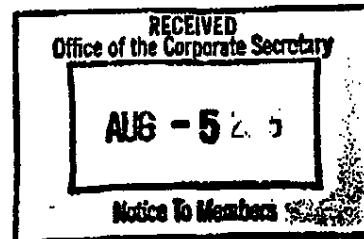


Office of the General Counsel



August 4, 2005

VIA AIRBORNE OVERNIGHT
Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, D.C. 20006-1500

Re: Notice to Members No. 05-40

Dear Ms. Sweeney:

Massachusetts Mutual Life Insurance Company ("MassMutual") and its wholly-owned broker-dealer subsidiary, MML Investors Services, Inc. ("MMLIST"), are pleased to have this opportunity to comment on the proposals set forth in NASD Notice to Members 05-40 (the "Proposal").

SUMMARY

- We support expanding the current non-cash compensation requirements to all securities products.
- We support prohibiting all product-specific cash and non-cash sales contests with respect to securities products that do not have an insurance component. We do not, however, support prohibiting all such contests with respect to securities products that have an insurance component such as variable life insurance products and variable annuities.
- The proposed language of new rule 2311 appears to have been imprecisely drafted. As such, the Proposal would inappropriately eliminate the flexibility that members that are wholly-owned by insurance companies currently have under NASD rules to participate in sales contests sponsored by their parent insurance companies. It would also place unprecedented limitations on members' internal non-cash compensation arrangements other than sales contests. Since neither of these issues was discussed in the text of NTM 05-40, we believe these results are unintended. Nonetheless, the language of new rule 2311 must be re-drafted (and submitted for member comment) to ensure that such tremendously disruptive and unanticipated impacts on members are prevented.

The Intent of the Proposal. NTM 05-40 articulates two goals: (1) extending the NASD's current non-cash compensation requirements to the sale and distribution of all securities, and (2) prohibiting all product-specific cash and non-cash sales contests. Our views on each of these items are as follows.

- ***Extending the current non-cash compensation requirements to the sale and distribution of all securities.*** We support extending the current non-cash compensation requirements to the sale and distribution of all securities. Since the current non-cash compensation rules apply to a wide spectrum of securities products including investment company securities, REITs, direct participation programs, and variable insurance products, we see no reason why the rules should not be extended to all other securities products. The same regulatory concerns that motivated the adoption of the non-cash compensation rules for the above-mentioned products would appear to exist with respect to all other securities products. As such, this aspect of the Proposal would eliminate a noticeable gap in the NASD's current regulatory structure.
- ***Prohibiting all product-specific cash and non-cash sales contests.*** We support those aspects of the Proposal that would prohibit all product-specific cash and non-cash sales contests but only insofar as such a ban would apply to securities products that lack an insurance component. Securities that have an insurance component (such as variable life insurance and variable annuities) should not be encompassed within the scope of this prohibition. Subjecting variable insurance products and traditional investment products to the same set of sales contest restrictions would not only be a classic case of "mixing apples and oranges" but would also place variable insurance products at a serious competitive disadvantage.

Although they share a common characteristic of being securities, traditional investment products and variable insurance products are designed to address fundamentally different consumer needs. Variable life insurance and variable annuity products are designed primarily to satisfy consumers' needs for insurance protection. In the case of variable life insurance, the risk being addressed is the risk of a person dying too soon.¹ Variable annuities address the risk of a person living too long.²

¹ "Variable life insurance is designed for individuals with an actual need for life insurance coverage." *Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June, 2004) (herein the "Joint Report")*.

² "Although variable annuities offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds: (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that can provide guaranteed income for life." *NASD Notice to Members 99-35*.

Traditional investment products, on the other hand, have no insurance components and are designed to satisfy consumers' needs for growth or protection of, or income from, their financial assets. Given the different audiences to which these products are marketed, and the different risks which these products address, sales contests involving these products can, and should, be treated differently. In proposing that these two distinct product classes be treated the same, the Proposal appears to be based on the unfounded assumption that every client is, at the beginning of a sales presentation, equally in need of both insurance protection and investment opportunities. The Proposal thus attempts to eliminate incentives that could lead a salesperson to steer a client to purchase an unsuitable product.

