

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44631; File No. SR-NASD-00-38]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Application of NASD Rules and Interpretive Materials to Exempted Securities

July 31, 2001.

#### I. Introduction

On June 16, 2000, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, filed with the Securities and Exchange Commission ("Commission" or "SEC") a proposed rule change pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> NASD Regulation amended its proposal on September 11, 2000,<sup>3</sup> and on March 28, 2001.<sup>4</sup> The proposal, as amended, will: (1) Adopt NASD Rule 0116, "Application of Rules of the Association to Exempted Securities," which will enumerate the NASD rules and interpretive materials that apply to exempted securities, including government securities but not municipal

securities; and (2) codify a NASD staff interpretation that the non-cash compensation provisions set forth in paragraph (g) of NASD Rule 2820, "Variable Contracts of an Insurance Company," apply to group variable contracts that are exempted securities.

Prior to the publication of the notice of the proposal, the Commission received two comment letters asking the Commission to refrain from approving the proposal on an accelerated basis, as NASD Regulation had requested.<sup>5</sup> The Commission published notice of the proposed rule change and Amendment No. 1 for comment in the **Federal Register** on October 4, 2000.<sup>6</sup> Following the publication of the **Federal Register** notice, the Commission received two additional letters regarding the proposal.<sup>7</sup> This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comments on, and is simultaneously approving, on an accelerated basis, Amendment No. 2 to the proposal.

#### II. Description of the Proposal

##### A. NASD Rule 0116

The Government Securities Act Amendments of 1993 ("GSAA")<sup>8</sup> eliminated the statutory limitations on the NASD's authority to apply sales practice rules to transactions in exempted securities, including government securities but not municipal securities.<sup>9</sup> In 1996, the Commission approved an NASD proposal implementing the expanded sales practice authority granted to the NASD pursuant to the GSAA.<sup>10</sup> The 1996 listed

Commercial Honor and Principles of Trade;" NASD Rule 2120, "Use of Manipulative, Deceptive or Other Fraudulent Devices;" NASD Rule 2210, "Communications with the Public;" IM-2210-1, "Communications with the Public about Collateralized Mortgage Obligations;" IM-2210-2, "Communications with the Public about Variable Life Insurance and Variable Annuities;" IM-2210-3, "Use of Rankings in Investment Companies Advertisements and Sales Literature;" NASD Rule 2250, "Disclosure of Participation or Interest in Primary or Secondary Distribution;" NASD Rule 2270, "Disclosure of Financial Condition to Customers;" NASD Rule 2310, "Recommendations to Customers (Suitability);" IM-2310-2, "Fair Dealing with Customers;" IM-2210-3, "Suitability Obligations to Institutional Customers;" NASD Rule 2320, "Best Execution and Interpositioning;" NASD Rule 2330, "Customers' Securities or Funds;" IM-2330, "Segregation of Customers' Securities;" NASD Rule 2340, "Customer Account Statements;" NASD Rule 2430, "Charges for Services Performed;" NASD Rule 2440, "Fair Prices and Commissions;" IM-2440, "Mark-Up Policy;" NASD Rule 2450, "Installment or Partial Sales;" NASD Rule 2510, "Discretionary Accounts;" NASD Rule 2520, "Margin Accounts;" NASD Rule 2521, "Margin Requirements—Exception for Certain Members" (formerly NASD Rule 2520(a); NASD Rule 2522, "Definitions Related to Options, Currency Warrants, Currency Index Warrants and Stock Index Warrants Transactions" (formerly NASD Rule 2520(b); NASD Rule 2770, "Disclosure of Price in Selling Agreements" (applicable only to traditional underwriting arrangements); NASD Rule 2780, "Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities;" NASD Rule 2910, "Disclosure of Financial Condition to Other Members;" NASD Rule 3010, "Supervision;" NASD Rule 3020, "Fidelity Bonds;" NASD Rule 3030, "Outside Business Activities of an Associated Person;" NASD Rule 3040, "Private Securities Transactions of an Associated Person;" NASD Rule 3050, "Transactions for or by Associated Persons;" NASD Rule 3060, "Influencing or Rewarding Employees of Others;" NASD Rule 3070, "Reporting Requirements;" NASD Rule 3120, "Use of Information Obtained in a Fiduciary Capacity;" NASD Rule 3110, "Books and Records;" IM-3110, "Customer Account Information;" NASD Rule 3130, "Regulation of Members Experiencing Financial and/or Operational Difficulties;" IM-3130, "Restrictions on a Member's Activity;" NASD Rule 3131, "Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties;" NASD Rule 3140, "Approval of Change in Exempt Status under SEC Rule 15c3-3;" NASD Rule 3230, "Clearing Agreements;" NASD Rule 3310, "Publication of Transactions and Quotations;" IM-3310, "Manipulative and Deceptive Quotations;" NASD Rule 3320, "Offers at Stated Prices" IM-3320, "Firmness of Quotations;" NASD Rule 3330, "Payment Designed to Influence Market Prices, Other than Paid Advertising;" NASD Rule 8110, "Availability to Customers of Certificate, By-Laws, and Rules;" NASD Rule 8120, "Complaints by Public Against Members for Violations of Rules;" NASD Rule 8130, "Complaints by District Business Conduct Committees;" NASD Rule 8140, "Complaints by the Board of Governors;" NASD Rule 8210, "Reports and Inspections of Books for Purpose of Investigation Complaints;" NASD Rule 8820, "Suspension of Members for Failure to Furnish Information Duly Requested;" NASD Rule 8310, "Sanctions for Violation of Rules;" IM-8310-1, "Effect of a Suspension, Revocation, or Bar;" IM-8310-2, "Release of Disciplinary Information;" NASD Rule 8320, "Payment of Fines, Other Monetary Sanctions, or Costs; and NASD Rule 8330, "Cost of Proceedings." As discussed more fully below, Amendment No. 2 clarifies NASD Regulation's reasons for including NASD Rules

