August 9, 2004

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

Re: Notice to Members 04-45—Proposed Rule Governing the Purchase, Sale or Exchange of Deferred Variable Annuities (June 2004)

Dear Ms. Sweeney:

Northwestern Mutual Investment Services, LLC ("NMIS") appreciates the opportunity to comment on NASD's proposed rule governing the purchase, sale or exchange of deferred variable annuities. NMIS was organized in 1968 and is wholly owned by The Northwestern Mutual Life Insurance Company. It offers a full range of securities products and services and is registered as a broker-dealer in all 50 states and the District of Columbia. NMIS has over 7,900 registered representatives, most of whom are also full-time insurance agents of Northwestern Mutual who sell traditional insurance products including life insurance, annuities, disability income insurance and long-term care insurance. Sales of variable insurance products and mutual funds make up most of NMIS's business.

I. Summary

Although we share NASD's concerns about the inappropriate sales practices described in Notice to Members 04-45 and in the Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 9, 2004), we urge NASD to withdraw the proposed rule and to reconsider whether proposing a product-specific rule for variable annuities is a well-reasoned response to the examination findings in the Staff Report.

We are also disappointed in the categorically negative way NASD has characterized variable annuities. The Notice to Members gives no indication that NASD appreciates the value of variable annuities from a financial planning context, the diversity of annuity products available or the variety of channels through which annuities are sold. Even worse, the proposed rule does not evidence a thorough understanding of existing laws and regulations applicable to variable annuities, which in addition to the NASD's conduct rules also include the Investment

Company Act of 1940, the Securities Exchange Act of 1934, the Securities Act of 1933 and state insurance codes.

The proposed rule combines two major features. One feature consists of novel elements that go well beyond Notice to Members 99-35. The elements include:

1) a separate disclosure document; and

2) a requirement that a registered principal approve the transaction within one business day after the application was signed.

We believe these novel elements are impractical and, ultimately, misguided.

The other feature is an attempt to restate existing requirements and to codify Notice to Members 99-35. As a matter of policy, we have treated the guidance issued by NASD about variable annuity sales in Notice to Members 99-35 and elsewhere as authoritative. To this extent, our objections to the proposed rule are primarily technical, but we also question whether adopting product specific suitability and supervision rules is necessary or ultimately will advance NASD's legitimate regulatory objectives.

II. Comments on NASD's General Approach

NASD solicited comments on whether the proposed rule should be based on an approach other than the guidelines discussed in NtM 99-35, and whether the proposed rule should cover all variable annuities, not just deferred variable annuity transactions. We believe the answer to both of these questions should be an emphatic "no." In fact, our strongest objections to the proposed rule are to those elements that go beyond the guidelines in NtM 99-35. We also doubt that proposing a new rule is an appropriate action under the circumstances, and question whether making product-specific suitability and supervision rules is a sound regulatory strategy generally.

For many of our customers, investing for future retirement income needs is among their most important financial objectives. Deferred variable annuities are part of a wide range of financial products used for retirement savings. In addition to deferred variable annuities, these products include not only mutual funds and other securities products, but also fixed annuities and certificates of deposit. For some of these customers, mutual funds or other products are a superior choice. For others, especially customers who want to be assured of guaranteed minimum annuity payout rates, variable annuities are a superior choice. Still others are best served by purchasing both products as part of a comprehensive retirement plan.[1]

[1] E.g., Ameriks, Veres & Warshawsky, Making Retirement Income Last a Lifetime, 14 Journal of Financial Planning 60 (December 2001). A deferred variable annuity offers the flexibility to annuitize practically immediately or at any other time the customer desires. Northwestern Mutual's deferred variable annuities can be annuitized without incurring additional sales charges.

In issuing the proposed rule, NASD has focused on the cost of owning an annuity contract while paying scant attention to the unique value of the product in protecting against the risk that a customer might outlive his or her savings. While it might be true that "various sources estimate the average annual expenses of a variable annuity range from 1.3 percent to 2.2 percent of the underlying assets in the account,"[2] deferred variable annuities are not the only financial products that charge recurring asset-based fees. The implication in Notice to Members is that these fees are of a different character and order of magnitude than they are for mutual funds, but this implication is a misleading generalization.[3] In fact, data available from Morningstar® shows that Northwestern Mutual's front-load Select[tm] Variable Annuity carries average annual expenses of 1.19 percent, which is lower than the 1.38 average annual expenses for class A mutual fund shares. Northwestern Mutual's back-load Select[tm] Variable Annuity carries average annual expenses of 1.94 percent, which is lower than the 2.09 percent average annual expenses for class B mutual fund shares.[4]

