

August 5, 2004

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

Re: NASD Notice to Members 04-45 relating to
Deferred Variable Annuity Sales Practices

There are many regulations already on the books of the NASD and the States that offer substantial investor protection with respect to variable annuities. Use the current regulations to root out the bad brokers. Most brokers are honest, hard working and have their client's best interest at heart.

The Notice states "...variable annuity sales have been the subject of more than 80 NASD disciplinary actions in the past two years". I would like the NASD to tell the membership, 80 out of how many transactions? Is it 80 out of 2 million? Additionally, how does this compare to the past five years?

I cannot support the current form of the proposal, which I believe to be duplicative, expensive and potentially counterproductive to the needs of investors seeking relevant, clear, easy to understand information that will help them evaluate the material aspects of the investment. As detailed below, I have several serious concerns about the separate disclosure document requirement as well as the principal review provision.

Disclosure and Prospectus Delivery

Among the most problematic aspects of the Rule Proposal is the requirement that members create and deliver to their clients, together with the prospectus, a separate risk disclosure document (the "Risk Disclosure") describing the main features of the particular variable annuity transaction. This Risk Disclosure, which is to be "brief" and in "plain-

English” must include, among other things, the various fees and costs, market risks, and tax implications of the specific deferred variable annuity transaction. In addition, prior to any exchange or replacement of a deferred variable annuity, the firm must also provide customers, in writing, (i) a summary of all significant differences between the existing and proposed annuity; (ii) a description of the surrender charges that may be assessed on the existing contract and those applicable to the proposed contract; (iii) a description of the costs associated with purchasing a new contract; and (iv) an explanation of the possibility of modifying or adjusting the existing contract to meet the customer’s objectives rather than replacing the contract (The “Replacement Disclosure”).

A. The Risk Disclosure May Distract Investors From Other Important Information Contained in the Prospectus

Although clearly well intended, the mandatory Risk Disclosure misses the mark and indeed, may be detrimental to the proposal’s principle goal of enhanced, pointed disclosure to investors. The sheer volume and complexity of the information to be included within this supposedly “brief” document undoubtedly will overwhelm investors, much less help the investor place the summary disclosure information in context with other equally important prospectus disclosures. Consider for example the amount and scope of information required under the Rule Proposal. As proposed, the Risk Disclosure must contain a litany of information, ranging from product specific fees and charges, to potential market risks, to federal, state and local tax treatment of the specific deferred variable annuity transaction. Notwithstanding firms’ best efforts to simplify and condense the disclosures, the Risk Disclosure -- even when written in “Plain English”-- will naturally evolve into a lengthy redundant recitation of prospectus information that certainly will present its own challenges to investors trying to gain a better understanding of the product.

Moreover, because the prospectus already identifies and explains many of the specified product features that would be the subject of the supplemental disclosure, a duplicative “summary” document also may have the unintended consequence of suggesting that the supplemental information deserves more weight and consideration than the other prospectus information. Such a result not only runs afoul of the Rule Proposal’s intended purpose, it undermines the role of the prospectus as the principal disclosure document intended to inform investors in making an investment decision.

In fact, I strongly question the value of yet another disclosure document in light of recent regulatory initiatives that would also mandate additional written disclosures to purchasers of variable annuities. For example, the Securities and Exchange Commission recently proposed new rules and rule amendments to require broker-dealers to provide customers with disclosures at the point-of sale and in transaction confirmations regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares and unit investment trust interests (including insurance securities).¹ Similarly, NASD also proposed amendments to Rule 2830 to require written disclosure of revenue sharing and differential cash compensation arrangements upon account opening or client purchase of investment company

¹ Release Nos. 33-8358 and 34-49148 (January 29, 2004) 69 FR 6438 (February 10, 2004).

shares.² In that regard, NASD is also contemplating expansion of the Rule 2830 to require disclosure of such arrangements with respect to the sale of variable annuities.

When viewed together, therefore, these recent regulatory initiatives coupled with the current Rule Proposal could result in a potential purchaser of variable annuities receiving the following:

- a current variable annuity prospectus;
- a disclosure of expected sales loads and fees, revenue sharing and special compensation;
- the Risk Disclosure;
- a summary of revenue sharing and differential compensation arrangements;
- a disclosure form for qualified annuities, if applicable; and
- a replacement Disclosure and State/Firm-required replacement disclosure form, if applicable.

These disclosures, of course, do not take into account other information already contained in other required documents, such as the new account documentation, the annuity application and possible replacement and exchange documents, where applicable. Therefore, while I wholeheartedly support regulatory efforts that ensure investors have the necessary tools to make informed investment decisions, we see little benefit in inundating investors with redundant disclosures. Simply put, it is the quality, not the quantity, of disclosure that matters. Accordingly, we respectfully request that the NASD reconsider the current proposal and pursue some or all of the alternatives described below, which we believe offer more effective and direct solutions that increase the likelihood that investors actually will read and understand the disclosure material.