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated September 11, 2000 ("Amendment No. 1"). In Amendment No. 1, NASD Regulation amended NASD Rule 0116 to: (1) Delete a reference to NASD Rule 2300; (2) replace a reference to IM-2520 with a reference to IM-2522; and (3) add references to NASD Rules 8110, 8120, 8210, 8221, 8222, 8223, 8224, 8225, 8226, 8227, 8310, IM-8310-1, IM-8310-2, NASD Rule 8230, and NASD Rule 8330.

<sup>4</sup> See letter from Patrice M. Gliniecki, Vice President and Deputy General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated March 27, 2001 ("Amendment No. 2"). In Amendment No. 2, NASD Regulation amended its proposal to: (1) Add NASD Rules 2521, "Margin Requirements—Exception for Certain Members," and 2522, "Definitions Related to Options, Currency Warrants, Currency Index Warrants and Stock Index Warrants Transactions," to NASD Rule 0116; (2) clarify that NASD Rule 2910, "Disclosure of Financial Condition to Other Members," NASD Rule 8220, "Suspension of Members for Failure to Furnish Information Duly Requested," and IM-8310-2, "Release of Disciplinary Information," were intended to apply to transactions and business activities related to exempted securities; and (3) clarify its reasons for including NASD Rules 8221 through 8227 in NASD Rule 0116.

<sup>5</sup> 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 ("ACLI I"); and letter from David A. Winston, Vice President, Government Affairs, National Association of Insurance and Financial Advisors ("NAIFA"), dated August 30, 2000 ("NAIFA I").

<sup>6</sup> See Securities Exchange Act Release No. 43370 (September 27, 2000), 65 FR 49240.

<sup>7</sup> See letter from Carl B. Wilkerson, Chief Counsel, Securities, ACLI, to Jonathan G. Katz, Secretary, Commission, dated October 17, 2000 ("ACLI II"); and letter from David A. Winston, Vice President, Government Affairs, NAIFA, to Jonathan G. Katz, Secretary, Commission, dated November 13, 2000 ("NAIFA II").

