

## OMB APPROVAL

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Form 19b-4

File No. SR - 2004 - 183

Amendment No. 

Proposed Rule Change by National Association of Securities Dealers

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial <input checked="" type="checkbox"/>	Amendment <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) <input checked="" type="checkbox"/>	Section 19(b)(3)(A) <input type="checkbox"/>	Section 19(b)(3)(B) <input type="checkbox"/>
			Rule		
			<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	
			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document



Exhibit 3 Sent As Paper Document

**Description**

Provide a brief description of the proposed rule change (limit 250 characters).

To create a new rule, proposed NASD Rule 2821, that includes recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities.

**Contact Information**

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name  Last Name   
Title   
E-mail   
Telephone  Fax

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date By   
(Name)

(Title)

NOTE: Clicking the button at right will digitally sign and lock  
this form. A digital signature is as legally binding as a physical  
signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EDFS website.

**Form 19b-4 Information**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change**

Add

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document



Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

**1. Text of Proposed Rule Change**

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to create a new rule, proposed NASD Rule 2821, that includes recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. Below is the text of the proposed rule change. Proposed new language is underlined.

\* \* \* \* \*

**2821. Members' Responsibilities Regarding Deferred Variable Annuities**

**(a) General Considerations**

This Rule applies to the purchase, sale or exchange of a deferred variable annuity and the subaccount allocations. This Rule does not apply to reallocations of subaccounts made after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to annuities sold in connection with tax-qualified, employer-sponsored retirement or benefit plans that are either defined as a "qualified plan" under Section 3(a)(12)(C) of the Exchange Act or meet the requirements of Internal Revenue Code Sections 403(b) or 457(b), unless, in the case of any such plan, a member makes recommendations to individual plan participants regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participants to whom the member makes such recommendations.

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. Except to the extent that specific provisions in this Rule govern, or unless the context otherwise requires, the provisions of the By-Laws and Rules and all other interpretations and policies of the NASD Board of Governors shall be applicable to transactions in deferred variable annuities, including, but not limited to, reallocations of subaccounts. In addition, for purposes of this Rule, the term "registered principal" shall mean either a person registered as 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, sale or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that (A) the customer has been informed of the material features of the deferred variable annuity, (B) the customer has a long-term investment objective, and (C) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer based on the information required by paragraph (b)(2) of this Rule. These determinations shall be documented and signed by the associated person recommending the transaction, in addition to being approved by a registered principal, as required by paragraph (c) of this Rule.

(2) Prior to recommending 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 contract, investment time horizon, existing investment and 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.

**(c) Principal Review and Approval**

(1) No later than two business days following the date when a member or person associated with a member transmits a customer's application for a deferred variable annuity contract to the issuing insurance company for processing, a registered principal shall review and approve the transaction, regardless of whether the transaction has been recommended. In reviewing the transaction, the registered principal shall consider whether (A) the customer appears to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles; (B) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age (standard established by the member) or with a short-term investment objective; (C) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member); (D) the transaction involves an exchange or replacement of a deferred variable annuity contract; and (E) the deferred variable annuity transaction involves a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements. Standards established by the

member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(2) When a member or a person associated with a member has recommended the transaction, a registered principal, taking into account the underlying supporting documentation described in paragraph (b)(2) of this Rule, shall review, approve and sign the suitability determination document required by paragraph (b)(1) of this Rule no later than two business days following the date when the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company for processing.

**(d) Supervisory Procedures**

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012 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. In particular, the member must implement procedures to screen for and require a registered principal's review of the following:

(1) A deferred variable annuity investment for a customer who does not appear to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles;

(2) A deferred variable annuity investment for a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age (standard established by the member) or with a short-term investment objective;

(3) A deferred variable annuity investment that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);

(4) A deferred variable annuity exchange or replacement;

(5) A deferred variable annuity investment for a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements; and

(6) A deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements.

Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

**(e) Training**

Members shall develop and document specific training policies or programs 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 liquidity issues, sales charges, fees, and market risks.

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

**2. Procedures of the Self-Regulatory Organization**

The proposed rule change was approved by the Board of Directors of NASD

Regulation, Inc. at its meeting on April 21, 2004, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on April 22, 2004. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the Board of Governors of NASD to adopt NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 120 days following publication of the Notice to Members announcing Commission approval.

**3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

(a) Purpose



NASD is proposing a rule change to create a rule, proposed Rule 2821, that would impose specific sales practice standards and supervisory requirements on members for transactions in deferred variable annuities. NASD has been concerned about deferred variable annuity sales for some time. In part, this concern stems from the complexities of the products, which can cause confusion both for persons associated with members who sell deferred variable annuities and for customers who purchase them.