Reputable registered representatives will, however, through their needs analysis processes and in satisfying their suitability obligations, determine as an initial threshold matter whether their clients need insurance protection or investment solutions and then present them with appropriate recommendations. A person needing insurance protection should not be offered a mutual fund, and a person interested solely in investment alternatives should not be offered a variable life insurance policy. The consumer's personal financial situation will dictate whether their needs can be addressed through insurance or investments.

The NASD has itself repeatedly noted the differences between variable insurance products and traditional investments.

- Communication about variable products "should not mislead the investor by obscuring or diminishing the importance of the life insurance features of the product, or by overemphasizing the investment aspects of the policy or potential performance of the subaccounts." *Joint Report at 17-18.*
- "Specific factors that could be considered under the NASD's suitability rule include: (1) a representation by a customer that his or her life insurance needs were already met; (2) the customer's express preference for an investment other than an insurance product; (3) the customer's inability to fully appreciate how much of the purchase payment or premium is allocated to cover insurance or other costs." *Notice to Members 96-86.*
- Stating that "variable life policies were not insurance but were an investment, savings, or retirement plan" was a misrepresentation actionable under NASD rules. *Notice to Members 00-44.*
- "The member should consider whether the customer desires and needs life insurance and whether the customer can afford the premiums likely needed to keep the policy in force." *NASD Notice to Members 00-44.*

Subjecting both insurance and investment products to identical sales contest bans fails to take into account the inherent differences between these product categories.³

The need for excluding variable insurance products from the scope of any ban on sales contests is even more evident when one considers the competitive marketplace in which variable insurance products are sold. Variable insurance products compete in the marketplace primarily with other insurance products such as fixed annuities, whole life insurance and term insurance. Since these other insurance products are not securities, they are not subject to NASD regulation and would not be subject to any NASD-mandated ban on sales contests.

In the highly incentive-based insurance profession, insurance companies often use contests and other sales incentive programs to encourage sales of insurance products.⁴ Under current rules, insurance companies are able to create incentive programs for both traditional and variable products.⁵ This enables insurers to create a level playing field for all insurance products sold through their wholly-owned broker-dealers. If the Proposal is adopted, however, insurers will no longer be able to create product-specific incentive programs for their variable life and variable annuity products. At the same time though, sales contests and other non-cash compensation programs involving whole life, fixed annuities and other non-registered products will continue.

The end result of this imbalance in the retail insurance marketplace will be a serious tilting in favor of non-SEC registered insurance products. Variable insurance products will be placed at a serious competitive disadvantage since they will no longer be able to be included in insurers' incentive programs (unless the affiliated broker-dealer included the full spectrum of its non-insurance products in the program). The omission of incentives for variable products will work to the detriment of consumers by limiting their insurance options since registered representatives would be less likely to present variable insurance products not included in an insurers' contests.⁶

³ We have no objection to a sales contest ban for securities products that have no insurance components.

⁴ Life insurance is sold, not bought. Sales incentive programs have been, and continue to be, cornerstones of the insurance sales process.

⁵ Contests involving variable products must, of course, satisfy the "equal crediting", "equal weighting" and other requirements of Conduct Rule 2820.

⁶ We expect that insurance-affiliated broker-dealers would not attempt to "level the playing field" by offering sales contests involving all of the firm's securities products (both traditional securities and variable products) primarily because this type of program would cause an unacceptable loss of focus on insurance products as well as generate increased costs.

We believe that the Proposal is misguided in its attempt to equate variable insurance products with investment products. These products are designed for different purposes, targeted to different audiences and serve different roles in customers' financial affairs. Variable insurance products should be allowed to compete with their natural competitors, fixed insurance products. When it comes to understanding a salesperson's motivations and conflicts, variable products must be evaluated in terms of their innate insurance components, not their ancillary investment characteristics.