<sup>8</sup> Government Securities Act Amendments of 1993, Pub. L. No. 103-202, Section 1(a), 107 Stat. 2344 (1993).

<sup>9</sup> The terms "exempted securities," "government securities," and "municipal securities," are defined in Sections 3(a)(12), 3(a)(42), and 3(a)(29) of the Act, respectively.

<sup>10</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (order approving File No. SR-NASD-95-39) ("1996 Order"). The 1996 Order approved the application of the following NASD rules to exempted securities, including government securities but not municipal securities: NASD Rule 2110, "Standards of

the NASD rules that would apply to exempted securities, including government securities but not municipal securities. In addition, Notice to Member ("NTM") 96-66, "SEC Expands Scope of Conduct Rules and other NASD Rules to Government Securities; Approves New Suitability 1," identified some of the NASD rules that would apply to exempted securities, including government securities but not municipal securities.<sup>11</sup>

NASD Regulation noted in its filing, however, that the list of NASD rules interpretative materials outlined in the 1996 Order was not incorporated into a specific NASD rule and does not currently appear in the NASD Manual. To enable members and other interested parties to identify the NASD rules and interpretative materials applicable to exempted securities, including government securities but not municipal securities, in a more efficient manner, NASD Regulation proposed to codify those NASD rules and interpretative materials in new NASD Rule 0116.<sup>12</sup>

In Amendment No. 2, NASD Regulation clarified that the rules and interpretative materials listed in NASD Rule 0116 should include NASD Rules 2521, 2522, 2910, 8221 through 8227, and IM-8310-2. Specifically, NASD Regulation noted that the 1996 Order approved the application of NASD Rule 2520, "Margin Accounts," to exempted securities, including government

securities but not municipal securities. At that time, current NASD Rules 2521, "Margin Requirements—Exception for Certain Members," and 2522, "Definitions Related to Options, Currency Warrants, Currency Index Warrants and Stock Index Warrants Transactions," were paragraphs (a) and (b), respectively, of NASD Rule 2520. Accordingly, NASD Regulations proposes to include NASD Rules 2521 and 2522 in NASD Rule 0116.<sup>13</sup>

In addition, NASD Regulation noted that NASD Rules 2910, "Disclosure of Financial Condition to Other Members," 8220, "Suspension of Members for Failure to Furnish Information Duly Requested," (now NASD Rules 8221 through 8227, as discussed below), and IM-8310-2, "Release of Disciplinary Information," were not included in the list of rules provided in the 1996 Order because, prior to the 1996 reorganization of the NASD's rules,<sup>14</sup> NASD Rules 2910 and 8220 and IM-8310-2 were Resolutions of the Board ("Resolutions") relating to Article III, Section 22, "Disclosure of Financial Condition," Article IV, Section 5, "Reports and Inspection of Books for Purpose of Investigating Complaints," and Article V, Section 1, "Sanctions for Violations of the Rules," respectively.<sup>15</sup> NASD Regulation states that the Resolutions were not included in the list provided in the 1996 Order because the Resolutions were considered part of the rules they accompanied and a specific reference to the Resolutions was deemed to be unnecessary. Because the 1996 Order listed the rules the resolutions accompanied as applicable to exempted securities, including government securities but not municipal securities, the Resolutions also applied to exempted securities, including government securities but not municipal securities. Accordingly, NASD Regulation proposes to include NASD Rules 2910 and 8221 through 8227 (formerly NASD Rule 8220, as discussed

below) and IM-8310-2 in NASD Rule 0116.<sup>16</sup>

NASD Regulation notes that prior to the 1996 reorganization of the NASD's rules, NASD Rule 8220 set forth potential penalties resulting from a member's failure to provide information requested by the NASD.<sup>17</sup> In 1997, the NASD amended its rules to replace NASD Rule 8220 with NASD Rules 8221, "Notice," 8222, "Hearing," 8223, "Decision," 8224, "Notice to Membership," 8225, "Termination of Suspension," 8226, "Copies of Notice and Decision to Member," and 8227, "Other Action Not Foreclosed."<sup>18</sup> According to NASD Regulation, NASD Rules 8221 through 8227 serve the same purpose as NASD Rule 8220 in that they provide potential penalties that may result from a member's or associated person's failure to provide information requested by the NASD.<sup>19</sup> In addition, NASD Regulation states that NASD Rules 8221 through 8227 provide procedural enhancements, including, for example, a hearing process through which a member or associated person may appeal an initial NASD decision made under NASD Rule 8221.<sup>20</sup>

