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Office of the Corporate Secretary
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Notice To Members

August 6, 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:

I am 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").

United Planners' Financial Services of America ("UPFSA") is a fully disclosed retail broker-dealer registered to conduct business in all domestic jurisdictions, with approximately 350 registered representatives offering securities through nearly 100 offices of supervisory jurisdiction. UPFSA is a subsidiary of Pacific Select Distributors, a subsidiary of Pacific Life Insurance. UPFSA is structured as a Limited Partnership. All UPFSA Partners and representatives are financial and investment planners that provide a variety of financial services to their clients.

I appreciate the opportunity to submit comments on the issues raised in the proposed rule change by the National Association of Securities Dealers, Inc (NASD) NTM 04-45. 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. The Proposed Rule would impose sales practice standards and supervisory requirements by member firms applicable to deferred variable annuities. NASD efforts to enhance investor protection are to be commended.

I have reviewed 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 am in general agreement that some action should be taken in the light questionable sales practices and investor confusion about variable annuity transactions. I support the concept of adapting the existing best practices guidelines into a rule, which would uniformly apply in the industry.

However, we believe that the Proposal taken in its entirety is impractical and overreaching, and would cause significant, unnecessary harm to retail member firms and variable contract sponsors. Further, I believe the Proposal, if implemented in its entirety, would exacerbate an already uneven playing field and could cause more confusion than clarity for investors. The Proposed Rule would go further by imposing significant new burdens on broker-dealers and registered representatives. I believe there are preliminary steps that could address the problems in a more effective and cost-efficient manner, and should be considered before more costly and burdensome obligations are imposed. As the President and CEO of UPFSA, I offer the comments below on the Proposed Rule followed by my specific recommendations.

<u>Concerns with the Proposed Rule</u>

1. **<u>As Proposed, Point-of-Sale Risk Disclosure Brochures are Unworkable</u>.**

The NASD's point-of-sale risk disclosure brochure concept is premature. The SEC has proposed its own point-of-sale disclosure rule, Proposed SEC Rule 15c2-3 under the Securities Exchange Act of 1934. The concept of a separate disclosure brochure is itself debatable. Investors are likely to be distracted from reading the prospectus and confused by multiple disclosure documents. The NASD should defer action on the point-of-sale disclosure aspects of its proposed rule until the SEC's rulemaking process has been completed. Most of the critical comments directed at the SEC's point-of-sale disclosure rule would also apply to the NASD proposal.

a. The concept of each broker-dealer creating, maintaining, and updating its own versions of risk disclosure brochures for each variable annuity product would be extraordinarily expensive, administratively impractical, and risky for broker-dealers. 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, <u>but not limited to,</u> 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.

   For example, UPFSA has selling agreements with more than 50 variable annuity issuers. Issuers may have four or more different variable annuity products. Each product's brochure would need to address differences in state laws, often resulting in at least four or five state-specific variations. In such a situation, the broker-dealer would be required to prepare, continually update, and manage 1,000 or more disclosure brochures. Additionally, registered representatives would be required to maintain and manage all of the separate disclosure brochures at each branch location. If a separate disclosure document is deemed desirable, then the issuing insurance companies who design the annuities and prepare the prospectuses should prepare it. This requirement 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, if not 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 it's own disclosure brochure. The potential for material errors and omissions is enormous. For each firm to gather the data to create a customized disclosure for each such product is an enormous duplication of resources. Two customers buying the same product from two different member firms will likely receive substantially different disclosure documents.

d) Unless a clear safe harbor is provided stating exactly what must be included, or may be excluded under this provision, creates a regulatory quagmire for members and ultimately confuse the public.

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 personal 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 work against the NASD's desired purpose of "brief and easy to read".

g) Member firms not engaged in the product creation business do not have the databases, facilities and expertise needed to create and update multiple disclosure documents. Additionally, sponsors would not have control of the content and accuracy of these disclosure documents describing the products they create and distribute, potentially adding to their regulatory and/or civil liability exposure.

2. **Suitability Determination Must Include Insurance and Securities Considerations.**

   The NASD acknowledges that a variable annuity contains both an insurance component and a securities component. The Proposed Rule appears to give little or no weight to the insurance features of a variable annuity in the suitability analysis.