Deferred variable annuities are hybrid investments containing both securities and insurance features. They offer choices among a number of complex contract features (*e.g.*, variable annuity contracts may offer various types of death benefits, rebalancing features, dollar cost averaging options, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options). The amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses. Investors also can be subject to the following fees or charges: surrender charges (which the investor owes if he or she withdraws money from the annuity before a specified period); mortality and expense risk charges (which the insurance company charges for the insurance risk it takes under the contract); administrative fees (which are used for recordkeeping and other administrative expenses); underlying fund expenses (which relate to the investment options); and charges for special features and riders. Moreover, an investor's withdrawal of earnings before he or she reaches the age of 59½ is generally subject to a 10-percent penalty under the Internal Revenue Code.

In addition to the complexity of the product—and perhaps, in part, because of it—NASD examinations and investigations have uncovered various questionable sales practices. In some instances, associated persons sold variable annuities to elderly customers for whom such long-term, illiquid products were not suitable. In others, associated persons sold variable annuities without explaining (and, in some cases, without knowing) the characteristics of the products. On a number of occasions, associated persons recommended that customers exchange one variable annuity contract for another without ensuring that such exchanges were beneficial for their customers or properly disclosing costs. NASD also determined that a number of firms had, in general, failed to adequately train and supervise associated persons regarding variable annuity sales.

When NASD first began noticing these problems, it acted quickly and persistently to address them on several fronts. NASD issued Notices to Members that provided guidelines and reminders about members' suitability obligations regarding variable annuities. NASD also issued Investor Alerts and Member Alerts, strengthened its examination program and brought a number of significant enforcement actions concerning variable annuities.

Despite these efforts, problematic sales practices continued. At present, NASD is still seeing some of the same problems that it first noticed in the late 1990s. In June 2004, NASD and the SEC issued a joint report on examination findings regarding broker-dealer sales of variable insurance products. See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) ("Joint Report"). As discussed in the Joint Report, recent NASD and SEC examinations uncovered a number

of problem areas, including suitability, disclosure, supervision, books/records and training. In addition to the NASD and SEC examinations discussed in the Joint Report, NASD's Variable Annuity Task Force, an organization-wide initiative, is in the process of conducting special exams of various members and, although the analyses of those exams are not complete, NASD has discovered problems similar to those reported in the Joint Report at some members. Moreover, NASD has received a number of customer complaints indicating that the customers did not understand the unique features of the deferred variable annuities and raising suitability concerns based on the customers' investment objectives and liquidity needs.

In light of these issues, NASD determined that it needed to create a rule specifically covering deferred variable annuities. In general, NASD's guidelines on sales of deferred variable annuities, created with substantial input from industry participants and published in Notice to Members 99-35 (May 1999), served as the basis for the proposed rule change.

The rule change would apply to the purchase, sale or exchange of a deferred variable annuity and the subaccount allocations. The rule change would not apply to reallocations of subaccounts made after the initial purchase or exchange of a deferred variable annuity. However, other NASD rules would continue to apply. For instance, NASD's suitability rule, Rule 2310, would apply to any recommendations to reallocate subaccounts.

The rule change also would not apply to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans. In part, NASD created this exception in recognition that, in general, the nature of sales to a plan sponsor, trustee

or custodian regarding the plan-level selection of investment vehicles and options involves a level of sophistication, negotiation and bargaining power not usually present in individual retail sales. Thus, the protection provided by the rule change is not necessarily required for such sales. However, if, in the case of any such plan, a member makes recommendations to individual plan participants regarding a deferred variable annuity, the rule change would apply as to the individual plan participants to whom the member makes such recommendations (but would not apply as to the plan sponsor, trustee or custodian regarding the plan-level selection of investment vehicles and options for such plans).

The proposed rule change has four main requirements. First, the proposal has requirements governing recommendations, including a suitability obligation, specifically tailored to deferred variable annuity transactions. See proposed Rule 2821(b).

Second, the proposal includes various principal review and approval obligations. See proposed Rule 2821(c). The proposal would require that, no later than two business days following the date when a member or associated person transmits a customer's application for a deferred variable annuity contract to the issuing insurance company for processing, a registered principal must review and approve the transaction. NASD Rule 2820(d) requires prompt transmission of the application and the purchase payment for a variable contract to the issuing insurance company. In this regard, principal review and approval should occur as soon as practicable after the customer signs the variable annuity application. The proposal would require, however, that in no event may principal review and approval occur later than two days after the application is forwarded to the issuing insurance company.

Third, members would be required to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule. See proposed Rule 2821(d). Pursuant to the proposed supervisory-procedure requirements, members would need to establish certain standards that are reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised. NASD also emphasizes that the member must have policies and procedures in place that are reasonably designed to ensure that an associated person sends the original application or a copy thereof to a principal for review within the two-day window discussed in the principal-review requirements.

