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October 5, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
Room 6507
450 Fifth Street, N.W.
Washington, D.C. 20549

By e-mail

RE: Supplemental comment on Release No. 34-48897; File No. SR-NASD-2003-104, *in light of NASD's July 29, 2004 Response to Comments on proposed definition of broker-dealer "branch office" under NASD Rule 3010(g)(2).*

Dear Mr. Katz:

The American Council of Life Insurers ("ACLI") is a national trade association with 399 broker-dealers representing 72 percent of all United States life insurance companies. We filed a letter of comment on the NASD's proposed branch office definition, and offer supplemental input in light of the NASD's *Response to Comments* dated July 29, 2004.[1]

Many of our member companies manufacture variable annuities and variable life insurance that are distributed through affiliated and independent broker-dealers. Our member companies and their broker-dealer affiliates have profound concerns with the NASD's proposed definition.

The initiative would have a significant, unique impact on our industry. We are, therefore, very interested in the substance and the merit of the NASD's *Response to Comments*, and take issue with the conclusions it draws.

Administrative Background

According to the NASD, the new definition would facilitate the creation of a branch office registration system through the NASD's Central Registration Depository ("CRD") to provide a more efficient, centralized method for broker-dealers to register

[1] A copy of the NASD filing can be found at http://www.nasdr.com/pdf-text/rf03_104_resp01.pdf .

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branch office locations as required by the rules and regulations of state securities laws and self-regulatory organizations, including NASD.

NASD asserts that centralized registration of branch offices "will provide efficiency, clarity, and costs savings" to broker-dealers. According to the NASD, the creation of a uniform registration system for branch offices through CRD also will allow NASD and other securities regulators to effectively examine such locations to further investor protections. NASD represents that the proposed definition establishes a broader national standard representing a coordinated effort among regulators to reduce inconsistencies in the definitions used by state and federal securities regulators.

The proposed branch office definition would replace the current definition that is based on the functions and services performed at the office. The NASD's proposed definition is based solely on the number of salespersons in the office without regard to the functions and services performed. As a result, many offices now operating as non-branch locations will be transformed into branch offices through the numerical threshold in the proposed definition.

The SEC's invitation of comment[2] on the proposed NASD definition of "branch office" was a lightning rod for critical feedback, generating over 846 letters. The majority of the letters opposed the proposed branch office definition.

In a parallel initiative, the NASD proposed a new uniform branch office registration form, labeled Form BR, in its Notice to Members 04-45.[3] According to the NASD, Form BR will enable broker-dealers to uniformly register their branch offices electronically with the NASD, the New York Stock Exchange (NYSE), and state securities administrators. We filed a letter of comment on Form BR with the NASD. A copy is attached to this submission for additional background and is incorporated by reference for purposes of the branch office definition.

Statement of Position

The branch office definition cannot be considered in an insular vacuum. It goes hand-in-glove with proposed Form BR. The economic implications of both proposals are inextricably intertwined. Estimated economic burdens are a fundamental ingredient of sound governmental rulemaking. The NASD has made no attempt to evaluate or quantify the economic burden of either proposal.

The branch office definition should not be bifurcated from proposed Form BR in time or substance. Segmentation of the two proposals is akin to naval navigation by dead

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[2] *See* Securities Exchange Act Rel. No. 48897 (December 9, 2003), 69 FR 70059 (December 16, 2004).
[3] *See* NASD NTM 04-45 at http://www.nasdr.com/pdf-text/0455ntm.pdf .

reckoning before scientific measures of longitude were developed.[4] Fragmentation of the proposals is reckless and imprecise.

The life insurance industry supports uniform electronic registration of branch offices through the NASD's CRD system. This concept offers the opportunity for efficient regulatory compliance. The NASD's definition of branch office, however, is a crucial ingredient to the operation and utility of Form BR.

The proposed branch office definition will impose a significantly disproportionate impact on broker-dealers affiliated with life insurers. These broker-dealers often operate with many non-branch locations having one or two salespersons. This reflects the nature and operation of distribution in the life insurance industry, and contrasts with full-service broker-dealers that primarily operate out of large branch offices.

As a result of these distinctions, the NASD's proposed branch office definition and Form BR will inflict multiple registration, filing and administrative fees on broker-dealers appropriately distributing variable life insurance and variable annuities through locations now classified as non-branch locations. Moreover, the revised definition will cause enormous structural and economic upheaval for broker-dealers that established their operations around the NASD's current definition of branch office.

Although the proposed definition and Form BR work efficiently for large full-service broker-dealers, there are other categories of broker-dealers within the NASD's membership for whom the proposals would impose significant operational and economic impediments, simply because of structural differences in their organizations.

The NASD's *Response to Comments* wholly dismisses the life insurance industry's economic and structural concerns in a conclusory fashion without explanation. The 1934 Act demands more than a hollow analysis of legitimate substantive and antitrust issues.

The *Response to Comments* does not evaluate how many current non-branch locations will be transformed into branch offices under the proposed definition. Without this information, the two initiatives fail to translate the aggregate new branch office registration fees that the proposals will trigger. This void is irresponsible and shocking as a matter of administrative rulemaking.

As a point of reference, over 50% of the NASD's registered representatives work for broker-dealers affiliated with life insurance companies. Although uniform state-federal branch office registration through the CRD can achieve commendable savings and efficiencies, Form BD will cause enormous economic dislocation if its operation is premised on the NASD's proposed definition of branch office.[5] Both the NASD and state

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[4] For an explanation of this concept, *See* Dava Sobel, *Longitude: The True Story of a Lone Genius Who Solved the Greatest Scientific Problem of His Time* (1996) Walker Publishing Company at 13.

[5] In comments on the proposal, one broker-dealer indicated that the new definition will trigger 3,000 new branch office registrations. The NASD failed to deal with this important issue. The financial burdens of the

securities regulators will generate increased filing and registration fees on Form BR by applying the proposed branch office definition. It is incumbent on the NASD to address the full economic consequences of its coextensive proposals.

The NASD's branch office proposal and *Response to Comments* cites inconsistencies in the definitions used by the SEC, NASD, NYSE and state securities regulators as a justification for the revised definition. While there are some inconsistencies among these regulators, the most universal definition implemented by the largest number of broker-dealers is the NASD's current definition of branch office. It begs the question, therefore, why the NASD's definition was not selected as the "uniform" branch office definition.

The NASD definition makes better sense because the NASD is the SRO regulating the greatest number of broker-dealers. Moreover, uniformity of the definition under state securities laws is a remotely achievable objective because coordinated legislative and administrative harmony among the 53 jurisdictions is unrealistic, and a very long-term proposition. In all likelihood, the states will remain a patchwork of non-uniform definitions. Consistency in state securities laws should not, therefore, have much weight in the selection of the most universal definition. Indeed, the proposed definition currently occurs in an infinitesimal number of states.

The NASD's *Response to Comments* eviscerates the administrative process by failing to objectively address thorny issues raised in comment letters. The response to critical feedback is evasive and unsubstantiated. The NASD's *Response to Comments* reflects a one-size-fits all approach to regulation modeled on the template of large full-service broker-dealers. The SEC should demand that the NASD conduct a more thorough, honest, and responsive digest of comments.[6]

The SEC cannot permit the branch office definition to advance without first determining that the NASD has unequivocally fulfilled the antitrust standards in the 1934 Act for SRO rules. On this score, the NASD has failed fully. Other less destructive alternatives are available. The NASD's SRO rule mechanisms should not be manipulated to satisfy the interests of full-service broker-dealers or state securities regulators. Uniform application of the NASD's current branch office definition would ameliorate the unwarranted economic burdens and would allow Form BR to operate seamlessly.

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proposal have a profound multiplier effect because many broker-dealers affiliated with life insurers share similar circumstances, structures and operations with the commentator.

[6] The SEC produces objective, detailed, and high quality digests of public comment on rulemaking proposals. The NASD should follow the SEC's lead and develop equally detailed, objective digests of public input in its responses to comment. A typical example of the SEC's high quality work can be seen in its digest of comments on proposed registration form amendments requiring disclosure about market timing and selective disclosure of portfolio holdings dated March 19, 2004, which is available at http://www.sec.gov/rules/extra/s72603summary.htm#P199_7861

Unlike full service firms, broker-dealers affiliated with life insurers tend to have many small, geographically dispersed non-branch locations. This reflects the insurance distribution systems through which variable products are marketed. Background on the characteristics of these limited-purpose broker-dealers is set forth below.

Several aspects of the proposal have a significant impact on branch and non-branch locations. As a result, the initiative will have a disproportionate impact on limited purpose broker-dealers affiliated with life insurers that operate many non-branch locations. That is wrong and easily avoidable.

Nothing in the NASD application for approval reveals whether the NASD thoroughly considered this issue of competition. Certainly nothing in the proposal or the NASD *Analysis of Comments* reveals any quantification of the number of non-branch locations that will be transformed into branches or the aggregate state and SRO revenue the transformation will generate annually. The 1934 Act demands more. Without better analysis, the NASD rule request is not ripe for SEC approval.

The NASD's proposal has not identified or even hinted at substantive inadequacies in the current definition of branch office. The proposed definition would not create greater regulatory efficiency or provide enhanced consumer protection. It would, however, generate substantial new and recurrent branch office registration fees for the NASD, the NYSE, and state securities regulators. That is a significant economic issue that must be addressed by the NASD and the SEC. This consequence has a tremendous impact on limited purpose broker-dealers affiliated with life insurers.

Excessive deference to a full-service business model is a figurative tail wagging the NASD body. The NASD should be required to act in a fashion reflecting all broker-dealers, not just a select group. The largest category of broker-dealers is outside the NYSE universe. More broker-dealers operate pursuant to the NASD's current definition of broker-dealer. Accordingly, an unequivocally more universal and more equitable definition exists in the current NASD branch office definition.

A Failure of the 1934 Act's Antitrust Standards

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.

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. 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.

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

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. 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.

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 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.

There are several worthwhile analytical benchmarks for evaluating the proposed branch office definition. In the Capital Markets Efficiency Act of 1996, Congress added Section 3(f) to the Exchange Act requiring that whenever the SEC is engaged in rulemaking under the Exchange Act, it shall "consider, in addition to the protection of

investors, whether the action will promote efficiency, competition and capital formation."[7]

Similarly, the legislation requires the SEC's Chief Economist to prepare an economic analysis report on each proposed SEC regulation that would be provided to each SEC Commissioner and published in the Federal Register before the regulation became effective. Congress indicated its hope "that this report will demonstrate serious economic analysis throughout the process of developing regulations."[8] When Form BR is submitted for SEC approval, we encourage the NASD to provide a well-documented economic impact analysis.

In the legislation, Congress noted that its amendments to the federal securities laws focus on the need to delineate more clearly the securities law responsibilities of federal and state governments.[9] "Currently that relationship is confusing, conflicting and involves a degree of overlap that may raise costs unnecessarily for American investors and the members of the securities industry."[10] In recognition of these problems, Congress preempted states from adopting broker-dealer books and records requirements.[11]

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[7]Pub. Law 104-290, 110 Stat. 3416 (October 11, 1996).

[8]S. Rep. 293 104th Cong., 2d Sess. (June 26, 1996) at 16, 33. This statutory change requires the SEC to conduct an economic analysis of all new regulations before they can enter into effect, potentially reducing the impact of future SEC regulations on the economy. *Id*. In his testimony on this legislation, SEC Chairman Levitt emphasized that "an appropriate balance can be attained in the federal - state arena that better allocates responsibilities, reduces compliance costs and facilitates capital formation, while continuing to provide for the protection of investors." *Id.* at 2.

[9]*Id*. at 2.

[10]*Id.* In a joint explanatory statement of the Committee of the Conference on this legislation, the Committee emphasized that the development and growth of the nation's capital markets has prompted the Congress to examine the need for legislation modernizing and rationalizing our scheme of securities regulation to promote investment, decrease the cost of capital, and encourage competition. The report observes the system of dual federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation. "That, in many instances, is redundant, costly, and ineffective." H.R. Rep. 864, 104th Cong. 2d. Sess. (Sept. 28, 1996) at 39.

