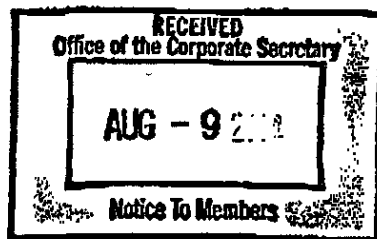




NATIONAL ASSOCIATION FOR VARIABLE ANNUITIES



August 6, 2004

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

RE: NTM 04-45

Dear Ms. Sweeney:

On June 9, 2004, the NASD proposed a new rule governing the purchase, sale, or exchange of deferred variable annuities.<sup>1</sup> The proposed rule would impose sales practice standards tailored specifically to transactions in deferred variable annuities and address suitability, disclosure, principal review, supervision and training. According to the Executive Summary in NTM 04-45, through this rule, the NASD hopes to deter improper sales practices and improve investors' understanding of the product. This letter of comment on the proposed rule is respectfully submitted by the National Association for Variable Annuities ("NAVA").<sup>2</sup>

#### *Summary of Rule Proposal*

**Suitability.** When recommending a deferred variable annuity, registered representatives would be required to make the following determinations: (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 and the underlying subaccounts are suitable for the particular customer. These determinations would have to be documented and signed.

**Disclosure.** Customers would have to be provided with a current prospectus and a separate, "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; (iv) federal and state tax

<sup>1</sup> Notice to Members 04-45 (June 2004).

<sup>2</sup> NAVA is a not-for-profit organization dedicated to the growth and understanding of annuity and variable life insurance products. NAVA represents all segments of the annuity and variable life industry with over 350 member organizations, including insurance companies, banks, investment management firms, distribution firms, and industry service providers.

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treatment; and (v) potential market risks. Prior to any exchange or replacement of a deferred variable annuity, customers would also have to be provided, in writing, (A) a summary of all significant differences between the existing and proposed annuity; (B) surrender charges that may be assessed on the existing contract and those applicable to the proposed contract; (C) costs associated with purchasing a new contract; and (D) the possibility of modifying or adjusting the existing contract to meet the customer's objectives rather than replacing the contract.

**Principal review.** No later than one business day following the date of execution of the application, a registered principal would be required to review and approve the transaction. The proposed rule sets out a number of specific factors that must be considered in reviewing the transaction. If the transaction had been recommended by a representative, the principal would have to review, approve and sign the suitability analysis document. If the transaction involves an exchange, the principal would have to review, approve and sign the exchange or replacement document.

**Supervisory procedures.** Members would be required to maintain written supervisory procedures reasonably designed to achieve compliance with the standards in the rule and to ensure that transactions are appropriately supervised.

**Training.** Training policies or programs would be required to ensure that all personnel understand the material features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment and market risks.

#### *Summary of NAVA's Position*

NAVA and its members support the efforts of the NASD and other regulators to ensure that all sales of deferred variable annuities comply with all applicable requirements, including suitability and full disclosure, and are supported by proper sales supervision, record keeping and training. The insurance industry takes the issue of unsuitable sales practices very seriously and NAVA is committed to working with regulators to ensure that variable annuities are sold appropriately in all instances.

However, we are concerned about the recent proliferation of rule proposals that would all require different written disclosures to be provided to purchasers of variable annuities. Without coordination of these various proposals, investors may be overwhelmed with written documentation, resulting in *less* rather than *better* understanding of the product.

In September 2003, the NASD proposed amendments to Rule 2830 that would require written disclosure of revenue sharing and differential cash compensation arrangements at the time a customer first opens an account or purchases shares of investment company securities.<sup>3</sup> Any such payments must be described, as well as the names of each offeror or investment company that provides the revenue sharing or differential compensation.

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<sup>3</sup> Notice to Members 03-54 (September 2003).

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The NASD is contemplating expansion of the rule to also require disclosure of such arrangements with respect to the sale of variable annuities.

