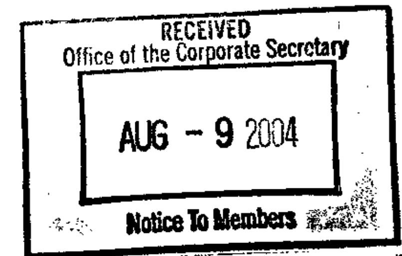
Michael J. Mungenast
President
2801 Highway 280 South
Birmingham, Alabama 35223
Phone: 205-268-5144
Phone: 1-800-288-3035
Fax: 205-268-5012
E-mail: mike.mungenast@proequities.com



August 6, 2004

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

Re: Notice to Members 04-45; Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities

Dear Ms. Sweeney:

ProEquities, Inc. ("ProEquities" or "the Firm"), a registered broker/dealer firm, wishes to submit these comments on Notice to Members 04-45, which seeks public input on a proposed new rule governing deferred annuity sales practices (the "Proposed Rule").

I. Overview

ProEquities agrees that all customers should receive timely and accurate information about the features, market risks, costs and other material considerations involved in the purchase, sale or exchange of a variable annuity. The Firm commends the NASD for attempting to improve the disclosures regarding these complex investments, so that customers can make informed decisions. The Firm also understands the NASD's desire to improve the supervision and training of registered representatives who engage in variable annuity transactions.

In our opinion, however, adoption of the Proposed Rule would improve the quantity, but not the quality, of the information that customers receive, and would do so in a manner that is neither cost-effective nor investor-friendly. We believe that the suggested disclosure document would exaggerate the importance of a relatively small number of variable annuity features, leading to unbalanced disclosure that is unlikely to improve the customer's overall understanding of the proposed transaction. Furthermore, the proposed requirement for registered principal approval within one business day after execution of the transaction is unworkable for a broker/dealer with representatives in outlying locations, and will often conflict with the broker/dealer's obligation to adequately supervise variable annuity trades. As discussed below, we believe that there are ways to accomplish the objectives of the Proposed Rule without forcing broker/dealers, registered representatives, and investors to bear the costs and burdens that the Proposed Rule would impose.

II. New Disclosure Document

Under the Proposed Rule, the Firm (or one of its registered representatives) would have to provide the customer with a "separate, brief and easy-to-read (written in "plain English") risk disclosure document that highlights the main features of the particular variable annuity transaction, including (i) liquidity issues, such as potential surrender charges and tax penalties, (ii) sales charges, (iii) fees, such as mortality and expense charges, administrative fees, charges for riders or special features, and investment advisory fees; (iv) federal and state tax treatment for variable annuities; and (v) potential market risks." The document must also give the customer information about any "free look" provision in the variable annuity contract.

A. The proposed disclosure document would not improve the quality of disclosure, or a customer's overall understanding of the transaction. Even if written in "plain English", the proposed document would be lengthy and complex. It would duplicate information that is found in the prospectus, which the customer already receives. Furthermore, since the customer would receive both a prospectus (which contains details of all material contract features) and the new "summary" disclosure document, he or she would naturally assume that the matters discussed in the summary are as important, or more important, than the other matters discussed in the prospectus. This would undermine the importance of the prospectus as the principal disclosure document for securities transactions, and result in unbalanced, confusing disclosure to customers.

B. Preparation and distribution of the proposed disclosure document would be costly and inefficient. Many broker/dealer firms have variable annuity contract selling agreements with numerous insurance companies, so their registered representatives can offer customers a selection of products that might best serve their needs. (For example, ProEquities currently sells variable annuity products from about 70 insurance companies.) As a result, the creation of product- and transaction-specific disclosures of the type outlined in the Proposed Rule would be expensive and time-consuming, to the detriment of the broker/dealer firms and, ultimately, to their customers. (To cite but one example, since each broker/dealer would have its own disclosure document, customers of the same variable annuity contract would receive differing disclosure documents for the same product.) Alternatively, broker/dealer firms might attempt to reduce their compliance costs by refusing to sell products of smaller insurers, reducing competition for variable annuity products and, perhaps, eliminating insurers that offer variable annuities with unique or unusual contract features.

