



PACIFIC SELECT DISTRIBUTORS

August 9, 2004

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

Re: *Comments on Notice to Members 04-45 - Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements for Deferred Variable Annuities Transactions*

Dear Ms. Sweeney:

Attached please find a comment letter prepared by John. L. Dixon, President of Pacific Select Distributors, Inc. ("PSD"). Mr. Dixon's letter summarizes the activities of Pacific Select Distributors and focuses on the concerns that retail broker-dealers have with the changes proposed in Notice to Members 04-45.

Pacific Life Insurance Company ("Pacific Life"), the parent of PSD and an issuer of variable annuities, also has concerns with the proposals. Pacific Life believes the comments submitted by National Association for Variable Annuities and American Counsel of Life Insurers best summarize Pacific Life's position.

We appreciate the opportunity to provide comments to your organization's proposal. All participants, including investors, issuers, broker-dealers and regulators, are best served with a reasoned, thoughtful process when contemplating changes to industry practices.

Sincerely,

S. Kendrick Dunn
Assistant Vice President

CC: Bill Robinson
John Dixon
Sharon Pacheco
Steve Toretto

PACIFIC SELECT DISTRIBUTORS, INC.

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Re: *Comments on Notice to Members 04-45 - Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements for Deferred Variable Annuities Transactions*

Dear Ms. Sweeney:

We are pleased to respond to the request for comments on the Notice to Members 04-45 (“Notice”), which proposes new rules including specific sales practice standards and supervisory requirements for transactions in deferred variable annuities (“Proposal”).

Pacific Select Distributors, Inc. (“PSD”) is a broker-dealer member firm of the National Association of Securities Dealers, Inc. (“NASD”) and is a subsidiary of Pacific Life Insurance Company. PSD has an affiliate relationship and directly or indirectly owns majority control of six retail NASD member firms. PSD also serves as a distributor of variable contracts and mutual funds offered by Pacific Life Insurance Company and its affiliates. Five of the six retail firms referenced above service and supervise registered representatives who are independent contractors. A majority of such representatives are financial and investment planners that provide a variety of financial services to their clients.

PSD is concerned about the impact of the Proposal on member firms that retail variable contracts, particularly those firms whose representatives are independent contractor business owners (“Independent Contractor Firms”). PSD is also concerned about the impact of the Proposal on manufacturers and distributors of variable contracts.

We have studied the “Joint Staff Report on Broker-Dealer Sales of Variable Insurance Products” issued by the SEC and NASD on June 8, 2004 (the “Report”) and concur that a review of sales practices and supervisory processes is appropriate. While we support certain aspects of this Proposal, we believe that the Proposal, taken in its entirety, is impractical and overreaching, and would cause significant, unnecessary harm to retail member firms that are good industry citizens. Further, we believe the Proposal, if

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implemented in its entirety, would exacerbate an already unlevel playing field and could cause more confusion than clarity for investors.

The Notice emphasizes that many firms have not followed the “best practices” guidelines previously issued by the NASD, primarily in Notice to Members 99-35. It is this fact that leads the NASD to the conclusion that such “best practices” should be codified in Rules. It is important to note that no further comprehensive advisory has been issued by the NASD updating (or reminding) firms of their obligations in the sale of variable annuity transactions for over four years. During that time the NASD and other regulators have participated in several “variable sweep exams” and considerable research has been done, resulting in the long-anticipated Report published by the SEC and NASD. It would have seemed reasonable if the NASD had taken this opportunity to update the “best practices” guidelines and re-emphasize the regulatory liability that has resulted where firms failed to adopt reasonable sales practices and supervisory oversight for variable annuity transactions. We believe issuance of an “updated 99-35” would encourage member firms, a majority of which are well-intentioned, to voluntarily make further improvements in supervision of variable annuity sales practices. That would be a more balanced approach than that outlined in the Proposal, which, if enacted in its present form, would impose an inflexible and expensive framework that will negatively impact all firms whether they were responding in good faith or not.

We believe that an updated sales practice advisory (as described above) combined with continued aggressive enforcement of current rules provides an adequate format for regulation of variable contract transactions. The only additional codification of sales practices in the Proposal that we would support is broad language reminding registered representatives, in conjunction with a sales presentation on variable annuities, they must deliver a current prospectus, inform the customer of the unique features of the variable annuity contract and determine that the deferred variable annuity as a whole and the underlying sub-accounts recommended are suitable for the particular customer.

We do not agree with the Proposal that unique, separate written and signed documentation of the suitability determination should be required for each variable annuity transaction. Suitability is an important part of any investment account, whatever investment products are involved and it is not practical to maintain separate, duplicate information for specific variable annuity transactions. Further, as pointed out below, we do not think it is helpful or desirable to create a unique approach to supervision and principal review of individual variable annuity transactions distinct from that appropriate for any investment transaction.