On January 29, 2004, the Securities and Exchange Commission proposed new rules and rule amendments to require broker-dealers to provide customers with information 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).<sup>4</sup> This information generally must be provided in writing and includes disclosure of front-end and back-end sales loads, sales fees, asset-based distribution or service fees, brokerage commissions, revenue sharing, and special compensation.

Therefore, considering all of the pending rule proposals together, as well as existing state disclosure requirements, a potential purchaser of a variable annuity could possibly receive the following mandatory disclosure documents:

- A summary of revenue sharing and differential compensation arrangements paid to the selling broker-dealer
- A point of sale disclosure of expected sales loads and fees, revenue sharing and special compensation
- A current variable annuity prospectus
- A separate risk disclosure document
- State required disclosure forms, included exchange forms

We fear that burdening customers with several different disclosure documents at the time they consider the purchase of a deferred variable annuity will be potentially confusing and may actually deter many people from even trying to read the information. As a result, the NASD's goal to improve disclosure and customers' understanding of deferred variable annuities will likely not be accomplished. We believe that, if a separate disclosure document is to be required, a coordination of effort by the NASD and SEC on the various pending proposals is necessary. NAVA would be happy to participate in such a joint undertaking or lend assistance in any way possible.

While we support the goals the NASD is seeking to achieve with this proposal, (i.e., to improve customer understanding of deferred variable annuities and to promote appropriate sales practices), we have concerns and questions regarding a number of the specific requirements in the proposed rule and believe that modifications and/or clarifications are necessary.

We appreciate the opportunity to offer the following comments on the proposed rule.

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<sup>4</sup> Release Nos. 33-8358 and 34-49148 (January 29, 2004).

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### **Unregistered variable annuity contracts**

The proposed rule is silent as to whether it was intended to apply to unregistered deferred variable annuity contracts. Section 3(a)(2) of the Securities Act of 1933 exempts from registration certain variable annuity contracts used to fund pension or profit-sharing plans meeting the requirements of various provisions of the Internal Revenue Code. The separate accounts through which these contracts are issued are likewise exempted from the requirements of the Investment Company Act of 1940 in Section 3(c)(11). As a result, variable annuity contract prospectuses are not required to be delivered to the plan or the employees who choose to enroll in the plan. We do not believe it would be appropriate to apply the proposed disclosure and prospectus delivery requirements to these unregistered contracts. Additionally, with such plans, typically no application for the annuity contract is executed by the plan or the participants and no recommendation is being made by a broker-dealer. Rather, as noted, the employee elects to enroll in the plan and have money contributed.

### **Deferred variable annuities used in ERISA pension plans**

Deferred variable annuities are frequently used as the funding vehicle in pension plans subject to the Employee Retirement and Income Security Act of 1974 (ERISA).<sup>5</sup> These generally are plans that are established and maintained by an employer or employee organization, or both, and are designed to provide retirement income or to defer income to the termination of covered employment, or beyond.

The sale of variable annuities to fund such plans is structured very differently from sales made to individual investors. These differences make the NASD's proposed rule unnecessary for variable annuities in ERISA defined plans.

When variable annuities are offered within ERISA defined pension plans, they are not being marketed and sold directly to individual consumers, but, rather, are sold to the employer or institution setting up the plan. The employer or institution is generally considered a fiduciary under ERISA and required by section 404(a) to discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries, and to exercise the care, skill, prudence, and diligence under the circumstances that a prudent man acting in a like capacity and familiar with such matters would use. In the case of an ERISA plan funded with a variable annuity contract, the fulfillment of these fiduciary duties includes a determination that the contract is a suitable investment option for the plan and the underlying investment portfolios are suitable for retirement savings.

Individual plan participants do not invest in the variable annuity funding the plan until after this initial suitability determination has been made by the plan fiduciary. Consequently, we see no benefit to requiring a subsequent, individual-by-individual

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<sup>5</sup> 29 USC 1001, et seq.