Fourth, the proposal has a training component. See proposed Rule 2821(e). Members would be required to develop and document specific training policies or programs designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of the proposal and that they understand the material features of deferred variable annuities.

As noted in Section 2 of this filing, NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 120 days following publication of the Notice to Members announcing Commission approval.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public

interest. NASD believes that the proposed rule change is consistent with the provisions of the Act noted above in that it will enhance members' compliance and supervisory systems and provide more comprehensive and targeted protection to investors in deferred variable annuities. As such, the proposed rule change will decrease the likelihood of fraud and manipulative acts and increase investor protection.

**4. Self-Regulatory Organization's Statement on Burden on Competition**

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

**5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

The proposed rule change was published for comment in NASD Notice to Members 04-45 (June 2004). A copy of the Notice to Members is attached as Exhibit 2a. NASD received 1,129 comments in response to the Notice. A copy of the index to comment letters received in response to the Notice is attached at Exhibit 2b (submitted in hard copy), and copies of the comment letters received in response to the Notice are attached as Exhibit 2c (submitted in hard copy). The overwhelming majority of commenters opposed the proposal. Fourteen commenters fully supported the proposal and an additional 20 commenters offered partial or qualified support for the proposal.

Most commenters questioned the need for the proposal described in the Notice, stating that the proposal is duplicative of existing rules and that NASD should simply enforce those existing rules. NASD disagrees. Certainly, NASD can and does vigorously pursue those who engage in misconduct, but after-the-fact enforcement

actions simply do not appear to be sufficiently effective at combating the problems NASD has uncovered.

Moreover, the proposed rule change does not merely aggregate existing requirements. The rule change is tailored to variable annuities and addresses issues not currently covered by existing rules. For instance, the rule change explicitly requires that an associated person have reasonable grounds for believing that the customer has been informed of the material features of the deferred variable annuity. The rule change describes the type of information that an associated person must consider in determining suitability for a deferred variable annuity. The rule change highlights the important factors that registered principals must consider before approving a deferred variable annuity transaction. The rule change also requires members to provide training to associated persons and registered principals regarding the unique features of deferred variable annuities.

A number of commenters also questioned the need for point-of-sale disclosures, stating in particular that the transaction-specific, written-disclosure requirements proposed in the Notice were unhelpful and unworkable. NASD has not included the written-disclosure requirements contained in its Notice in the current proposed rule change, but will continue to explore this issue and will separately consider whether to propose such requirements in the future. NASD notes, however, that proposed Rule 2821(b) (Recommendation Requirements) continues to provide, as in the Notice, that no member or associated person shall recommend to a customer the purchase, sale or exchange of a deferred variable annuity unless the member or associated person has a reasonable basis to believe that, among other things, the customer has been informed of

the material features of the deferred variable annuity. This provision will promote increased customer awareness of the material terms and features of the variable annuity, although, unlike the written-disclosure requirements contained in the Notice, the "Recommendation Requirements" do not prescribe the specific form of disclosure. NASD further notes that the Commission has proposed a rule that would require point-of-sale disclosure of certain fee information regarding, among other products, variable annuities. See SEC Proposed Rule Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. Nos. 33-8358, 34-49148, IC-26341 (Jan. 29, 2004), 69 FR 6438 (Feb. 10, 2004).

Numerous commenters argued that the timing of principal review in the Notice was unreasonable and could actually prohibit principals from thoughtfully reviewing transactions. The Notice stated that a principal had to review and approve the transaction no later than one business day following the date when the customer signed the application. In recognition of the commenters' concerns, NASD modified the timing of principal review. The rule change now would require principal review and approval no later than two business days following the date when the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company. NASD believes that this requirement provides more than sufficient time for a principal to thoroughly review and, if appropriate, approve the transaction. NASD encourages members to create internal procedures requiring principal review in an even more expeditious time period, if possible in light of the member's business model and other considerations.



NASD disagrees with those commenters who suggested that state-required "free look" periods make early principal review unnecessary. In general, a "free look" period allows the customer to terminate the contract without paying any surrender charges and receive a refund of the purchase payments or the contract value, as required by applicable state law. Free-look periods, which vary by state law, typically range from 10 to 30 days.

