



NATIONAL REGULATORY SERVICES

323A Main Street – PO Box 71 – Lakeville CT 06039

August 3, 2004

Ms. Barbara Sweeney
Office of Corporate Secretary
National Association of Securities Dealers
1735 K Street, NW
Washington, DC 20006-1599

RE: NASD’s Proposed Rule to “Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities”

Dear Ms. Sweeney:

National Regulatory Services (“NRS”), a nationally recognized regulatory consulting firm, founded in 1983, respectfully submits the following in response to the NASD’s request for comments regarding the proposed new rule to “Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities.”

While Notice to Members 04-45 requests comments as to whether the proposed rule should address both deferred and non-deferred variable annuity transactions, our comments do not differentiate. NRS has rarely seen non-deferred variable transactions undertaken by its broker/dealer clients, and we do not feel that it is the area where on-going sales practice abuses are most prevalent.

Overall, NRS believes if the regulators continue to place emphasis on enforcing current regulations to stem the instances of sales practice abuses involving variable annuities, only one or two new rules may be required.

NRS believes that many of the proposed variable annuity regulations under NTM 04-45 would be redundant, in that existing regulations already exist which can be applied to adequately regulate this business. NRS has therefore concluded that the majority of the additional regulations proposed in this area are unnecessary. Two exceptions to this are noted further herein (under the “Disclosure and Prospectus Delivery” section, calling for a “plain English” risk disclosure

document and the required “replacement/exchange” document under “Principal Review”).

In terms of redundancy, based on the current body of regulations, NASD has been quite effective in bringing enforcement actions regarding variable annuity sales abuses, as evidenced by the number of cases publicized this year.

Anecdotally, NRS is aware that broker-dealers have begun to tighten up client suitability standards, surveillance and supervision of variable annuity transactions in response to the NASD’s enforcement actions.

In addition, the release of the “SEC and NASD Joint Staff Report on Broker-Dealer Sales of Variable Insurance Products,” dated June 9, 2004, has already served, to enhance such compliance efforts.

Following are our comments on each proposed section of proposed new rule:

Proposed Rule Provision (“Appropriateness/Suitability”)

Notice to Member (“NTM”) 04-45 states:

“Appropriateness/Suitability. The proposed rule would require members and persons associated with members to make the following determinations when recommending a deferred variable annuity transaction: (1) the customer has been informed of the unique features of the deferred variable annuity, (2) the customer has a long-term investment objective, and (3) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer. These determinations would have to be documented and signed by the associated person who makes the recommendation and performs the required analysis.”

NRS Comment

As existing regulations largely address the goals of the Rule’s proposed requirements, NRS questions the need for an additional rule regarding suitability.

To illustrate this redundancy, with regards to client suitability, NASD Rule 2310 requires the following:

“In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.”

To make such a determination, Rule 2310 goes on to require a “*reasonable effort*” to gather certain suitability related client information, including the client’s

investment objectives. SEC Rule 17a-3(17) also calls for gathering suitability related client data, again, including investment objectives, for natural persons.

On the matter of client disclosures, it appears that ample written disclosures are already provided to clients, such as the prospectus, replacement/exchange disclosure forms, and, quite often, additional descriptive sale literature. Moreover, such written disclosures are in addition to information provided verbally by the registered representative.

Finally, the proposal states that “*these determinations would have to be documented and signed by the associated person who makes the recommendation and performs the required analysis.*” This requirement is similar to the provision in NASD Rule 3110(c) which already requires broker-dealers to obtain a signature from the registered representative, as well as a supervising principal, on a new account document when accepting new business.

Given the above, we question whether there a compelling need to go further by adding regulations that are largely redundant.

Proposed Rule Provision (“Disclosure and Prospectus Delivery”)

NTM 04-45 states:

- *Disclosure and Prospectus Delivery. The proposed rule would require members and associated persons to provide the customer a current prospectus and 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, but not limited to, (1) liquidity issues, such as potential surrender charges and the IRS penalty; (2) sales charges; (3) fees, such as mortality and expense charges, administrative fees, charges for riders or special features and investment advisory fees; (4) federal tax treatment of variable annuities; (5) any applicable state and local government premium taxes; and (6) market risk. The risk disclosure document also would have to inform the customer whether a "free look" period applies to the variable annuity contract, during which the customer can terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments. In addition, the risk disclosure document would require the member or associated person to inform the customer that all applications to purchase or exchange a deferred variable annuity contract are accepted subject to review and approval by a designated registered principal. The member would be required to provide the prospectus and risk disclosure document regardless of whether the transaction had been recommended.*

NRS Comment

Providing investors with a current prospectus is already required by the SEC (under Section 5 of the '34 Act), and failure to comply with the SEC in this matter

can be cited by the NASD under existing Rule 2110. It is NRS' opinion that there is no need for an additional rule requiring delivery of a prospectus to clients.

