

Notice to Members

JUNE 2004

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Senior Management

KEY TOPICS

Deferred Variable Annuities
Disclosure
Sales Practices
Suitability
Supervision
Training

REQUEST FOR COMMENT

Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities

NASD Seeks Comment on Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities; **Comment Period Expires August 9, 2004**

Executive Summary

Deferred variable annuities are complex investment instruments that have both insurance and securities features.¹ On various occasions in the past, NASD has highlighted the unique features of these products for both members and potential investors. With the help of industry participants, for instance, NASD previously issued "best practices" guidelines in *Notice to Members (Notice or NtM) 99-35* (May 1999). Notwithstanding these efforts, some members continue to engage in problematic sales practices in this area, and some investors continue to be confused by certain features of these products.² As a result, NASD seeks comment on a proposed rule (Attachment A) relating to transactions in deferred variable annuities.

In general, *NtM 99-35* served as the basis for the proposed rule. The proposed rule includes suitability, disclosure, principal review, supervisory and training requirements tailored specifically to transactions in deferred variable annuities.

Action Requested

NASD encourages all interested parties to comment on the proposed rule. Comments must be received by August 9, 2004. Members and interested persons can submit their comments using the following methods:

- ▶ mailing in written comments; or
- ▶ e-mailing written comments to pubcom@nasd.com.

Written comments submitted via hard copy should be mailed to:

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

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web Site. Generally, comments will be posted on the NASD Web Site one week after the end of the comment period.³

Before becoming effective, any rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.⁴

Questions/Further Information

As noted above, hard-copy comments should be mailed to Barbara Z. Sweeney. Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, Regulatory Policy and Oversight (RPO), at (240) 386-4533; or James S. Wrona, Associate General Counsel, Office of General Counsel, RPO, at (202) 728-8270.

Background

NASD has become increasingly concerned about some members' unsuitable recommendations and inadequate supervision of transactions in deferred variable annuities. Based on recent discussions, examinations, and enforcement cases, NASD believes that a rule specifically addressing transactions in deferred variable annuities is needed to ensure that investors are adequately protected.⁵

Deferred variable annuities have many unique features that make them complex investments. In addition to the hybrid nature of deferred variable annuities (*i.e.*, they contain both securities and insurance features), most deferred variable annuities offer numerous choices among a number of complex contract features.⁶ Moreover, the amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses.

Investors also can be subject to the following fees or charges: *surrender charges*, which the investor owes if he or she withdraws money from the annuity before a specified period; *mortality and expense risk charges*, which the insurance company charges for the insurance risk it takes under the contract; *administrative fees*, which are used for recordkeeping and other administrative expenses; *underlying fund expenses*, which relate to the investment options; and *charges for special features and riders*, which may include provisions such as a stepped-up death benefit or a guaranteed minimum income benefit. Various sources estimate that average annual expenses of a variable annuity range from 1.3 percent to 2.2 percent of the underlying assets in the account.⁷

In addition, an investor's withdrawal of earnings before he or she reaches age 59^{1/2} is generally subject to a 10 percent penalty under the Internal Revenue Code. Furthermore, while the earnings accumulate on a tax-deferred basis in the variable annuity, when variable annuity earnings are paid out they are taxed as ordinary income, not as capital gains (which may be taxed at a lower rate).

Because of the complex features of these products, NASD has issued a number of *Notices, Investor Alerts, and Member Alerts* that address deferred variable annuities. In particular, in May 1999, NASD issued *NtM 99-35*, which provided guidance to assist members in developing appropriate procedures relating to the purchase, sale or exchange of deferred variable annuities.⁸

Although many members offer deferred variable annuities in a manner consistent with NASD's existing rules (and a large segment adhere to the guidance provided in *NtM 99-35*), certain firms continue to engage in unacceptable sales and supervision practices regarding these products. For instance, variable annuity sales have been the subject of more than 80 NASD disciplinary actions in the past two years. These disciplinary actions involved a wide array of misconduct regarding the sales of variable annuity products, including excessive switching, misleading marketing, failure to disclose material facts, unsuitable sales, inadequate training and supervision of salespeople and deficient written supervisory procedures.⁹ Recent NASD and SEC examinations of variable product sales revealed similar deficiencies.¹⁰ NASD and the SEC, moreover, have received numerous customer complaints indicating that the customers did not understand the unique features of the products and raising suitability concerns based on the customers' investment objectives and liquidity needs.¹¹ NASD's proposed rule would address these continuing deficiencies and provide more comprehensive and targeted protection to investors in deferred variable annuities.