#### *B. Application of NASD Rule 2820(g) to Group Variable Contracts That Are Exempted Securities*

NASD Regulation also proposes to codify an NASD staff interpretation that the non-cash compensation provisions set forth in NASD Rule 2820(g) apply to variable contracts that are exempted securities by including NASD Rule 2830(g) in NASD Rule 0116.<sup>21</sup> NASD Regulations notes that at the time the NASD identified the NASD rules that would apply to exempted securities, including government securities but not municipal securities, the NASD had not adopted NASD Rule 2820(g) and, accordingly, NASD Rule 2820(g) was not included in the list provided in the 1996 Order.

NASD Regulation states that because certain group variable contracts are exempted securities under the Act, members have questioned whether NASD Rule 2820(g) applies to group variable contracts. NASD Regulation states that it has interpreted NASD Rule 2820(g) to apply to group variable

2521, 2522, 2910, 8220 (which was expanded to include current NASD Rules 8221 through 8227), and IM-8310-2 in its list of rules and interpretative materials applicable to exempted securities, including government securities, other than municipal securities. See Amendment No. 2, *supra* note 4.

<sup>11</sup> NTM 96-66 advised NASD members that the GSAA eliminated the statutory limitations on the NASD's authority to apply its sales practice rules to transactions in exempted securities, including government securities but not municipal securities. NTM 96-66 also noted that the Commission approved amendments to the NASD's rules implementing the expanded sales practice authority on August 20, 1996. Although NTM 96-66 listed some of the NASD rules that would apply to exempted securities, including government securities but not municipal securities, NTM 96-66 omitted from its list of NASD rules in the 8000 Series which were included in the 1996 Order.

<sup>12</sup> Specifically, NASD Rule 0116(b) states that, unless otherwise indicated within a particular provision, the following NASD rules and interpretative materials apply to transactions and business activities relating to exempted securities but not municipal securities, conducted by members and associated persons: 2110, 2120, 2210, IM-2210-1, IM-2210-2, IM-2210-3, 2250, 2270, 2300, 2310, IM-2310-2, IM-2310-3, 2320, 2330, IM-2330, 2340, 2430, 2450, 2510, 2520, 2521, 2522, 2770, 2780, 2820(g), 2910, 3010, 3020, 3030, 3040, 3050, 3060, 3070, 3110, IM-3110, 3120, 3130, IM-3130, 3131, 3140, 3230, 3310, IM-3310, 3320, IM-3320, 3330, 8110, 8120, 8210, 8221, 8222, 8223, 8224, 8225, 8226, 8227, 8310, IM-8310, IM-8310-1, IM-8310-2, 8320, and 8330. See Amendment No. 2, *supra* note 4.

<sup>13</sup> See Amendment No. 2, *supra* note 4.

<sup>14</sup> In 1996, the Commission approved a proposal that reorganized the NASD's rules into their current format. See Securities Exchange Act Release No. 36698 (January 11, 1996), 61 FR 1419 (January 19, 1996) (order approving File No. SR-NASD-95-51).

<sup>15</sup> Specifically, the Resolution relating to Article III, Section 22 was "Requirement of Members to Furnish Recent Financial Statement to other Members;" the Resolution relating to Article IV, Section 5 was "Suspension of Members for Failure to Furnish Information Duly Requested;" and the Resolution relating to Article V, Section 1 was "Notice to Membership and Press of Suspensions, Expulsions, Revocations, and Monetary Sanctions and Release of Certain Information Regarding Disciplinary History of Members and Their Associated Persons."

