solicited member comment on the proposed amendments, commenters' responses focused on issues relating solely to government securities. Since the publication of NTM 96-66, however, NASD Regulation has received requests regarding whether, and to what extent, the Conduct Rules apply to sales of Group Variable Contracts by NASD members and their associated persons.

This *Notice* clarifies that under the expanded sales-practice authority granted to NASD Regulation pursuant to the GSAA, the Conduct Rules as approved in amended form by the SEC apply to the sale of Group Variable Contracts and other exempted securities (other than municipal securities) by NASD members and their registered representatives.[5]

Group Variable Contracts

Many life insurance companies create variable annuity and life insurance contracts and distribute such products to qualified retirement plans directly, or through broker/dealers. Qualified retirement plans permit plan participants, through employer and/or employee contributions, to accumulate tax-deferred savings paid out upon retirement or termination of employment.

Insurance companies structure variable annuity and life insurance contracts to provide investment options or life insurance benefits for qualified retirement plans, typically at the discretion of the plan participant rather than the employer. The investment options may consist of underlying stock and bond investment portfolios, the values of which fluctuate with the market value of the securities in the portfolio. Through the use of variable life insurance contracts, the insurance company may also provide a death benefit for the contractholder or plan participant. The types of customers who purchase Group Variable Contracts vary from large corporations to small businesses.

NASD Regulation believes that Group Variable Contracts present many of the investor protection concerns presented by other types of securities, and that the Conduct Rules must apply to sales of these products by members and their registered representatives. For example, registered representatives should perform a thorough suitability analysis and should provide adequate disclosure to their customers concerning Group Variable Contracts. In addition, member firms should have the same opportunity to supervise transactions by their registered representatives in Group Variable Contracts. Because of similar investor protection issues, NASD Regulation has long applied its Conduct Rules to sales by members and their registered representatives of individual variable annuities, variable life insurance, and mutual funds. The Conduct Rules apply only to sales of Group Variable Annuity Contracts by NASD members and their registered representatives.

Therefore, NASD members whose registered representatives sell or distribute Group Variable Contracts must review, and amend if necessary, their existing supervisory and compliance systems, policies, and procedures to ensure that sales practices relating to Group Variable Contracts are properly addressed in the member's oversight and regulation of such sales practices. NASD Regulation will include a review for compliance in those areas during its examinations and, to the extent needed, will provide future interpretive guidance on the scope of the application of individual rules.

Questions concerning this *Notice* may be directed to Thomas M. Selman, Director, Advertising/Investment Companies Regulation, NASD Regulation, at (240) 386-4533; or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Endnotes

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

[2] Before enactment of the GSAA, Section 15A(f) of the Exchange Act prevented registered securities associations from exercising authority over transactions by a registered broker or dealer in any exempted security.

[3] Rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.

[4] Section 3(a)(12)(A)(iv) includes as an exempted security "… any security arising out of a contract issued by an insurance company, which...security is issued in connection with a qualified plan as defined in subparagraph (c) of this paragraph."

[5] Other exempted securities under Section 3(a)(12) include: any interest in a single trust fund or a collective trust fund maintained by a bank issued in connection with a qualified plan; any interest in a pooled income fund, collective trust or investment fund that is excluded from the definition of an investment company under the Investment Company Act of 1940; and any interest in a church plan or account that is excluded from the definition of an investment company under the Investment Company Act of 1940. The Conduct Rules would apply to the sale of such securities by NASD members and their registered representatives.