We also believe a simplified language summary of certain facts about variable annuity contracts could be helpful to customers. However, as pointed out below we feel strongly that it is inappropriate to require that such a document be created by the member firm or its representative. Rather, we suggest that if the NASD concludes such a document is important, the SEC should be petitioned to promote or require that variable annuity prospectuses be simplified and/or supplemented by a plain language summary prepared

by the sponsor of the annuity. Alternatively, we believe that a generic brochure created by the NASD could be a practical solution.

Any rule changes that relate to variable annuity transactions should take into consideration that these transactions result in a contract between the customer and the insurance company issuing the annuity. This means that subsequent transactions such as changes in sub-accounts, additional investments into the contract (even those that result in additional compensation to the member firm and representative) and partial or full liquidations can be initiated by the customer with little or no involvement by the member firm or representative who participated in the initial purchase transaction.

We agree that member firms that handle variable annuity transactions should provide adequate training for their representatives; however, we believe current rules describing the firm element training requirements provide sufficient documentation of this requirement. There is a risk that creating a specific rule for annuity training may create the impression that training is not required for products not specified.

Our major concerns about the Proposal are:

- 1) The Proposal demonstrates a bias against variable annuity contracts and, if implemented, would create an unfair competitive environment for variable annuity contracts. While the proposal does not include any explicit negative statements about variable annuities, the proposed imposition of disclosure and supervisory requirements more detailed and onerous than that for any other product line send a clear and damaging message to the member firm, the registered representative and the public customer. The Proposal cites an increased volume of customer complaints as justification for this harsher treatment. We believe that the volume of customer complaints has increased across all investment product lines, including mutual funds. It is our belief that this increase in complaints does not primarily result from unique characteristics of annuities or sales practice violations. Rather, the increase results primarily from market volatility, negative media coverage and increased promotion of litigation by plaintiff attorneys. Regulatory enforcement actions are also cited as a basis for imposing more restrictions on the sale of variable annuity contracts; yet the published information indicates that the volume of enforcement actions may be even higher with respect to mutual funds.
- 2) The Proposal creates an entirely unique supervisory framework for the sale of variable annuity products at a time when any member firm that takes regulation seriously has already fully engaged its technology and human resources attempting to implement the unprecedented volume of new rules and demands promulgated by regulators, including the NASD, over the past 18 months. The proposal, if implemented in its current form, would require that variable annuity business be processed and supervised differently than any other product line, resulting in inefficiency, much increased costs and serious erosion of existing compliance and supervisory systems.

The requirement that a supervising principal fully duplicate the selling representative's role with respect to every single variable annuity transaction is clearly overreaching. This requirement suggests that no selling representative is capable of assessing suitability for any variable annuity transaction. The unique review by principals described in the Proposal - requiring that a principal have personal knowledge of the customer and sign off on a detailed suitability summary and, in the case of a 1035 exchange, a detailed comparison of old and new contract - would require a substantial diversion of supervisory resources from other important duties and create an unfair financial penalty on any firm that engages in variable annuity business. For a firm that provides access to a large number of variable contracts, this requirement would force allocation of two to three times the supervisory staff for variable annuity production as compared to any other product line. Further, meeting the proposed requirement that such principal review and approval be completed within one day of any transaction is an unrealistic requirement. The majority of Independent Contractor Firms - which transact almost 1/3 of the industry's retail business - operate with small, remote offices and utilize centralized supervisory functions that depend either on electronically transmitted customer and product data or on mailed original applications for principal review. Where data for review is transmitted electronically, implementation of the Proposal would require huge expenditures to create unique systems to meet the detailed requirements for review of variable contract transactions and unique documentation, including original signatures from both the representative(s) and the supervising principal(s). Where "application way" business is mailed from branches to the home office for supervisory review, the one day rule would be unworkable.

The Proposal describes a supervisory approach that would only fit a "traditional, wire-house" style of doing business - where a group of representatives are housed in the same facility as a branch manager who oversees their transactions. This is not the model within which a majority of variable transactions take place today.

- 3) The Proposal would require that retail firms create and provide a customized disclosure document to customers in conjunction with every variable annuity transaction. The Proposal calls for a document that is separate from the prospectus, brief and easy to read yet requires that document to highlight the features of the particular variable annuity transaction including, but not limited to, liquidity issues, sales charges, fees of all types (including mortality and expense charges, administrative fees, charges for riders or special features and investment advisory fees), surrender charges, tax treatment and issues, and market risk. We note that the insurance attributes that are the qualities that most attract investors to consider variable annuities are missing from the listing of features suggested for highlighting.