B. Economic and Administrative Difficulties Associated with a Separate Risk Disclosure

Equally troublesome is the considerable economic and administrative burdens to member firms associated with a stand-alone disclosure document. Particularly for financial institutions that offer numerous annuities, the cost and effort involved in creating, delivering and updating the disclosure documents for each product could be significant. Moreover, most firms simply are not in a position to have their advisors manually calculate transaction-based expenses at the point of sale. Nor do they have integrated systems that capture all permutations of all available products in order to calculate the expenses for the advisor at the point of sale.

Also please note that compliance with NASD's requirement of disclosure of particular features of the transaction in the context of unsolicited trades may prove to be very difficult in instances where the broker-dealer has no business relation with the insurance company and/or limited ability to obtain the requisite information. In the end, this may impact adversely investors' ability to purchase annuities on an unsolicited basis.

² Notice to Members 03-54 (September 2003).

III. Principal Review

I also have serious concerns about subjecting, deferred variable annuity sales to a special, separate supervisory review process as proposed under the amendments. Currently, NASD Rule 3010(d) requires a registered principal to review and endorse, in writing, all securities transactions. The Proposed Rule would expand this requirement for deferred variable annuities transactions and require a registered principal to review and approve all deferred variable annuity transactions, whether recommended or not, not later than one business day following the “date of execution” of the deferred variable annuity application. In addition, where the transaction has been recommended, or involves an exchange or replacement, the registered principal must review, approve and sign the suitability determination document or the exchange or replacement analysis form, also within one business day of the execution of the application.

IV. Additional Comments

In addition to the forgoing, I offer the following additional comments with respect to other aspects of the Rule Proposal. We note that as with the other comments in this letter, the below list is not intended to be all-inclusive, but a starting point of an ongoing regulatory dialogue with the NASD as it moves forward with this initiative.

A. Scope of the Rule

Under the Rule Proposal, the current prospectus and a separate risk disclosure document must be provided “prior to effecting any purchase, sale or exchange of a deferred variable annuity.” I believe that this requirement should apply to the initial sale of the variable annuity only and not to in-force transactions or the exercise of contractual rights, such as reallocation of the annuity sub-accounts or add-on purchases. I do not believe any additional benefit to the consumer results by providing additional prospectuses or disclosure with every sub-account reallocation or premium investment.

I also request clarification that, where a retirement plan is structured as a variable annuity, the Rule Proposal would apply at the plan sponsor – not the plan participant – level. It would be impractical to require broker-dealers to provide disclosure and suitability reviews at the plan participant level and could subject broker-dealers to additional liability that is inappropriate under these circumstances.

B. NASD’s Proposed “Free Look” Provision

Under the proposal, the risk disclosure document must inform customers whether a “free look” period applies to the contract “during which the customer can terminate the contract without paying any surrender charges and receive a refund of his or her purchase

payments.” As a general matter, the laws of the state of issue govern free look rules. While some states do permit a return of premium, the majority of states allow investors to receive contract value (or the greater of the two) in the event a customer elects to terminate the contract.

C. Signature Requirement

The proposed rule would also require that a suitability determination document be prepared and signed by both the associated person making a recommendation for the purchase, sale or exchange of a deferred variable annuity and by a registered principal. The registered principal would also be required to sign the analysis form prepared in the case of an exchange or replacement of a deferred variable annuity. As written, the rule proposal does not specify what type of signature is required or expressly provide for an electronic process.

As a threshold matter, I requests that NASD clarify that a “wet” or ink signature is not necessary and that an electronic signature is acceptable, to the extent a signature requirement remains within the Rule Proposal.³ Moreover, with regard to the requirement for the registered principal to “sign” the suitability determination document and replacement disclosure analysis form, I request that this requirement be replaced by “authorized” or “evidenced by”. This approach, I believe, better accommodates the various methods by which approval and sign-off are, or could be, made in the marketplace.

Furthermore, an electronic process, with appropriate record retention, should be compliant with the Rule Proposal. I would therefore request NASD to confirm that suitability determinations to be “documented and signed” could include representations made under an associated person’s identification through an electronic sales system. I believe that the information required to support a suitability determination could be accumulated in an electronic file, and can be reviewed and approved electronically with the registered principal electronically signifying his or her approval. I recommend that section (c) (2) of the Rule Proposal therefore be revised or annotated to indicate that the appropriateness/suitability determination “document” can be created and stored electronically, and that registered principal review and approval can be indicated electronically. These comments also apply to section (c) (3) of the Rule Proposal concerning registered principal review and approval of an exchange/replacement analysis document related to each replacement sale of a deferred variable annuity.