In general, the proposed rule would codify and make mandatory the guidelines issued by NASD in *NtM 99-35*, mentioned above. These requirements represent the industry's best practices with respect to transactions in deferred variable annuities.¹² The proposed rule also would create certain written disclosure and principal review requirements. The proposed rule's key provisions include:

- ▶ **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.
- ▶ **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.¹³ 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.¹⁴

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- ▶ **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).¹⁵

In addition, when the member or an associated person has recommended the transaction, a registered principal would be required to review and approve the suitability analysis document no later than one business day following the date of execution of the deferred variable annuity application. Finally, 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. The proposed rule would allow a member to use an existing exchange or replacement form authorized by a state insurance commission or other regulatory agency to satisfy the exchange or replacement disclosure provision to the extent that the regulatory agency's form requires disclosure of the information required by NASD's proposed rule. These principal review requirements would permit a customer to review, complete and execute an application for a deferred variable annuity in a one-step process, subject to a designated principal's subsequent review and approval no later than one business day following the date of execution of the deferred variable annuity application.

- ▶ **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.

Request for Comment

NASD is soliciting comment on its proposed rule covering the purchase, sale, or exchange of deferred variable annuities. NASD requests comment on whether the rule, in general, should be modeled after the “best practices” guidelines discussed in *NtM 99-35*, the current approach, or whether some alternative approach would be more appropriate. For instance, NASD considered, but decided against, modeling the proposal after certain provisions of the options and futures rules. See, e.g., NASD Rules 2860(16) and (19); 2865(16) and (19). Another approach might be to limit the sale of deferred variable annuities to certain categories of investors. Moreover, members could be required to provide a comparison that would indicate the results that comparable products might provide the investor. NASD also seeks feedback on whether the proposed rule should cover all variable annuity transactions, not just deferred variable annuity transactions. In responding to this issue, NASD requests that commenters discuss whether and to what extent certain requirements in the proposed rule would need to be modified.

In addition to seeking comment on NASD’s general approach, NASD requests comment on the proposed rule’s specific provisions. In this regard, NASD encourages comment on the proposed risk disclosure provision. The proposed rule would require members to provide a customer with a risk disclosure document regarding certain features of the specific deferred variable annuity that is the subject of the transaction. As currently drafted, the proposed rule would require, among other items, disclosure of product-specific fees and charges (such as mortality and expense charges, administrative fees, charges for riders or special features, and investment advisory fees), federal and state tax treatment for the deferred variable annuity, and potential market risks. NASD seeks comment in particular on whether the risk disclosure document should focus on information applicable to all deferred variable annuity products sold by the firm rather than product-specific information. If so, commenters should discuss the rationale for this alternative approach and the types of general information that the proposed rule should require members to disclose in order to effectively educate potential investors in deferred variable annuities. Commenters, moreover, should consider whether a combination of some product-specific and some general information would be an appropriate third option for the risk disclosure provision.

NASD also recognizes that the SEC has proposed a rule that would require point of sale disclosure of certain fee information regarding, among other products, variable annuities. See SEC Proposed Rule Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. Nos. 33-8358, 34-49148, IC-26341 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004). NASD is interested in commenters' views of the potential interplay of NASD's proposal and the SEC's proposal.

Finally, NASD requests comment on certain standards discussed in the proposed rule's principal review and supervisory procedures provisions. Those provisions state, in part, that principals should analyze—and supervisory procedures should be established to screen for—among other things, transactions involving (1) a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age or with a short-term investment objective, and (2) an amount of money that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount. NASD considered imposing bright-line measures for these requirements, for example, a specific percentage of the customer's net worth or specific dollar amount, a specific age ceiling. NASD believes, however, that members are in a better position to determine appropriate standards based on their particular business models, salespeople and customers. As currently drafted, the proposed rule would require that the standards a member adopts be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised. Nonetheless, NASD seeks comment on whether NASD should revise the proposed rule so that the rule lists explicit, fixed standards developed by NASD. If so, NASD requests suggestions on the explicit standards that would be appropriate for each category.