[11]*Id.* In connection with the NASD and NYSE Form BR and branch office proposals, the North American Securities Administrators Association (NASAA) has proposed a definition of branch office. *See* http://www.nasaa.org/nasaa/abtnasaa/display_top_story.asp?stid=487. NASAA's action contradicts NSMIA's proscription on recordkeeping rules because the combined impact of Form BR and a state branch office definition directly involves recordkeeping practices.

The NASAA proposal deviates from the NASD's branch office definition, and includes investment advisers in the definition even though NSMIA stripped state securities administrators of jurisdiction over broker-dealers with greater that $25 million of assets under management. *See* Sargent, *The National Securities Markets Improvements Act-One Year Later*, 53 Bus. Law 507 (1998); Friedman, The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers, 53 Bus. Law 511 (1998).

There are several other important guideposts to evaluating proposed rulemaking under the Exchange Act and helping to intelligently balance the costs and burdens of compliance against the goals of new regulation. Section 23(a) of the Exchange Act requires the SEC to consider the anti-competitive effects of rule changes, and to balance any impact against the regulatory benefit to be obtained. This benchmark will certainly play a role in the industry's comments on the form when the SEC circulates it for notice and comment under the Administrative Procedure Act.

The NASD has ducked the economic burdens that the branch office definition creates. The *Response to Comments* is devoid of any numerical or financial estimates. We are doubtful that the NASD has the raw data to conduct a meaningful economic analysis of the proposal's state and SRO impact. The 1934 Act mandates that SROs must satisfy important antitrust hurdles to prevent unhealthy anticompetitive conduct.

Approval of the NASD's proposal in the absence of thorough, substantiated economic evidence would be an abdication of the SEC's statutory responsibility. The proposal can be easily revised to eliminate its anticompetitive consequences and resubmitted for SEC approval. We strongly recommend the latter.

The Unique Nature of Broker-Dealers Affiliated with Life Insurers

Broker-dealers affiliated with life insurance companies are significantly different from full service or "wire-house" broker-dealers in their operations, products and services. The securities activities of broker-dealers affiliated with life insurers are a component of a larger insurance business. Many registered representatives operate principally as life insurance and annuity salespersons. Securities sales frequently constitute an incidental amount of business relative to insurance product sales by an office or registered representative.

As a by-product of this relationship, supervision and compliance is often conducted through the vehicle of an insurance distribution system. Consequently, registered representatives of broker-dealers affiliated with life insurers are often present in numerous small, geographically dispersed offices. The cost and burden of the proposal would, therefore, be disproportionately greater for these broker-dealers compared to full service firms.

The range of products offered by these limited purpose broker-dealers is typically narrow and focuses upon the distribution of variable insurance contracts and mutual funds. It may be helpful to consider those securities activities and services *not* offered by most broker-dealers affiliated with life insurers. Typically, these firms do not maintain discretionary accounts permitting registered representatives to purchase and sell securities on behalf of a client without specific approval of each transaction. On an industry-wide basis, these broker-dealers generally do not take custody of client funds, securities or assets. This type of firm does not typically "carry" customer accounts.

Insurance broker-dealers usually require that payment for variable insurance or securities products be made by check payable to the processing office, and not by check payable to the agent/registered representative. Variable contracts and shares in investment companies are issued directly to purchasers and do not constitute bearer instruments. Consequently, the opportunity for misappropriation of these instruments by registered representatives is virtually nonexistent.

Broker-dealers affiliated with life insurers generally do not maintain "open accounts" or facilitate the implementation of stop orders and limit orders, which obviates many potential brokerage problems. Similarly, because these broker-dealers do not typically make available cash management accounts or manage free cash balances, many associated operational and logistical difficulties are absent. Broker-dealers affiliated with life insurers do not make markets in securities or underwrite new issues of securities. This obviates common pressures for unsuitable sales practices.

In several instances, the federal securities laws and the NASD regulations provide appropriate regulatory exceptions because these limited purpose broker-dealers are different from full service broker-dealers. For example, SIPC membership is not required (or allowed) because these entities do not make margin loans or take custody of customer assets or securities. Similarly, net capital requirements do not apply since these limited purpose broker-dealers. In the same way, the proposed amendment should be refined to properly fit all broker-dealers, and not just full service firms.

The Proposed Branch Office Definition:
Substantial Systems, Structural, and Operational Impact

In the early 1990's, the NASD significantly revised its supervision rule, especially as it involves the definitions of branch office and office of supervisory jurisdiction (OSJ). These definitions are pivotal because the distribution networks of broker-dealers associated with life insurers typically involve numerous small, geographically dispersed offices that are classified and regulated as non-branch locations, rather than OSJs or branches under the NASD Rules of Conduct.

After the NASD amended its supervision Rule 3110, broker-dealers affiliated with life insurers significantly restructured their operations to comply with the definitional and supervisory changes. These firms comply with the NASD's standards.

Under NASD Conduct Rule 3110, an OSJ is any business location of a broker-dealer at which one or more of the following functions take place: (i) order execution or market making; (ii) structuring of public offerings or private placements; (iii) maintaining custody of customer's funds or securities; (iv) final acceptance (approval) of new accounts for the members; (v) review and endorsement of customer orders; (vi) final approval of advertising or sales literature for use by members associated with a member;

and (vii) responsibility for supervising the activities of persons associated with the broker-dealer at one or more of the broker-dealer's offices. Several of these definitional elements, such as market making, private placements, and retaining custody of customer assets have little, if any, applicability to most insurance broker-dealers. The principal characteristics relevant to insurance broker-dealers include final acceptance of new accounts, endorsement of purchase orders, supervision responsibilities and sales literature approval.

Rule 3110 also defines the term "branch office" as any business location of the broker-dealer identified to the public or customers by any means as a location at which the investment banking or securities business is conducted on behalf of the member.[12] In contrast to some state definitions of branch office, the NASD definition excludes any location identified solely in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the office of the broker-dealer responsible for supervising the activities of the identified location. The NASD has issued two interpretations embellishing this position.[13]

The meaning of the branch office definition has significant compliance and regulatory implications for broker-dealers. For example, a registered principal of the broker-dealer must conduct on-site inspection of all branches annually.[14] The business activities, volume and number of salespersons can require more frequent examinations of specific branches. Broker-dealers must identify appropriately registered persons in each branch to supervise the activities of that office.[15] Compliance procedures must be tailored to the nature and volume of business of each branch.

Because variable insurance products are typically sold through existing insurance distribution networks, confusing or inconsistent application of the branch office and OSJ definitions can foster significant economic and structural consequences.[16] Careful evaluation of the branch office definition is important, particularly in maintaining the different regulatory status of non-branch locations.

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[12]NASD Conduct Rule 3110(g)(2) (2004).

[13]*See* 4 NASD Regulatory and Compliance Alert 1 (Feb. 1990) at 7 (clarifying interpretations on branch office communications) and NASD Notice to Members 89-34 (Apr. 1989) at 204 (clarifying the meaning of business advertisements and public listings).

[14]NASD Conduct Rule 3110(g)(2) (2004).

[15]NASD Conduct Rule 3110(g)(2) (2004).

[16]Some life agents, while associated with a formal life insurance sales agency, actually conduct business in homes. Inappropriate designation of these locations as branch offices would be unreasonably burdensome and without regulatory purpose.

Compliance with the NASD's supervision standards in Rule 3110 necessitates careful, constant attention to fulfill its requirements and to properly maintain the distinctions between OSJs, branch offices, and non-branch locations. For insurance affiliated broker-dealers, review and control over sales literature and business location communications are particularly essential to maintaining these definitional distinctions.[17] In addition, broker-dealers' advertisements may include a local telephone number or local post-office box provided that the advertisement also identify the location and telephone number of the appropriate branch office or OSJ. The NASD has stated, however, that these advertisements must *not* include the address of the non-branch location.[18]

Given the technical precision in the NASD's branch office requirements, a revised definition would create enormous operational and structural burdens for broker-dealers that have adjusted to the current NASD standards. Further, NASD requirements create meaningful supervision and compliance enhancements that directly apply to broker-dealers operating in every state jurisdiction. In light of these regulatory enhancements, the need for a new, incompatible branch office definition is uncompelling.

In some states a "local office" definition successfully generates increased revenue from filing fees assessed on a larger number of locations. This is unseemly and unconstructive as a matter of state-federal regulatory harmony. By converting the branch office definition from a functionally based approach to a crude numerical formulation, the NASD will cause an enormous number of non-branch locations to become branch offices, which will trigger profound, and unnecessary registration, filing and administrative costs.

Creating a new "branch office" definition will burden the organization and operation of broker-dealers that were substantially restructured in response to NASD Rule 3110. The books and records that state securities regulators often seek to obtain can be equivalently accessed based upon existing NASD standards concerning branch and non-branch locations.

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[17] The NASD has published responses to private interpretations that clarify the rule's definition of a branch office and the exemption from branch office registration available for non-branch locations. A location may be exempt from registration at a branch office if it is identified to the public only in telephone book listings, business cards, or stationary that also include the address and telephone number of the branch office or OSJ responsible for supervising the non-branch business location. *See* 4 NASD Regulatory and Compliance Alert 1 (Feb. 1990) at 7. Additionally, any complaints coming through the central site must be sent to the office or offices with jurisdiction over the non-branch business, according to this NASD interpretation. Another interpretation allows broker-dealer sales literature to include the local address of a non-business location, if it also identifies the location and telephone number of the broker-dealer's appropriate OSJ or supervisory branch office.

[18] An additional NASD interpretation allows the use of the broker-dealer's main office address and telephone number for reply purposes on sales literature, advertisements, business cards, and business stationary. Use of a central site instead of a branch or OSJ for replies can occur only where significant and geographically dispersed offices have a supervisory system appropriate to the operation. *Id*. at 7.

Further, the NASD's numerically based branch office proposal would have a disproportionate competitive impact on smaller limited purpose broker-dealers in contravention with Section 23(a) of the Exchange Act. Due to differences in their markets and approach as discussed above, limited purpose broker-dealers tend to have greater numbers of small, geographically dispersed offices compared to full service broker-dealers.

For example, purchasers of variable annuities and variable life insurance do not tend to make repeat purchases of those products. Customers do not typically buy one variable product, sell it, and buy another. Variable products are long-term vehicles. Purchasers of these products fill out extensive applications identifying essential insurance underwriting and suitability information. The applications are carefully reviewed by the life insurers issuing the products to assure that the product is right for the customer and the customer satisfies underwriting standards.

There is not an absence, therefore, of information or review about the products' appropriateness. The nature of these products does not lend to the abuses for which state securities regulators seek added regulatory information. These variable insurance contracts are not "speculative" or high-risk instruments. VLI provides basic death benefit protection and variable annuities are long-term accumulation products with permanent annuity purchase rate guarantees on annuitization.

Moreover, state securities regulators generally lack jurisdiction to regulate VLI and variable annuities. Under the laws of every jurisdiction authorizing insurers to issue variable contracts funded by separate accounts, the state insurance commissioner is vested with exclusive authority to regulate separate account products. [19] This exclusive regulatory approach dovetails with the fact that variable contracts are excluded from the definition of "security" in most states. [20]

According to NTM 04-55, the proposed form seeks to provide state securities regulators with useful information on a local level. Since most state securities administrators lack jurisdiction over variable products, this information is not germane to

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[19] *See* Section 4, Model Variable Contract law, National Association of Insurance Commissioners (1996), which provides: Notwithstanding any other provision of law, the commissioner shall have sole authority to regulate the issuance and sale of variable contracts, and to issue such reasonable rules and regulations as may be appropriate to carry out the purposes and provisions of this Act.

