

PACE INVESTOR RIGHTS PROJECT

Pace University School of Law

DIRECTOR OF RESEARCH
BARBARA BLACK
914- 422-4236
BBLACK@LAW.PACE.EDU

78 NORTH BROADWAY
WHITE PLAINS, NY 10603
FAX: 914-422-4391
WWW.LAW.PACE.EDU/PIRP

DIRECTOR OF ADVOCACY
JILL I. GROSS
914-422-4061
JGROSS@LAW.PACE.EDU

STAFF ATTORNEY-EDUCATION
ALICE OSHINS
914-861-9105
AOSHINS@LAW.PACE.EDU

August 9, 2004

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

Re: NASD Notice to Members 04-45 — Request for Comment

Dear Ms. Sweeney:

We are writing in response to NASD's request for comments to NASD Notice to Members 04-45 — Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities. We are commenting on behalf of the Pace Investor Rights Project whose mission includes advocacy in the area of investor justice.

The proposed rule seeks to impose specific sales practice standards and supervisory requirements on NASD members for transactions in deferred variable annuities. As the NASD notes, despite the issuance of "best practices" guidelines in *NtM 99-35* (May 1999), some of its members continue to engage in problematic sales practices and some investors continue to be confused by certain features of deferred variable annuities. According to Mary L. Schapiro, NASD Vice Chairman and President of Regulatory Policy and Oversight, "[t]he vast majority of [NASD's] enforcement actions in [variable annuities] involve suitability, disclosure and supervision issues[.]"¹ Similar abuses have been seen when brokers recommend variable annuity exchanges or "switching."²

¹ See NASD News Release — NASD Disciplines Three Firms, Three Brokers for Variable Annuity Abuses — Total Fines Exceed \$500,000, With Two Brokers Permanently Barred (May 20, 2004) (Three Firms News Release), available at http://www.nasdr.com/news/pr2004/release_04_034.html.

² See NASD News Release — NASD Charges Waddell & Reed with Suitability Violations Relating to Thousands of Variable Annuity Exchanges and Seeks Customer Compensation; Two Senior Execs Also Charged (January 14, 2004) (W&R News Release), available at http://www.nasdr.com/news/pr2004/release_04_004.html.

We support NASD's efforts to curtail persistent, problematic sales practices by its members and to better educate investors. However, we are not convinced that adoption of the proposed rule would have prevented harm to the investors victimized in the enforcement actions cited above. Thus, we do not believe that the proposed rule is sufficient, by itself, to deter the worst offenders who are apparently willing to forge signatures,³ falsify confirmation documentation,⁴ sell products to ineligible customers,⁵ or even implement company-wide annuity exchange campaigns in apparent disregard of existing NASD conduct rules.⁶ Nevertheless, we believe that adoption of the proposed rule will have a beneficial effect on those registered personnel who normally operate within the rules and regulations, by reducing the unfair selling pressure they face to stay competitive with those in the industry who put only their own financial interests first. In regard to the latter, we recommend that NASD step up its intensity of enforcement and exact far stiffer penalties. Currently, it is not apparent that brokers are facing a difficult cost-benefit choice before proceeding with a questionable transaction.⁷

We support NASD's decision to model the proposed rule after the "best practices" guidelines issued in *NiM 99-35*. In particular, we support the requirement that members provide certain information (i.e., current prospectus and "plain English" risk disclosure document) and undertake certain actions (i.e., seek registered principal review and approval of an executed application or provide additional documentation when an exchange transaction is involved) whether or not the member recommends the transaction. We believe that such steps are warranted by the complexity of variable annuity transactions. Furthermore, we recommend that the risk disclosure document also include examples that illustrate the negative effect of surrender charges, tax penalties, sales charges, recurring expenses, etc. For example, a table might show the year-by-year surrender charges for a hypothetical \$10,000 investment, assuming that the investment remained flat. In addition, the document should warn investors that purchasing variable annuities within tax-advantaged accounts is not necessary to defer taxes on any gains.

For recommended transactions, we endorse the requirement that a member not only undertake an appropriateness/suitability analysis but also document and sign any such analysis. This requirement not only provides a regulatory paper trail but also reminds the member that the analytical undertaking is a serious obligation. We also agree with the requirement that a registered principal conduct a review and approval of applications and exchanges no later than one business day following the execution of an application. This is an improvement over the current "best practices" guidelines that specify no fixed turnaround time.

We do not favor modeling the proposed rule after certain provisions of the options and security futures rules as the products are not similar. A variable annuity involves a single transaction, while options and security futures involve trading accounts where transactions are generally of much shorter duration and involve different types of risks.