NASD has found comments from member firms and the public, as well as state and federal regulators, to be a valuable resource in the decision-making process. NASD encourages all interested parties to comment on the concepts discussed above regarding the proposed rule. NASD will consider the comments it receives in determining whether to submit the proposed rule as a formal rule change to the SEC and, if so, the form that the rule change will take. As noted above, comments must be submitted by **August 9, 2004**.

Endnotes

- 1 Generally speaking, a deferred variable annuity is a contract between an investor and an insurance company. The insurance company promises to make periodic payments to the contract owner or beneficiary at some future time and, should the contract owner die during the accumulation phase, to pay a death benefit to the beneficiary. Deferred variable annuities offer choices among a number of complex contract features. See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint SEC/NASD Staff Report), available at www.nasdr.com/white_paper_0600804.asp ("For example, [variable annuity] contracts may offer various types of death benefits, rebalancing features, dollar cost averaging options, assorted payout structures, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options."). Deferred variable annuities, although issued by insurance companies, are securities under the federal securities laws and are sold through broker-dealers. *Id.*
- 2 See Joint SEC/NASD Staff Report, *supra* note 1 (discussing deficiencies found during examinations of and enforcement actions involving variable products, including suitability, marketing, supervision, disclosure, and maintenance of books and records).
- 3 See *NtM 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 4 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Section 19 of the Exchange Act and rules thereunder.
- 5 See *supra* note 2 and accompanying discussion.
- 6 See *supra* note 1 and accompanying discussion.
- 7 Joint SEC/NASD Staff Report, *supra* note 1 (citing Andrea Coombes, *Perfect Tool—For a Select Few: Variable Annuities Have Limited Use, Schwab Study Finds*, CBS MarketWatch.com, Nov. 8, 2002; John P. Huggard, *Investing with Variable Annuities* §703, at 27 (Parker-Thompson Pub. 2002)).
- 8 In addition to *NtM 99-35*, NASD issued *NtM 96-86* (Dec. 1996), which reminded members that sales of variable annuities are subject to NASD suitability requirements. NASD, moreover, has issued a number of *Investor Alerts* covering the unique features and potential risks of variable annuities. Recently, NASD also issued a *Member Alert* reminding members of their responsibilities regarding hypothetical tax-deferral illustrations in variable annuity communications.
- 9 See Joint SEC/NASD Staff Report, *supra* note 1 (discussing various NASD and SEC disciplinary actions involving variable annuity products).
- 10 *Id.* (explaining results of recent NASD and SEC examinations of broker-dealer sales of variable annuity products).
- 11 *Id.* (discussing customer complaints regarding variable annuity products).
- 12 A number of members helped create the guidelines discussed in *NtM 99-35*, and many have adopted them based on NASD's issuance of the *NtM*. The guidelines in *NtM 99-35*, however, are not mandatory, and some members have not adopted them. As a result, because of continued sales practice and supervision problems related to deferred variable annuities, NASD is proposing the rule described herein.

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- 13 The member or its associated persons would be responsible for providing the prospectus and separate, brief, and easy-to-read (written in “plain English”) risk disclosure document to the investor. NASD does not regulate insurance companies, and the proposed rule applies to member firms. Nonetheless, members would be allowed to use a separate, brief and easy-to-read risk disclosure document prepared by the issuing insurance company if such document conformed to the requirements of the proposed rule. Again, however, it would be the responsibility of the member firm and its associated persons to ensure compliance with all aspects of the proposed rule, including the risk disclosure document.
- 14 Non-recommended transactions would include those for which the member acts only as an order taker. For instance, the proposed rule’s requirements that apply to any transaction, regardless of whether the transaction had been recommended, would include a situation where a customer contacts the member and, without any input from the member, places an order on his or her own for XYZ deferred variable annuity.
- 15 A deferred variable annuity purchased for a tax-qualified retirement account does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified plan itself. Such transactions are of particular concern to NASD, especially in light of certain fees and charges associated with many deferred variable annuities. Thus, principals must ensure that the deferred variable annuity’s other features make the purchase of the deferred variable annuity for the tax-qualified retirement account appropriate.

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ATTACHMENT A

Text of Rule Change

New language is underlined.