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suitability analysis every time an eligible participant elects to enroll in the plan and begin making contributions. Moreover, requiring such additional analysis and the related written disclosures and principal review would result in significant burdens on these important plans which are helping millions of Americans save for retirement.

The proposed requirement that customers be provided with a disclosure document and current prospectus prior to effecting the purchase of a deferred variable annuity is problematic when variable annuities are used in ERISA pension plans. Under most such plans, a prospectus is provided initially to the plan administrator and later to participants after enrollment in the plan with the transaction confirmation. Again, given that the plan fiduciary has already carefully considered the features, costs, etc. of the variable annuity contract and determined that it is a suitable funding vehicle for the plan, we see no additional benefit to requiring that each plan participant be given these documents prior to election.

Another practical problem with applying the proposal to this context arises with pension plans that contain a "negative election" option. These options are common with ERISA defined pension plans and provide for an automatic contribution of a stated percentage of an employee's salary by the employer in those instances where the employee has failed to make an affirmative election. This automatic contribution is consistent with the strong public policy to encourage Americans to save adequately for retirement and has been sanctioned by the Internal Revenue Service. Under these circumstances, it would obviously be impractical to require that a disclosure document and prospectus be provided to participants who have failed to make an affirmative election to enroll in the plan prior to effecting the transaction. The broker/dealer and issuing insurance company would likely not even be aware of these individuals prior to the initial contribution being made on their behalf by the employer.

We recommend that deferred variable annuity contracts used to fund a pension plan defined under ERISA be exempted from the requirements of the proposed rule.

### **Signature requirements**

As noted above, the proposed rule would 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. The proposed rule does not specify what type of signature is required nor expressly provide for an electronic signature. This ambiguity should be resolved to make clear that a "wet" or ink signature is not necessary. Under E-SIGN (the Electronic

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Signature in Global and National Commerce Act)<sup>6</sup> and UETA (the Uniform Electronic Transactions Act)<sup>7</sup>, a record or signature may not be denied legal effect or enforceability solely because it is in electronic form, and if a law requires a record or signature, an electronic record or signature may satisfy the law. The NASD staff has previously concluded that, with certain enumerated safeguards, a member may utilize electronic signatures for principal approval of new customer accounts and endorsement of transactions under NASD Rules 3110(c)(1)(C) and 3010(d).<sup>8</sup> If signatures are to be required under the proposed rule, the rule should specifically state that they can be made electronically. Another solution to this problem would be to eliminate the requirement that the documents be signed and instead require that they be "acknowledged" or "authorized" or something similar.

## Section (b)

### Scope of Section (b)(1)

Section (b)(1) of the proposed rule would require the provision of a current prospectus and a separate risk disclosure document "prior to effecting any purchase, sale or exchange of a deferred variable annuity." It is our understanding that "purchase" in this context refers to the original purchase of a variable annuity contract and does not include subsequent subaccount purchases or transfers. Variable annuity contracts allow owners to make additional investments in the portfolios offered in the contract, either on a regular basis through automatic payroll deductions, or irregularly as personal financial circumstances permit. Contract owners also are usually permitted to transfer value between subaccounts on a tax-free basis and many contracts offer automatic portfolio rebalancing programs which periodically shift value between subaccounts in order to maintain the contract owner's original diversification. We see no benefit to requiring the provision of additional prospectuses and risk disclosure documents every time additional premiums are invested in a contract or contract value is reallocated. Such a requirement would also be unduly burdensome to the broker-dealers and issuing insurance companies.

### Section (b)(1)(B) – the risk disclosure document

The proposed risk disclosure document would require brief disclosure of certain, main features of the deferred variable annuity that is the subject of the contemplated transaction. Much of the specified disclosure items are already discussed in detail in the contract prospectus.

