

August 5, 2005

**VIA E-MAIL**

Ms. Barbara Z. Sweeney  
NASD Office of the Corporate Secretary  
1735 K Street, NW  
Washington, DC 20006-1500

**Re: NASD Notice to Members 05-40  
Proposed Rule 2311 Governing Sales Contests and Non-Cash  
Compensation**

Dear Ms. Sweeney:

On behalf of American Family Securities, LLC (“AmFam Securities”), we respectfully submit this letter of comment regarding proposed NASD Conduct Rule 2311 (the “Proposed Rule”) published for comment by NASD, Inc. (“NASD”) in Notice to Members 05-40 (“NTM 05-40”). AmFam Securities is engaged solely in the sale of variable life insurance policies (“VLI”) and variable annuity contracts (“VA(s)"). While AmFam Securities agrees generally with certain aspects of the Proposed Rule, there are several specific aspects of the Proposed Rule that AmFam Securities believes should be revised or clarified.

**THE PROPOSED RULE**

In NTM 05-40, NASD proposed to eliminate the current non-cash compensation rules, including NASD Conduct Rule 2820(g)(4) which is applicable to variable contracts, and replace them with the Proposed Rule. NASD expressed two over-arching goals with respect to the Proposed Rule: (1) to ban all “sales contests” based on product type; and (2) to expand prohibitions on non-cash compensation to apply to *all* securities, as opposed to only certain types of securities.<sup>1</sup> NASD’s stated rationale for extending the ban on sales contest to all securities is that the same conflicts that underlie sales contests for variable contracts, for example, are also applicable to the sales of other

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<sup>1</sup> Currently, the non-cash compensation provisions only restrict the payment and acceptance of non-cash compensation in connection with the sale of direct participation programs, variable contracts, investment company securities, and public offerings of real estate investment trusts.

securities, such as stocks and bonds. With respect to the ban on all sales contests based on product type, NASD stated that any sales contest that favors one security over another, or that favors one type of security over another, is problematic because it has “the potential to create an incentive to engage in conduct unrelated to the best interests of customers.”<sup>2</sup> Thus, under the Proposed Rule, the only permissible type of “sales contest” would be one that is based on the “total production” of all securities. Furthermore, according to NTM 05-40, the Proposed Rule also would prohibit increased bonuses that are awarded for the sale of specific securities or types of securities within a defined period of time.

Importantly, the Proposed Rule also would eliminate the current non-cash compensation provision which grants non-member companies express authority to conduct non-cash compensation arrangements with “its sales personnel who are associated persons of an affiliated member.”<sup>3</sup> This provision was utilized by our parent company, American Family Mutual Insurance Company, by our affiliate, American Family Life Insurance Company, and also by many other insurance companies issuing variable insurance products through affiliated broker-dealers, to participate in non-cash compensation arrangements in conjunction with their affiliated broker-dealers and in compliance with the specific requirements under Rule 2820(g)(4)(D)(i)-(iv).

## COMMENTS

As described in more detail below, AmFam Securities has three primary comments with respect to the Proposed Rule: (1) NASD should adhere to its previously announced position and permit total production to apply separately to VLI and VA and to permit sales contests to be held separately for VLI and VAs; (2) NASD should clarify that insurance companies affiliated with a broker-dealer can participate in sales contests under Rule 2311 to the same extent as they were permitted under Rule 2820(g)(4)(D); and (3) NASD should clarify that bonuses based on all securities offered by a broker-dealer are permitted and adopt a de minimis exception for product specific bonuses.

### **VLI and VA “Total Production” and “Sales Contests”**

AmFam Securities believes that the requirement to include VLI and VAs in the same sales contest should be reconsidered and rejected and that the total production requirements should apply separately to VLI and VAs. While AmFam Securities understands the general policy behind standardizing the treatment of all securities compensation is to eliminate the ability to influence the behavior of registered representatives to favor the recommendation of one product over another, it does not believe that requiring that the “total production” of VLI and VAs in one sales contest will ultimately satisfy that policy goal. AmFam Securities believes that NASD should retain

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<sup>2</sup> NTM 05-40 at p. 5.

<sup>3</sup> NASD Conduct Rule 2820(g)(4)(D).

its clearly articulated policies with respect to VLI and VA sales contests, and not rush to lump all securities contests together simply to create an elegant rule that covers all sales contest for all securities products. In NASD's Notice to Members announcing the approval of the non-cash compensation rules for variable contracts,<sup>4</sup> NASD stated that "[b]ecause of substantial differences in design, purpose, cost structure, commissions payouts, and target audience for variable annuity and variable life products, NASD Regulation has determined that the total production and equal weighting requirements may apply separately to variable annuity and variable life products, and they do not need to be combined in the same incentive arrangement."<sup>5</sup>

AmFam Securities believes that there is no compelling reason to alter NASD's existing view with respect to the treatment of the equal production and total weighting of, and separate sales contests for, VLI and VAs. NTM 05-40 provides no specific discussion of the rationale for departing from its previously articulated policy in NTM 98-75. There is no evidence that the factors identified above leading to NASD's determination with respect to the treatment of equal production, total weighting, and separate sales contests for VLI and VA have changed. Moreover, if the general policy of NASD is to ensure that no conflicts will arise because "total production" of all products (in our case variable life insurance and variable annuities) will be used to determine sales contest winners, that policy likely will not be satisfied because of the particular structural differences between VLI and VAs that NASD identified in NTM 98-75, which are highlighted below.