Allowing a suitability analysis, for instance, to be reviewed by a principal long after an insurance company issues a deferred variable annuity contract would be inconsistent with an adequate supervisory system (which must be reasonably designed to detect and prevent problematic sales). A delayed principal review would make it difficult for a member to quickly identify problematic trends, such as mini-replacement campaigns (a practice in which registered representatives exchange a high percentage of their customers' existing contracts for new contracts, in some cases to meet production requirements or to generate commissions). Allowing principal review to occur after a significant delay also would be contrary to the normal practice for review of transactions involving other types of investments. Moreover, NASD believes that members should contact customers as soon as possible if a principal discovers a problem with the transaction, which could not occur if the principal does not review the transaction for a prolonged period. Further, there may very well be disincentives to reject transactions as time elapses. Finally, some customers may not be aware of or fully comprehend free-look periods. For these reasons, it would be inappropriate to allow for principal review beyond the period stated in the current proposed rule change.

A number of commenters also called for the elimination of the principal review requirements for non-recommended transactions. Due to the complexity of the products,

NASD believes that it is appropriate to require firms to review all deferred variable annuity transactions for problematic sales practices. The rule change creates standards that will ensure that firms perform a consistent, baseline analysis of transactions, regardless of whether the particular transaction has been recommended, thereby enhancing investor protection for all customers. NASD, moreover, is aware of instances where registered representatives have told their firms that variable annuity transactions were not recommended in order to bypass their firms' compliance requirements for recommended or solicited sales. The rule change's principal-review requirements for non-recommended transactions should reduce the incentive for persons to engage in such conduct.

Finally, a number of commenters stated that the rule change should not apply to transactions involving tax-qualified, employer-sponsored retirement or benefit plans. After further analysis, NASD agrees with these commenters and has created an exception for transactions involving such plans under certain circumstances.

NASD emphasizes, however, that members should pay close attention to sales of deferred variable annuities in individual IRAs, which do not qualify for the proposed exception for tax-qualified, employer-sponsored retirement or benefit plans. A deferred variable annuity purchased for an individual IRA does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA itself. Moreover, unlike transactions for tax-qualified, employer-sponsored retirement or benefit plans, transactions in individual IRAs do not normally involve a fiduciary or other sophisticated intermediary who understands the unique features of deferred variable annuities and who can interact with the member on the customer's behalf. Sales of

deferred variable annuities to non-sophisticated customers in IRAs are of particular concern to NASD, especially in light of certain fees and charges associated with many deferred variable annuities. Thus, principals must ensure that the deferred variable annuity's features other than tax deferral make the purchase of the deferred variable annuity for the individual IRA appropriate. In this regard, members should note that paragraph (c)(1)(A) and paragraph (d)(1) of the proposed rule require principals to determine whether the customer appears to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles.

**6. Extension of Time Period for Commission Action**

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Not applicable.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

**9. Exhibits**

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. NASD Notice to Members 04-45 (June 2004).

Exhibit 2b. Index to comments received in response to NASD Notice to Members 04-45 (June 2004), submitted in hard copy.

Exhibit 2c. Comments received in response to NASD Notice to Members 04-45

(June 2004), submitted in hard copy.

**EXHIBIT 1**

**SECURITIES AND EXCHANGE COMMISSION**

(Release No. 34- ; File No. SR-NASD-2004-183)

**SELF-REGULATORY ORGANIZATIONS**

Proposed Rule Change by National Association of Securities Dealers, Inc.  
Relating to Sales Practice Standards and Supervisory Requirements for Transactions in  
Deferred Variable Annuities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD.

**I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change**

NASD is proposing to adopt NASD Rule 2821, to create recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. Below is the text of the proposed rule change. Proposed new language is underlined.

\* \* \* \* \*

**2821. Members' Responsibilities Regarding Deferred Variable Annuities**

**(a) General Considerations**

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

This Rule applies to the purchase, sale or exchange of a deferred variable annuity and the subaccount allocations. This Rule does not apply to reallocations of subaccounts made after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to annuities sold in connection with tax-qualified, employer-sponsored retirement or benefit plans that are either defined as a "qualified plan" under Section 3(a)(12)(C) of the Exchange Act or meet the requirements of Internal Revenue Code Sections 403(b) or 457(b), unless, in the case of any such plan, a member makes recommendations to individual plan participants regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participants to whom the member makes such recommendations.

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. Except to the extent that specific provisions in this Rule govern, or unless the context otherwise requires, the provisions of the By-Laws and Rules and all other interpretations and policies of the NASD Board of Governors shall be applicable to transactions in deferred variable annuities, including, but not limited to, reallocations of subaccounts. In addition, for purposes of this Rule, the term "registered principal" shall mean either a person registered as 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, sale or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to

believe that (A) the customer has been informed of the material features of the deferred variable annuity, (B) the customer has a long-term investment objective, and (C) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer based on the information required by paragraph (b)(2) of this Rule. These determinations shall be documented and signed by the associated person recommending the transaction, in addition to being approved by a registered principal, as required by paragraph (c) of this Rule.