We believe it would be more helpful to customers to integrate the proposed risk disclosure document into the prospectus by including the information regarding the main features of the contract in the front of the prospectus, rather than provide them with both a prospectus and a separate document. Combining the two into a single document would,

<sup>6</sup> Pub. L. No. 106-229, 114 Stat. 464 (2000).

<sup>7</sup> Drafted by the National Council of Commissioners for Uniform State Law (1999).

<sup>8</sup> Interpretive Letter to Ms. Laurie Moret, American Express Financial Corporation (November 26, 1997).

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we believe, increase the likelihood that customers will read both of these important disclosures.

Furthermore, although it is the member broker-dealer who would be responsible under the rule to provide the prospectus and risk disclosure document, we believe that the broker-dealer should be permitted to have these documents prepared by the underwriting insurance company. The insurance company already is responsible for the preparation of the contract prospectus and is in the best position to know what information to include in the risk disclosure document and when and how to update the information.

In addition, having the disclosures prepared by the insurance company issuing the particular deferred variable annuity and incorporating them into the prospectus will result in uniformity of the information that will be provided to customers regarding a given contract. Many issuers of variable insurance contracts utilize multiple broker-dealers to sell their products. For example, some of our members have indicated that they have several hundred selling agreements with third party broker-dealers. If these various broker-dealers each prepared their own disclosure documents, there would likely be inconsistencies in the way the contract's features are described.

We also have comments in regard to some of the specific items that must be addressed in the risk disclosure document.

Subsection (iv) requires disclosure regarding the federal and state tax treatment for variable annuities. The proposal does not indicate the areas of taxation that must be discussed, such as whether only the income taxation treatment of variable annuities needs to be explained, or also other areas such as estate taxes, gift taxes and generation skipping transfer taxes, or the degree of specificity that is required in the description of the tax treatment. We believe that a general discussion of the federal income tax treatment of annuities during the accumulation period, annuity payments, withdrawals and death benefits should be acceptable as a brief, easy-to-read disclosure that will help customers understand the principal tax issues involved with the purchase of a deferred variable annuity. State premium taxes vary from state to state, and most states do not levy a premium tax on annuities at all. Again, we believe a general discussion about possible state premium taxes which can be part of a single, uniform disclosure document that can be used in all states should be sufficient.

The proposed rule requires the risk disclosure document to 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." In fact, pursuant to the laws in a majority of states, many variable annuity contracts return the current contract value rather than the purchase payment (or the greater of the two) if a customer elects to terminate the contract. We recommend that this provision in the proposed rule be modified to state that customers who terminate their contracts during the free look period will receive a refund of his or her contract value or purchase payments, as required by state law.

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The risk disclosure document must also 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. We believe this requirement should be modified to add "and acceptance of the contract by the underwriting insurance company."

Section (b)(2) of the proposed rule would require the provision of additional information in the case of an exchange or replacement of a deferred variable annuity. This would include a comparison of all significant differences between the existing and proposed deferred variable annuities' contractual provisions, guarantees, death benefits, withdrawal provisions and/or tax treatment. The information would be required regardless of whether the transaction has been recommended. We see some practical problems with requiring the provision of a comparison of contracts when a member has not recommended the exchange or replacement. There will likely be many occasions when the member may not be able to obtain all of the specified information regarding the existing contract. For example, if the transaction is an external exchange or replacement, the member will not have a copy of the contract and will have to rely on the customer to provide the information. Another area where the rule's requirement would be particularly impractical would be variable annuity sales that are initiated by the customer over the internet. Under this circumstance, the member will not have a copy of the existing contract to review nor opportunity to obtain the contract information from the customer.

We recommend that the proposed rule be modified so as not to require the comparison document in those instances where the exchange or replacement is initiated by the customer.