The insurance distribution system is working, and has worked, effectively for decades. By banning product-specific sales contests for variable insurance products, the Proposal would be destroying a competitive environment that has served the interests of both insurance consumers and insurance distributors well.

Unintended Consequences of the Proposal. Although NTM 05-40 focuses exclusively on the two issues discussed above, a careful reading of the language of proposed new rule 2311 uncovers the disturbing fact that the Proposal would do far more than implement the articulated two new regulatory requirements. If adopted as currently drafted, new Rule 2311 would not only impose inappropriate restrictions on members' internal non-cash compensation programs (other than sales contests) but also remove a key provision that the insurance industry has relied on for years. We seriously hope that these outcomes are the result of simple drafting errors, and that it was not the intent of the NASD to surreptitiously effect radical changes in well-established and generally accepted non-cash compensation requirements.

The Proposal would create new Conduct Rule 2311 by eliminating the non-cash compensation provisions from the existing rules where they are located and consolidating them in rule 2311. Thus, to evaluate the impact of the Proposal, it is necessary to examine not only the language of the new Rule, but also the language that will remain in the old rules after the non-cash compensation provisions are deleted.

Elimination of Insurance Company Programs. Proposed rule 2311 mysteriously eliminates a key provision that is of crucial importance to members that are affiliated with insurance companies. Both the variable products and investment company non-cash compensation rules currently contain a provision that allows non-cash compensation arrangements between "a non-member company and its sales personnel who are associated persons of an affiliated member", provided that the "equal crediting" and "equal weighting" requirements are satisfied.⁷ This provision was inserted into the rules in recognition of the fact that in the insurance industry it is the parent insurance company,

⁷ See Rule 2820(g)(4)(D) and 2830(1)(5)(D).

not the subsidiary broker-dealer, that sponsors and operates most sales contests.⁸ The NASD has, since the non-cash compensation rules were first adopted, believed that these parent insurance company programs were appropriate as long as they complied with the equal credit and equal weighting requirements.

It is unclear why this provision was dropped from the language of new Rule 2311. There is simply no discussion of this issue in NTM 05-40. We conclude, therefore, that this was a simple drafting error, and that there was no intent to actually take away from insurance-affiliated members their ability to send their associated persons to events sponsored by their parent insurance companies. We would expect that this provision will be re-inserted in the final language of any new rule.

If, however, the disappearance of this provision represents the NASD's actual intent to eliminate this long-standing privilege afforded insurance-affiliated members, then we strongly believe that fundamental due process and fairness necessitates that the NASD articulate its reasoning in a Notice to Members and provide members with an opportunity for comment.

In a similar vein, we oppose the deletion of sections 2820(g)(4)(E) and 2830(l)(5)(E) which currently allow "contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons" under certain circumstances.⁹ Since the Proposal would allow members to continue to conduct sales contests (as long as they included all of the member's securities products), we strongly believe that this provision should be retained. As noted in footnote 8, the special relationship between insurance companies and their wholly-owned broker-dealer subsidiaries generates intertwined compensation issues. These sub-sections thus provide insurance affiliated members with some of the flexibility they need to obtain funding from their parent insurance companies for some of their incentive programs. There is no regulatory reason why such flexibility should be eliminated.

Restriction of internal non-cash compensation arrangements. A second, apparently unintended consequence of the proposed new language of rule 2311 would be that, for the first time, limits would be imposed on firms' internal non-cash compensation awards

⁸ "Particularly in the life insurance industry, non-member insurance companies may hold non-cash sales incentive programs for their sales personnel who are also associated persons of the non-member's affiliated broker-dealer and are licensed to sell both non-securities insurance products and variable contract securities. It is common practice, for example, for a member's parent life insurance company to award "points" for the sale of all insurance products - including securities - toward attendance at the insurance company's annual "leadership conference". Moreover, the exception recognizes that, as a practical matter, an insurance company or investment company affiliated with a broker-dealer is in a position through intra-corporate transfers to contribute to and through its relationship to affect the structure of its affiliated broker-dealer's in-house incentive compensation program." SEC Rel. 34-38993, 62 Fed. Reg. at 47088 (Sept. 5, 1997).