Substantially all states have enacted this language. *See, e.g.* Cal. Ins. Code §10506 (1996); Conn. Gen. Stat. §38-154 (1994). The appendix to this letter contains statutory charts to each jurisdiction highlighting the status of variable contracts under state securities and insurance laws. The appendix also contains summary maps on these issues.

[20] *See, e.g.* Tile 4 Cal. Corp. Code §25019 which provides: "Security" means . . . . "Security" does not include: . . . (3) any insurance or endowment policy or annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period. . . . *See also* §7302(a)(13) Del. Securities Act (1995); §11-101(p)(2) Md. Securities Act (1996).

state securities regulators' needs when broker-dealers limit securities sales to variable life insurance and variable annuities. In this light, the expense and burden of accumulating and updating the proposed form's information at every location greatly outweighs its unsubstantiated regulatory value.

Other important considerations support excluding non-branch locations of broker-dealers affiliated with life insurers from the branch office definition. Unlike the full service firms on which the definition is focused, broker-dealer involvement with the customer usually ceases after the application is submitted to the issuing insurer. The life insurance company becomes the principal ongoing contact for the purchaser of this long-term product. Indeed, Exchange Act Release No. 8389 [21] recognizes this relationship and allows insurers to fulfill ministerial and clerical record management functions without having to register as a broker-dealer.

Similarly, unlike full service broker-dealers with large multi-person offices, broker-dealers affiliated with life insurers frequently have many small offices that are often geographically dispersed. In recognition of this factor and the more limited range of products, the NASD rules allow a supervising registered representative to perform supervisory functions conducted by principals at full service broker-dealers. [22]

While we strongly support coordination of state and federal registration, we oppose this rulemaking in many respects because it is designed around the template of a full service broker-dealer and fits limited purpose firms poorly. Without revision, the initiative would impair competition because it would impose a disproportionate impact on limited purpose broker-dealers

The desire to harmonize and coordinate state and federal securities regulation is worthwhile and commendable. The proposal, however, needs extensive screening and revision in order to assure that the proposal "will promote efficiency, competition and capital formation," as required under the Capital Markets Efficiency Act of 1996.

Slim Reasoning in the NASD's *Response to Comments*

The NASD's *Response to Comments* is exceptionally brief and unsubstantiated. Aspects of the *Response to Comments* defy logic and exhibit selective perception. Several examples illustrate.

In response to numerous comments that the proposed definition will cause unwarranted economic burdens, the NASD states that

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[21] *See*, Exchange Act Rel. No 8389 (Aug. 29, 1968), *reprinted in* [1968 Trans. Binder] Fed. Sec. L. Rep.(CCH) ¶ 77,594. *See also*, Sentry Insurance (SEC no-action letter publicly available Sept. 6, 1987); Century Life of America (SEC no-action letter publicly available Aug. 6, 1987); Mutual Benefit Life Ins. Co. (SEC no-action letter publicly available Jan 21, 1985).

[22] NASD Conduct Rule 3110(a)(4).

> Persons who satisfy the requirements of the definition of "broker" and "dealer" set forth in the Exchange Act are required to register, absent an exemption. All broker-dealers are subject to a core set of regulatory requirements, such as net capital requirements, books and records rules, supervision requirements, and registration of principals, etc.

This NASD statement is disturbingly disconnected from the commentators' point. These commentators did not request an exemption from registration as broker-dealers. Contrary to the NASD's assertion, these limited-purpose broker-dealers did not seek less rigorous substantive regulation. Rather, they advocated a reasonable and fair definition of branch office that accommodates all broker-dealers and their business models. The NASD statement is unresponsive to the comments articulated and gives an inaccurate depiction of commentators' positions.

The NASD's *Response to Comments* further states that

> The proposed branch office definition does not modify a firm's responsibility to supervise or monitor activities at any location where it engages in securities business. NASD rules require a firm to supervise such activities regardless of whether the location is registered or not.

This statement leaves the incorrect impression that broker-dealers affiliated with life insurers somehow believe that non-branch locations should be subject to different or lesser supervision standards. In this observation, the NASD conjures an answer to comments not raised. The NASD would be better suited to address directly the significant issues it declined to answer or chose to deflect.

In response to numerous comments that the proposed branch office definition would trigger significant new registration fees by transforming non-branch locations into branches, the NASD stated its belief that

> [T]he registration fee for each branch office is reasonable and necessary to cover the NASD's current regulatory and examination program. In addition, by assessing the same fee on each branch office, NASD believes the fees result in an equitable allocation of a reasonable fee among its members. In this regard, there are certain fundamental costs associated with regulating any branch office, regardless of the size or activity.

That statement is the NASD's sole "analysis" of the proposal's economic burdens! Responsible administrative rulemaking demands more. Simply asserting that the fee for each branch office is reasonable and necessary does not make the case, and has nothing to do with the fundamental question of whether the proposed definition of branch office is appropriate. The NASD displays a troubling non sequitur in its explanation. The progress of the proposal should be frozen indefinitely until the NASD can generate rigorous quantifiable data justifying the economic impact of the revised definition of branch

office.

Where are the numbers supporting the conclusion that the fees are both reasonable and necessary? How many non-branch locations will be defined as branch offices? Precisely what economic impact will this have on broker-dealers affiliated with life insurers? How much will the aggregate annual state and SRO fees be under the proposal? How can the NASD assert that the fees result in an equitable and reasonable allocation among its members without any supporting documentation or analysis? Is the NASD contending that its unit cost for regulating a small non-branch location is the same as a large branch office of a full-service broker-dealer?

What supports the NASD assertion that the fees are a reasonable allocation among its members when the definition will have a disproportionate impact on broker-dealers affiliated with life insurers? What are the comparative aggregate fees projected between full service broker-dealers and those affiliated with life insurers? These are only a sample of questions the NASD needs to address before the proposal can advance. The proposal's unquantified fees should not advance like a magician's sleight of hand.

In responding to comments on a proposed exclusion from branch office registration in Rule 3010(g)(E)'s for locations with fewer than 25 annual securities transactions if the office is used primarily to engage in non-securities transactions, the *Response to Comments* states that

> NASD believes that the 25-transaction limit in the exclusion is reasonable and necessary to promote investor protection. While NASD understands that certain locations may engage in securities business incidental to their primary business, for example, selling insurance products, a location that engages in a significant amount of securities transactions annually should be subject to examination by regulators to ensure that the activities at such location are in compliance with applicable rules and regulations.

The NASD response provides no explanation about how the 25-transaction limit was reached, or how it is reasonable and necessary. It appears to be a figure arbitrarily chosen without a quantifiable foundation. Under the current NASD branch office definition, regulators are free to examine non-branch locations in the course of branch and OSJ exams, and often do so. There is nothing in the reconfigured branch office definition or the 25-transaction exemption that provides regulators with newfound authority to examine non-branch locations that does not already exist today. In this instance, the NASD cites a dubious justification. This 25-transaction limit is unsubstantiated in the *Response to Comments* and lacking in any quantifiable analysis.

Numerous commentators, including ACLI, stated that the proposed rule was anticompetitive and would unnecessarily add to the cost of doing business. In response, the NASD simply states that it disagrees, although no explanation of its rationale is provided. The NASD has completely failed to address commentators' concerns that the proposal is significantly skewed in favor of the business model of full-service broker-

dealers.

It is certain that the NASD's proposed definition will generate significant new and annual branch office filing fees for the NASD, NYSE and state securities administrators from non-branch locations that will be transformed into branch offices under the proposal. Limited-purpose broker-dealers affiliated with life insurers will carry the largest increase in these registration fees and status conversions because they operate under a business model with numerous small, geographically dispersed non-branch locations.

Nothing in the proposal suggests that these non-branch locations are the source of systemic regulatory problems. In fact, broker-dealers affiliated with life insurers have a significantly smaller incidence of NASD disciplinary actions compared to full-service broker-dealers.[23] Accordingly, the restructuring of the branch office definition has no correlation with regulatory enforcement issues. It simply has two primary objectives: (i) facilitating electronic registration of branch offices on Form BD, and (ii) generating significant additional recurrent revenue for securities administrators.

The False Premise of Conflicting Definitions and Uniformity

The NASD represents that the proposed definition establishes a broader national standard and reduces inconsistencies in the definitions used by state and federal securities regulators. We strongly disagree with the premise implicit in this statement.

The most universal current definition of branch office is the NASD's definition. The NASD's suggestion that different definitions appear in state securities codes and regulations is incorrect and unsubstantiated. The Uniform Securities Act does not define the term branch office, nor does any state securities code. A few states define the term "local office" by administrative regulation.

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[23] The nature and incidence of NASD disciplinary actions was discussed in ACLI's comment dated August 9, 2004 on *NASD Notice to Members 04-45: Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities.* In that letter, ACLI stated *inter alia*:

> We have also studied the nature and relative incidence of SEC complaint data. These objective data sources do not support the initiative's putative purpose. Here are the facts: over 50% of the NASD's 675,000 registered representatives work for broker-dealers affiliated with life insurers. Unsuitable variable annuity sales account for only 0.32% of the NASD's total disciplinary actions on average over the past five years. As a matter of perspective, there were 19,562,666 individual variable annuity contracts in 2000. These are not ratios that compel regulatory overhauls.
>
> Similarly, the SEC's Office of Consumer Affairs fields a relatively small number of complaints about broker-dealers marketing variable annuities. For example, the SEC logged 14 times as many broker-dealer complaints about equity security as variable annuities, and 4.5 as many mutual fund complaints as variable annuities for the 12 months ending May 31, 2004.

See also Wilkerson, *Trend Analysis in NASD Disciplinary Actions,* PRACTICING LAW INSTITUTE (PLI), UNDERSTANDING VARIABLE INSURANCE PRODUCTS (2003) for a more expansion discussion of the subject.

Even if the NASD's proposed branch office definition was approved, it is highly unlikely that it would harmonize the term under state laws and regulations because coordinated legislative and administrative actions among the 53 jurisdictions is unrealistic, and a very long-term proposition. In all likelihood, the states will remain a patchwork of non-uniform definitions. Uniformity of state definitions is a regulatory red herring.

Other recent SRO rule proposals introduce new definitions and procedures belying the NASD's contention that its proposed branch office definition coordinates terminology among different securities regulators. The NYSE's September 3, 2004 filing with the SEC concerning NYSE Rule 342 proposes a new definition of "Limited Purpose Office" that would include branch offices with registered representative "that conduct limited business activities, or that have limited registration qualifications (e.g., Series 6-Investment Company and Variable Contracts Products Representative or Series 52-Municipal Securities Representative."[24] The NYSE already has a companion definition of "small office." The September 23 filing would add a new definitional interpretation to the mix.

In its filing, the NYSE explains that

> [a]s members and member organizations have been faced with ever changing demographics of their workforce, economies, regulatory and market environments, many have responded by changing the nature of and manner in which their business is conducted. The rise of small, multi-function offices that perform a combination of services such as banking, insurance, mutual funds and brokerage business, are examples. Continued advances in technology and surveillance capabilities enable members and member organizations to adequately supervise and control from their headquarters, or other control location, the business activities of their associated persons in such locations. Given the surveillance and monitoring capabilities of the firms and the limited scope of business activities conducted in these offices, the requirement for an onsite qualified branch office manager often may not be practicable or necessary. This has caused the Exchange to reexamine whether the exemption from the onsite qualified branch office manager requirement should continue to be bound by a limit of three RRs, or whether different criteria, such as limited sales activity, with proper risk-based supervisory controls and follow-up, warrant the regulatory relief currently provided to small offices. [25]

We agree with the NYSE observations about the variations in the size and nature of different broker-dealer operations. Those views directly support our position that a single one-size-fits-all approach to the branch office definition is uncompelling and unwarranted.

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[24] *See* File No SR-NYSE-2004-51.
[25] *Id* at 3.