<sup>16</sup> See Amendment No. 2, *supra* note 4.

<sup>17</sup> See Amendment No. 2, *supra* note 4.

<sup>18</sup> See Securities Exchange Act Release No. 38908 (August 7, 1997), 62 FR 43385 (August 13, 1997) (order approving File No. SR-NASD-97-28).

<sup>19</sup> See Amendment No. 2, *supra* note 4.

<sup>20</sup> See Amendment No. 2, *supra* note 4.

<sup>21</sup> NASD Rule 2820(g) limits the manner in which members and associated persons may pay or accept non-cash compensation in connection with the sale or distribution of variable contracts.

contracts that are exempted securities since the adoption of NASD Rule 2820(g). To clarify the application of NASD Rule 2820(g) to group variable contracts that are exempted securities, NASD Regulation proposes to codify the current staff interpretation by including NASD Rule 2820(g) in NASD Rule 0116.<sup>22</sup>

### III. Summary of Comments

The Commission received four comment letters from two commenters regarding the proposal.<sup>23</sup> The two comment letters received prior to the publication of the **Federal Register** notice of the proposal asked the Commission to refrain from approving the proposal on an accelerated basis, as NASD Regulation had requested in its proposal.<sup>24</sup> As noted above, the Commission published the proposal for comment on October 4, 2000.<sup>25</sup>

In the comment letters received after the publication of the **Federal Register** notice, the ACLI and the NAIFA urged the Commission not to approve the proposal.<sup>26</sup> In addition, the commenters asked the Commission to order the NASD to rescind NTM 97-27, "Application of NASD Conduct Rules to Group Variable Contracts and Other Exempted Securities,"<sup>27</sup> and to issue an interpretative position stating that the rules cited in NTM 96-66 do not apply to the variable contracts distributed to qualified plans.<sup>28</sup>

Among other things, the ACLI asserts that the GSAA eliminated the statutory limitation on the NASD's authority to apply its sales practice rules to government securities, but not to other types of exempted securities. Accordingly, the ACLI believes that the NASD lacks the authority to apply its conduct rules to the sale of unregistered

variable contracts that fund qualified retirement plans.

In addition, the ACLI maintains that the "multiple, unnecessary layering of regulation caused by proposed [NASD] Rule 0116 and the codification of NTM 97-27 creates an anticompetitive burden \* \* \*" that reduces the product choices available to consumers and increases costs in the distribution of variable contracts by sales persons who are NASD registered representatives.<sup>29</sup> The ACLI maintains that NTM 97-27 has disrupted the marketing of variable contracts to qualified retirement plans.

The ACLI also asserts that the variable contracts distributed to qualified plans have not been the source of market conduct or sales practice abuses, and that the application of the NASD's conduct rules to these products is redundant and unnecessary because the Department of Labor, state insurance commissions, and other federal laws extensively regulate variable contracts that fund qualified retirement plans.

Like the ACLI, the NAIFA maintains that the GSAA was intended to apply only to government securities and that the NASD's application of its conduct rules to group variable contracts in NTM 97-27 represents an expansion of the NASD's jurisdiction that was not authorized by Congress or the Commission. In addition, the NAIFA believes that NASD regulation of variable contracts funding qualified retirement plans is unnecessary because state and federal authorities extensively regulate the sale of these products. The NAIFA also states that NTM 97-27 has caused significant anti-competitive effects and disrupted the marketing of variable contracts to qualified retirement plans.<sup>30</sup>

NASD Regulation responded to the commenters in a letter dated January 26, 2001.<sup>31</sup> In its response, NASD Regulation states that the GSAA amended Section 15A(f) of the Act to permit the application of the NASD's rules to all exempted securities, other than municipal securities. NASD Regulation notes that although Congress specifically excluded municipal securities from its grant of authority to the NASD in the GSAA, Congress did not exclude group variable contracts from its grant of authority to the NASD.

