

Deferred Variable Annuities

SEC Approves Amendments to NASD Rule 2821 Governing Purchases and Exchanges of Deferred Variable Annuities

Effective Date: February 8, 2010

Executive Summary

On April 15, 2009, the SEC approved amendments to NASD Rule 2821 governing purchases and exchanges of deferred variable annuities.¹ Among other things, the amendments:

- ▶ limit the rule's application to recommended transactions;
- ▶ change the triggering event that begins the principal review period; and
- ▶ clarify various other issues through new supplementary material to the rule.

The rule text is set forth in Attachment A and is effective February 8, 2010.

Questions regarding this *Notice* should be directed to:

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Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topic(s)

- ▶ Deferred Variable Annuities
- ▶ Principal Review
- ▶ Sales Practices
- ▶ Suitability
- ▶ Supervision

Referenced Rules & Notices

- ▶ NASD Rule 2310
- ▶ NASD Rule 2330
- ▶ NASD Rule 2820
- ▶ NASD Rule 2821
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 15c3-3
- ▶ Regulatory Notice 07-53

Background & Discussion

NASD Rule 2821 establishes sales practice standards regarding purchases and exchanges of deferred variable annuities.² The rule addresses four main areas of concern. First, the rule has requirements governing broker recommendations, including suitability and disclosure obligations. Second, it includes various principal review and approval obligations. Third, the rule requires member firms to establish and maintain supervisory procedures reasonably designed to achieve compliance with the standards set forth in the rule. Fourth, the rule has a training component.

The recommendation and training sections currently are effective.³ The effective dates of the principal review and supervisory procedures sections were stayed to give the SEC time to consider amendments that FINRA filed after careful consideration of public comments.⁴ On April 15, 2009, the SEC approved those amendments, which become effective on **February 8, 2010**.⁵ As described in more detail below, the amendments, among other things, limit the rule's application to recommended transactions, change the triggering event that begins the principal review period, and clarify various other issues through new supplementary material to the rule.

Limiting Application of the Rule to Recommended Transactions

Prior to the amendments, paragraph (c) of NASD Rule 2821 would have required principals to treat "all transactions as if they have been recommended for purposes of this principal review." After carefully considering the public comments, FINRA proposed, and the SEC approved, limiting the rule's application to recommended transactions. This approach is consistent with that taken by FINRA's general suitability rule, NASD Rule 2310.⁶ Moreover, because the vast majority of purchases and exchanges of deferred variable annuities are recommended by brokers, the rule will cover most transactions. FINRA emphasizes that firms must implement reasonable measures to detect and correct instances of recommended transactions that brokers mischaracterize as non-recommended. Where the transaction truly is initiated by the customer and not recommended by the broker, there generally is less concern regarding potential or actual conflicts of interest and less need for heightened sales-practice requirements. This change also promotes competition by allowing a wide variety of business models to exist, including those premised on keeping costs low by, in part, eliminating the need for a sales force and large numbers of principals.

Modifying the Starting Point for the Seven-Business-Day Review Period

Under the earlier version of paragraph (c) of NASD Rule 2821, principals were required to review and determine whether to reject or approve a deferred variable annuity transaction no later than seven business days after the customer signed the

application. Based on the public comments, FINRA proposed, and the SEC approved, modifying the beginning of the period within which the principal must review and determine whether to approve or reject the application. Pursuant to the amendments, the period will begin to run not from the date of the customer's signature but from the date when a firm's office of supervisory jurisdiction (OSJ) receives a complete and correct copy of an application.⁷ To help ensure that the process remains efficient from the beginning, the amendments also require the associated person who recommended the annuity to promptly transmit the complete and correct application package to the OSJ.⁸ FINRA emphasizes, however, that the time begins to run when *any* OSJ at the firm receives the complete and correct application. A firm does not get to pick which OSJ starts the clock.

Clarifying Issues Through Supplementary Material

The supplementary material examines issues that were raised by multiple groups and that potentially could have a significant impact on how firms sell or process deferred variable annuities. The supplementary material makes clear, for instance, that firms generally allowed to handle and carry customer funds under SEA Rules 15c3-1 and 15c3-3 are not prohibited by NASD Rule 2821 from depositing funds for a deferred variable annuity prior to principal approval.