The NYSE believes that allowing a risk-based supervision for limited purpose offices would benefit member's and member organization's diverse business models while maintaining the integrity of their supervision and control systems. The proposed Interpretation sets forth factors to be used in determining whether a location qualifies as a limited purpose office and the supervisory requirements for such office, including: (i) the number of registered persons in the office, their registration category and the functions they perform; (ii) the scope and types of business activities conducted; (iii) the nature and complexity of products and services offered; (iv) the volume of business done; (v) the adequacy of procedures to supervise the limited purpose office activities; and (vi) the adequacy and independence of systems and supervisory persons for regular and "for cause" internal and third party inspections and audits.[26]

Again, these worthwhile NYSE statements corroborate our support for a function-based branch office definition rather than a definition with a crude numerical threshold. Clearly, the NYSE is advocating a regulatory structure that accommodates different business models and commendably recognizes offices operating differently from full-service branch offices. We applaud the NYSE thinking, and cite it as a reason to abandon the NASD's proposed branch office definition.

The NASD proposal suggests that the proposal will harmonize the branch office definition with the definition of "office" in Rules 17a-3 and 17a-4 under the 1934 Act. This constitutes a stretched "apples and oranges" comparison. Rules 17a-3 and 17a-4 are books and records rules distinguishable from the role of the branch office definition in supervision, control and monitoring.

Moreover, the SEC crafted these rules to allow storage of broker-dealer books and records in other centralized locations from a local office, so long as they could be produced in a reasonable time period for inspections and examinations. These SEC actions recognized different business models and practices, and rejected a one-size-fits-all approach to regulation. It is ironic, therefore, that the NASD cites these rules in support of the proposed definition.

The SEC has also recently issued specific interpretive guidance on "Remote Office Supervision."[27] The SEC 's positions highlight specific supervisory procedures for "small, remote offices," in recognition of the different approaches to broker-dealer

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[26] *Id* at 6. NYSE indicates a system of supervision and control reasonably designed to detect and prevent wrongdoing, which meets the requirements of Rule 342 may include (1) clearly articulated and enforced policies and procedures, with sufficient resources to implement them; (2) systematic monitoring of activity using routine and exception reporting criteria; (3) an appropriate system of follow-up and review if "red flags" are detected, and mechanisms for verifying that deficiencies are corrected; (4) routine and "for cause" inspections, including possible use of unannounced surprise inspections; (5) offsite monitoring of trading, handling of funds, and use of personal computers; (6) designating supervisors and clearly delineating supervisory responsibilities, including a system of review and follow-up to ensure that supervision is independent, and diligently exercised; (7) monitoring outside business activities and selling away; (8) monitoring and surveillance of internal and external communications; and (9) education and training of RRs and their supervisors so they understand their responsibilities under the firm's procedures, as well as under the securities laws and rules applicable to their business.

[27] SEC Division of Market Regulation Staff Legal Bulletin No. 17 (Mar. 19, 2004).

business models, distribution systems, and organizational structures. The same broad-minded approach should apply to the application of the NASD's branch office proposal.

The NASD explains that state and federal securities administrators coordinated with SROs to develop the proposal. These same regulators will benefit directly from enhanced, recurrent filing fees under a branch office definition applying a numerical, and not a function based, approach. Such coordination is not surprising.

In sum, the assertion that the proposed branch office definition will eliminate state and federal inconsistencies is unproven and incorrect. It provides an unreliable and insufficient basis for SEC approval.

Conclusion

The SEC should not approve the NASD's proposed branch office definition until its economic implications are fully explained and justified. Unsubstantiated conclusions are insufficient for this critical responsibility. The branch office definition is inextricably intertwined with Form BR, the new branch office registration form. Neither proposal should be developed and approved in an insular vacuum or on a different time line.

The life insurance industry supports uniform electronic registration of branch offices through the NASD's CRD system. This concept offers the opportunity for efficient regulatory compliance. The NASD's definition of branch office, however, is a crucial ingredient to the operation and utility of Form BR. The proposed branch office definition will impose a significantly disproportionate impact on limited-purpose broker-dealers affiliated with life insurers.

The NASD's current branch office definition based on specific functions and operations provides a sound and fair means to identify branch offices. In contrast, the proposed branch office definition operates on a crude numerical approach without any regard to the unique characteristics of individual offices.

As a consequence, the proposed definition provides an all-or-nothing, zero-sum approach to regulation. While this may be administratively convenient and financially rewarding for SROs and state securities regulators, it is fundamentally inequitable and counter intuitive. The NASD should abandon its proposed definition and retain its current branch office definition.

The largest category of broker-dealers is outside the NYSE universe. More broker-dealers operate pursuant to the NASD's current definition of broker-dealer. Accordingly, an unequivocally more universal and more equitable definition exists in the current NASD branch office definition. The NASD should be required to act in a fashion reflecting all broker-dealers, not just a select group. This practice would facilitate coordinated use of Form BR by state and federal securities regulators free of anticompetitive burdens.

The proposed branch office definition will not harmonize state, federal, and self-regulatory terminology. Instead, it will provoke aberrations and inflict unnecessary burdens. Limited-purpose broker-dealers affiliated with life insurers will face added, recurrent registration fees on a disproportionate scale. The proposal violates the proscription against anticompetitive self-regulatory conduct, and creates unwarranted antitrust violations.

Our objections to the proposed branch office definition can be ameliorated in several ways. The NASD could successfully achieve state-federal definitional uniformity by retaining its current branch office definition and having the NYSE and state securities regulators follow suit. This approach will involve significantly fewer regulatory overhauls, allowing Form BR to be implemented more rapidly and more efficiently.

Alternatively, if the proposed definition is adopted and approved, the definition should provide a permanent exclusion from the branch office definition for non-branch locations distributing variable contracts.[28] To do otherwise foists unreasonable and excessive fees on a select category of NASD broker-dealers through a thinly veiled disguise. We strongly recommend the current NASD definition of branch office as the cleanest, most equitable, and most universal regulatory solution.

We greatly appreciate your attention to our views. If any questions develop, please call. Thank you for your courtesy.

Sincerely,

Carl B. Wilkerson

CC: William H. Donaldson, Chairman
Paul Atkins, Commissioner
Roel Campos, Commissioner
Cynthia A. Glassman, Commissioner
Harvey Goldschmid, Commissioner
Annette L. Nazareth, Director, SEC Division of Market Regulation
Katherine A. England, Assistant Director, Division of Market Regulation

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[28] The proposal's two exceptions for primary residence and 25 or fewer annual securities transactions primarily assist full-service and NYSE broker-dealers, and do not remediate the disproportionate burdens of the proposals on insurance affiliated broker-dealers. Another partial solution to the proposals' disproportionate impact would be to waive filing and registration fees permanently for non-branch locations that are converted into branches simply due to the proposed numerical threshold in the proposal. Regretably, the NASD has indicated that it has summarily dismissed this solution. *See* http://www.nasdr.com/pdf-text/rf03_104_resp01.pdf

CARL B. WILKERSON
VICE PRESIDENT & CHIEF COUNSEL
SECURITIES & LITIGATION

ATTACHMENT 1

September 2, 2004

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

RE: NASD Notice to Members 04-55; Proposed Uniform Branch Office Registration Form BR.

Dear Ms. Sweeney:

We appreciate the opportunity to comment on proposed Form BR, a uniform broker-dealer branch office registration form. The American Council of Life Insurers ("ACLI") is a national trade association with 399 members representing 72 percent of all United States life insurance companies.

Many of our member companies offer and distribute variable annuities and variable life insurance through affiliated and independent broker-dealers. Our member companies and their broker-dealer affiliates have concerns with the NASD's proposed Form BR. The initiative would have a significant, unique impact on our industry.

Brief Overview

According to NASD Notice to Members 04-55, Form BR will enable broker-dealers to uniformly register their branch offices electronically with the NASD, the New York Stock Exchange (NYSE), and state securities administrators. Form BR would be administered through the NASD's Central Registration Depository (CRD) System. NTM 04-55 indicates that Form BR will reconcile inconsistencies between existing branch office registration forms, and will eliminate duplicative questions.

Summary of Position

- The life insurance industry supports uniform electronic registration of branch offices through the NASD's CRD system. This concept offers the opportunity for efficient regulatory compliance.

- The proposal, however, suffers significant procedural and administrative defects. The timing of the proposal is out of sequence. The form and its instructions are

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confusing and unclear in several respects.

- The NASD's definition of branch office is a crucial ingredient to the operation and utility of Form BR. The NASD's proposal to revise the definition of branch office, which the life insurance industry opposes, remains outstanding.

- Form BR will have a disproportionate and negative impact on broker-dealers affiliated with life insurers if the NASD's proposed definition of "branch office" is implemented. This will create unwarranted anticompetitive burdens prohibited by the 1934 Act.

- The design of Form BR favors large New York Stock Exchange (NYSE) broker-dealers over broker-dealers that are not NYSE members. Form BR duplicates Schedule E of Form BD.

- The brief 30-day comment period during the peak of the summer vacation season will not elicit sufficiently broad input. Consequently, this NASD comment period is not functionally meaningful.

- The NASD should withdraw the proposed form until imprecise aspects of the proposal are rectified, the branch office definition is finalized in a competitively balanced manner, and the duplication of Form BD is eliminated.

Expanded Discussion

The proposed form puts the cart before the horse. The definition of the term "branch office" is a core feature of the Form BR, and is currently in a state of flux. The SEC invited comment on a revised NASD definition of branch office in December 2003. The proposed definition was very controversial, eliciting 840 letters of comment.[1] The proposed definition remains outstanding, and the current NASD definition of branch office is operative.

In light of the uncertainty surrounding the definition of branch office, it is premature to publish a branch office registration form for comment. The scope and operation of the proposed form is uncharted. Procedurally, the impact and operation of the proposed form cannot be readily ascertained. Comments will be significantly different under the current and proposed definitions of branch office. Good rulemaking demands greater precision.

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[1] The NASD filed a response to comments on the proposed "branch office" definition dated June 29, 2004. *See* http://www.nasdr.com/pdf-text/rf03_104_resp01.pdf . ACLI filed a letter of comment on the proposal, which is attached in the appendix to this letter. The NASD's response to comments disregards the numerous comments filed in opposition to the proposed definition without adequate explanation or justification.

We emphasize the importance of the pending branch office definition because this proposed revision will have a significantly disproportionate impact on broker-dealers affiliated with life insurers. As explained in greater detail below, these broker-dealers often operate with many non-branch locations having one or two salespersons. This reflects the nature and operation of distribution in the life insurance industry, and contrasts with full-service broker-dealers that primarily operate out of large branch offices.

As a result of these distinctions, the NASD's proposed branch office definition and Form BR will inflict multiple registration, filing and administrative fees on broker-dealers appropriately distributing variable life insurance and variable annuities through locations now classified as non-branch locations. Although the proposed definition and Form BR work efficiently for large full-service broker-dealers, there are other categories of broker-dealers within the NASD's membership for whom the proposals would impose significant operational and economic impediments, simply because of structural differences in their organizations.

The proposal lacks an economic impact statement. As a point of reference, over 50% of the NASD's registered representatives work for broker-dealers affiliated with life insurance companies. Although uniform state-federal branch office registration through the CRD can achieve commendable savings and efficiencies, Form BD will cause enormous economic dislocation if its operation is premised on the NASD's proposed definition of branch office.[2] Both the NASD and state securities regulators will generate increased filing and registration fees on Form BR by applying the proposed branch office definition. It is incumbent on the NASD to address the full economic consequences of its coextensive proposals.

The NASD, and the SEC through its approval process, must avoid unnecessary anticompetitive SRO rulemaking. The branch office definition establishes a one-size-fits-all approach that is unacceptable and contrary to the antitrust protections in the 1934 Act. Further action on Form BR should be stayed until the proposed branch office definition is rectified to accommodate equitably *all* broker-dealer organizations.

In its branch office and Form BD proposals, the NASD emphasizes the goal of uniform definitions and forms. This objective is commendable and most important to full-service broker-dealers subject to the oversight of the NYSE, the NASD, and state securities administrators. It is less important to broker-dealers only subject to the NASD's jurisdiction. Most broker-dealers affiliated with life insurers are not NYSE members, and those limiting their securities activities to variable products are not subject to the jurisdiction of state securities administrators.[3]

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[2] The notice on the NASD's proposed branch office definition did not quantify how many current non-branch locations would be converted into branch locations.