Our representatives typically do not call on a customer knowing in advance what the customer's needs are or which products might best address them. As a company selling a range of products that includes mutual funds, variable annuities and other financial products, we believe the degree to which the proposed rule goes beyond NtM 99-35 will impose inappropriate bureaucratic requirements on the sale of variable annuities. These requirements will create arbitrary obstacles for all variable annuity recommendations, not just unsuitable ones. They ultimately will raise costs to our customers and tilt the playing field decisively against variable annuities and toward mutual funds and other products for reasons that have nothing to do with the customer's financial situation and needs. Regulations that create these kinds of arbitrary market distortions are not in the public interest.[5]

III. Principal Approval Within One Business Day

One of the novel elements of the proposed rule is the requirement that a registered principal review and approve a variable annuity application no later than one business day following the date of execution of the deferred variable annuity application, which appears in subsection (c). Performing the procedures described in this subsection for any product sold on an application-way basis is simply not practical within a single business day.

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[2] NtM 04-45 at n. 7.

[3] In fact, one of the sources indirectly cited to support this claim took care to emphasize this point and concluded by saying, "under the right set of circumstances, VAs can be an appropriate investment for your clients." Y. Ding & J. Peterson, Are Variable Annuities Right for Your Clients? 16 Journal of Financial Planning 66 (Jan. 2003).

[4] See "Variable Annuities to Consider," USA Today, Oct 18, 2002 at 3B.

[5] The range of products and different regulators involved in retirement savings markets should prompt NASD to give careful attention to competitive considerations before singling out a particular product for expensive, inflexible mandatory procedures. See Section 3(f) of the Securities Exchange Act of 1934.

In similar contexts, the SEC by rule allows insurance companies two business days after receipt to process a complete variable annuity application[6] and by order exempts insurance companies from the standard t+3 settlement time frame.[7] The same kinds of considerations supporting these actions weigh in favor of allowing more time for suitability supervision here.

Moreover a one business-day time limit is unnecessary. State insurance laws typically give customers the right to return a variable annuity contract for any reason even after it is delivered. The length of these "free look" provisions vary from 10 days to 60 days, depending on the state and other circumstances. These "free look" provisions offer a greater opportunity to redress unsuitable variable annuity sales after the fact than for products that do not offer a right to return and for which the one business-day time limit would not apply. Imposing a one business-day time limit solely for deferred variable annuities is both unnecessary and arbitrary.

We also do not believe it is appropriate to impose requirements of the kind specified in paragraph (c) on any person unless the person is recommending the transaction. Claims that a particular variable annuity transaction was not recommended might appropriately be regarded with skepticism, but such transactions are not universally recommended by the member firm that effects the transaction. An insurance company's principal underwriter, for example, might be deemed to effect a transaction and yet might not have any relationship with the customer at all, and some customers enter into variable annuity transactions based on the advice of investment advisers or others who are not NASD members. The kind of principal review specified is likely to be particularly inappropriate in the context of employee benefit plans, where the NASD member might not even have the specified information about individual participants. A person should be responsible for the kind of written analysis required in this subsection because they made a recommendation, not because they happen to be an NASD member.

IV. The Separate Risk Disclosure Document

Another novel element of the proposed rule is the delivery of a separate risk disclosure document, which appears in subsection (b)(1)(B). The specifications for the risk disclosure document essentially duplicate the elements of the eleven item variable annuity profile, which many variable annuity issuers, including Northwestern Mutual, deliver with their prospectuses (see table below). The SEC's Division of Investment Management has given no-action assurances concerning the contents of these variable annuity profiles and has encouraged their use.[8]

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[6] Rule 22c-1(c) under the Investment Company Act allows two business days for processing an initial variable annuity application that is in good order. The rule allows up to five business days to complete a variable annuity application that is not in good order, or longer if the customer consents.

[7] *Securities Transaction Settlement*, Release No. 33-7177 (June 6, 1995) (available on Westlaw 1995 WL 357899); Industry Comment Letter (publicly available November 3, 1995) (available on Westlaw 1995 WL 815284).

[8] National Association for Variable Annuities, SEC no-action letter (pub. avail. May 30, 1997); Industry Comment Letter (Nov. 7, 1996); National Association for Variable Annuities, [1996 Transfer Binder] Fed. Sec. L. Rep. ¶ 77,222 (June 4, 1996).