The proposed disclosure of federal and state tax consequences is of particular concern. Most broker/dealers have a general understanding of the federal tax law principles that apply to variable annuities, and could provide a generic description of the principal federal income tax consequences of a variable annuity purchase. However, most broker/dealers do not have the expertise required to make similar estate and gift tax, income with respect to a decedent, generation skipping transfer tax, and state tax

disclosures (especially with respect to such unusual issues as state premium taxes). This type of tax information is more properly provided by tax professionals. Imposing this new requirement would increase the potential liability of member firms, while giving customers information that is more appropriately provided by other advisors.

Under the Proposed Rule, the member firm would have to give the customer the new disclosure document before "effecting any purchase, sale or exchange" of a variable annuity. After making the initial purchase, customers often make addition contributions to the variable annuity. These subsequent purchases are often small amounts, and may be made as part of a regular investment program. In addition, many customers make additional investments by sending funds directly to the insurance company on an "application way" basis, without even consulting with the member firm or its registered representatives. The Firm recommends that the proposed disclosure (if adopted) be required only for the initial purchase of the variable annuity, not for subsequent investments.

*C. **Suggested alternatives.*** ProEquities believes that (a) the customer should be able to rely on the prospectus as his or her best, most balanced source of information about a variable annuity product, and (b) the issuing insurance company is in the best position to produce a disclosure document that accurately portrays the material features of the contract (including the specific items contemplated by the Proposed Rule). For these reasons, and to streamline the disclosure process to the benefit of all concerned (including the investing public), the Firm recommends that the NASD work with the Securities and Exchange Commission to develop "plain English" prospectuses for variable annuities that contain the types of disclosures contemplated by the Proposed Rule. As part of this process, the SEC could take a broader view of the prospectus requirements, and could seek public input on ways to improve overall prospectus disclosure. In this way, the party that is the most familiar with the product will prepare the most important disclosures, using uniform standards developed after public comment.

If the NASD concludes that an additional, duplicative disclosure document is needed, the Firm strongly recommends that the document be less product- and transaction-specific than the document described in the Proposed Rule. For example, a disclosure that the transaction may result in certain enumerated types of charges (such as sales charges, surrender charges, administrative expenses, etc.), and advising the customer to refer to the prospectus or the registered representative for more information, would be just as useful, and much less expensive to create and distribute. The Firm recommends that tax disclosures be limited to a generic discussion of federal income and estate tax treatment of variable annuities, with a recommendation that the customer consult a competent tax advisor for more information (including information about state tax issues).

III. Exchanges and Replacements

Under the Proposed Rule, if a variable annuity transaction involved an exchange or replacement, the customer would have to be provided with a written disclosure that

provides specific, detailed information about the transaction in question, including a detailed summary of the differences between the old and new contract provisions, surrender charges, costs, and the possibility of modifying or adjusting the old contract to meet the customer's objectives. The member firm would be allowed to use an existing form that has been authorized by a state insurance commission (or other regulatory agency) in order to satisfy this requirement.

Once again, this document would duplicate information that is readily available from the contract terms and prospectuses of the applicable variable annuity contracts. Furthermore, as noted above, many broker/dealers (including ProEquities) sell variable annuity contracts with numerous insurance companies. Since no one can force state insurance commissions to develop forms that comply with NASD requirements, broker/dealers will not be able to rely on insurers to develop exchange forms that meet those requirements. As a result, broker/dealers will have to develop and deliver their own forms—forms that will, in many cases, duplicate some or all of the information that the insurer and/or state insurance commission may already require. This will make exchange transactions more expensive and more confusing for the customer, without improving the quality of the disclosure in any meaningful way.

Another difficulty may arise if the insurance company whose contract is being exchanged does not cooperate with the broker/dealer. In some cases, the broker/dealer may not have a business relationship with that insurance company. In other cases, the insurance company may delay providing information to the broker/dealer or its customer, while attempting to talk the customer out of doing the proposed exchange. In these circumstances, it may be difficult or impossible for a broker/dealer or its representatives to collect all of the information to be provided on the proposed exchange disclosure form.