[3] Attached to this letter are maps and charts showing the status of variable contracts under state securities and insurance laws. 48 jurisdictions grant the insurance commissioner exclusive jurisdiction to regulate the issuance and sale of variable life insurance and variable annuities. Only eight jurisdictions define variable contracts as securities under the state securities code.

Our objections to the proposed branch office definition can be ameliorated by having the NASD, NYSE and state securities administrators adopt the current branch office definition as a uniform term. Because the NASD has jurisdiction over more broker-dealers than the NYSE or state securities administrators, this offers the most even-handed solution. Alternatively, if the proposed definition is adopted and approved, the NASD should provide an exclusion from the branch office definition for non-branch locations distributing variable contracts.[4]

The proposal's two exceptions for primary residence and 25 or fewer annual securities transactions primarily assist full-service and NYSE broker-dealers, and do not remediate the disproportionate burdens of the proposals on insurance affiliated broker-dealers. Without appropriate modification, the Form BR and branch office proposals will contradict the proscription against anticompetitive SRO rules in the 1943 act.

Clarification and Duplication

Proposed Form BR duplicates the information required by Schedule E of Form BD, the current broker-dealer registration form administered by the SEC. According to the NASD notice, "SEC staff has indicated that it would *consider* endorsing the proposed Form BR as a replacement for Schedule E of Form BD."[5] This reference equivocates. Without a formal SEC action eliminating Schedule E, proposed Form BR is premature, and would exacerbate administrative burdens. Form BR should be withheld until the SEC acts.

Items 3 and 4 of Form BR may inappropriately draw broker-dealers into supervision and liability for outside business activities because of the nature and depth of information elicited. This deviates from current practices where registered representatives are required to notify the broker-dealer of outside activities. This practice reflects an appropriate mechanism to monitor unauthorized securities sales (selling away) without exposing the broker-dealer to secondary liability over non-securities activities it does not supervise.

The instructions to Item 5 does not provide helpful guidance on undefined headings in this item. What is intended to be entered under the headings "Disclosure," "SD," and "Independent Contractor?" The instructions provide no clue. We understand that SD signifies statutory disqualification. Does the heading reference an individual with a disqualification that has been permitted to continue working following a SD hearing?

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[4] Another partial solution to the proposals' disproportionate impact would be to waive filing and registration fees permanently for non-branch locations that are converted into branches simply due to the proposed numerical threshold in the proposal. Regretably, the NASD has indicated that it has summarily dismissed this solution. *See* http://www.nasdr.com/pdf-text/rf03_104_resp01.pdf

[5] *See* footnote 4 in NASD NTM 04-45. [Emphasis added in text].

We are greatly concerned that the 30-day cycle stipulated in the form for amendments will have a disastrous impact on broker-dealers with many current non-branch locations that will be inappropriately converted to branch offices under the NASD's proposal. The sheer number of offices and filings that would need updates on a very short time horizon is daunting, and offers another good reason to retain the current NASD definition of branch office. The proposal does not evaluate the burdensome economic impact of this consequence.

The Unique Nature of Broker-Dealers Affiliated with Life Insurers

Broker-dealers affiliated with life insurance companies are significantly different from full service or "wire-house" broker-dealers in their operations, products and services. The securities activities of broker-dealers affiliated with life insurers are a component of a larger insurance business. Many registered representatives operate principally as life insurance and annuity salespersons. Securities sales frequently constitute an incidental amount of business relative to insurance product sales by an office or registered representative.

As a by-product of this relationship, supervision and compliance is often conducted through the vehicle of an insurance distribution system. Consequently, registered representatives of broker-dealers affiliated with life insurers are often present in numerous small, geographically disperse offices. The cost and burden of the proposal would, therefore, be disproportionately greater for these broker-dealers compared to full service firms.

The range of products offered by these limited purpose broker-dealers is typically narrow and focuses upon the distribution of variable insurance contracts and mutual funds. It may be helpful to consider those securities activities and services *not* offered by most broker-dealers affiliated with life insurers. Typically, these firms do not maintain discretionary accounts permitting registered representatives to purchase and sell securities on behalf of a client without specific approval of each transaction. On an industry-wide basis, these broker-dealers generally do not take custody of client funds, securities or assets. This type of firm does not typically "carry" customer accounts.

Insurance broker-dealers usually require that payment for variable insurance or securities products be made by check payable to the processing office, and not by check payable to the agent/registered representative. Variable contracts and shares in investment companies are issued directly to purchasers and do not constitute bearer instruments. Consequently, the opportunity for misappropriation of these instruments by registered representatives is virtually nonexistent.

Broker-dealers affiliated with life insurers generally do not maintain "open accounts" or facilitate the implementation of stop orders and limit orders, which obviates many potential brokerage problems. Similarly, because these broker-dealers do not typically make available cash management accounts or manage free cash balances, many associated operational and logistical difficulties are absent. Broker-dealers affiliated with

life insurers do not make markets in securities or underwrite new issues of securities. This obviates common pressures for unsuitable sales practices.

In several instances, the federal securities laws and the NASD regulations provide appropriate regulatory exceptions because these limited purpose broker-dealers are different from full service broker-dealers. For example, SIPC membership is not required (or allowed) because these entities do not make margin loans or take custody of customer assets or securities. Similarly, net capital requirements do not apply since these limited purpose broker-dealers. In the same way, the proposed books and records rule amendments should be refined to properly fit all broker-dealers, and not just full service firms.

The Branch Office Definition: Substantial Systems, Structural, and Operational Impact

In the early 1990's, the NASD significantly revised its supervision rule, especially as it involves the definitions of branch office and office of supervisory jurisdiction (OSJ). These definitions are pivotal because the distribution networks of broker-dealers associated with life insurers typically involve numerous small, geographically dispersed offices that are classified and regulated as non-branch locations, rather than OSJs or branches under the NASD Rules of Conduct.

After the NASD amended its supervision Rule 3110, broker-dealers affiliated with life insurers significantly restructured their operations to comply with the definitional and supervisory changes. These firms comply with the NASD's standards.

Under NASD Conduct Rule 3110, an OSJ is any business location of a broker-dealer at which one or more of the following functions take place: (I) order execution or market making; (ii) structuring of public offerings or private placements; (iii) maintaining custody of customer's funds or securities; (iv) final acceptance (approval) of new accounts for the members; (v) review and endorsement of customer orders; (vi) final approval of advertising or sales literature for use by members associated with a member; and (vii) responsibility for supervising the activities of persons associated with the broker-dealer at one or more of the broker-dealer's offices. Several of these definitional elements, such as market making, private placements, and retaining custody of customer assets have little, if any, applicability to most insurance broker-dealers. The principal characteristics relevant to insurance broker-dealers include final acceptance of new accounts, endorsement of purchase orders, supervision responsibilities and sales literature approval.

Rule 3110 also defines the term "branch office" as any business location of the broker-dealer identified to the public or customers by any means as a location at which the investment banking or securities business is conducted on behalf of the member.[6] In contrast to some state definitions of branch office, the NASD definition excludes any

[6]NASD Conduct Rule 3110(g)(2) (2004).

location identified solely in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the office of the broker-dealer responsible for supervising the activities of the identified location. The NASD has issued two interpretations embellishing this position.[7]

The meaning of the branch office definition has significant compliance and regulatory implications for broker-dealers. For example, a registered principal of the broker-dealer must conduct on-site inspection of all branches annually.[8] The business activities, volume and number of salespersons can require more frequent examinations of specific branches. Broker-dealers must identify appropriately registered persons in each branch to supervise the activities of that office.[9] Compliance procedures must be tailored to the nature and volume of business of each branch.

Because variable insurance products are typically sold through existing insurance distribution networks, confusing or inconsistent application of the branch office and OSJ definitions can foster significant economic and structural consequences.[10] Careful evaluation of the branch office definition is important, particularly in maintaining the different regulatory status of non-branch locations.

Compliance with the NASD's supervision standards in Rule 3110 necessitates careful, constant attention to fulfill its requirements and to properly maintain the distinctions between OSJs, branch offices, and non-branch locations. For insurance affiliated broker-dealers, review and control over sales literature and business location communications are particularly essential to maintaining these definitional distinctions.[11] In addition, broker-dealers' advertisements may include a local telephone number or local post-office box provided that the advertisement also identify the location and telephone

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[7]*See* 4 NASD Regulatory and Compliance Alert 1 (Feb. 1990) at 7 (clarifying interpretations on branch office communications) and NASD Notice to Members 89-34 (Apr. 1989) at 204 (clarifying the meaning of business advertisements and public listings).

[8]NASD Conduct Rule 3110(g)(2) (2004).

[9]NASD Conduct Rule 3110(g)(2) (2004).

[10]Some life agents, while associated with a formal life insurance sales agency, actually conduct business in homes. Inappropriate designation of these locations as branch offices would be unreasonably burdensome and without regulatory purpose.

[11]The NASD has published responses to private interpretations that clarify the rule's definition of a branch office and the exemption from branch office registration available for nonbranch locations. A location may be exempt from registration at a branch office if it is identified to the public only in telephone book listings, business cards, or stationary that also include the address and telephone number of the branch office or OSJ responsible for supervising the non-branch business location. *See* 4 NASD Regulatory and Compliance Alert 1 (Feb. 1990) at 7. Additionally, any complaints coming through the central site must be sent to the office or offices with jurisdiction over the non-branch business, according to this NASD interpretation. Another interpretation allows broker-dealer sales literature to include the local address of a non-business location, if it also identifies the location and telephone number of the broker-dealer's appropriate OSJ or supervisory branch office.

number of the appropriate branch office or OSJ. The NASD has stated, however, that these advertisements must *not* include the address of the non-branch location.[12]

Given the technical precision in the NASD's branch office requirements, a revised definition would create enormous operational and structural burdens for broker-dealers that have adjusted to the current NASD standards. Further, NASD requirements create meaningful supervision and compliance enhancements that directly apply to broker-dealers operating in every state jurisdiction. In light of these regulatory enhancements, the need for a new, incompatible branch office definition is uncompelling.

In many states a "local office" or "branch office" definition successfully generates increased revenue from filing fees assessed on a larger number of locations. This is unseemly and unconstructive as a matter of state-federal regulatory harmony. By converting the branch office definition from a functionally based approach to a crude numerical formulation, the NASD will cause an enormous number of non-branch locations to become branch offices, which will trigger profound, and unnecessary registration, filing and administrative costs.

Creating a new "branch office" definition will burden the organization and operation of broker-dealers that were substantially restructured in response to NASD Rule 3110. The books and records that state securities regulators often seek to obtain can be equivalently accessed based upon existing NASD standards concerning branch and non-branch locations.

Further, the NASD's numerically based branch office proposal would have a disproportionate competitive impact on smaller limited purpose broker-dealers in contravention with Section 23(a) of the Exchange Act. Due to differences in their markets and approach as discussed above, limited purpose broker-dealers tend to have greater numbers of small, geographically dispersed offices compared to full service broker-dealers.

For example, purchasers of variable annuities and variable life insurance do not tend to make repeat purchases of those products. Customers do not typically buy one variable product, sell it, and buy another. Variable products are long term vehicles. Purchasers of these products fill out extensive applications identifying essential insurance underwriting and suitability information. The applications are carefully reviewed by the life insurers issuing the products to assure that the product is right for the customer and the customer satisfies underwriting standards.

There is not an absence, therefore, of information or review about the products' appropriateness. The nature of these products does not lend to the abuses for which state

[12] An additional NASD interpretation allows the use of the broker-dealer's main office address and telephone number for reply purposes on sales literature, advertisements, business cards, and business stationary. Use of a central site instead of a branch or OSJ for replies can occur only where significant and geographically disbursed offices have a supervisory system appropriate to the operation. *Id*. at 7.

securities regulators seek added regulatory information. These variable insurance contracts are not "speculative" or high risk instruments. VLI provides basic death benefit protection and variable annuities are long-term accumulation products with permanent annuity purchase rate guarantees on annuitization.