Comparison of Proposed Risk Disclosure Document with Variable Annuity Profile		
Product Feature	Proposed Rule	Variable Annuity Profile
liquidity issues, such as potential surrender charges and tax penalties	(b)(1)(B)(i)	Item 7. Access To Your Money
sales charges	(b)(1)(B)(ii)	Item 5. Expenses
fees, such as mortality and expense charges, administrative fees, charges for riders or special features, and investment advisory features	(b)(1)(B)(iii)	Item 5. Expenses
federal and state tax treatment for variable annuities	(b)(1)(B)(iv)	Item 4. Taxes
potential market risk	(b)(1)(B)(v)	Item 1. The Annuity Contract; Item 8. Performance
"free look" period	Narrative	Item 10. Other Information

The only item specified in NASD's proposed risk disclosure document that is not covered in the variable annuity profile is a notice "that all applications to purchase or exchange a deferred variable annuity are accepted subject to review and approval by a designated registered principal." We doubt consumers would find this technical information of such great importance as to warrant an entirely new disclosure document.

If NASD intends to mandate the use of such a disclosure document (which the SEC has not done), we urge NASD to make clear that use of variable annuity profiles in accordance with current SEC guidance satisfies its requirements. A proliferation of required point-of-sale disclosure documents is at least as likely to confuse and overwhelm consumers as it is to communicate useful information to them.[9]

We also believe the requirement of a "separate" document is ill-considered. Northwestern Mutual's variable annuity profile is typographically distinct from the product prospectus, for example, but it is printed in the same booklet as currently permitted by the SEC. We do not believe NASD should override the SEC's guidance in this regard.

V. Restatements of Existing Requirements

Of course, much of the proposed rule merely restates requirements that already apply under NASD's current Conduct Rules, including Conduct Rule 2310 (Recommendations to

[9] The point-of-sale disclosures proposed by the SEC in *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, Release No. 34-49148 (January 29, 2004), if adopted, would be another lengthy, technical document containing a different summary of some, but not all, of the information specified in NASD's proposed risk disclosure document.

Customers (Suitability)), Conduct Rule 3010(d)(1) (Review of Transactions) and Conduct Rule 3110 and IM 3110-1 (Customer Account Information). To this extent, we urge NASD to consider whether its interests might be better served by issuing new interpretive material under the existing rules, an approach which could be less anti-competitive and otherwise preferable to adopting an entirely new rule only for deferred variable annuities.[10]

(a) Appropriateness/Suitability

Subsection (a) of the proposed rule ("Appropriateness/Suitability") essentially is a restatement of existing requirements. Rule 2310(a) (Recommendations to Customers (Suitability)) already requires members to have reasonable grounds for believing that all recommendations to purchase, sell or exchange any security are suitable. Furthermore, Rule 2310(b) requires a member to make reasonable efforts to obtain information about the customer's investment objectives and other information needed to make suitable recommendations.

Subsection (a) clarifies that the new suitability requirements also apply to persons associated with a member. We doubt there is any real confusion about this point. Rule 2310 has generally been interpreted, correctly in our view, as applying to associated persons as well as to member firms. To the extent there is confusion about this point we doubt a new rule is needed to dispel it.

Subsection (a) requires that members and their associated persons have a reasonable basis to believe that the customer has been informed of the material features of the deferred variable annuity. As a practical matter, we doubt this language adds anything not already covered by Rules 2110, 2120, IM-2210-2, IM-2310-2 and 3010.

Subsection (a) indicates that the customer must have a "long-term investment objective." But Rule 2310 has generally been interpreted, correctly in our view, to mean that variable annuity purchases should only be recommended to customers with a long-term investment objective. We do not understand the different language in the proposed rule to signal new substantive suitability standards in this regard.

Moreover attempting to codify the guidelines issued in NtM 99-35 introduces an element of rigidity that presents potential problems of interpretation in special cases. For example, if a customer who already owns a variable annuity changes from a long-term to a short-term investment objective, could a registered representative recommend a withdrawal or surrender of the variable annuity to raise cash? Read literally, the proposed rule would prohibit such a recommendation to any customer under any circumstances, because even a recommendation to

[10] We assume NASD intends the proposed rule to apply instead of the existing rules where deferred variable annuities are concerned. It would be helpful if this intention were clarified.

sell (surrender or take a withdrawal from) a variable annuity contract would require a long-term investment objective.

Subsection (a) requires members and their associated persons to have a reasonable basis to believe that the deferred variable annuity and the underlying subaccounts are suitable for the particular customer. Again, Rule 2310 has generally been interpreted, correctly in our view, to require this kind of suitability analysis. It hardly seems necessary to codify this interpretation in a new rule now, after NASD has brought enforcement actions to emphasize the point under Rule 2310.[11]

Subsection (a) requires members and their associated persons to obtain certain minimum suitability information. Although virtually the same guidance appeared in NtM 99-35, the proposed rule contains several seemingly arbitrary, unexplained variations. Also, since NtM 99-35 was published, the Securities and Exchange Commission has promulgated Rule 17a-3(a)(17), which creates a similar, but not identical, list of minimum customer account record requirements and which also applies to member firms under Rule 3110(a). We note, too, that the SEC took some care in formulating and interpreting the customer account record requirements in Rule 17a-3(a)(17) to assure that they are not applied in circumstances where they do not make sense. They only apply, for example, where a natural person is a customer or owner and where a suitability determination must be made. Interpretive guidance concerning their application to trusts and employee benefit plans has been issued.[12] We urge NASD to consider whether there is some essential reason for mandating yet another list of minimum suitability information before imposing the associated costs of compliance on firms selling deferred variable annuities.