However, NRS does agree with the proposed requirement to have a "plain English" risk disclosure document which accompanies the prospectus. When Chairman Levitt was concerned about the clarity of mutual fund prospectuses for the average investor, he required all mutual funds to turn their prospectuses into plain English, a move applauded by the entire financial industry. NRS would prefer that the plain English requirement for variables be put on the issuer, rather than placing the burden on the broker/dealer. However, regardless of who is ultimately responsible, NRS does believe that a plain-English risk disclosure document would be an excellent tool for both investors and sales representatives.

Proposed Rule Provision ("Principal Review")

NTM 04-45 states:

Principal Review. No later than one business day following the date of execution of the deferred variable annuity application, a registered principal would be required to review and approve the transaction, regardless of whether the transaction had been recommended. In reviewing the transaction, the registered principal would need to take into account whether (1) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age or with a short-term investment objective; (2) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount; (3) the transaction involves an exchange or replacement of a deferred variable annuity contract; (4) the customer's account has a particularly high rate of deferred variable annuity exchanges or replacements; (5) the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; and (6) the purchase of the deferred variable annuity is for a tax-qualified retirement account (e.g., a 401(k) plan, IRA)

Under NTM 04-45, the new rule would require that *"when the transaction involves an exchange or replacement of a deferred variable annuity, regardless of whether the transaction has been recommended, a registered principal would need to review and approve a separate exchange or replacement document (which would cover issues specific to exchanges or replacements) no later than one business day following the date of execution of the deferred variable annuity application.*

NRS Comment

NRS agrees with the proposed requirement to *"review and approve a separate exchange or replacement document (which would cover issues specific to*

exchanges or replacements) no later than one business day following the date of execution of the deferred variable annuity application.”

NRS further recommends that a provision be added to require a customer’s signature on the replacement /exchange document, as such a provision would serve to clarify disclosures made to clients and document the suitability determination.

However, NRS believes the first provision noted above to be redundant, in that NASD Rule 3010 currently requires that *“Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions.”* This provision of Rule 3010 applies to all transactions, including variable annuities. While there are no specific time frames attached to Rule 3010, NRS has observed that the required principal review, for all transactions including variable annuities, most often occurs within one or two business days after the completion of the application by the registered representative.

Furthermore, NASD Rule 3010 requirements are in addition to the provision in NASD Rule 3110 which requires a principal to sign-off on new accounts.

Essentially, these existing rules already require supervisory review and signatures for variable annuity transactions as clearly indicated in the January 14, 2004 NASD complaint charging a broker/dealer *“for recommending 6,700 variable annuity exchanges to its customers without determining the suitability of the transactions.”*

Proposed Rule Provision (“Supervisory Procedures”)

NTM 04-45 states:

Supervisory Procedures. Members would be required to establish and maintain specific written supervisory procedures reasonably designed to achieve and evidence compliance with the standards set forth in the proposed rule.

Training. Members would need to develop and document specific training policies or programs designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of the proposed rule and that they understand the unique features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment, and market risks.

NRS Comments

Existing NASD Rules already require both of the above areas to be addressed.

NASD Rule 3010 requires firms to maintain written supervisory policies and procedures for all aspects of the firm's business as follows:

"Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of this Association."

The above requirement obviously extends to all aspects of a firm's business, including variable annuities.

The same can be said for the proposed training provision of the rule. Current continuing education rules require that members maintain a firm element training program that is tailored to the needs of the firm. The NASD already calls for the following training program minimum standards:

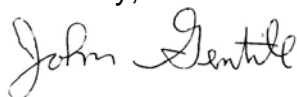
"Minimum Standards for Training Programs - Programs used to implement a member's training plan must be appropriate for the business of the member and, at a minimum must cover the following matters concerning securities products, services, and strategies offered by the member:

- (i) General investment features and associated risk factors;*
- (ii) Suitability and sales practice considerations;*
- (iii) Applicable regulatory requirements."*

Therefore, in terms of supervisory procedures and continuing education training, we question whether there a compelling need to go further by adding to existing regulations

In closing, NRS greatly appreciates the opportunity to comment on the proposed rule amendments. If this letter raises any questions or concerns, we look forward to hearing from you so as to address any issues which may be unclear.

Sincerely,



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