D. Suitability Requirement

As a threshold matter, I seek clarification that requesting clarification that a Series 9 &10 (or 8) satisfies the "registered principal" supervision requirement since this will enable firms to integrate already existing supervisory structures.

³ This is entirely consistent with the Electronic Signature in Global and National Commerce Act (ESIGN) and the Uniform Electronic Transactions Act (UETA), which provide that a record or signature may not be denied legal effect or enforceability solely because it is in electronic form.

I also find problematic the one-size-fits all approach contemplated by the rule with regard to principal review of six factors. Rather than specific fixed standards, I believe NASD should articulate general guidelines and grant firms maximum flexibility in developing those guidelines that are appropriate to their business operations. Such an approach better recognizes and accommodates the great diversity of firm size, distribution channels and business models. Furthermore, and in all events, I strongly urge NASD to avoid any bright-line requirements that the annuity not exceed a stated percentage of the customer's net worth or is more than a stated dollar amount. Either test, we believe, ignores the reality that clients may have accounts at multiple broker-dealers and therefore could produce an inaccurate picture of the client's actual suitability.

Further to this point, the Rule Proposal states that no associated person shall recommend a deferred variable annuity unless he or she believes that the customer has a long-term investment objective. Although this is most certainly the norm, there may be product-specific circumstances that support purchase of a deferred variable annuity without a long-term investment objective. In certain limited circumstances, investors may purchase deferred variable annuities without such long-term objectives. For instance, deferred variable annuities can have fixed-rate investment options with relatively high interest rates and no surrender or asset-based charges. Some afford an immediate right to annuitize and therefore can be attractive to investors because of appealing annuity purchase rates. In such cases, if a client is appropriately informed of the material features of the product, and the associated person has made a good-faith determination that the product and the underlying sub-accounts are suitable for the customer, then the sale could be entirely appropriate. For these reasons as well, we request that NASD reconsider the current proposal's suitability provisions and focus instead on standards that assess suitability based on a client's overall circumstances, without specific constraints.

Additionally, *many investors purchase variable annuities to trade* index funds like the Pro Funds. These trades can be made from a strategy of technical analysis. There could be hundreds of trades over a period of one year. **The objective of these investors is shot term profit.**

Finally, I believe the suitability analysis process and principal review should apply to the initial sale of the variable annuity only and not to in-force transactions or the exercise of contractual rights, such as reallocation of the annuity sub-accounts or add-on purchases. As noted above, to impose an ongoing obligation on advisors is redundant and impractical particularly since clients can exercise these rights without involving their registered representatives. The fact is, broker-dealers are inherently unable to answer certain questions that the NASD would require that they answer in order to demonstrate suitability; specifically, attributes of previous contracts and investment allocations where the investor holds a contract sold by another broker-dealer or sponsored by an insurance company with which the broker-dealer has no relationship. In such cases, unless the investor provides the information (which they frequently do not have or do not care to share), the broker would be forced to refuse that investor's business.

E. Federal and State Tax Information in the Risk Disclosure Document

The proposal also requires disclosure regarding the federal and state tax treatment for variable annuities. I request clarification as to the scope of this disclosure. For example, it is unclear whether the “taxation treatment” disclosure requirement is limited to income taxation treatment of variable annuities or whether it extends to other areas as well, such as estate taxes, gift taxes, treatment of income with respect to a decedent, and generation skipping transfer taxes. In any case, inclusion of this type of information in a firm disclosure document is extremely burdensome and potentially could lead to unwarranted liability to member firms. Indeed, firms typically advise clients that their registered representatives are not tax advisors and that clients should consult their own tax advisors for information on the tax effects of a particular investment decision. Moreover, while firms could readily formulate a generic statement generally describing federal income tax treatment of annuity accumulation, payments, withdrawals and death benefits, a written description of all applicable state and local tax implications for each annuity the firm offers will prove much more difficult. Indeed, it is our understanding that state premium taxes vary from state to state, and most states do not levy a premium tax on annuities at all. Accordingly, I urge the NASD once again to consider our earlier recommendation that this type of disclosure is most effective coming from the issuer through an enhanced prospectus that can then be used by all broker-dealers that offer a particular product to investors.

IV. Conclusion

I appreciate the opportunity to provide comments on this Rule Proposal. While I commend the NASD’s efforts to improve the quality and usefulness of disclosure and sales practices within the context of variable annuity transactions, I believe that other, more workable solutions exist. Better yet, use the current NASD and State laws to protect investors.

Sincerely,

Claire D. Hart
Registered Rep