Finally, subsection (a) requires suitability determinations to be documented and signed by the associated person recommending the transactions, in addition to being approved by a registered principal, as required by paragraph (c) of the new rule. To the extent this requirement is a restatement of what Rules 2310, 3010(d)(1) and 3110(c)(1)(C) already require, it is unnecessary. To the extent it requires more, it appears arbitrarily to tilt the playing field away from deferred variable annuities.

(b) Disclosures and Prospectus Delivery

Subsection (b)(1)(A) requires the delivery of a prospectus before effecting any purchase, sale or exchange of a deferred variable annuity. It has been our practice to deliver a prospectus for the product applied for to the applicant no later than the time the application is signed. If it is this practice NASD intends to make mandatory, the technical jargon used in the proposed rule, "prior to effecting any purchase, sale or exchange of a deferred variable annuity," is

[11] E.g., Mutual Service Corporation, No. C05010053 (Dec. 5, 2001); First Union Brokerage Services, Inc., No. C05010010 (Feb. 15, 2001); Lutheran Brotherhood Securities Corp., No. C05010003 (Feb. 15, 2001), among others cited in the appendix accompanying the Staff Report.

[12] See *Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934*, Release No. 34-47910 (May 29, 2003) (interpretive release).

unnecessarily broad and ambiguous. Read literally, it could be interpreted to require the delivery of a prospectus for an annuity to be surrendered as well as a prospectus for an annuity to be purchased. We continue to believe that the formulation in NtM 99-35 is more appropriate than subsection (b)(1)(B) in light of the prospectus delivery requirements established by the Securities Act of 1933.[13]

Subsection (b)(2)(A) appears to be essentially a "switch letter" procedure. We agree that "switch letter" procedures are an important supervisory tool, but we believe firms should have the flexibility to develop procedures reasonably adapted to their businesses. The subsection also is unclear on certain important points. For example, it might be reasonable to inform customers in a generic fashion that existing contracts sometimes can be modified or adjusted to meet their needs. It is not reasonable to require a representative in all exchange or replacement cases to provide a written analysis of specific modifications or adjustments to a particular contract. The documentation necessary to prepare such an analysis is not always available.

It also is not clear whether NASD intends the term "replacement" to have the same meaning it has in the various state insurance codes. The subsection appears to have been drafted with only replacements of one deferred variable annuity contract for another deferred variable annuity contract in mind, but it might also be read to apply to any use of deferred variable annuity contract values to purchase other financial products, including other fixed or variable annuities, mutual funds or certificates of deposit. Finally, it would be helpful if NASD would replace the word "significant" in paragraph (b)(2)(A) with "material," which has a defined meaning in securities regulation.

(d) Supervisory Procedures and (e) Training

Subsection (d) of the proposed rule sets forth six particular factors that must be addressed in supervisory procedures for deferred variable annuity sales. We think these factors are appropriate and support them in principle. Likewise, subsection (e) sets forth certain elements of training programs for variable annuities required for associated persons and registered principals. We also think these elements are appropriate and support them in principle. We do not believe it is necessary to incorporate these elements in a separate rule, given that they are already covered in a principles-based fashion under Rules 3010 and 1120. We do not support subsection (d) and (e) to the extent they incorporate the rigid, bureaucratic requirements imposed elsewhere in the proposed rule without regard to a reasonableness standard or to the range of business models in use in the industry.

[13] NtM 99-35 states: "To the extent practical, a current prospectus should be given to the customer when a variable annuity is recommended."

VI. The Development by NASD of Explicit, Fixed Suitability Standards

NASD solicited comments on whether the proposed rule should incorporate explicit, fixed suitability standards developed by NASD, or indeed, whether sales of deferred variable annuities should be limited to certain categories of investors. These are radical notions completely out of step with the disclosure-based pattern of federal securities regulation. Federal regulators have consistently rejected merit regulation of securities for good reasons that should not need to be revisited here. Likewise, we urge NASD to resist any "bright-line measures" for suitability standards. NASD and other securities regulators have long recognized that supervision and suitability are matters for reasoned judgment, not mathematical certainty. Variable annuities have many unique features, but none of them call for a departure from this axiom.

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Thank you for the opportunity to comment. If you have any questions, please call me at (414) 665-5034.

Very truly yours,

Mark A. Kaprelian
Secretary

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