

# DRIGGERS, SCHULTZ & HERBST

A PROFESSIONAL CORPORATION  
COUNSELORS AT LAW  
2600 WEST BIG BEAVER ROAD  
SUITE 550

TROY, MICHIGAN 48084

TELEPHONE (248) 649-6000

TELECOPIER (248) 649-6442

LAURENCE S. SCHULTZ  
JAY A. HERBST  
RICHARD B. TOMLINSON  
DANIEL R. BOYNTON  
JOSEPH W. THOMAS  
RAYMOND J. STERLING  
WILLIAM C. SCHAEFER  
JAMES J. MAJERNIK  
EDWARD S. TOTH  
MARK E. MUELLER  
CHRISTOPHER P. MANSUR  
ELIZABETH M. MALONE  
LAWRENCE J. POCHRON, JR.  
JACK E. GRAY, JR.

NATHAN B. DRIGGERS  
(1929-1998)

OF COUNSEL  
LAURA D. MASON  
BARBARA D. URLAUB

August 9, 2004

Ms. Barbara Z. Sweeney  
Office of the Corporate Secretary  
National Association of Securities Dealer, Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006-1500

**Re:** Comments to NASD Variable Annuity Proposal; NASD NTM 04-45

Dear Ms. Sweeney:

As an attorney having represented investors for over 30 years, I have witnessed a wide variety of wrongdoing by the brokerage community involving a diversity of investment products. However, the abuses in the sale of variable annuities stand out because of the complex nature of the product, its built-in negative features, and its aggressive marketing to the general public.

Although variable annuities by their nature should have limited appeal to investors, reports are that almost \$1 trillion in variable annuities have been sold by the brokerage community. But the attraction of variable annuities to the brokerage community appears to have little to do with the quality of the product or its suitability for the general public.

As the SEC and NASD have repeatedly recognized, this complex, expensive insurance-based product is primarily sold as a tax-deferred vehicle to invest in mutual funds to people who are unable to understand it and for whom it is fundamentally unsuitable. My clients have been victimized repeatedly by sales pitches comparing variable annuities to CD's; representing variable annuities to be a common way to invest in mutual funds; selling tax-deferred variable annuities to accounts that are already tax-deferred; unnecessarily replacing existing variable annuities for elderly clients; and even arranging mortgages for clients without funds to generate money to buy variable annuities. Often clients do not understand annuitization, nor are they aware there is a death benefit or surrender charge.

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There is a simple, obvious reason for these extreme and repeated investor abuses. Variable annuities are not bought, they are sold; and the reason is that they are probably the highest commission product available to the general brokerage community. With commissions typically running 7 percent or more, up to \$70 billion in fees may have been generated from the almost \$1 trillion in variable annuities outstanding.

Commissions from individual investor purchases are offensive, often running in the tens of thousands of dollars. In my experience, these commissions are never disclosed to investors, and my clients have been shocked, amazed, and insulted to find that their broker had such a great economic incentive to sell them these products. When asked about commissions, the standard broker reply is: "You don't pay me. I'm paid by the insurance company." The amount of the commission and the fact that the commissions are paid out of fees and/or the surrender charge are not disclosed.

Because of their incredible profitability, variable annuity abuses are not just due to individual rogue brokers. The wrongdoing is widespread and has been institutionalized. Brokers are trained to push variable annuities on the general public. Publications by the NASD identifying abuses and recommending "best practices" to the industry have been ignored by many firms. There are simply too many brokerage firms and sales persons who cannot resist the economic opportunity represented by variable annuities.

These are among the many reasons I support the following NASD proposals:

#### Best Practice Standards Must Be Mandatory

Regulation of variable annuities can no longer be based on NASD "best practice" recommendations or guidelines. Widespread variable annuity sales abuses are commonplace. The incentive to sell is apparently overwhelming and irresistible. Mandatory regulation is essential, including simplified disclosure and strict supervision confirmed in writing.