FINRA also reconsidered the question of whether firms could forward funds to insurance companies for deposit in the companies' "suspense accounts" prior to principal approval. FINRA has modified its earlier position rejecting such a process, discussed in *Regulatory Notice 07-53* (Nov. 2007), and now will allow such action under certain conditions, including, *inter alia*, that the insurance company segregate the funds in a manner equivalent to that required of a member firm under SEA Rule 15c3-3.

In addition, the supplementary material discusses:

- customers' lump-sum payments for the purchase of deferred variable annuities and other products;
- the forwarding of customer checks or funds to an IRA custodian prior to principal approval;
- the timing of "transmittal" of the application where an insurance company and its affiliated broker-dealer share office space and/or employees;
- consideration of what constitutes a "reasonable effort" to determine whether a customer has had a recent exchange at another broker-dealer; and
- the permissibility of using information required for principal review in the contract issuance process.

Endnotes

- 1 See Exchange Act Release No. 59772 (April 15, 2009), 74 FR 18419 (April 22, 2009) (Order Approving File No. SR-FINRA-2008-019) (Approval Order).
- 2 In general, a variable annuity is a contract between an investor and an insurance company, whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint Report), available at www.sec.gov/news/studies/secnasdvip.pdf.
- 3 Paragraphs (a), (b), and (e) of NASD Rule 2821, as approved in SR-NASD-2004-183, became effective on May 5, 2008.
- 4 On April 17, 2008, FINRA filed a proposed rule change, which became effective upon filing, to delay the effective date of paragraphs (c) and (d) of NASD Rule 2821 until after the SEC's approval or disapproval of a substantive proposed rule change. See Exchange Act Release No. 57769 (May 2, 2008), 73 FR 26176 (May 8, 2008) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2008-015).
- 5 See Approval Order, *supra* note 1.
- 6 FINRA has proposed to adopt a modified version of NASD Rule 2310 as FINRA Rule 2111 in the Consolidated FINRA Rulebook. See *Regulatory Notice 09-25* (May 2009).
- 7 As FINRA and the SEC previously have noted, "Many broker-dealers are subject to lower net capital requirements under SEA Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under SEA Rule 15c3-3 because they do not carry customer funds or securities." See Exchange Act Release No. 56376 (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007) (Order Granting Exemption to Broker-Dealers from Requirements in SEA Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks).

Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it "promptly transmits" the checks to third parties. The SEC has interpreted "promptly transmits" to mean that "such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities." *Id.* at 52400. In conjunction with its approval of Rule 2821, the SEC provided an exemption to the "promptly transmits" requirement as long as, among other things, the "principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with the rule." *Id.* at 52401. In its order approving the recent amendments, the SEC explained that the exemption order continues to apply, notwithstanding the new starting point for the principal review period under NASD Rule 2821. See Approval Order, *supra* note 1, at 18422 n.37.

NASD rules also could have conflicted with the seven-business-day period. NASD Rule 2330, for instance, generally prohibits improper use of customer funds, and NASD Rule 2820 specifically requires firms to “transmit promptly” the application and purchase payment for a variable annuity contract to the issuing insurance company. Because of this potential conflict, FINRA provided an exemption similar to that provided by the SEC. FINRA stated that a firm may hold an application for a deferred variable annuity and a customer’s non-negotiated check payable to an insurance company for up to seven business days without violating either NASD Rule 2330 or 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to NASD Rule 2821. As with the SEC’s exemption order, FINRA’s exemption continues to apply even though the triggering event for the principal review period has changed via the recently approved amendments. (FINRA has proposed to adopt NASD Rule 2330 as FINRA Rule 2150 in the Consolidated FINRA Rulebook—see SR-FINRA-2009-014 (filed March 24, 2009)—and to adopt NASD Rule 2820 as FINRA Rule 2320 in the consolidated FINRA rulebook—see Exchange Act Release No. 59762 (April 14, 2009), 74 FR 18269 (April 21, 2009) (Notice of Filing File No. SR-FINRA-2009-023)).

- 8 However, the provision, amended paragraph (b)(3) of NASD Rule 2821, would not preclude the customer from transmitting the complete and correct application package to the OSJ. For instance, there may be occasions where the application package is technically complete and correct but the customer wants to review the purchase or exchange further at home and then send the application to the OSJ. Proceeding in such a manner is not inconsistent with the proposed provision.

Attachment A

Text of Amended Rule

New language is underlined; deletions are in brackets.