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Members' Responsibilities Regarding Deferred Variable Annuities

(a) Appropriateness/Suitability

(1) No member or person associated with a member shall recommend to any customer the purchase, sale or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that (A) the customer has been informed of the material features of the deferred variable annuity; (B) the customer has a long-term investment objective; and (C) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer based on the information set forth in paragraph (a)(2) of this rule. These determinations shall be documented and signed by the associated person recommending the transaction, in addition to being approved by a registered principal, as required by paragraph (c) of this Rule.

(2) Prior to recommending a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, liquidity needs, liquid net worth, marital status, number and age of dependents, occupation, risk tolerance, savings, tax status and

such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(b) Disclosure and Prospectus Delivery

(1) Prior to effecting any purchase, sale or exchange of a deferred variable annuity, regardless of whether the transaction has been recommended, a member or person associated with a member must provide the customer:

(A) A current prospectus; and

(B) 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 risk disclosure document also must inform the customer whether a "free look" period applies to the deferred 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 must inform the customer that all applications to purchase or exchange a deferred variable annuity are accepted subject to review and approval by a designated registered principal.

(2) Prior to effecting any exchange or replacement of a deferred variable annuity, a member or person associated with a member must, in addition to the information

required by paragraph (b)(1) and regardless of whether the transaction has been recommended, provide the customer with the following information in writing:

(A) A summary of all significant differences, if any, between the existing and proposed deferred variable annuities' contractual provisions, guarantees, death benefits, withdrawal provisions and/or tax treatment;

(B) Surrender charges, including both those that may be assessed on the surrender of the existing contract and those applicable to the proposed contract;

(C) Costs that are associated with purchasing a new contract, including new sales loads and other start-up expenses; and

(D) The possibility, if any, of modifying or adjusting the existing contract to meet the customer's objectives rather than exchanging or replacing the contract.

A member or person associated with a member may use an existing exchange or replacement form authorized by a state insurance commission or other regulatory agency to satisfy the disclosure requirements of this paragraph to the extent that the regulatory agency's form requires disclosure of the information required by this Rule. If the regulatory agency does not require disclosure of all of the information required by this Rule, a member or person associated with a member may create and use an addendum to the regulatory agency's form.

(c) Principal Review

(1) No later than one business day following the date of execution of the deferred variable annuity application, a registered principal shall review and approve the transaction, regardless of whether the transaction has been recommended. In reviewing the transaction, the registered principal shall consider whether (A) the customer's age or

liquidity needs make a long-term investment inappropriate, such as a customer over a specific age (standard established by the member) or with a short-term investment objective; (B) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member); (C) the transaction involves an exchange or replacement of a deferred variable annuity contract; (D) the deferred variable annuity transaction involves a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements; (E) the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; and (F) the purchase of the deferred variable annuity is for a tax-qualified retirement account (e.g., 401(k) plan, IRA). Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(2) When a member or a person associated with a member has recommended the transaction, a registered principal, taking into account the underlying supporting documentation described in paragraph (a)(2) of this Rule, shall review, approve and sign the appropriateness/suitability determination document required by paragraph (a)(1) of this Rule no later than one business day following the date of execution of the deferred variable annuity application. This principal review and approval requirement is in addition to the requirements of paragraph (c)(1) and, if applicable, paragraph (c)(3) of this Rule.

(3) When the transaction involves an exchange or replacement of a deferred variable annuity, regardless of whether the transaction has been recommended, a registered principal must review, approve and sign the exchange or replacement analysis

form or addendum described in paragraph (b)(2) of this Rule no later than one business day following the date of execution of the deferred variable annuity application. This principal review and approval requirement is in addition to the requirements of paragraph (c)(1) and, if applicable, paragraph (c)(2) of this Rule.

(d) Supervisory Procedures

In addition to the general supervisory and recordkeeping requirements of Rules 3010 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen for and require a registered principal's review of the following:

(1) A deferred variable annuity investment for a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age (standard established by the member) or with a short-term investment objective;

(2) A deferred variable annuity investment that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);

(3) A deferred variable annuity exchange or replacement;

(4) A deferred variable annuity investment for a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements;

(5) A deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; or

(6) A deferred variable annuity investment for any tax-qualified retirement account (e.g., 401(k) plan, IRA).

Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(e) Training

Members shall 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 this Rule and that they understand the material features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment, and market risks.

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