Under the Proposed Rule, a compensation contest would be excluded from the definition of "sales contest," and thus not be prohibited, if it includes the "total production" of all securities sold by an associated person. NTM 05-40 does not define total production, but the most likely measures in our case would appear to be either (1) premium payments, or (2) commission income. Because of the structural and pricing differences between VLI and VAs, the use of either of these measures for a sales contest could create an incentive for a registered person to favor one product over the other.<sup>6</sup> Premium payments for VAs (which are used primarily to create a source of retirement income) are likely to be larger than VLI premiums. Therefore, if the sales contest awards are based on premium payments then there could be an incentive for a registered representative hoping to win the sales contest to offer VAs. Commission payouts, on the other hand, are typically higher for VLI than for VAs on the same amount of premium dollars. Therefore, if commission payouts are the trigger for a sales contest, VLI could be favored by a registered representative hoping to win the sales contest because it typically has a higher payout.

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<sup>4</sup> Notice to Members 98-75 (Sept. 1998) ("NTM 98-75").

<sup>5</sup> NTM 98-75 at p. 580-581. This position is also re-affirmed by NASD in Notice to Members 99-55 (July 1999) at question number 6.

<sup>6</sup> AmFam Securities is of the view that the differences between the VLI and VAs are so significant that it is highly unlikely that a registered representative would ever be "choosing" between which product to offer a client.

Note, however, that the analysis of the incentives created by a sales contest cannot be viewed in isolation, and it is more complicated than simply determining whether a “winner” of the sales contest is incented to sell VLI or VA. As you know, a registered representative participating in a sales contest will also receive standard cash compensation for the sale of the security. Therefore, while a sales contest might create an incentive for a registered representative to favor one particular product or security over another to win the contest, that registered representative could have conflicting incentives created by the nature of their standard cash compensation. Both the different pricing and structure of VLI and VAs, as well as the additional variable of the standard compensation paid to a registered representative outside of a sales contest, indicate that the ability to eliminate (or even rationally minimize) conflicts based on requiring a single “sales contests” including the “total production” of both VA and VLI is probably not possible.

AmFam Securities believes that NASD should continue to rely on its previously articulated authority with respect to VLI and VA sales contests.

#### **Sales Contest Participation by an Insurance Company that is Affiliated with a Member Firm**

Based on the new formulation of the Proposed Rule, and the proposed deletion of Rule 2820(g)(4), AmFam Securities is concerned with the ability of an affiliated insurance company to participate in a sales contest under the Proposed Rule in the same manner as it could participate under Rule 2820(g)(4)(D). As you know, NASD included the language that refers to participation in sales contest by “non-member companies and its sales personnel who are associated persons of an affiliated member” in Rule 2820(g)(4)(D) in large part to address the relationship between an insurance company’s agents who are also registered representatives of an affiliated broker-dealer. In NTM 98-75, NASD explained this by stating that “NASD Regulation recognizes that in the life insurance industry, for example, non-member insurance companies may hold no-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 variable contract securities and non-securities insurance products.”<sup>7</sup> AmFam Securities believes that there is no reason to eliminate the ability of affiliated insurance companies to participate in sales contests under the Proposed Rule to the same extent as they were eligible to participate under current Rule 2820(g)(4)(D). Without some clarification of this issue, AmFam Securities is concerned that the provisions of Rule 2820(g)(1) could be read as foreclosing the participation of the affiliated insurance company in the sales contest.<sup>8</sup>

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<sup>7</sup> NTM 98-75 at p. 580.

<sup>8</sup> While Rule 2820(g)(1) does allow for compensation, including a sales contest, to come from someone other than the member firm under certain circumstances, it seems very unlikely that there is an SEC rule, release or no-action letter that specifically addresses this situation.

AmFam Securities suggests that the Proposed Rule, Rule 2820 or interpretive materials make clear that the participation of an insurance carrier affiliated with a broker-dealer be permissible for "sales contests" to the same extent as it was permissible under Rule 2820(g)(4)(D).

### **Bonuses**

NTM 05-40 states that bonuses may be deemed to be "sales contests," and thus are subject to the same rules under the Proposed Rule (e.g., all securities and total production) as any other sales contests. Our understanding of this description is that if a bonus, payable for some defined period (e.g., monthly, annually), is based on the total production of all securities offered, then such a bonus would be permissible because it would not meet the definition of a "sales contest." AmFam Securities requests that NASD clarify that not all bonuses would be prohibited sales contests.

In addition, AmFam Securities believes that there should be a de minimis exception to the proposal to prohibit "product-specific" bonuses. While AmFam Securities understands the NASD's rationale for prohibiting large, product-specific bonuses determined based on production, it believes that certain bonuses should be excluded from the definition of "sales contest."

### **CONCLUSION**

AmFam Securities recognizes and appreciates the time and resources that NASD and its staff have devoted to the Proposed Rule. We are pleased to have this opportunity to provide comments to the NASD, and we appreciate the NASD staff's careful consideration of our specific recommendations and requests for clarification.

Respectfully Submitted,

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BY:   
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