In response to the commenters' assertions that the codification of NTM 97-27 will result in multiple and

unnecessary layers of regulation, NASD Regulation states that the application of the NASD's sales practice rules to group variable contracts will protect investors and promote the integrity of markets generally. NASD Regulation also notes that the scope, focus, and concern of NASD rules differ significantly from federal and state regulations that may require plan sponsors to act as fiduciary and for the benefit of plan participants and beneficiaries. NASD Regulation states, for example, that NASD rules require registered representatives to perform a thorough suitability analysis when making recommendations to customers and require that adequate disclosures be made to customers concerning group variable contracts. In addition, NASD Regulation notes that the NASD's rules restrict certain uses of non-cash compensation where such compensation could create point-of-sale incentives that might compromise the requirement to match the investment needs of the customer with the most appropriate investment product. NASD Regulation also states that members are subject to extensive supervisory requirements and must supervise activities by their registered representatives relating to group variable contracts.

### IV. Discussion

After carefully considering the comments and NASD Regulation's response, the Commission finds, for the reasons discussed below, that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the NASD. In particular, the Commission finds that the proposal is consistent with section 15A(b)(6) of the Act<sup>32</sup> in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.<sup>33</sup>

#### A. NASD Rule 0116

In the 1996 Order,<sup>34</sup> the Commission approved the NASD's proposal to implement the expanded sales practice authority granted to the NASD pursuant to the GSAA. The 1996 Order included a list of NASD rules that would apply to exempted securities, including government securities but not municipal

<sup>22</sup> Because NASD Rule 2820(g) applies only to transactions in variable products, the rule change would result in NASD Rule 2820(g) expressly applying to all variable products that are securities, including variable products that are exempted securities, such as group variable or similar products. NASD Regulation is not at this time recommending that other provisions of Rule NASD Rule 2820 apply to exempted securities.

<sup>23</sup> See ACLI I and NAIFA I, *supra* note 5, and ACLI II and NAIFA II, *supra* note 7.

<sup>24</sup> See ACLI I and NAIFA I, *supra* note 5.

<sup>25</sup> See Securities Exchange Act Release No. 43370, *supra* note 6.

<sup>26</sup> See ACLI II and NAIFA II, *supra* note 7.

<sup>27</sup> In NTM 97-27, NASD Regulation asserted that the expanded sales practice authority that the Commission approved in the 1996 Order permits NASD Regulation to apply the NASD's conduct rules ("Conduct Rules") to members and their registered representatives who sell or distribute group variable contracts and other exempted securities, other than municipal securities, and that such securities are subject to the Conduct Rules.

<sup>28</sup> See ACLI II and NAIFA II, *supra* note 7.

<sup>29</sup> See ACLI II, *supra* note 7 at 11.

<sup>30</sup> See NAIFA II, *supra* note 7.

<sup>31</sup> See letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated January 26, 2001 ("January 26 Letter").

<sup>32</sup> 15 U.S.C. 78o-3(b)(6).

<sup>33</sup> In approving the proposal, the Commission has considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>34</sup> See note 10, *supra*.

securities.<sup>35</sup> To the extent that NASD Rule 0116 codifies in one place the list of NASD rules that the Commission approved in the 1996 Order, the Commission finds that the proposal is consistent with the Act and does not raise new regulatory issues. The Commission believes that NASD Rule 0116 should help members more easily identify the NASD rules applicable to exempted securities, including government securities but not municipal securities.

As discussed more fully above, former NASD Rule 8220 was one of the NASD rules in the 1996 Order.<sup>36</sup> Following the 1996 Order, the NASD revised its rules to replace former NASD Rule 8220 with NASD Rules 8221 through 8227, which serve the same purpose as former NASD Rule 8220.<sup>37</sup> Like former NASD Rule 8220, current NASD Rule 8221 sets for the potential penalties, including suspension from membership or association, resulting from a failure to provide information requested by the NASD. NASD Rules 8222 through 8227 provide procedural protections, including, for example, a hearing process for members or associated persons who have received a notice issued pursuant to NASD Rule 8221. Because NASD Rules 8221 through 8227 serve the same purpose as former NASD Rule 8220, and, in addition, provide procedural protections for members and associated persons, the Commission believes that it is reasonable for the NASD to include NASD Rules 8221 through 8227 in NASD Rule 0116.