Moreover, state securities regulators generally lack jurisdiction to regulate VLI and variable annuities. Under the laws of every jurisdiction authorizing insurers to issue variable contracts funded by separate accounts, the state insurance commissioner is vested with exclusive authority to regulate separate account products. [13] This exclusive regulatory approach dovetails with the fact that variable contracts are excluded from the definition of "security" in most states. [14]

According to NTM 04-55, the proposed form seeks to provide state securities regulators with useful information on a local level. Since most state securities administrators lack jurisdiction over variable products, this information is not germane to state securities regulators' needs when broker-dealers limit securities sales to variable life insurance and variable annuities. In this light, the expense and burden of accumulating and updating the proposed form's information at every location greatly outweighs its unsubstantiated regulatory value.

Other important considerations support excluding non-branch locations of broker-dealers affiliated with life insurers from the branch office definition. Unlike the full service firms on which the definition is focused, broker-dealer involvement with the customer usually ceases after the application is submitted to the issuing insurer. The life insurance company becomes the principal ongoing contact for the purchaser of this long-term product. Indeed, Exchange Act Release No. 8389 [15] recognizes this relationship and allows insurers to fulfill ministerial and clerical record management functions without having to register as a broker-dealer.

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[13] *See* Section 4, Model Variable Contract law, National Association of Insurance Commissioners (1996), which provides: Notwithstanding any other provision of law, the commissioner shall have sole authority to regulate the issuance and sale of variable contracts, and to issue such reasonable rules and regulations as may be appropriate to carry out the purposes and provisions of this Act.

Substantially all states have enacted this language. *See, e.g.* Cal. Ins. Code §10506 (1996); Conn. Gen. Stat. §38-154 (1994). The appendix to this letter contains statutory charts to each jurisdiction highlighting the status of variable contracts under state securities and insurance laws. The appendix also contains summary maps on these issues.

[14] *See, e.g.* Tile 4 Cal. Corp. Code §25019 which provides: "Security" means . . . . "Security" does not include: . . . (3) any insurance or endowment policy or annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period. . . . *See also* §7302(a)(13) Del. Securities Act (1995); §11-101(p)(2) Md. Securities Act (1996).

[15] *See*, Exchange Act Rel. No 8389 (Aug. 29, 1968), *reprinted in* [1968 Trans. Binder] Fed. Sec. L. Rep.(CCH) ¶ 77,594. *See also*, Sentry Insurance (SEC no-action letter publicly available Sept. 6, 1987); Century Life of America (SEC no-action letter publicly available Aug. 6, 1987); Mutual Benefit Life Ins. Co. (SEC no-action letter publicly available Jan 21, 1985).

Similarly, unlike full service broker-dealers with large multi-person offices, broker-dealers affiliated with life insurers frequently have many small offices that are often geographically dispersed. In recognition of this factor and the more limited range of products, the NASD rules allow a supervising registered representative to perform supervisory functions conducted by principals at full service broker-dealers. [16]

While we strongly support coordination of state and federal registration, we oppose this rulemaking in many respects because it is designed around the template of a full service broker-dealer and fits limited purpose firms poorly. Without revision, the initiative would impair competition because it would impose a disproportionate impact on limited purpose broker-dealers

The desire to harmonize and coordinate state and federal securities regulation is worthwhile and commendable. The proposal, however, needs extensive screening and revision in order to assure that the proposal "will promote efficiency, competition and capital formation," as required under the Capital Markets Efficiency Act of 1996. The NASD should more thoroughly evaluate the proposal to avoid duplications and conflicts with existing securities law requirements, and to prevent unnecessary administrative practices that burden different types of broker-dealers unequally.

There are several worthwhile analytical benchmarks for evaluating the proposed form. In the Capital Markets Efficiency Act of 1996, Congress added Section 3(f) to the Exchange Act requiring that whenever the SEC is engaged in rulemaking under the Exchange Act, it shall "consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation."[17]

Similarly, the legislation requires the SEC's Chief Economist to prepare an economic analysis report on each proposed SEC regulation that would be provided to each SEC Commissioner and published in the Federal Register before the regulation became effective. Congress indicated its hope "that this report will demonstrate serious economic analysis throughout the process of developing regulations."[18] When Form BR is submitted for SEC approval, we encourage the NASD to provide a well-documented economic impact analysis.

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[16] NASD Conduct Rule 3110(a)(4).

[17] Pub. Law 104-290, 110 Stat. 3416 (October 11, 1996).

[18] S. Rep. 293 104th Cong., 2d Sess. (June 26, 1996) at 16, 33. This statutory change requires the SEC to conduct an economic analysis of all new regulations before they can enter into effect, potentially reducing the impact of future SEC regulations on the economy. *Id.* In his testimony on this legislation, SEC Chairman Levitt emphasized that "an appropriate balance can be attained in the federal - state arena that better allocates responsibilities, reduces compliance costs and facilitates capital formation, while continuing to provide for the protection of investors." *Id.* at 2.

In the legislation, Congress noted that its amendments to the federal securities laws focus on the need to delineate more clearly the securities law responsibilities of federal and state governments.[19] "Currently that relationship is confusing, conflicting and involves a degree of overlap that may raise costs unnecessarily for American investors and the members of the securities industry."[20] In recognition of these problems, Congress preempted states from adopting broker-dealer books and records requirements.[21]

There are several other important guideposts to evaluating proposed rulemaking under the Exchange Act and helping to intelligently balance the costs and burdens of compliance against the goals of new regulation. Section 23(a) of the Exchange Act requires the SEC to consider the anti-competitive effects of rule changes, and to balance any impact against the regulatory benefit to be obtained. This benchmark will certainly play a role in the industry's comments on the form when the SEC circulates it for notice and comment under the Administrative Procedure Act.

Conclusion

The life insurance industry supports uniform electronic registration of branch offices through the NASD's CRD system. This concept offers the opportunity for efficient regulatory compliance.

Form BR, however, is not ready for prime time. It is a cart put before the horse because the NASD's definition of branch office is a crucial ingredient to the operation and utility of Form BR. The NASD's proposal to revise the definition of branch office, which the life insurance industry opposes, remains outstanding.

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[19] *Id*. at 2.

[20] *Id.* In a joint explanatory statement of the Committee of the Conference on this legislation, the Committee emphasized that the development and growth of the nation's capital markets has prompted the Congress to examine the need for legislation modernizing and rationalizing our scheme of securities regulation to promote investment, decrease the cost of capital, and encourage competition. The report observes the system of dual federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation. "That, in many instances, is redundant, costly, and ineffective." H.R. Rep. 864, 104th Cong. 2d. Sess. (Sept. 28, 1996) at 39.

[21] *Id.* In connection with the NASD and NYSE Form BR and branch office proposals, the North American Securities Administrators Association (NASAA) has proposed a definition of branch office. *See* http://www.nasaa.org/nasaa/abtnasaa/display_top_story.asp?stid=487. NASAA's action contradicts NSMIA's proscription on recordkeeping rules because the combined impact of Form BR and a state branch office definition directly involves recordkeeping practices.

The NASAA proposal deviates from the NASD's branch office definition, and includes investment advisers in the definition even though NSMIA stripped state securities administrators of jurisdiction over broker-dealers with greater that $25 million of assets under management. *See* Sargent, *The National Securities Markets Improvements Act-One Year Later*, 53 Bus. Law 507 (1998); Friedman, The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers, 53 Bus. Law 511 (1998).

Form BR will have a disproportionate and negative impact on broker-dealers affiliated with life insurers if the NASD's proposed definition of branch office is implemented. This will create unwarranted anticompetitive burdens prohibited by the 1934 Act.

Our objections to the proposed branch office definition can be ameliorated in several ways. The NASD could successfully achieve state-federal definitional uniformity by retaining its current branch office definition and having the NYSE and state securities regulators follow suit. Alternatively, if the proposed definition is adopted and approved, the definition should provide an exclusion from the branch office definition for non-branch locations distributing variable contracts.[22]

The brief 30-day comment period during the peak of the summer vacation season will not elicit sufficiently broad input. Consequently, this NASD comment period is not functionally meaningful. Comments from other interested parties should be accepted beyond the short deadline. It is also very troubling that the proposed branch office definition was circulated for a 21-day comment period that occurred over the last two weeks of 2003 and the first week of 2004, a time period when many businesses are closed and individuals are out of the office.[23] Together, both of these very related initiatives have experienced non-functional exposure.

The NASD should withdraw the proposed form until the branch office definition is finalized in a competitively balanced manner. If an acceptable definition of branch office can be adopted in advance, then the form should be tightened up and clarified.

We greatly appreciate your attention to our concerns. If any questions develop, please call.

Sincerely,

Carl B. Wilkerson

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[22] The proposal's two exceptions for primary residence and 25 or fewer annual securities transactions primarily assist full-service and NYSE broker-dealers, and do not remediate the disproportionate burdens of the proposals on insurance affiliated broker-dealers.Another partial solution to the proposals' disproportionate impact would be to waive filing and registration fees permanently for non-branch locations that are converted into branches simply due to the proposed numerical threshold in the proposal. Regretably, the NASD has indicated that it has summarily dismissed this solution. *See* http://www.nasdr.com/pdf-text/rf03_104_resp01.pdf

[23] In light of these timing deficiencies, the NASD should not even consider advancing the proposal to take effect upon filing with the SEC, as referenced in footnote 2 of NTM 04-55.

THE STATUS OF VARIABLE CONTRACTS UNDER STATE SECURITIES AND INSURANCE LAWS			
State	**Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts**	**Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"**	Other Parallel Exclusions from State Securities Code
Alabama	§27-38-4	[1]	§ 8-6-2(10)
Alaska	§21.42.370(k)	§45.55.990 (32)	
Arizona	§20-651 (l)	[2]	
Arkansas	§23-81-405	§23-42-102(15)(B)	
California	§10506(h)	§25019	
Colorado	§10-7-404 (l)	§11-51-201 (17)	
Connecticut	§ 38a-433(c)	§36b-3(17)	
Delaware	§2932(d)	§7302(13)	
D.C.	§31-4442(f)	[3]	
Florida	§ 627.805	[4]	

[1] Definition of "security" in Alabama includes "annuity contract **unless** issued by an insurance company."[*See,* §8-6-2(10)]. Variable annuities issued by a life insurance company, therefore, are excluded from the definition of security in Alabama.

[2] No categories of any kind are excluded from the definition of security in Arizona. [*See*, § 44-1801(26)].

[3] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in the District of Columbia. [*See*, §31.5601.01(31)(A)].

[4] No categories of any kind are excluded from the definition of security in Florida. [*See*, §517.021(19)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
Georgia	§33-11-65(h)	[5]	
Guam	§12204	§46401(l)	
Hawaii	§431:10D-118(d)	[6]	
Idaho	§41-1939(1)	§30-1402(12)	Bulletin 88-9
Illinois	5/245.24	[7]	
Indiana		§23-2-1-1(k)(1)	
Iowa	§508A.4	§502.102(19)	
Kansas	§40-436(l)	§17-1252(j)	
Kentucky	§304.15-390(7)	[8]	
Louisiana	§1500(J)	[9]	

[5] Georgia statute refers only to variable *annuities* in the exclusion from the definition of security. Therefore, variable life insurance contracts are technically not within the exclusion, although exclusion of both variable annuities and variable life insurance contracts was probably intended by legislature. [*See*, §10-5-2(26)].

[6] Definition of "security" in Hawaii does not include any insurance or endowment policy or fixed *annuity* contract. Variable *life* insurance, therefore, is excluded from definition. [*See*, §485-1(13)].

[7] No exclusion from the definition of security for any type of insurance, endowment, or annuity contracts in Illinois. [*See*, §2.1].