³ See Three Firms News Release, *supra* note 1.

⁴ *Id.*

⁵ *Id.*

⁶ See W&R News Release, *supra* note 2.

⁷ *Id.* It is not clear from the News Release that the brokers who effected the inappropriate annuity exchanges will face NASD discipline despite having had no reasonable grounds for recommending an exchange. On average, each exchanged contract generated more than \$5,500 in commissions and more than \$100 per year in ongoing fee sharing.

In light of the proposed rule, we recommend that NASD revisit (1) the adequacy of the content covered on the Series 6 examination;⁸ and (2) the sufficiency of oversight provided by a Series 26 registered principal as opposed to a Series 24 registered principal. We prefer the Series 24 examination because it not only places a greater emphasis on general regulatory and compliance issues but also tends to carry added industry credibility.

Moreover, we believe that the Securities and Exchange Commission's recent proposal to require additional disclosures for mutual funds⁹ may press NASD to reassess whether it is appropriate for sales of mutual funds and variable products to operate under a common registration/examination umbrella. Although we support the disclosure of information that enhances investor protection, we do not believe that disclosures emphasizing detailed sales fees and costs for mutual funds are a substitute for NASD's proposed rule covering deferred variable annuities.

NASD also requested comment on the proposed rule's provisions for principal review and supervisory procedures, noting that it rejected bright-line measures in deference to its belief that each member is better able to determine its own appropriate standards for review of the suitability of variable annuity transactions. We disagree. Based on supervisory problems documented at Waddell & Reed, we believe that permitting firms to individually set their own standards would invite abuse and provide an "it met the standard" defense to abusers. We recommend that familiar and objective factors such as age, income, liquidity needs, and net worth be used to create uniform standards of review.

We envision that the framework for such a system would assign each customer with an eligibility score that would slot each customer into a category such as "solidly eligible," "maybe eligible" or "solidly ineligible." In this simplified example, a score based on the factor of age alone might designate someone over 100 years old as solidly ineligible and someone in his thirties as solidly eligible. Some range of ages in between would represent the "maybe eligible" category. We believe that some firms would choose not to pursue business outside of the solidly eligible category. However, other firms would likely try to maximize their business generation in all feasible categories. We recommend that the latter treat "maybe eligible" customers as exceptions who would be subject to (1) additional pre-transaction documentation requirements; and (2) post-transaction tracking and monitoring. Comparisons between the track records of the "solidly eligible" and "maybe eligible" customers could be used to refine the standards and the scoring system.

Although we are optimistic that the proposed rule will help investors, the events at Waddell & Reed lead us to doubt whether the "sound practices" cited in the SEC/NASD joint

⁸ A standalone Series 6 registration limits a representative to investment company and variable products, a very limited subset of the Series 7 general securities representative registration. Representatives who conduct business in options and security futures products not only have specific product registrations, they generally also have Series 7 registrations.

⁹ See SEC Proposed Rule — Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. No. 34-49148 (Jan. 29, 2004).

report¹⁰ would have been effective in stopping abuses that were alleged to have been encouraged by the president of the company and the national sales manager.¹¹ Apparently, concerns voiced by some salespersons and supervisors did not stop others from engaging in and/or approving questionable transactions. Thus, we reiterate our recommendation that NASD manifest clearly its willingness to enforce its rules and regulations by demonstrating to brokers and their supervisors that they will be held individually accountable for their respective actions and will not be shielded from enforcement actions because their firm or senior management is charged with violations.

Finally, given that both sales efforts and related abuses are concentrated in the deferred variable annuity area, we believe the focus on deferred products rather than non-deferred products is appropriate at this time. Nevertheless, if changes in compensation structures increase selling efforts in other variable annuity products, NASD should consider additional rule changes.

We appreciate the ability to voice our concerns and approval of NASD's efforts to protect the investor. Thank you for your consideration of these comments. Please do not hesitate to contact us if you would like to discuss these issues further.

Respectfully submitted,

/s/ Jill I. Gross
Jill I. Gross, Director of Advocacy

/s/ Barbara Black
Barbara Black, Director of Research

/s/ Bob Kim
Bob Kim, Student Intern

¹⁰ See Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2004), available at http://www.nasdr.com/pdf-text/sec_nasd_report_060804.pdf.

¹¹ See W&R News Release, *supra* note 2 (“In response to pressure from senior management, some Waddell regional vice presidents took steps to encourage exchanges.”)