⁹ Unlike its proposed elimination of subsection (D), the NASD did discuss in the NTM its intention to eliminate subsection (E).

which are not based on sales contests. Currently, the non-cash compensation limitations pertaining to gifts, meals, tickets, etc. apply only when an external party attempts to provide these items to a person affiliated with a member.¹⁰ Given the member's ability to supervise and control the awarding of such items to its own personnel, the current non-cash compensation rules were never intended to, and do not, apply to a firm's internal non-cash arrangements with its own personnel.¹¹

Members currently utilize a wide variety of non-cash compensation programs with their associated persons other than sales contests. They may take them out for meals, entertain them, provide them with gifts and prizes, etc. The provision of these items may, in many situations, not be related to any sales-based contest. Unless the language of proposed new 2311 is modified, this long-standing flexibility provided to members and their associated persons will be eliminated, and members would be forced to operate within the substantive restrictions of proposed paragraph 2311(b). Members should not be forced to limit gifts, meals and tickets to their own associated persons in accordance with proposed 2311(b) since the NASD has not historically restricted firms' internal compensation arrangements and there is no valid regulatory purpose for doing so.

Non-cash compensation arrangements that are internal to the employer-employee relationship do not raise the same supervisory concerns that are present in the compensation arrangements between a non-member and the associated persons of unaffiliated broker-dealers selling its products.¹²

Members should be allowed, as they always have been, maximum flexibility in designing compensation programs for their own registered representatives and associated persons. (Note that the mysteriously dropped subsection 2820(g)(4)(D) also expressly allowed "non-cash compensation arrangements between a member and its associated persons"). The NASD has not identified any actual or potential abuses associated with members' current internal non-cash compensation arrangements that are not based on sales contests.

¹⁰ See SEC Rel. 34-38993, 62 Fed. Reg at 47086 (Sept. 5, 1997). "The NASD is proposing to adopt exceptions that would permit an associated person to accept from a person other than his or her employer" the gifts, meals, etc. specified later in the rule.

¹¹ For example, rule 2820(g)(4) provides, in part, that "notwithstanding the provisions of paragraph (g)(1), the following non-cash compensation arrangements are permitted ...". Paragraph (g)(1), in turn, specifically prohibits an associated person of a member from accepting any compensation from anyone other than the member with which the person is associated. This specific reference to paragraph (g)(1) confirms that the current non-cash compensation rules (other than those pertaining to sales contests) do not apply to non-cash compensation arrangements between a member and its own registered representatives.

¹² See SEC Rel. 34-38993, 62 Fed. Reg at 47088 (Sept. 5, 1997).

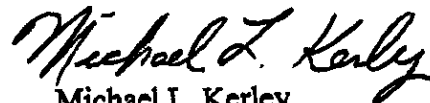
Accordingly, the language of proposed rule 2311 must be amended to preserve these internal non-sales contest arrangements.¹³

Commissions versus contests. A final, unintended consequence of the language of new rule 2311 is possible interference with members' internal compensation programs. Although NTM 04-40 discusses the NASD's intent not to interfere in members' traditional cash compensation programs, further clarity is needed in drawing the line between sales contests and basic compensation programs. For example, if a firm utilizes a tiered, commission schedule for a product (i.e., commissions increase as volume increases) then it is possible that such a schedule could be viewed as a prohibited sales contest. The final rule should, therefore, exclude fixed commission schedules from the definition of sales contest.

CONCLUSION

For the reasons specified above, the Proposal should not be adopted as currently drafted. We welcome the opportunity to discuss our views with the NASD at its convenience.

Sincerely,



Michael L. Kerley
Vice President and Associate
General Counsel

¹³ A suggested solution here would be to insert the phrase "notwithstanding the provisions of Conduct Rules 2820(g)(1) and 2830(1)(1)" immediately before the words "or directly or indirectly" in paragraph (b) of proposed rule 2311.