#### B. Grant of Authority Under the GSAA

The ACLI and NAIFA assert that the GSAA permitted the NASD to apply its sales practice rules solely to government securities and not to unregistered variable contracts that are exempted securities. The Commission notes, as it stated in the 1996 Order,<sup>38</sup> that the GSAA eliminated the statutory limitations on the NASD's authority to apply sales practice rules to transactions in exempted securities, including government securities but not municipal securities. Although Congress specifically excluded municipal securities. Although Congress specifically excluded municipal securities from its grant of authority to the NASD under the GSAA, it did not exclude any other type of exempted securities from its grant of authority.<sup>39</sup>

Indeed, as amended, Section 15A(f) of the Act explicitly refers only to municipal securities. Accordingly, the NASD has the authority to apply its sales practice rules to transactions in group variable products that are exempted securities.

With regard to the commenters' assertions that NTM 97-27 has created a competitive burden and disrupted the marketing of variable contracts qualified retirement plans, the Commission notes that NASD Regulation maintains that sales of group variable contracts raise investor protection issues similar to those presented by sales of other types of securities products that are subject to the NASD's rules, such as individual variable annuities, variable life insurance, and mutual funds.<sup>40</sup> NASD Regulation also notes that NASD rules require registered representatives to perform a thorough suitability analysis when making a recommendation to a customer and require adequate disclosures to customers concerning group variable contracts.<sup>41</sup> In addition, NASD members must supervise activities by their registered representatives relating to group variable contracts.<sup>42</sup>

The Commission believes that the application of the NASD's sales practice rules to the sale of group variable contracts will help to ensure that customers purchasing group variable contracts that are securities are subject to the same sales practice protections as customers purchasing similar exempted securities. Accordingly, although the application of the NASD's rules to sales of group variable contracts may have

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." Section 3(a)(12)(C) indicates that, for purposes of subparagraph (A)(iv), "the term 'qualified plan' means (i) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, (ii) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, or (iii) a governmental plan as defined in section 414(d) of such Code which as been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (i), (ii), or (iii) of this subparagraph which (I) covers employees some or all of whom are employees within the meaning of section 401(c) of such Code, or (II) is a plan funded by an annuity contract described in section 403(b) of such Code."

<sup>40</sup> See January 26 Letter, *supra* note 31.

<sup>41</sup> See January 26 Letter, *supra* note 31.

<sup>42</sup> See January 26 Letter, *supra* note 31.

affected the marketing of group variable contracts to qualified retirement plans, the Commission believes that the proposal does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, consistent with section 15A(b)(9) of the Act.

#### C. NASD Rule 2820(g)

NASD Rule 2820(g) addresses the payment and acceptance of non-cash compensation in connection with the sale or distribution of variable contracts. NASD Regulation proposes to include NASD Rule 2820(g) in NASD Rule 0116 to clarify that NASD Rule 2820(g) applies to group variable contracts that are exempted securities. Because NASD Rule 2820(g) had not been adopted at the time of the 1996 Order, it was not included in the 1996 Order's list of NASD rules applicable to exempted securities, including government securities but not municipal securities. However, NASD Regulation states that it has consistently interpreted NASD Rule 2820(g) to apply to group variable contracts that are exempted securities since the adoption of NASD Rule 2820(g).

The Commission believes that including NASD Rule 2820(g) in NASD Rule 0116 will clarify NASD Regulation's position that NASD Rule 2820(g) applies to all variable contracts that are securities, including variable contracts that are exempted securities. In addition, the Commission believes that application of NASD rule 2820(g) will protect investors and the public interest by helping to reduce the point-of-sale impact of non-cash sales incentives that may compromise the duty of registered representatives to match the investment needs of customers with the most appropriate investment product.<sup>43</sup>

#### D. Accelerated Approval of Amendment No. 2

The Commission finds good cause for approving Amendment No. 2 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 2 strengthens the proposal by clarifying NASD Regulations' rationale for including NASD Rules 2521, 2522, 2910, 8221 through 8227, and IM-8310-2 in NASD Rule 0116. Accordingly, the Commission finds it is consistent with Sections 15A(b)(6) and 19(b) of the Act to approve Amendment No. 2 on an accelerated basis.