(2) Prior to recommending 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 contract, investment time horizon, existing investment and 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.

**(c) Principal Review and Approval**

(1) No later than two business days following the date when a member or person associated with a member transmits a customer's application for a deferred variable annuity contract to the issuing insurance company for processing, a registered principal shall review and approve the transaction, regardless of whether the transaction has been recommended. In reviewing the transaction, the registered principal shall consider whether (A) the customer appears to have a

demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles; (B) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age (standard established by the member) or with a short-term investment objective; (C) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member); (D) the transaction involves an exchange or replacement of a deferred variable annuity contract; and (E) the deferred variable annuity transaction involves a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements. Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(2) When a member or a person associated with a member has recommended the transaction, a registered principal, taking into account the underlying supporting documentation described in paragraph (b)(2) of this Rule, shall review, approve and sign the suitability determination document required by paragraph (b)(1) of this Rule no later than two business days following the date when the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company for processing.

**(d) Supervisory Procedures**

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012 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. In particular, the member must implement procedures to screen for and require a registered principal's review of the following:

(1) A deferred variable annuity investment for a customer who does not appear to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles;

(2) A deferred variable annuity investment for a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age (standard established by the member) or with a short-term investment objective;

(3) A deferred variable annuity investment that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);

(4) A deferred variable annuity exchange or replacement;

(5) A deferred variable annuity investment for a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements; and

(6) A deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements.

Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

**(e) Training**

Members shall develop and document specific training policies or programs 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 liquidity issues, sales charges, fees, and market risks.

\* \* \* \* \*

**II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

**A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

**1. Purpose**

NASD is proposing a rule change to create a rule, proposed Rule 2821, that would impose specific sales practice standards and supervisory requirements on members for transactions in deferred variable annuities. NASD has been concerned about deferred variable annuity sales for some time. In part, this concern stems from the complexities of the products, which can cause confusion both for persons associated with members who sell deferred variable annuities and for customers who purchase them.

Deferred variable annuities are hybrid investments containing both securities and insurance features. They offer choices among a number of complex contract features

(e.g., variable annuity contracts may offer various types of death benefits, rebalancing features, dollar cost averaging options, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options). The amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses. Investors also can be subject to the following fees or charges: surrender charges (which the investor owes if he or she withdraws money from the annuity before a specified period); mortality and expense risk charges (which the insurance company charges for the insurance risk it takes under the contract); administrative fees (which are used for recordkeeping and other administrative expenses); underlying fund expenses (which relate to the investment options); and charges for special features and riders. Moreover, an investor's withdrawal of earnings before he or she reaches the age of 59½ is generally subject to a 10-percent penalty under the Internal Revenue Code.

In addition to the complexity of the product—and perhaps, in part, because of it—NASD examinations and investigations have uncovered various questionable sales practices. In some instances, associated persons sold variable annuities to elderly customers for whom such long-term, illiquid products were not suitable. In others, associated persons sold variable annuities without explaining (and, in some cases, without knowing) the characteristics of the products. On a number of occasions, associated persons recommended that customers exchange one variable annuity contract for another without ensuring that such exchanges were beneficial for their customers or properly disclosing costs. NASD also determined that a number of firms had, in general,

failed to adequately train and supervise associated persons regarding variable annuity sales.

When NASD first began noticing these problems, it acted quickly and persistently to address them on several fronts. NASD issued Notices to Members that provided guidelines and reminders about members' suitability obligations regarding variable annuities. NASD also issued Investor Alerts and Member Alerts, strengthened its examination program and brought a number of significant enforcement actions concerning variable annuities.

Despite these efforts, problematic sales practices continued. At present, NASD is still seeing some of the same problems that it first noticed in the late 1990s. In June 2004, NASD and the SEC issued a joint report on examination findings regarding broker-dealer sales of variable insurance products. See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) ("Joint Report"). As discussed in the Joint Report, recent NASD and SEC examinations uncovered a number of problem areas, including suitability, disclosure, supervision, books/records and training. In addition to the NASD and SEC examinations discussed in the Joint Report, NASD's Variable Annuity Task Force, an organization-wide initiative, is in the process of conducting special exams of various members and, although the analyses of those exams are not complete, NASD has discovered problems similar to those reported in the Joint Report at some members. Moreover, NASD has received a number of customer complaints indicating that the customers did not understand the unique features of the deferred variable annuities and raising suitability concerns based on the customers' investment objectives and liquidity needs.

In light of these issues, NASD determined that it needed to create a rule specifically covering deferred variable annuities. In general, NASD's guidelines on sales of deferred variable annuities, created with substantial input from industry participants and published in Notice to Members 99-35 (May 1999), served as the basis for the proposed rule change.