[8] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Kentucky [*See*, §292.310(18)].

[9] Fixed insurance endowment and annuity contracts are excluded from the definition of security in Louisiana. The Louisiana statute also refers to variable annuity contracts in the exclusion from the definition of security. [*See*, §51:702(15)(6)(i)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
Maine	§2537(12)	§10501(18)	
Maryland	§16-601(b)	§11-101(r)(2)	
Massachusetts	§132G	§401(k)	
Michigan	§ 500.925, § 500.4000	§451.801(z)	
Minnesota	§§61A.18, 61A.20	§80A.14(18)(a)(l)	
Mississippi	§83-7-45	§75-71-105(n)	
Missouri	§376.309(6)	§409.401(o)	
Montana	§33-20-602	[10]	
Nebraska	§44-2220	§8-1101(15)	
Nevada	§ 688A.390(4)	[11]	
New Hampshire	§408:52	§421-B:2(XX)(a)	
New Jersey	§ 17B:28-14	§ 49:3-49(m)	

[10] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Montana. [*See*, §30-10-103(22)(b)].

[11] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Nevada. [*See*, §90.295(1)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
New Mexico	§59A-20-30(E)	[12]	Opinion No. 69-97 Reaffirms Exclusive Authority of Insurance Commissioner and precludes Securities Commissioner jurisdiction
New York	§4240(7)	[13]	
North Carolina	§58-7-95(r)	§78A-2(11)	
North Dakota		[14]	
Ohio	§3911.011(C)	[15]	

[12] No exclusion from the definition of security for any type of insurance, endowment, or annuity contracts in New Mexico. [See, §58-13B-2(X)].

[13] The New York statutes do not specifically define "securities" in a manner similar to other states. Section 352, which grants investigate power to the attorney general, defines security as "…any stocks, bonds, notes, evidences of interest or indebtedness or other securities, including oil and mineral deeds or leases and any interest therein … or negotiable documents of title, or foreign currency orders, calls or options therefore hereinafter called security or securities…." *See* N.Y. Gen. Bus. Law §352(1).

[14] No categories of any kind excluded from definition of security in North Dakota. [*See*, §10-04-02(15)].

[15] No categories of any kind excluded from definition of security in Ohio. [*See,* §1707.01(B)].

State	**Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts**	**Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"**	Other Parallel Exclusions from State Securities Code
Oklahoma	§6061(D)[16]	§71-1-2(w)	
Oregon		§59.015(19)(b)(A)	
Pennsylvania	§506.2(d)[17]	§1-102(t)(iii)	
Puerto Rico	§1334[18]	[19]	
Rhode Island	§27-32-7	[20]	
South Carolina	§38-67-40	§35-1-20 (15)	

[16]The statute's grant of exclusive jurisdiction to the Insurance Commissioner is unique in additionally stating that "the companies which issue them [variable contracts] and the agents or other persons who sell them shall not be subject to the Oklahoma Securities Act nor to the jurisdiction of the Oklahoma Securities Commission thereunder."

[17]The statute's grant of exclusive jurisdiction to the Insurance Commissioner has a unique added sentence which states: "Variable contracts, and agents or other persons who sell variable contracts, shall not be subject to the act of December 5, 1972 (P.L. 1280, No. 284), known as the 'Pennsylvania Securities Act of 1972,' or to regulation by the Pennsylvania Securities Commission."

[18]This section states that "[t]he Commissioner shall have authority to prescribe appropriate rules and regulations to carry out the purposes and provisions of sections 1301, 1329 and 1330 of this title." §1335 also states that "[t]he powers granted to the Securities Office of the Treasury Department under sections 851-895 of Title 10 known as Uniform Securities Act, with regard to the regulation and supervision of all the aspects of the variable annuities insofar as they are securities, shall in no wise [sic] be affected upon the taking effect of this section and sections 1329—1334 of this title. These securities, the variable annuities, shall continue under the coverage of the Securities Act and the regulations approved under said statute."

[19]Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Puerto Rico. [*See*, §881(1)].

[20][*See*, §7-11-101(20)(i)] Only fixed insurance, endowment and annuity contracts excluded, but §7-11-101(20)(ii) excludes group *variable* contracts subject to ERISA.

State	**Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts**	**Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"**	Other Parallel Exclusions from State Securities Code
South Dakota	§58-28-31[21]	[22]	
Tennessee	§56-3-508	§48-2-102(13)(E)	
Texas	Art. 3.75(8)	Art. 581-4(A)	
Utah	§31A-5-217.5(6)	§61-1-13(24)(b)(i)	
Vermont	§3858	[23]	
Virginia		§13.1-501(A)	

[21]The provision granting the Insurance Commissioner exclusive jurisdiction to regulate variable contracts reflects the language of the NAIC Model Variable Contract Statute, but also contains two additional unique sentences stating that "The division of securities may, upon request by the director, review the underlying investments in securities of variable contracts. The division of securities may require filing a disclosure document with the division of securities pursuant to chapter 47-31A." *But see*, South Dakota Insurance Bulletin 93-2 (Revised December 17,1993), which states that "Over the past year, the Division of Securities has reviewed the [variable] products for compliance with specific securities requirements. For the most part, the Division of Securities has found that the products meet its requirements and that nothing out of the ordinary is disclosed in the filings. In an attempt to conserve regulatory resources, the Division of Securities will no longer review variable products. The Division will continue to assert its jurisdiction over the variable agents, requiring registration as it always has, and will enforce the anti-fraud provisions of the law against violators."

[22]Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in South Dakota. [*See*, §47-31A-401(m)].

[23]No categories of any kind are excluded from the definition of security in Vermont. [*See,* §4202(a)(16)].

State	**Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts**	**Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"**	Other Parallel Exclusions from State Securities Code
Washington	§13.1-501[24]		
West Virginia	§33-13A-4	§32-4-401(n)	
Wisconsin	[25]	§551.02(13)(b)	
Wyoming	§26-16-502(d)	§17-4-113(a)(xi)	

[24]Although granting the insurance commissioner sole authority to regulate the issuance and sale of variable contracts, the provision further states that the insurance commissioner shall not have jurisdiction "for the examination, issuance or renewal, suspension or revocation, of a security salesman's license issued to persons selling variable contracts. To carry out the purposes and provisions of this chapter he or she may independently, and in concert with the director of financial institutions, issue such reasonable rules and regulations as may be appropriate."

[25]§611.24 of the Wisconsin Insurance Code grants the Insurance Commissioner significant authority to regulate variable contracts, but lacks reference to the insurance commissioner's "sole" or "exclusive" jurisdiction as contained in other insurance codes or the NAIC Model Variable Contract Statute.

NUMERICAL SUMMARY OF VARIABLE CONTRACT STATUS CHART	
# of jurisdictions granting Insurance Commissioner *exclusive jurisdiction* to regulate the issuance and sale of variable annuities and variable life insurance contracts	48
# of jurisdictions excluding *all* insurance endowment and annuity contracts from the definition of "Security" in state securities code	34/37[26]
# of jurisdictions *specifically* defining variable annuity and variable life insurance contracts as a "Security" in state securities code (i.e., these states have inserted the optional bracketed language "[a fixed sum of]" from § 401(l) of the USA of 1956.	8[27]
# of jurisdictions excluding *no* categories of any kind from the definition of "Security" in state securities code	6[28]
# of jurisdictions having *no* exclusion from the definition of "Security" for *any* type of insurance, endowment or annuity contract (i.e., fixed *and* variable insurance, endowment or annuity contracts are defined to be securities).	2[29]

[26]The total of 37 could be used for this category, but needs explanation because in four states the definitional exclusions do not include *all* variable insurance, endowment or annuity contracts.

- The definition of "security" in Alabama includes "annuity contract **unless** issued by an insurance company."[*See,* §8-6-2(10)]. Variable annuities issued by a life insurance company, therefore, are excluded from the definition of security in Alabama.

- The Georgia statute refers only to variable *annuities* in the exclusion from the definition of security. Therefore, variable life insurance contracts are technically not within the exclusion, although exclusion of both variable annuities and variable life insurance contracts was probably intended by legislature. [*See*, §10-5-2(26)].

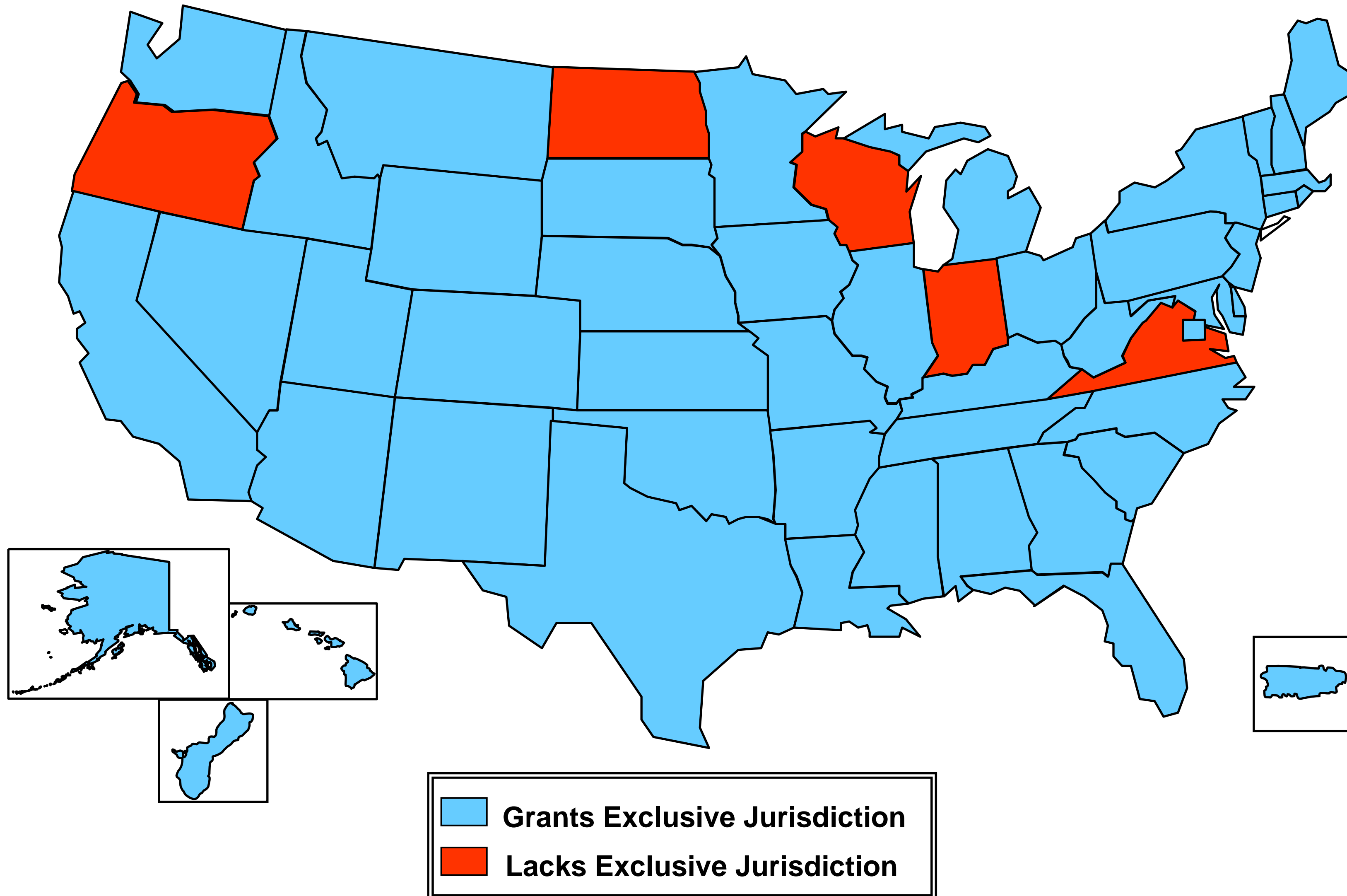
- The definition of "security" in Hawaii does not include any insurance or endowment policy or fixed *annuity* contract. Variable *life* insurance, therefore, is excluded from definition. [*See*, §485-1(13)].

