AIG VALIC

VALIC Financial Advisors, Inc.
2929 Allen Parkway
Houston, TX 77019

713.831.5241
713.831.5931 Fax
713.854.6935 Cellular
david_denboer@aigvalic.com

**David H. den Boer**
Senior Vice President
Chief Compliance Officer

August 9, 2004

***Via Email Delivery***

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, N.W.
Washington, D.C. 20006-1500

**RE: COMMENTS TO THE NASD'S PROPOSED RULE GOVERNING THE PURCHASE, SALE OR EXCHANGE OF DEFERRED VARIABLE ANNUITIES - (NOTICE TO MEMBERS 04-45)**

Dear Ms. Sweeney:

The Variable Annuity Life Insurance Company ("VALIC") and VALIC Financial Advisors, Inc. ("VFA"), a wholly-owned broker-dealer subsidiary of VALIC and a member of the NASD,[1] appreciate the opportunity to comment on the above-referenced rule proposal (the "Proposal") which, when adopted, would require broker-dealers to establish sales practice standards, specified disclosures, training, and enhanced supervisory requirements tailored specifically to transactions in deferred variable annuities.

VALIC is a stock life insurance company engaged primarily in the sale of fixed and variable annuity contracts on a group and individual basis. It provides tax-deferred fixed and variable annuities to more than 25,000 employer-sponsored retirement plans and programs throughout the United States. VALIC's variable annuities are distributed almost exclusively through VFA. For the most part, such annuities are offered under qualified employer-sponsored retirement plans and programs described under Sections 401, 403, 457 and related sections of the U.S. Internal Revenue Code of 1986, as amended (the "Code") (collectively, such plans are referred to as "qualified retirement plans" or "plans" for convenience hereinafter). These qualified retirement plans are funded in a variety of ways, including through contributions made by way of pre-tax salary deferrals, mandatory employee contributions, and employer contributions. This comment letter draws on VALIC's long experience working with small, medium, and large qualified retirement plans.[2]

---

[1] For ease of reference, VALIC and VFA are hereinafter collectively referred to as "VALIC" unless otherwise indicated.

[2] The comments set forth in this letter are not made on behalf of any qualified retirement plan, plan sponsor or plan administrator. That said, VALIC's more than 40 years of experience in providing

Our comments to the Proposal address only those issues related to qualified retirement plans and suggest that certain requirements be tailored appropriately for qualified retirement plans to avoid any unintended, adverse consequences because adequate consideration may not have been given to the Proposal's application to the administration of qualified retirement plans.

## I. Proposed Enhanced Suitability Rules for Variable Annuities Offered Under a Qualified Retirement Plan Should More Accurately Reflect the Specific Circumstances of Those Plans.

The proposed rule, in subparts (a)(1) and (a)(2), would impose new appropriateness/suitability requirements on the sale of variable annuities. We believe that these proposed rules, and any related suitability rules, should more adequately reflect the circumstances of the qualified retirement plans.

In setting forth the requirements of both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA"), Congress specified that the funding vehicle for a qualified retirement plan could either be an annuity contract or a trust (or in some cases, a custodial account). VALIC variable annuities frequently serve as the principal funding vehicle for qualified retirement plans. VALIC believes the NASD should acknowledge that there is a difference between the use of variable annuities as the primary funding vehicle for a qualified retirement plan and those used as investments in an individual account in a qualified trust. When used as the primary funding vehicle, a variable annuity must satisfy certain specific requirements in the Code and ERISA, and typically is offered as part of a bundled package of plan and participant-level services.

If a variable annuity is offered under a plan's trust, or custodial account with no additional related services, a suitability determination which focuses solely or primarily on the expense structure, death benefit and annuity features of the variable annuity may be appropriate. When the variable annuity is the funding vehicle or accompanied by critical plan and participant-level services, the question of suitability must take those factors into account. Moreover, where the employer has taken an active role in selecting available plan investments, or limited permitted investment products to annuities, those factors are material to any suitability determination at the product level.

As a result, we believe that any variable annuity suitability/appropriateness guidance issued by the NASD should also state that a registered representative and a registered principal may:

1. If the qualified retirement plan specifies that only annuities may be used for funding, consider the terms of the relevant qualified retirement plan as fulfilling the suitability analysis as to the use of an annuity;

---

retirement plan services to tens of thousands of employee-sponsored retirement programs qualifies us to assess the possible impact of the Proposal on qualified retirement plans, plan sponsors and plan administrators.