The rule change would apply to the purchase, sale or exchange of a deferred variable annuity and the subaccount allocations. The rule change would not apply to reallocations of subaccounts made after the initial purchase or exchange of a deferred variable annuity. However, other NASD rules would continue to apply. For instance, NASD's suitability rule, Rule 2310, would apply to any recommendations to reallocate subaccounts.

The rule change also would not apply to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans. In part, NASD created this exception in recognition that, in general, the nature of sales to a plan sponsor, trustee or custodian regarding the plan-level selection of investment vehicles and options involves a level of sophistication, negotiation and bargaining power not usually present in individual retail sales. Thus, the protection provided by the rule change is not necessarily required for such sales. However, if, in the case of any such plan, a member makes recommendations to individual plan participants regarding a deferred variable annuity, the rule change would apply as to the individual plan participants to whom the member makes such recommendations (but would not apply as to the plan sponsor, trustee or custodian regarding the plan-level selection of investment vehicles and options for such plans).

The proposed rule change has four main requirements. First, the proposal has requirements governing recommendations, including a suitability obligation, specifically tailored to deferred variable annuity transactions. See proposed Rule 2821(b).

Second, the proposal includes various principal review and approval obligations. See proposed Rule 2821(c). The proposal would require that, no later than two business days following the date when a member or associated person transmits a customer's application for a deferred variable annuity contract to the issuing insurance company for processing, a registered principal must review and approve the transaction. NASD Rule 2820(d) requires prompt transmission of the application and the purchase payment for a variable contract to the issuing insurance company. In this regard, principal review and approval should occur as soon as practicable after the customer signs the variable annuity application. The proposal would require, however, that in no event may principal review and approval occur later than two days after the application is forwarded to the issuing insurance company.

Third, members would be required to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule. See proposed Rule 2821(d). Pursuant to the proposed supervisory-procedure requirements, members would need to establish certain standards that are reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised. NASD also emphasizes that the member must have policies and procedures in place that are reasonably designed to ensure that an associated person sends the original application or a copy thereof to a principal for review within the two-day window discussed in the principal-review requirements.

Fourth, the proposal has a training component. See proposed Rule 2821(e). Members would be required to develop and document specific training policies or programs designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of the proposal and that they understand the material features of deferred variable annuities.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 120 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public interest. NASD believes that the proposed rule change is consistent with the provisions of the Act noted above in that it will enhance members' compliance and supervisory systems and provide more comprehensive and targeted protection to investors in deferred variable annuities. As such, the proposed rule change will decrease the likelihood of fraud and manipulative acts and increase investor protection.

**B. Self-Regulatory Organization's Statement on Burden on Competition**

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. **Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

The proposed rule change was published for comment in NASD Notice to Members 04-45 (June 2004). A copy of the Notice to Members is attached as Exhibit 2a. NASD received 1,129 comments in response to the Notice. A copy of the index to comment letters received in response to the Notice is attached at Exhibit 2b (submitted in hard copy), and copies of the comment letters received in response to the Notice are attached as Exhibit 2c (submitted in hard copy). The overwhelming majority of commenters opposed the proposal. Fourteen commenters fully supported the proposal and an additional 20 commenters offered partial or qualified support for the proposal.

Most commenters questioned the need for the proposal described in the Notice, stating that the proposal is duplicative of existing rules and that NASD should simply enforce those existing rules. NASD disagrees. Certainly, NASD can and does vigorously pursue those who engage in misconduct, but after-the-fact enforcement actions simply do not appear to be sufficiently effective at combating the problems NASD has uncovered.

Moreover, the proposed rule change does not merely aggregate existing requirements. The rule change is tailored to variable annuities and addresses issues not currently covered by existing rules. For instance, the rule change explicitly requires that an associated person have reasonable grounds for believing that the customer has been informed of the material features of the deferred variable annuity. The rule change describes the type of information that an associated person must consider in determining suitability for a deferred variable annuity. The rule change highlights the important



factors that registered principals must consider before approving a deferred variable annuity transaction. The rule change also requires members to provide training to associated persons and registered principals regarding the unique features of deferred variable annuities.