(Paragraphs (a), (b), and (e) of Rule 2821 currently are effective. New paragraphs (c) and (d) and the supplementary material, as well as amendments to paragraphs (a), (b), and (e), are effective February 8, 2010.)

* * * * *

2821. Members' Responsibilities Regarding Deferred Variable Annuities

(a) General Considerations

(1) Application

This Rule applies to recommended [the] purchases [or] and exchanges of [a] deferred variable annuity[y]ies and recommended initial [the] subaccount allocations. This Rule does not apply to reallocations among [of] subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the [Securities] Exchange Act [of 1934] or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

(2) Creation, Storage, and Transmission of Documents

For purposes of this Rule, documents may be created, stored, and transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

(3) Definitions

For purposes of this Rule, the term "registered principal" shall mean a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24) or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

(b) Recommendation Requirements

(1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with Rule 2310 and, in particular, that there is a reasonable basis to believe that

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by [sub]paragraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by [sub]paragraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer[’s account] has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer’s age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(3) Promptly after receiving information necessary to prepare a complete and correct application package for a deferred variable annuity, a person associated with a member who recommends the deferred variable annuity shall transmit the complete and correct application package to an office of supervisory jurisdiction of the member.

(c) Principal Review and Approval

Prior to transmitting a customer’s application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

A registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule.

The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and then approved or rejected the transaction.

(d) Supervisory Procedures

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012, 3013, and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

(e) Training

Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in [sub]paragraph (b)(1)(A)(i) of this Rule.

• • • Supplementary Material: -----

.01 Under Rule 2821, a member that is permitted to maintain customer funds under SEA Rules 15c3-1 and 15c3-3 may, prior to the member's principal approval of the deferred variable annuity, deposit and maintain customer funds for a deferred variable annuity in an account that meets the requirements of SEA Rule 15c3-3.

.02 If a customer provides a member that is permitted to hold customer funds with a lump sum or single check made payable to the member (as opposed to being made payable to the insurance company) and requests that a portion of the funds be applied to the purchase of a deferred variable annuity and the rest of the funds be applied to other types of products, Rule 2821 would not prohibit the member from promptly applying those portions designated for purchasing products other than a deferred variable annuity to such use. A member that is not permitted to hold customer funds can comply with such requests only through its clearing firm that will maintain customer funds for the intended deferred variable annuity purchase in an account that meets the requirements of SEA Rule 15c3-3. In such circumstances, the checks would need to be made payable to the clearing firm.

.03 Rule 2821 does not prohibit a member from forwarding a check made payable to the insurance company or, if the member is fully subject to SEA Rule 15c3-3, transferring funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will (1) segregate the member's customers' funds in a bank in an account equivalent to the deposit of those funds by a member into a "Special Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member's principal approval, and (3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application.

.04 A member is not prohibited from forwarding a check provided by the customer for the purpose of purchasing a deferred variable annuity and made payable to an IRA custodian for the benefit of the customer (or, if the member is fully subject to SEA Rule 15c3-3, funds) to the IRA custodian prior to the member's principal approval of the deferred variable annuity transaction, as long as the member enters into a written agreement with the IRA custodian under which the IRA custodian agrees (a) to forward the funds to the insurance company to complete the purchase of the deferred variable annuity contract only after it has been informed that the member's principal has approved the transaction and (b), if the principal rejects the transaction, to inform the customer, seek immediate instructions from the customer regarding alternative disposition of the funds (e.g., asking whether the customer wants to transfer the funds to another IRA custodian, purchase a different investment, or provide other instructions), and promptly implement the customer's instructions.

.05 Rule 2821 requires that the member or person associated with a member consider whether the customer has had another deferred variable annuity exchange within the preceding 36 months. Under this provision, a member or person associated with a member must determine whether the customer has had such an exchange at the member and must make reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months. An inquiry to the customer as to whether the customer has had an exchange at another broker-dealer within 36 months would constitute a "reasonable effort" in this context. Members shall document in writing both the nature of the inquiry and the response from the customer.

.06 Rule 2821 requires principal review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing...." In circumstances where an insurance company and its affiliated broker-dealer share office space and/or employees who carry out both the principal review and the issuance process, FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

.07 Rule 2821 does not prohibit using the information required for principal review and approval in the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer. For instance, the rule does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, i.e., paper or electronic) that the insurance company uses for the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

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