- The Louisiana statute also refers to variable annuity contracts in the exclusion from the definition of security. [See, §51:702(15)(6)(i)]

[27]These states are: DC, KY, MT, NV, PR, RI, SD and WA. There is a qualification to one state in this category. RI excludes from the definition of security *group* variable contracts subject to ERISA.

[28]These states are: AZ, FL, ND, NY, OH, and VT.

States Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts



By Carl B. Wilkerson, Vice President and Chief Counsel – Securities & Litigation,
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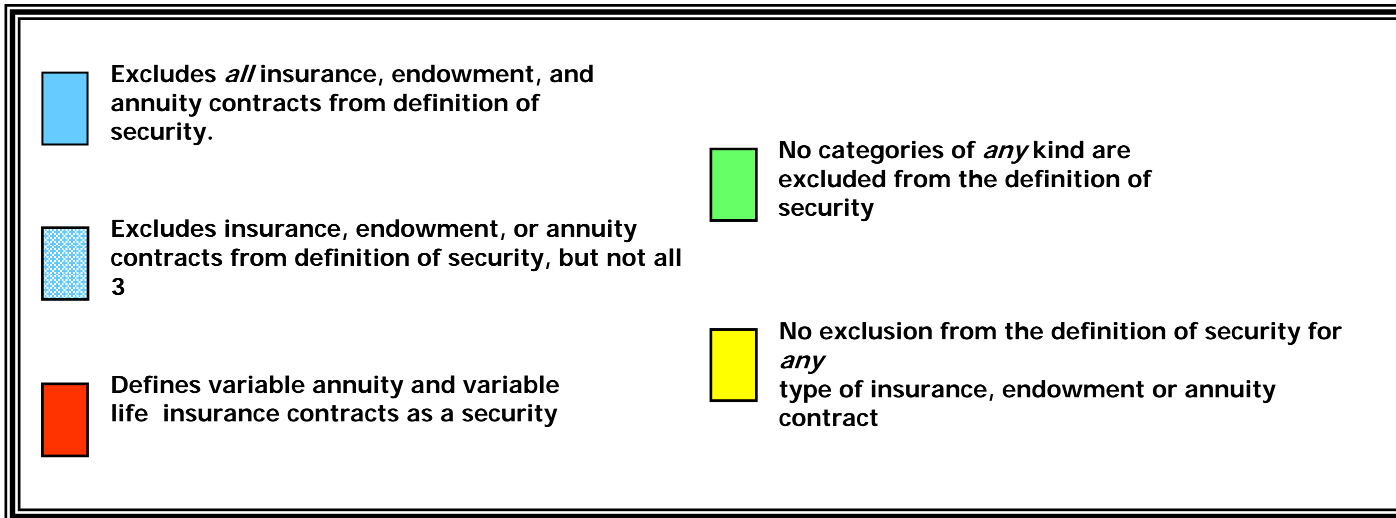
Status of Variable Contracts Under State Securities Laws



CARL WILKERSON
CHIEF COUNSEL, SECURITIES & LITIGATION

ATTACHMENT 2

December 23, 2003

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
Room 6507
450 Fifth Street, N.W.
Washington, D.C. 20549

By e-mail

RE: Substantive submission and request for comment period extension on Release No. 34-48897; File No. SR-NASD-2003-104; *Proposed NASD definition of broker-dealer "branch office."*

Dear Mr. Katz:

The American Council of Life Insurers respectfully requests that the comment period on Release No. 34-48897 be extended for 75 days to provide an opportunity for careful analysis and constructive comment on the NASD proposal. The Release invited comment on proposed changes to the NASD definition of broker-dealer "branch office," and appeared in the Federal Register Vol. 68 No. 241 on December 16, 2003, and contains a 21-day comment period expiring January 6, 2004.

The American Council of Life Insurers ("ACLI") is a national trade association with 399 members representing 72 percent of all United States life insurance companies. Many of our member companies offer and distribute variable annuities, variable life insurance and mutual funds directly or through affiliated and independent broker-dealers. Our member companies and their broker-dealer affiliates have concerns with the NASD's proposed revisions to the "branch office" definition. The initiative would have a significant, unique impact on our industry.

SEC oversight of SRO rule proposals ensures balanced regulations in the public interest, and provides an important protection against SRO rules that may impede competition. The full execution of SEC oversight and public comment is fundamental to sound rulemaking and robust competition. We have actively addressed the scope of the

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"branch office" definition since 1989 with the NASD, and since 1993 with the North American Securities Administrators Association.

Brief Background

Over 50% of the 662,311 NASD registered representatives work for broker-dealers affiliated with life insurance companies. Many of these salespersons work out of smaller, geographically dispersed "non-branch" locations pursuant to existing NASD rules. Insurance affiliated broker-dealers have constructed their structure and operations based on the NASD's current branch office definition.

The proposed rule change would replace the current function-based threshold in the NASD's branch office definition with a strictly numerical yardstick of salespersons per office. While this approach may not present issues for full service broker-dealers, it provokes significant financial and structural impediments to limited purpose broker-dealers. The proposed rule's burden on this large segment of the NASD universe has been disregarded. Disparities in the rule's impact may have profound anti-competitive consequences.

Timing Considerations

Several time-related considerations warrant extension of the comment period. The proposed rule changes are significant and have been evolving since 1993 in several different proposals. The proposal amendments merit thorough discussion and analysis. Procedurally, several aspects of the proposal raise significant concerns under the Administrative Procedure Act. Additionally, the proposal will have an anticompetitive impact on limited purpose broker-dealers.

The 21-day comment period is insufficient to address the issues raised in the release. As a practical matter, most observers will have significantly fewer than 21 days to digest the proposal after accounting for time consumed in postal delivery of the Federal Register following its December 16, 2003, printing date. Moreover, some of the changes and cost considerations appeared for the first time in the release, and will require substantial time to analyze.

Most significantly, the 21-day comment period occurs over the last two weeks of 2003 and the first week of 2004, a time period when many businesses are closed and individuals are out of the office. Consequently, the already unacceptably brief comment period is rendered nearly meaningless.

Industry trade associations circulate regulatory proposals, elicit membership input, develop a consensus, and circulate a draft letter of comment before submission. This is a worthwhile, but time intensive, process that is difficult to execute in 21 days.

The NASD itself spent over 13 months (approximately 400 days) analyzing and revising the proposal after the October 21, 2002 comment period ended. In light of this lengthy time period for NASD review of the proposal, industry commentators should be entitled to a reasonable comment period longer than 21 days. The SEC staff itself has been reviewing the NASD filing since July 1, 2003, when the NASD initially submitted its proposal for SEC approval. Given these lengthy periods for NASD and SEC review, a 75-day extension to the comment period is quite reasonable.

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.[1]

A meaningful comment period on the NASD's proposed rulemaking is important. The 21-day comment period is dysfunctional on several levels. The NASD filing indicates that over 137 letters of comment were filed on the NASD's circulation to its members that raised a variety of concerns. Not all of the concerns were addressed in the NASD filing and digest of comments. Some were ignored completely. A 21-day comment period during the peak of the holiday season is inadequate to flesh out the NASD's responsiveness to the letters of comment.

The NASD's internal rulemaking process does not reflect the makeup of the NASD's membership, because full-service broker-dealers dominate the NASD governance and committee structure. Some limited-purpose broker-dealers, therefore, question the fairness of internal NASD rule proposals, and instead rely on trade association representatives to voice objections during the SEC approval process. This role cannot be reasonably conducted during a 21-day comment period.

Anti-Competitive Consequences

Several aspects of the rule amendment would impose unreasonable burdens on competition. The NASD requires broker-dealers to submit a filing fee for all "branch offices." The proposed rule would elevate most current "non-branch" locations to "branch offices," that would trigger NASD filing fees. Broker-dealers affiliated with life

[1] *See, A Guide to Federal Agency Rulemaking*, Administrative Conference of the United States (1983) at 124 [revised and republished in 1990].

insurers tend to have numerous "non-branch" locations and will face significant added NASD filing fees and structural burdens as a consequence. In contrast, full-service broker-dealers predominately operate out of branch offices rather than "non-branch" locations.

Several commentators suggested that the NASD reduce its registration fees so that the rule change is revenue neutral, and its financial burden on broker-dealers is minimized. The release and the NASD's filing failed to respond to these comments completely. Nothing in the release quantifies how many of the "non-branch" locations will be converted to branch offices with filing fee requirements.

Incredibly, the NASD asserts that the "it does not believe the proposed rule change, as amended, would result in *any* burden on competition that is not necessary or appropriate in furtherance of the" Securities Exchange Act of 1934. The Exchange Act demands more than hollow, unsubstantiated proclamations.

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]

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

[3] *Id*. at 12.

[4] *See*, 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"].

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

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.[5] 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.

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 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.[6]

The NASD's rule request for SRO rule approval does not fulfill the important SEC and statutory goals to protect both competition and investors. The NASD should fully quantify the economic impact the proposed amendments impose on broker-dealers affiliated with life insurers that have distribution through "non-branch" locations. The aggregate number of changed locations and new filing fees should be clearly stated and balanced against the amendments' purpose. The SEC should not approve the NASD initiative without modifications to remedy the rules' anticompetitive impact.

Other Issues Raised by the Proposal

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[5] *Id.*

[6] *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

There are several additional reasons that a comment extension should be granted in this instance.

- The 21-day comment period is excessively short, and occurs during the peak of the year-end holiday season. Absent an extended comment period, the proposal amounts to stealth regulation.

- The release does not identify any emergencies or rapidly moving market developments associated with this regulatory matter. The subject of the initiative has been under consideration by NASAA and the NASD for many years in various stages. In light of the slow pace at which the matter has already proceeded, an extension of the brief 21-day comment period for 75 days is reasonable.

- In the definition of "branch office," the new changes implement a one-size-fits-all approach patterned after full-service NYSE broker-dealers that could cause unnecessary disruption for broker-dealers that are not NYSE members or full-service broker-dealers. The rule changes would have a greater total impact on smaller broker-dealers compared to larger full service broker-dealers.

- Release No. 34-48897 seeks "commentators' specific views on the primary residence exception and the divergent proposals by the NASD and the NYSE's proposed annual 50-business day limitation on engaging in securities activities from a primary residence." A 21-day comment period during the peak of the year-end holiday season is insufficient to address these important questions.

- The genesis of the amendments occurred in proposals over the years that were designed to give state securities commissions new or better inspection tools. In most states, variable insurance products are excluded from the definition of "security" and are, therefore, outside the scope of state securities regulation. The substantial expense and burden of the proposed amendments are not justified for limited purpose broker-dealers whose securities activities are limited to variable products excluded from state securities regulation. In addition, NASAA has not demonstrated its inability to gain efficient access to broker-dealer records.

- The regulatory changes will have a significant negative impact on limited purpose broker-dealers, such as those affiliated with life insurance companies, and would unreasonably burden competition.

Conclusion

An extended comment period will not unduly lengthen this regulatory matter, and will foster constructive, thoughtful input on the issues raised by the Commission. For these reasons, we respectfully request that the Commission extend the comment period on Release No. 34-48897 for a longer period as permitted under the APA. The regulatory process and the public interest will be better served by a deliberative, not rushed, review

of the NASD's rule amendments. These regulatory modifications are too important to miss full exposure to public scrutiny.

We greatly appreciate your attention to our concerns. If any questions develop, please call.

Sincerely,

Carl B. Wilkerson

cc: William H. Donaldson, Chairman
Paul Atkins, Commissioner
Cynthia A. Glassman, Commissioner
Harvey Goldschmid, Commissioner
Roel Campos, Commissioner
Annette L. Nazareth, Director, SEC Division of Market Regulation
Robert L. D. Colby, Deputy Director, SEC Division of Market Regulation

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