A number of commenters also questioned the need for point-of-sale disclosures, stating in particular that the transaction-specific, written-disclosure requirements proposed in the Notice were unhelpful and unworkable. NASD has not included the written-disclosure requirements contained in its Notice in the current proposed rule change, but will continue to explore this issue and will separately consider whether to propose such requirements in the future. NASD notes, however, that proposed Rule 2821(b) (Recommendation Requirements) continues to provide, as in the Notice, that no member or associated person shall recommend to a customer the purchase, sale or exchange of a deferred variable annuity unless the member or associated person has a reasonable basis to believe that, among other things, the customer has been informed of the material features of the deferred variable annuity. This provision will promote increased customer awareness of the material terms and features of the variable annuity, although, unlike the written-disclosure requirements contained in the Notice, the "Recommendation Requirements" do not prescribe the specific form of disclosure. NASD further notes that the Commission has proposed a rule that would require point-of-sale disclosure of certain fee information regarding, among other products, variable annuities. See SEC Proposed Rule Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other

Securities, Rel. Nos. 33-8358, 34-49148, IC-26341 (Jan. 29, 2004), 69 FR 6438 (Feb. 10, 2004).

Numerous commenters argued that the timing of principal review in the Notice was unreasonable and could actually prohibit principals from thoughtfully reviewing transactions. The Notice stated that a principal had to review and approve the transaction no later than one business day following the date when the customer signed the application. In recognition of the commenters' concerns, NASD modified the timing of principal review. The rule change now would require principal review and approval no later than two business days following the date when the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company. NASD believes that this requirement provides more than sufficient time for a principal to thoroughly review and, if appropriate, approve the transaction. NASD encourages members to create internal procedures requiring principal review in an even more expeditious time period, if possible in light of the member's business model and other considerations.

NASD disagrees with those commenters who suggested that state-required "free look" periods make early principal review unnecessary. In general, a "free look" period allows the customer to terminate the contract without paying any surrender charges and receive a refund of the purchase payments or the contract value, as required by applicable state law. Free-look periods, which vary by state law, typically range from 10 to 30 days.

Allowing a suitability analysis, for instance, to be reviewed by a principal long after an insurance company issues a deferred variable annuity contract would be inconsistent with an adequate supervisory system (which must be reasonably designed to

detect and prevent problematic sales). A delayed principal review would make it difficult for a member to quickly identify problematic trends, such as mini-replacement campaigns (a practice in which registered representatives exchange a high percentage of their customers' existing contracts for new contracts, in some cases to meet production requirements or to generate commissions). Allowing principal review to occur after a significant delay also would be contrary to the normal practice for review of transactions involving other types of investments. Moreover, NASD believes that members should contact customers as soon as possible if a principal discovers a problem with the transaction, which could not occur if the principal does not review the transaction for a prolonged period. Further, there may very well be disincentives to reject transactions as time elapses. Finally, some customers may not be aware of or fully comprehend free-look periods. For these reasons, it would be inappropriate to allow for principal review beyond the period stated in the current proposed rule change.

A number of commenters also called for the elimination of the principal review requirements for non-recommended transactions. Due to the complexity of the products, NASD believes that it is appropriate to require firms to review all deferred variable annuity transactions for problematic sales practices. The rule change creates standards that will ensure that firms perform a consistent, baseline analysis of transactions, regardless of whether the particular transaction has been recommended, thereby enhancing investor protection for all customers. NASD, moreover, is aware of instances where registered representatives have told their firms that variable annuity transactions were not recommended in order to bypass their firms' compliance requirements for recommended or solicited sales. The rule change's principal-review requirements for

non-recommended transactions should reduce the incentive for persons to engage in such conduct.

Finally, a number of commenters stated that the rule change should not apply to transactions involving tax-qualified, employer-sponsored retirement or benefit plans. After further analysis, NASD agrees with these commenters and has created an exception for transactions involving such plans under certain circumstances.

NASD emphasizes, however, that members should pay close attention to sales of deferred variable annuities in individual IRAs, which do not qualify for the proposed exception for tax-qualified, employer-sponsored retirement or benefit plans. A deferred variable annuity purchased for an individual IRA does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA itself. Moreover, unlike transactions for tax-qualified, employer-sponsored retirement or benefit plans, transactions in individual IRAs do not normally involve a fiduciary or other sophisticated intermediary who understands the unique features of deferred variable annuities and who can interact with the member on the customer's behalf. Sales of deferred variable annuities to non-sophisticated customers in IRAs are of particular concern to NASD, especially in light of certain fees and charges associated with many deferred variable annuities. Thus, principals must ensure that the deferred variable annuity's features other than tax deferral make the purchase of the deferred variable annuity for the individual IRA appropriate. In this regard, members should note that paragraph (c)(1)(A) and paragraph (d)(1) of the proposed rule require principals to determine whether the customer appears to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD- 2004-183 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD- 2004-183. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2004-183 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>3</sup>

Secretary

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<sup>3</sup>

17 CFR 200.30-3(a)(12).

# Notice to Members

JUNE 2004

REQUEST FOR COMMENT

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance  
Senior Management

## Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities

NASD Seeks Comment on Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities; **Comment Period Expires August 9, 2004**

## KEY TOPICS

Deferred Variable Annuities  
Disclosure  
Sales Practices  
Suitability  
Supervision  
Training

## Executive Summary

Deferred variable annuities are complex investment instruments that have both insurance and securities features.<sup>1</sup> On various occasions in the past, NASD has highlighted the unique features of these products for both members and potential investors. With the help of industry participants, for instance, NASD previously issued "best practices" guidelines in *Notice to Members (Notice or NtM) 99-35* (May 1999). Notwithstanding these efforts, some members continue to engage in problematic sales practices in this area, and some investors continue to be confused by certain features of these products.<sup>2</sup> As a result, NASD seeks comment on a proposed rule (Attachment A) relating to transactions in deferred variable annuities.