#### Plain English Disclosure

Requiring broker-dealers to provide investors with a plain English risk disclosure document is particularly appropriate. Experience has shown that many investors in variable annuities are unaware of the basic elements of the product. While much of this disclosure information is contained in a lengthy prospectus provided to investors, it is virtually impossible for the average

person to read and understand the prospectus, understand the risks, and determine whether the product may be suitable.

New Rules Should Include Specific Suitability Standards and Allow Sales Only to Sophisticated, Long-Term Investors

The new variable annuity rules must take into account the complexity of variable annuities and the many negative features of the product which render it unsuitable for the average investor.

In fact, there are very few brokers who truly understand the product. Even your description of the negative features of variable annuities in NTM 04-45 omitted important negatives. For example, you did not point out that on death, a variable annuity owner does not get a stepped-up tax basis, in contrast to a mutual fund holder. And since variable annuities are subject to federal estate tax, this means the beneficiaries must pay both the estate tax on the annuity and ordinary income tax on any appreciation. And you did not describe that the death benefit, although paid for annually by the annuity holder, is worth nothing if the subaccounts have appreciated as of the date of death. Further, even if the death benefit is paid, it is only equal to the difference between the net amount contributed (contributions less withdrawals), or some stepped-up figure, and the current market value, if lower. The death benefit is essentially only incremental protection and therefore becomes extremely expensive insurance. These additional negative features are important to elderly purchasers, who represent a fertile market for the brokerage industry.

On balance, the only logical conclusion is that variable products are suitable for a very small percentage of the public. To qualify, investors must be able to understand the product and must be able to evaluate its features and conclude that there are advantages which outweigh the considerable disadvantages.

It is therefore essential that the proposed rule include a suitability standard to protect the public, limiting sales to sophisticated investors. Only sophisticated investors are qualified to evaluate this complex product. If an investor cannot understand what he or she is buying, the product must be considered unsuitable. Even the use of an investor representative would be a mistake, because the brokerage community has proven it cannot be trusted to comply with standards allowing the exercise of any judgment in the sale of this profitable product.

An additional suitability standard should allow sales only to people with long-term investment objectives.

Commission Percentage and Actual Dollar Amount of Commissions Should Be Disclosed

The new rules also must recognize that the problems with variable annuities are for the most part driven by one consideration: large commissions. It is for this reason that the rules must explicitly address the commission issue. For example, the rule requiring the plain English disclosure of commissions must be explicit and must require a detailed disclosure.

The investor must clearly understand that a substantial commission is being paid for the transaction even though the commission may be paid by the insurance company. The amount of the commission, as well as the manner of its calculation, should be disclosed. It is only with this type of disclosure that investors will realize the true motivation their broker has for making the sale and be able to measure the degree of the broker's conflict of interest. An example of such disclosure regarding a 7 percent commission follows:

For selling you this variable annuity, your broker's firm will receive a commission of \$700 for each \$10,000 invested by you. For example, if you invest \$100,000, the commission paid to the broker's firm would equal \$7,000. You are purchasing \$\_\_\_\_\_ of variable annuities in this transaction; and therefore, the total commission paid is \$\_\_\_\_\_.

If trailing commissions are to be paid, this should also be disclosed in detail.

The Amount of Commissions on Variable Annuities Should Be Regulated

Another aspect of the commissions that should be considered by the NASD is to reduce the commissions paid on variable annuities so they are comparable with those paid on the underlying investments. If variable annuity commissions are equivalent to those on mutual funds, there will be no incentive for a broker to sell a variable annuity unless it is truly suitable and consistent with the customer's investment objectives. As it stands, where commissions on variable annuities are substantially greater than those paid on mutual funds, the broker has a built-in incentive to push the variable annuity even though a naked mutual fund sale may be more appropriate.

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I applaud your efforts to strictly regulate the sale of these products in the interest of investor protection.

Very truly yours,

Laurence S. Schultz

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