2. Consider the employer's review process, in selecting eligible investment products under the plan, as satisfying some or all of any required suitability determination as to the offering of a variable annuity (or, for that matter, any other product) under the employer's plan; and,
3. Consider the full range of benefits and services provided within and along with the annuity contracts, in determining the suitability of offering a variable annuity (or, for that matter, any other product) under the employer's plan.

The following provides a more thorough discussion of the above issues:

**A. *The Proposal Should Accommodate Sponsor Plan Design.***

Because of the framework established by ERISA or similar state laws applicable to governmental plans, as well as employer-specific selection and authorization processes, qualified retirement plans involve some important additional investor safeguards that are not available in other individual sales of variable annuities. The structure and investments used to fund a qualified retirement plan frequently undergo a selection and "vetting" process by employers and various professionals quite unlike the process surrounding investments by ordinary investors.

For example, employer sponsors of qualified retirement plans typically engage benefits experts to assist the employer to optimize plan design, documentation, administration and investment selection for the sponsor and the particular participant group (*e.g.*, school teachers, hospital staff, etc.). These benefits experts include actuaries, attorneys, human resources managers, investment advisors, pension consultants, tax advisors, third party administrators, union representatives, and other professionals. It is the qualified retirement plan's sponsor, with the counsel of its benefit experts, that selects investment options, not plan participants or registered representatives. Indeed, these sophisticated professionals have expertise in areas well beyond that of the registered representatives (such as actuarial sciences). The role of these experts is exemplified in the "request-for-proposal" ("RFP") process which shows that, in many cases, the decision to include a variable annuity as an investment/insurance option within a qualified plan was made by the plan sponsor or its consultant – demonstrating that, in this context, the inclusion of a variable annuity option is more of a plan design issue than an ordinary investment issue, and therefore something that member firms cannot be held to account for.

Moreover, in the case of governmental plans[3] maintained for public employees, state legislatures, education boards and benefit committees also play a role in authorizing and selecting plan investments and providers.

With or without a formal RFP process, many plan sponsors require investment providers to provide specific compliance services. For many public school districts, these types of requirements are frequently imposed through a "hold harmless" agreement.

---

[3] Governmental plans may not be subject to ERISA, although in most states they are subject to a comprehensive regulatory framework comparable to ERISA.

Historically, annuity providers have been more willing to enter into such agreements than others. This can be a factor in deciding which products will be available under the plan.

Qualified retirement plan participants, therefore, are afforded protections by the oversight of the sponsoring employer and its professional advisors, and the statutory framework applicable to the formation of the plan. This is unlike sales to ordinary investors, who may select from a seemingly limitless number of available investment products without any of the pre-screening processes conducted by employers and professionals, or other statutory protections described above.

We agree that member firms should consider the suitability of any recommended variable annuity purchase, whether or not inside a qualified retirement plan. Appropriate suitability standards should apply to any security that may be purchased under a qualified retirement plan, regardless of whether it is an annuity, a mutual fund, or some other investment. The Proposal, however, should take into account the extent to which the qualified retirement plan sponsor has selected or limited the investment options made available under the qualified retirement plan and how this process impacts a suitability analysis. It also is against this general backdrop that our remaining comments should be considered.

### B. *Variable Annuities are Frequently Purchased as the Primary Funding Vehicle.*

The Proposal specifically identifies the placement of a deferred variable annuity into a tax-qualified retirement account (*i.e.*, employer-sponsored retirement plans such as a 401(k) plan) as one of several factors that should be given particular attention by a principal who is reviewing the suitability of an annuity purchase. We understand that the NASD is particularly concerned about these transactions because they do not provide any additional tax deferred treatment of earnings beyond what is provided by the tax-qualified plan itself. This, combined with the fees and charges associated with many deferred variable annuities, has prompted the NASD to propose heightened suitability requirements on member firms to ensure that the annuities' other features make the transaction suitable or "appropriate."[4] The Proposal does not take into consideration, however, that Congress anticipated that many qualified retirement plans could, and likely would, be funded exclusively by annuities. In these circumstances, the qualified retirement plan is, in effect, an annuity – variable or otherwise.