3. **Variable Annuities in Tax-Qualified Retirement Plans are not Unsuitable.**

   The Proposed Rule implies that variable annuities in tax-qualified retirement plans are presumed to be unsuitable. However, a variable annuity may have additional features that attract an investor with a qualified retirement plan, without regard to the absence of additional tax advantage. Some customers needing the insurance benefits may lack the money outside of their retirement plan to obtain it. An employer's contributions to the retirement plan may only be utilized when the annuity is purchased within the plan. Customers may be seeking to maximize the contributions to their retirement plan. Purchasing an annuity inside a retirement plan account permits a customer to obtain the insurance benefits using pre-tax dollars, perhaps allowing the customer to afford more benefits. The National Association for Variable Annuities ("NAVA") has identified a variety of benefits of a variable annuity in a tax-qualified retirement plan, including lifetime income payments, family protection through the death benefit, and guaranteed fees. The primary goal of a retirement plan is not to obtain tax deferral but to provide retirement income that will last for the life of the recipient. Variable annuities are designed to accomplish this goal by providing for the accumulation of assets during the owner's income-producing years, and guaranteeing payments in retirement that last for as long as he or she lives. Many defined contribution plans do not otherwise offer their participants this option, so for people who want income they cannot outlive, a variable annuity can be very attractive.

4. **Customer Information Required Should be Uniform.**

   Section (a)(2) of the Proposed Rule requires that firms obtain additional information about customers purchasing variable annuities. A different standard for variable products will be more difficult and confusing for representatives, and more expensive for firms. Uniform standards for all products (as is the current practice) are cheaper, easier, less confusing for representatives and more importantly, the public. All required customer data gathering should be prescribed in one section of the NASD rules to avoid inadvertent omissions.

5. **Comparison of Old and Replacement Policies is Not Always Possible.**

The Proposed Rule would mandate a comparison of the old annuity's features and costs with the replacement policy's features and costs. A customer may not have retained a copy of the old policy or an associated person may not have access to it. The issuer of the old policy may be uncooperative in furnishing a copy if it knows the customer is considering replacing the old product and can be expected to press the customer not to make a change. Must the firm decline to do business with that customer because the required comparison cannot be made? The rule should allow for a customer's certification that the old policy is unavailable. There are instances when, because of competition driving policy enhancements in variable product market place, an old policy can be readily determined to be outdated or no longer appropriate because of new features without an extensive analysis.

6. **One Business Day Turn-around is Unnecessary and Unworkable.**

The required principal's review, approval, and suitability determination must come within one business day after the customer has signed the application. 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.

In many firms, a designated principal may not be available on such short notice due to other firm responsibilities. Often times, principals reviewing transactions will request additional information before granting approval, and the information cannot be compiled in one day. Today, representatives in satellite offices often send completed applications to the home office by regular mail. The Proposed Rule would require faxes or overnight delivery services, adding to the cost of the transaction and placing unwarranted time pressure on supervisors.

An investor is adequately protected by the "free look" period that starts when he or she receives the policy. The one-day review requirement creates a substantial burden, the possibility of inadvertent errors, and no additional investor protection. The short time frame may, in fact, hinder some firms' existing review processes. The rule could provide (and require disclosures to state) that in all cases an application is not accepted until the review and approval has been given by the designated principal, not just in the case of replacements and exchanges.

7. **Standards for Principal Review are Unclear.**

The Proposed Rule references "red flag" standards that are to be set by the firm, but offers no guidance or benchmarks to assist a firm in developing those standards. For example, what customer age does the NASD find troublesome? What percentage of net worth? What absolute dollar figure? What is a "long term" investment objective in the context of annuities? By requiring principals to consider these factors but not giving any guidance on what the NASD would consider unsuitable, the NASD is not giving firms adequate tools to comply with the rule.

8. ***Suitability Obligations for Unsolicited Sales are not Warranted.***

The proposed rule's distinction between the suitability analysis for recommended versus unsolicited transactions is confusing and ambiguous. The apparent distinction appears to be that for recommended transactions the front-line associated person must make an initial suitability determination, but for unsolicited transactions the suitability determination must be made by the reviewing principal - in either case suitability must be determined before the transaction is concluded. In recommended transactions, the designated principal is required to consider "underlying supporting documentation" but apparently that is not required in the case of unsolicited orders. The rule's text can be read to treat documenting the suitability analysis differently. If the NASD contemplates a more limited suitability analysis for unsolicited transactions, that distinction is not clear from the text of the rule.

Current NASD rules do not require suitability determinations for unsolicited transactions in any other products. Firms are currently required to obtain basic new customer information from all customers, regardless of whether orders are solicited or unsolicited. Creation of a new suitability standard for unsolicited orders of variable annuities is not appropriate and may lead to unwarranted calls for the same requirement to be applied to other complex financial products.

Response to Other Requests for Comments

In addition to comments on specific provisions of the proposed rule, in NTM 04-45 the NASD requested comments in specific areas. Briefly summarized, the NASD asked members to comment on the following questions. Comments follow each *subject:*

1. **Should the NASD's rule be modeled after the "best practices" guidelines discussed in NTM 99-35, the proposed approach, or an alternate approach such as prescribing the types of investors to whom variable annuities can be sold?**

Comment: The NASD's final rule should be modeled after the "best practices" guidelines. Applicable benchmarks ("red flags") should be defined and presented as rebuttable presumptions. Factors which could warrant exceeding the benchmarks could also be identified. Flexibility is important, but well-defined standards will better assure consistency throughout the industry.