This requirement for a customized disclosure statement to be prepared by retail broker-dealers should be removed from the Proposal for the following reasons:

- a) Any level of detail on just the inclusions listed in the Proposal would result in a document that is neither brief nor easy to read.
- b) Member firms, which offer a wide variety of variable annuity products with many sub-accounts and riders, would have an impossible task to maintain current and accurate disclosure documents for every potential transaction. This requirement would penalize the member firm that offers a broad line of variable annuity products and reward the firm that only sells a limited line (only proprietary?) of annuity products.
- c) This requirement would result in massive duplication of effort and inconsistencies in disclosure to customers. Variable annuity products with wide distribution are sold by hundreds of member firms. Each firm would be required to create its own disclosure brochure. The potential for material errors and omissions are frightening. For each firm to gather the data to create a current, customized disclosure document for each such product is an enormous waste of resources. Further, with the potential regulatory and civil liability facing the member firms, each will consult with their own counsel to create all manner of disparate disclosure brochures. Two customers buying the same product from two different member firms will likely receive substantially different disclosure documents.
- d) Unless a safe harbor is provided stating clearly what must be included or may be excluded, this provision creates a regulatory quagmire for members.
- e) This requirement would be impossible to fulfill in the framework of a normal sales process. For example, advance creation of the required document would be impossible if the client is permitted to make point of sale decisions as to choice of sub-account(s), optional riders, etc. It is hard to imagine how a representative could meet this requirement and present a variable annuity product by phone to an existing customer or even complete a transaction in a single in-person meeting.
- f) This requirement creates a civil liability trap for member firms, with the required disclosure document providing an attractive foundation on which to base allegations of inadequate or omitted disclosures. This increased exposure to civil liability will lead members to construct legally crafted disclosure documents that will not fulfill the NASD's desired purpose of "brief and easy to read".
- g) Member firms not in the product creation business do not have the databases, facilities and expertise needed to create and update multiple disclosure documents.
- h) Sponsors would not control the content and accuracy of disclosure documents specifically describing the products they create and distribute, potentially adding to their regulatory and/or civil liability exposure.

- i) This requirement is practically the same as attempting to regulate annuity product manufacturers through the member firms that sell their products.

If the NASD determines that a “plain English” summary of key points about variable annuity contracts is essential, then we suggest that one of the following approaches would be a more practical approach:

- a) Work with the SEC to develop a “plain English” summary that would be a required inclusion in the front of every variable annuity prospectus.
 - b) Work with the SEC and industry representatives to create a single generic brochure and make it mandatory that it be provided to any prospective customer considering a variable annuity transaction
- 4) As referenced earlier, the Proposal is unfairly burdensome for firms that carry a wide range of variable annuity products. Such firms would be severely penalized for doing a good thing – maximizing flexibility for their associated representatives and their public customers. For example, consider one of the independent contractor member firms owned by PSD. That firm has over 1,500 representatives, most of whom provide diversified financial and investment planning services. The firm offers stocks, bonds and a wide variety of packaged products (including mutual funds, variable insurance and annuity contracts, third party money managers, reits, etc.) to the customers of its representatives. There are no special incentives to sell proprietary or any preferred products. In keeping with this philosophy, the firm has selling agreements with over 50 of the 100-plus life insurance companies offering variable annuities. Those agreements encompass a universe of over 400 distinct variable annuity products. Typically, a financial planner registered with the firm would select a small number of such products – perhaps 5 or less – which he/she knows well and are comfortable with. This selection of annuity products is included in the range of products from which that planner suggests their customers construct their investment portfolios. Among the 1,500-plus representatives in the firm, every one of the 400 distinct products may be utilized, but each representative who sells annuities will on average only focus on a small number of products. If the Proposal were implemented in its current form, this firm would have to commit the resources to create a customized disclosure document at a moment’s notice on any of the 400-plus products. The firm would have to have in its employ supervisors capable of reviewing and approving within 24 hours a transaction in any of those 400 products. We do not think that would be possible. More likely, the only way to comply with the Proposal would be to substantially narrow the firm’s product offerings to the detriment of its customers. We want to emphasize that this is not an extreme example. Rather it is typical of the independent contractor environment in which approximately 1/3 of retail securities transactions are conducted today.

As a distributor of variable annuity products issued by Pacific Life, PSD is also concerned that the Proposal, if implemented in its entirety, would result in member firms taking dramatic steps to lessen the financial impact of the requirements for customized disclosure documents, and the unique, detailed requirements for supervision of variable contract transactions. Such steps might include substantially reducing the number of variable annuity products offered and/or aggressively discouraging the sale of variable annuities by reducing commissions paid to representatives or placing severe restrictions on such transactions. We believe variable annuities are a very attractive and practical investment vehicle for the majority of Americans and it would be a disservice to the public to adopt the provisions of this Proposal that unfairly penalize broker-dealers that offer variable annuities.

Any parts of the Proposal that are finally considered for implementation should be coordinated with the several other related pending rule proposals. For example, in September 2003, the NASD proposed amendments to Rule 2830 that would require written disclosure of revenue sharing and differential compensation arrangements at the time a customer opens an account or acquires mutual fund shares. It is our understanding that the NASD is considering expanding that proposal to require such disclosure regarding variable annuities. Further, in January 2004, the SEC proposed rule amendments that would require broker-dealers to provide customers with additional written disclosures at point of sale and in confirmations. These proposals would effect mutual fund shares and unit investment trust interests (including insurance contracts) and the SEC requested input on whether the proposal should apply more broadly to variable contracts.

Thank you again for providing the opportunity for the industry to participate in the rule making process.

Sincerely,

John L. Dixon
President