#### *1. Tax-Deferral Basics With Respect to Qualified Retirement Plans*

Two requirements must be satisfied before contributions to a qualified retirement plan will enjoy tax-deferred treatment. First, there must be a qualifying plan or program. Second, contributions must be made to one of the types of funding vehicles that are

---

[4] The term "suitable" appears to be used synonymously with the term "appropriate" in the Proposed Rule. If different meanings for the two words are intended, however, we ask that the NASD provide clarification of these differences.

specifically permitted under the Code. These vehicles include an annuity contract, a trust, or a custodial account. If both requirements are not met, the contributions will not qualify for tax deferral. In addition, in the case of a plan that is subject to the requirements of ERISA, (except in the case of an insurance policy) the contributions must be made to a trust. *A qualifying annuity* (as distinguished from an annuity that might be purchased within the relevant trust or custodial account) *satisfies all of these relevant requirements of both the Code and ERISA.*

It is for this reason that the use of annuities as more than just an investment product inside employer-sponsored retirement plans has been recognized consistently and continuously in the Internal Revenue Code for as long as the Code has recognized the plans themselves. For example, Code section 403(b) initially only allowed annuities as permitted arrangements for those plans, and when custodial accounts were added as an alternative in 1974 they were, and still are, specifically referred to as annuity contracts. In other words, the annuity contract is recognized as the primary product and the custodial account is identified as the alternative. Moreover, the custodial account is only permitted to offer regulated investment companies, i.e., mutual funds. Thus, the only single 403(b) arrangement (annuity or custodial account) that can offer both investments that fluctuate in value and investments that provide a guarantee of principal and a stated periodic interest rate, is an annuity contract. In a 403(b) arrangement, it is the annuity contract or the custodial agreement, and not the plan, which is required by the Code to impose the majority of the plan's compliance requirements.

Under other employer-sponsored plans, including plans described in section 401(a) and governmental plans described in section 457(b), assets in the plan are required to be held in a qualifying trust, custodial account or annuity contract. Each qualified retirement plan must satisfy these funding requirements. See Code sections 401(f), 403(a), and 457(g). If an annuity contract held under the plan does not satisfy these requirements, it must instead be held as an investment of a qualifying trust or a custodial account, and cannot stand alone as a plan funding arrangement.

Many plans sponsored by private sector employers, including not-for-profit employers, are also subject to the requirements of Title I of ERISA. Section 403 of ERISA requires all assets under the plan to be held in qualifying insurance policies (including qualifying variable annuities) or a trust for the benefit of plan participants and beneficiaries.

### *2. Plan Features*

It is not uncommon for an annuity to be the only investment product offered under an employer's plan. This could be the case for several valid reasons, including:

- In the case of certain governmental plans for public employees, the governing law specifically requires contributions to be held in an annuity contract.
- The sponsor desired the provision of services offered by the insurer issuing the variable annuity. For example, a non-annuity provider that offers its products primarily through direct sales by phone or over the internet, or

through independent sales representatives that are not supervised by the provider or one of its affiliated companies, may be unwilling to accept responsibility for compliance with some or all of the applicable Code requirements.

- Circumstances may not justify the offering of more than one provider's product. This can be the case, for example, with small employers and with national employers with widely dispersed workforces.
- Finally, the total cost of the annuity provider's offering, including underlying investment fees and ancillary service fees), may not differ substantially from the total cost of one or more non-annuity provider offerings (and related trust and other expenses).

The relevant suitability rules should address this situation, recognizing that plan participation is unavailable without the annuity contract.

### C. *Variable Annuities are Frequently Purchased as Part of a Bundled Package of Plan Investments and Services.*

There are a number of circumstances in which the purchase of a deferred variable annuity can be suitable within an employer-sponsored plan above and beyond the valuable insurance features such as death benefit protection (which is unavailable in a trust or custodial account), or annuitization. Additionally, the provision of plan-level services by the annuity provider can avoid the need to separately engage additional plan service providers, saving participants and sponsors the cost of such additional services. This includes acceptance of responsibility for maintaining the qualification of the contract and performance of plan-level services. Such services include participant recordkeeping, monitoring of contribution limits, administration of withdrawal restrictions, administration of distribution requirements, satisfaction of otherwise applicable trust or custodial account requirement under the Internal Revenue Code ("Code") and/or ERISA, assistance in the event of an IRS or DOL audit, and a willingness to indemnify the plan sponsor with respect to some or all of the above services. They can also include the provision of local in-person services to individual participants, including but not limited to enrollment assistance, ongoing account assistance, personal education and guidance, and optional investment advice and/or account investment management.

Moreover, many member firms and their registered representatives serving qualified retirement plan sponsors and their participants do much more than offer variable annuity contracts (including certificates under group variable annuity contracts). These registered representatives, along with member firms and their affiliates, may also provide additional services such as (1) education about the need to save for retirement, (2) information about the specific provisions of the employer's retirement plan(s), (3)assistance to participants in choosing between available plans offered by the employer, and (4) enrollment services. Member firms also provide administrative services that

include plan and contract-level restrictions and contribution limitations, distribution restrictions, plan loan applications, and coordination of plan administrative procedures across multiple employer sites, either within the same geographical area or across the country.