The NASD should not prescribe the types of investors to whom variable annuities can be sold. That approach eliminates all flexibility and runs counter to many customers' benefits.

2. **Should the proposed rule cover all variable annuity transactions, and not just "deferred variable annuities"?**

   Comment: No, in the absence of material compliance issues and customer complaints, the increased costs - which customers will ultimately bear - do not warrant extending the regulation to other products.

3. **Should the risk disclosure document focus on information applicable to all deferred variable annuities offered by the firm, rather than product-specific disclosures? Can investors be more effectively educated in other ways?**

   Comment: If after a careful analysis a separate risk disclosure document is deemed warranted, a product-specific brochure is virtually unworkable for the reasons described above. Most of the desired customer education could be accomplished with generally applicable disclosures. As described above, with the NASD's input the SEC should evaluate changes in the content and format of variable annuity prospectuses.

4. **How would the NASD's rule interplay with the SEC's proposed point-of-sale disclosure rule?**

   Comment: The NASD's action on the proposed risk disclosure brochure should be deferred until the SEC has completed its analysis and rulemaking process for its proposed rule. The NASD should consider many of the comments submitted to the SEC about the SEC's rule because of the similarity of concepts. The NASD's rule should be shaped by the final SEC rulemaking.

5. **The NASD is considering bright-line metrics for the suitability screening prescribed by the proposed rule. What metrics should be considered the standard for age, net worth, absolute value, investment horizon, sophistication, etc.**

Comment: For the reasons described above, clearly articulating the benchmarks for determining suitability is an important step to achieving more uniform application of the NASD's "best practices" or the Proposed Rule. A joint task force would be most appropriately assigned the responsibility for gathering input from a variety of interested and disinterested sources and synthesizing appropriate metrics. Those standards would be best presented as rebuttable presumptions, together with a description of the most important factors that may justify going beyond the presumptive benchmarks.

Recommended Preliminary Steps

1. Develop Consensus and Publish "Red Flag" Benchmarks.

Today, the suitability benchmarks (the "red flags") by which firms will be judged upon examination are not well defined nor well understood. NTM 04-45 identifies several benchmarks, which are to be set by each firm. While flexibility is important, the industry, regulators, and arbitrators could more uniformly and consistently apply better-defined benchmarks. The standards could be published by the NASD as "best practices" or as a rule. Input on these standards could be obtained from insurance companies, other financial service and professional associations, and knowledgeable academics.

2. SEC should re-examine the efficacy of its prospectus requirements.

Improving customers' understanding of variable annuity products is a critical part of addressing the problems. The SEC, with NASD input, should review and revise the content and format of prospectuses to make them more meaningful to customers. If the SEC and NASD continue to believe prospectuses are so ineffective that separate risk disclosure brochures are necessary, then those separate documents should be prepared by the issuing insurance companies and filed with the SEC as a part of their registration statements. This approach would best assure accuracy, completeness, and uniformity of disclosures with the lowest overall cost of implementation – costs which will ultimately be borne by customers.

3. Investor Education Could Be Enhanced More Effectively in Other Ways.

The reasoning behind the proposed risk disclosure brochure is, in part, intended to improve investor education. The NASD could spearhead a joint NASD/SEC/insurance and broker-dealer industry task force to create an industry-wide educational brochure or disclosure document of general application that could be delivered to all variable annuity customers prior to signing contract applications. For example, options-related risk disclosures are required for every new options account. Customer acknowledgements of these disclosures could be built into application forms used by the issuing insurance companies, thus better assuring and confirming customers' basic understanding of the variable annuities product they are purchasing.

Conclusions

As a Limited Partner of United Planners', I support reform to address the problems that have been identified by the SEC and NASD in the Joint Report. I believe that current rules already provide sufficient guidance for sales practices and supervision related to variable annuity transactions, and that those rules should continue to be fully enforced. However, I am not opposed to documenting in the rules the requirement that a registered representative, in conjunction with a sales presentation on variable annuities, must inform the customer of the unique features of a 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. I believe the recommendations described above are an important – and necessary – first step in addressing many of the underlying causes for these industry problems.

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. 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 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.

UPFSA 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 transaction-by-transaction suitability review and approval by supervising principals. 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 must remember that the established and most effective method of documenting product features is through the prospectus. To pursue the expanding disclosures will confuse and ultimately hurt the consumer, in that good investments become encumbered by such documentation. In requiring additional disclosure brochures, the costs are ultimately going to be passed down to the consumer, which is who we were trying to protect in the first place. The disclosures that are ultimately decided upon need to be incorporated in to the existing industry document.

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 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.

I agree that member firms, which sell variable annuity transactions, should provide adequate training for their representatives; but I 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.

I 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.

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

Sincerely,

Thomas H. Oliver

Thomas H. Oliver
President
CEO