Furthermore, in the Firm's experience, some of the required disclosures would require review of the original variable annuity contract—a document that some customers are unable or unwilling to locate. In many cases, however, the customer will still wish to proceed with the exchange, since the benefits of the new contract (or the performance or lack of features of the old contract) are readily apparent. In this situation, it may be inappropriate to delay or refuse to execute the transaction, merely because the exchange analysis document contemplated by the Proposed Rule cannot be properly completed.

IV. Principal Review

The Proposed Rule would require a registered principal of the member firm to "review and approve" each deferred variable annuity application (whether or not recommended by the firm) "no later than one business day following the date of execution of the deferred variable annuity application." If the firm has recommended the transaction, or if the transaction involves an exchange or replacement, the Proposed Rule would require a registered principal of the member firm to "review, approve and sign" the suitability determination document and/or the exchange or replacement analysis form (as the case may be) within that same one business day period. As part of this process,

the registered principal would be required to review, among other things, the factors listed in paragraph (c)(1) of the Proposed Rule.

A. The proposed principal review requirement would be impractical for broker/dealers to implement, and an undue inconvenience to customers. Many broker/dealers (including ProEquities) have variable annuity trades approved by registered principals who are not in the same location as the registered representative who submitted the trade. It would be expensive (at best) or impossible (at worst) for the registered principal to collect, review, approve and sign all of the required paperwork within the time period specified by the Proposed Rule. If a registered principal could not properly review the trade within the one business day time period, the member firm would have to reject the trade and return the paperwork to the registered representative. In our experience and judgment, this process would result in delays in executing trades that are ultimately determined to be suitable and appropriate. These delays would, in turn, lead to customer dissatisfaction (and delay investment of the customer's funds), while not facilitating compliance in any meaningful way.

B. The proposed principal review requirement for trades that were not recommended by the member firm would impose a new, unwarranted suitability determination on broker/dealer firms and their registered principals. Paragraph (c) (1) of the Proposed Rule would require a registered principal to make a suitability determination with respect to a customer's purchase of a variable annuity, even if the proposed trade had not been recommended by the member. Current NASD Conduct Rule 2310(a) generally requires the member firm to make a suitability determination only if the member firm recommended the trade. The NASD should not impose a new, burdensome suitability determination on non-recommended transactions, as set forth in the Proposed Rule. If the NASD believes that this course of action is appropriate, we recommend that the NASD revisit the suitability requirements of Rule 2310(a) in a broad-based rulemaking, and not impose additional standards for suitability review on a single product.

C. The proposed principal review requirement would, in many cases, *be inconsistent with the NASD's objective of improved supervisory review.* The proper review of a variable annuity transaction (particularly an exchange or replacement transaction) requires the registered principal to read, review and analyze a great deal of information. If the Proposed Rule is adopted, the registered principal will also have to request and review exception reports (such as those regarding exchanges in the customer's account or in the accounts of all customers of the registered representative) before approving an exchange or replacement. In many cases, inquiries to the customer, registered representative, insurance company, or broker/dealer compliance department may also be warranted.

In the Firm's opinion, imposing an artificial one-day time limit on this review is unnecessary, and would result in either (1) reviews that are conducted in a hurried manner, or (2) legitimate trades that are initially rejected because the registered principal is unable to complete an adequate review before the one-day period is over. The first

result is contrary to everything the NASD is attempting to accomplish with the Proposed Rule. The second result would lead to unnecessary costs to the broker/dealer, and needless delays in the execution of customer transactions.

D. Suggested alternatives and other comments. NASD Conduct Rule 3010(d) currently requires each member firm to "establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions." As noted above, NASD Conduct Rule 2310(a) requires each member firm to make a suitability determination for each trade that is recommended by the firm. ProEquities does not believe that trades in variable annuity products need to be reviewed, endorsed or approved in a manner different from that set forth in the current rules. If the NASD determines that special rules regarding review and approval of variable annuity trades are required, we strongly recommend that the registered principal only be required to complete the review within a reasonable time.