For exchanges or replacements, the proposal would also require the member to provide a written explanation regarding the possibility of modifying or adjusting the existing contract to meet the customer's objectives rather than exchanging or replacing the contract. We have very serious concerns about this requirement in those instances where the member selling the new variable annuity contract is not the broker of record of the contract to be replaced. In the absence of an effective selling agreement and state insurance appointment between the member and the issuer of the existing contract, the member would have no legal authority to evaluate or recommend modifications or amendments to the existing contract.

#### **Section (c) – Principal Review**

Review and endorsement by a registered principal, in writing, is already required for all securities transactions by NASD Conduct Rule 3010(d). The proposed rule would expand this requirement for transactions with deferred variable annuities 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



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has been recommended, or involves an exchange or replacement, the registered principal must review, approve and sign the appropriateness/suitability determination document or of the application. It is our understanding that "execution" in this context refers to the signing of the application by the customer. This is a critical point since it is the event that would trigger the proposed principal review deadline and should be made clear.

A one business day time period for this principal review, approval and sign-off is not realistic and would significantly impact how deferred variable annuities are delivered. In many instances, transactions and supporting documentation will have to be sent to a centralized location for the principal review. Moreover, the type of thorough review contemplated by the proposal would likely include a review of the client file, review of appropriate corporate compliance reports, and in some instances, discussions with staff in order to answer questions and obtain additional information needed for approval of the transaction. Our members do not believe this can be accomplished in one business day in all instances. If the review is to be meaningful, a reasonable period of time must be provided in which to conduct it.

The proposed rule does not specify whether the principal review is to take place before or after the annuity transaction is sent to the insurance company. If the intent of the rule is to have the review occur before transmittal, it will by definition cause a delay in the process and disadvantage variable annuity purchasers who, for example, may have taken money out of other investments in order to purchase the annuity. In addition, customers who purchase multiple products at the same time will expect them all to be processed at the same time, and this will not be possible if the deferred variable annuity transaction must undergo this additional review and approval process before it can be forwarded on to the insurance company. The current supervisory review and approval requirements of Rule 3010 apply universally to all securities products and contain no specific timeframe. The imposition of a product-specific procedure for deferred variable annuities may make them a less competitive and attractive option for a broker to present.

We think what is most important is that there be this kind of comprehensive principal review and approval, not that it must occur within one business day. Moreover, a one business day time requirement for the review of deferred variable annuity transactions only seems unnecessary since deferred variable annuities are the only investment products which by law are required to provide a free look period during which the purchaser may change his or her mind and receive a refund. This free look period varies by state and is typically at least ten days.

Section (c)(1)(B) would require the principal, when reviewing a deferred variable annuity transaction, to consider whether the amount of money invested exceeds a stated percentage of the customer's net worth. We believe it should be the customer's liquid net worth that should be considered. This would provide consistency with section (a)(2) that requires members to obtain information concerning a customer's liquid net worth. We also think liquid net worth is the more relevant comparison in assessing the contemplated transaction.

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The annuity industry is actively working to develop a straight through processing system for annuity transactions which would eliminate the traditional written application and a "wet" or written signature. We believe such processing will streamline business operations and reduce costs for all participants. We understand that the phrase "deferred variable annuity application" as used in this section of the proposed rule does not relate only to written applications but also encompasses electronic or paperless applications. If this is the case, we request that this be clarified in the final rule.

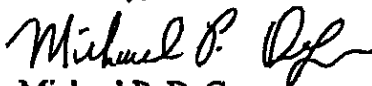
**(d) – Supervisory Procedures**

The numbered paragraphs in Section (d) are superfluous since each of the items enumerated are already addressed in section (c) of the rule and required to be included in the principal review. We believe all that is required in this section is the first paragraph.

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Again, we appreciate the opportunity to comment. If we can answer any questions or be of further assistance, please contact me at (703) 707-8830, extension 20, or Judith Hasenauer at (954) 545-9633. Ms. Hasenauer chairs NAVA's Regulatory Affairs Committee.

Sincerely,



Michael P. DeGeorge  
General Counsel