<sup>43</sup> See Securities Exchange Act Release No. 40214 (July 15, 1998), 63 FR 39614 (July 23, 1998) (order approving File No. SR-NASD-97-35).

<sup>35</sup> See note 10, *supra*.

<sup>36</sup> See Amendment No. 2, *supra* note 4.

<sup>37</sup> See Amendment No. 2, *supra* note 4.

<sup>38</sup> See note 10, *supra*.

<sup>39</sup> Under Section 3(a)(12)(A) of the Act, the term "exempted security" includes "any security arising

## V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether amendment No. 2 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-00-38 and should be submitted by August 28, 2001.

## VI. Conclusion

*It Is Therefore Ordered*, pursuant to section 19(b)(2) of the Act,<sup>44</sup> that the proposed rule change (SR-NASD-00-38), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>45</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44635; File No. SR-NSCC-2001-10]

### Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Enhancing the Insurance Processing Service

August 1, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on June 5, 2001, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") the

proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by NSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change consists of an enhancement to the Insurance Processing Service ("IPS"). The enhancement will allow members and insurance carrier members of NSCC to transmit data and information to each other regarding their state licensing and appointments activities and to settle payments between themselves relating thereto.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

##### (A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to enhance IPS to allow members and insurance carrier members of NSCC to transmit data and information to each other regarding their state licensing and appointments activities and to settle payments between themselves related thereto.

A license is an authorization from a state insurance department permitting the licensee to sell insurance under the guidelines established by the insurance laws of that state. Insurance carriers sponsor certain agents (also known in the industry as producers) to be licensed by particular states. The enhancement to IPS related to licensing ("Licensing enhancement") will allow insurance distributors who are members to request insurance carrier members to sponsor licenses for agents. Licensing will allow members and insurance carrier members to electronically exchange standardized relevant information about the agent.

The insurance carrier members can then use the information (to the extent permitted by applicable state law) to sponsor licenses with state insurance departments. The contacts between insurance carrier members and state insurance departments will not be made through NSCC. In addition, the Licensing enhancement will allow insurance carrier members and members to communicate information to each other regarding the status of a license request.

An appointment is an authorization from an insurance carrier permitting the appointee to sell the products of that particular carrier in a particular state. Appointments are periodically renewed. The enhancement to IPS related to appointments and renewals and terminations thereof ("Appointments") will allow insurance distributors who are members to request insurance carrier members to appoint agents to sell products in a particular state, renew and terminate appointments, and change demographic information relating to agents (collectively "appointment activity"). Appointments will also allow members and insurance carrier members to electronically exchange standardized, relevant information about the agents. The insurance carrier members can use the information (to the extent permitted by applicable state law) to help them carry out appointment activity with the relevant state insurance departments. The contacts between insurance carrier members and state insurance departments will not be made through NSCC. In addition, the appointments enhancement will allow insurance carrier members and members to communicate information to each other regarding the status of a request relating to appointment activity.

The processing of data and information described above will be substantially similar to the processing of data and information that IPS carries out today.

There will be money settlements associated with Licensing and Appointments. For example, insurance distributors who are members may from time to time reimburse insurance carrier members for licensing fees that the insurance carrier members pay to state insurance departments with respect to agents. The processing of settlement of payments for licensing and appointments will be similar to IPS's processing of settlement payments for its Applications (APP) and Subsequent Premiums (SUB) functions.

NSCC's Rule 57, Sec. 1 states that NSCC "may provide a service to enable Members and Insurance Carrier members to (i) transmit such data and

<sup>44</sup> 15 U.S.C. 78s(b)(2).

<sup>45</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> The Commission has modified the text of the summaries prepared by NSCC.