For purposes of suitability determinations, the Proposed Rule virtually ignores the very reasons most investors purchase variable annuity products—to participate in a tax-deferred investment program, to access insurance benefits and protection features, and to acquire the guaranteed income options offered through variable annuity contracts. We believe that paragraph (c)(1) of the Proposed Rule should explicitly refer to these common variable annuity contract features.

ProEquities also requests the NASD to reconsider the Proposed Rule's requirement that a registered principal "sign" the appropriateness/suitability determination document and/or exchange or replacement analysis. We believe that a requirement that the member firm be able to demonstrate (through "wet ink" signatures, electronic approvals, or otherwise) that the registered principal has reviewed and approved the transaction is all that is necessary.

V. Suitability Standards

The Proposed Rule anticipates that each broker/dealer will establish standards regarding the customer's age, a percentage of the customer's net worth, a stated dollar amount invested, a "particularly high rate of ...exchanges or replacements" in the customer's account, and a "particularly high rate of ...exchanges or replacements" in the registered representative's customer base. It is obvious that different broker/dealers would, in good conscience, establish different standards. For example, different broker/dealers might use ages 60, 62, 65, 70, 75 or 80 for the first proposed standard. Under the Proposed Rule, the broker/dealer is subject to the hindsight of the NASD, disgruntled customers, and their counsel, if the broker/dealer selects an age that a regulator or arbitrator later determines was inappropriate. This type of *de facto* rulemaking is inefficient and expensive.

In our view, there is no reason to believe that the sale of a variable annuity to a customer of a given age (for example) at one broker/dealer firm is less likely (or more likely) to be suitable than the sale of a variable annuity to a customer of the same age at a

different broker/dealer. If the NASD believes that, in general, variable annuity sales to customers who exceed a certain age (or meet the other criteria listed above) should be subject to special scrutiny by registered representatives and registered principals, it should announce what those standards are. Broker/dealer firms could then apply uniform standards to these trade review practices.

The Firm also disagrees with the NASD's apparent determination (as indicated in paragraph (a)(1) of the Proposed Rule) that an investor must have a long-term investment objective in order for a variable annuity purchase to be suitable. This is, of course, generally true, but in limited cases special contract features may make a variable annuity suitable for other investors as well. We do not object to making a general disclosure that variable annuities are more often appropriate when the customer has a long-term investment objective, but do not believe the NASD should mandate when one particular aspect of a customer's financial situation makes a particular type of investment inherently unsuitable.

We strongly encourage the NASD to make it clear that the standards referred to above merely indicate that a transaction may require special scrutiny. The NASD should explicitly state that these standards are not a "bright line" test, and the fact that a transaction falls into one or more of the categories noted above does not automatically mean that it is not suitable. Of course, these standards would not need to be safe harbors, either—the member firm would always bear the responsibility for recommending suitable trades, taking into account all of the information known about the customer (not just one or two special items, as suggested by the Proposed Rule's emphasis on age and other enumerated factors).

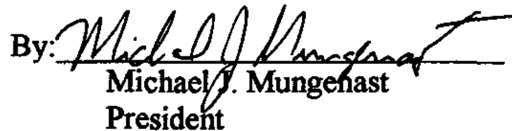
In addition, the Firm believes that it is unnecessary and impractical to review the rate of exchanges in a registered representative's customer base every time a customer submits an exchange or replacement transaction. This type of exception report is more appropriately used on a periodic basis (for example, once a quarter) to determine whether there are any trends in a registered representative's business practices that need to be reviewed. Of course, if the reports do create a "red flag", special supervision of the representative's business may be in order. As a general matter, however, the Firm believes that running such a report after each exchange or replacement transaction is submitted is not a cost-effective method to review these transactions, and would not significantly improve the supervision thereof.

VI. Conclusion

ProEquities appreciates this opportunity to comment on the Proposed Rule. We commend the NASD for trying to improve the quality and usefulness of variable annuity disclosure documents and the supervision of variable annuity transactions. As noted above, however, we believe that other, preferable solutions exist. If you wish to discuss the Proposed Rule, this letter, or any thoughts, comments, questions or suggestions that you may have, please call me at (205)268-5144.

Very truly yours,

PROEQUITIES, INC.

By: 
Michael J. Mungenast
President