In short, many registered representatives and member firms offer employer-sponsored plans a comprehensive set of services in addition to the underlying investment products at no additional charge to the plan sponsor or the participant other than the fees charged under the annuity contract.[5]

## II. The "One Business Day" Rule for Registered Principal Review and Approval is Impractical for Qualified Retirement Plan Administration

The subparts of section (c) of the Proposal require that a registered principal must review and approve a variable transaction no later than one business day following the execution of the deferred variable annuity application, regardless of whether the transaction has been recommended. We believe this "one business day" principal review requirement does not adequately consider the practical realities of plan enrollment and plan investment administration and will likely cause overly-burdensome administrative problems for many, if not most qualified retirement plans, their administrators and service providers. Our practical experiences lead us to believe that even the most efficient plan enrollment, investment transfer, and payroll administration procedures cannot be readily conformed to coordinate with the time standard imposed upon registered principals under the Proposal.

The practical circumstances of plan enrollment most often requires the registered representative to meet with participants at the work-site, removed from the location of the registered principal. In addition, some plans will require the routing of deferred variable annuity applications and enrollment forms through plan administrators and third party administrators. Moreover, for qualified retirement plans subject to the requirements of ERISA, review by the Plan Administrator of both the salary reduction agreement and the annuity application and enrollment form can constitute the plan fiduciary's approval of the transaction. In each of these cases, obtaining a registered principal's approval within one business day frequently will not be either possible or practical, and can take even longer in the case of large, multi-location employers (*e.g.*, university systems and healthcare systems) whose qualified retirement plans are administered out of a central office.

Efficient plan administration is further complicated when a qualified retirement plan sponsor replaces an existing investment product with a deferred variable annuity offered by another provider. In such cases, the employer may direct the transfer of all plan assets to the new provider, or may give each participant the option of transferring to

---

[5] Some customized or optional additional services may involve a fee to the plan sponsor or to the participant.

the new provider or remaining with the previous provider. In either case, it will frequently be very difficult to comply with the "one business day" rule.

Therefore, we encourage consideration of a time standard alternative that would still meet the NASD's core objectives. One alternative could be that the one business day requirement does not apply to contracts issued under employer-sponsored plans. Rather, such plans would be subject to a more flexible standard of "prompt" or "reasonable" review given the processing and administrative realities of group plans. Another alternative could be to toll the time limitation during plan processing. We would be happy to discuss these or other alternatives with the staff.

## III. Tax Advice

Because such qualified retirement plans are comprehensively regulated by the Code and ERISA or, in the case of governmental plans, state law, in many cases the nature of any disclosures is governed by that law. The proposed rule would require a registered representative to provide to a prospective investor a summary of the federal and state tax treatment for variable annuities, and would further require that in the event of a replacement of an annuity contract (which could include replacement by a non-annuity product) a summary of relevant differences between the old and new investment product, including tax treatment, must be provided.

The NASD should ensure that any disclosures are consistent with the applicable regulatory framework. Any final rule should clarify the requirements to disclose tax matters, to ensure that such requirements do not become a mandate to render tax advice, which is beyond the capacity of many registered representatives and even registered principals. In the case of an annuity contract issued under an employer-sponsored plan, since distributions from all investment products under the plan (annuities, trusts and custodial accounts) are treated in the same way, the disclosure requirement can be greatly simplified in such cases.

We also provide general comment as to the requirements for providing federal and state tax treatment "highlights" in the context of qualified retirement plans. Few would disagree that the tax laws and rules prescribed for retirement plan qualification are voluminous and complex. Moreover, the tax status of any individual can vary based on a wide array of factors. Any requirement for providing "highlights" should remain just that, and should focus solely on the tax treatment of distributions from the annuity contract, and not on tax matters at the plan level which are not unique to the annuity contract. No member, registered representative or registered principal should be required to provide tax advice to an investor. Finally, any required disclosure regarding the necessity of investing in an annuity contract under an employer-sponsored plan should take into account the necessity of both the plan and the qualifying underlying investment arrangement (annuity contract, trust or custodial account).

* * *

We appreciate the opportunity to share our comments with the NASD and hope we have provided you with sufficient information that due consideration will be given to unique needs of qualified retirement plan sponsors, administrators and service providers. We believe that, with reasonable accommodations, the objective of investor protection set out in the proposed rule can be fully achieved without undue burden, complication, and expense to qualified plan sponsors and administrators.

We are available to meet and discuss these issues, particularly the impact on group variable products, at your request.

Very truly yours,

David den Boer

David den Boer

cc: Barbara Stettner, Esq.