In general, *NtM 99-35* served as the basis for the proposed rule. The proposed rule includes suitability, disclosure, principal review, supervisory and training requirements tailored specifically to transactions in deferred variable annuities.

04-45

## Action Requested

NASD encourages all interested parties to comment on the proposed rule. Comments must be received by August 9, 2004. Members and interested persons can submit their comments using the following methods:

- ✦ mailing in written comments; or
- ✦ e-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com).

Written comments submitted via hard copy should be mailed to:

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

**Important Notes:** The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web Site. Generally, comments will be posted on the NASD Web Site one week after the end of the comment period.<sup>3</sup>

Before becoming effective, any rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>4</sup>

## Questions/Further Information

As noted above, hard-copy comments should be mailed to Barbara Z. Sweeney. Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, Regulatory Policy and Oversight (RPO), at (240) 386-4533; or James S. Wrona, Associate General Counsel, Office of General Counsel, RPO, at (202) 728-8270.

## Background

NASD has become increasingly concerned about some members' unsuitable recommendations and inadequate supervision of transactions in deferred variable annuities. Based on recent discussions, examinations, and enforcement cases, NASD believes that a rule specifically addressing transactions in deferred variable annuities is needed to ensure that investors are adequately protected.<sup>5</sup>



Deferred variable annuities have many unique features that make them complex investments. In addition to the hybrid nature of deferred variable annuities (*i.e.*, they contain both securities and insurance features), most deferred variable annuities offer numerous choices among a number of complex contract features.<sup>6</sup> Moreover, the amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses.

Investors also can be subject to the following fees or charges: *surrender charges*, which the investor owes if he or she withdraws money from the annuity before a specified period; *mortality and expense risk charges*, which the insurance company charges for the insurance risk it takes under the contract; *administrative fees*, which are used for recordkeeping and other administrative expenses; *underlying fund expenses*, which relate to the investment options; and *charges for special features and riders*, which may include provisions such as a stepped-up death benefit or a guaranteed minimum income benefit. Various sources estimate that average annual expenses of a variable annuity range from 1.3 percent to 2.2 percent of the underlying assets in the account.<sup>7</sup>

In addition, an investor's withdrawal of earnings before he or she reaches age 59½ is generally subject to a 10 percent penalty under the Internal Revenue Code. Furthermore, while the earnings accumulate on a tax-deferred basis in the variable annuity, when variable annuity earnings are paid out they are taxed as ordinary income, not as capital gains (which may be taxed at a lower rate).

Because of the complex features of these products, NASD has issued a number of *Notices*, *Investor Alerts*, and *Member Alerts* that address deferred variable annuities. In particular, in May 1999, NASD issued *NtM 99-35*, which provided guidance to assist members in developing appropriate procedures relating to the purchase, sale or exchange of deferred variable annuities.<sup>8</sup>

Although many members offer deferred variable annuities in a manner consistent with NASD's existing rules (and a large segment adhere to the guidance provided in *NtM 99-35*), certain firms continue to engage in unacceptable sales and supervision practices regarding these products. For instance, variable annuity sales have been the subject of more than 80 NASD disciplinary actions in the past two years. These disciplinary actions involved a wide array of misconduct regarding the sales of variable annuity products, including excessive switching, misleading marketing, failure to disclose material facts, unsuitable sales, inadequate training and supervision of salespeople and deficient written supervisory procedures.<sup>9</sup> Recent NASD and SEC examinations of variable product sales revealed similar deficiencies.<sup>10</sup> NASD and the SEC, moreover, have received numerous customer complaints indicating that the customers did not understand the unique features of the products and raising suitability concerns based on the customers' investment objectives and liquidity needs.<sup>11</sup> NASD's proposed rule would address these continuing deficiencies and provide more comprehensive and targeted protection to investors in deferred variable annuities.

In general, the proposed rule would codify and make mandatory the guidelines issued by NASD in *NtM 99-35*, mentioned above. These requirements represent the industry's best practices with respect to transactions in deferred variable annuities.<sup>12</sup> The proposed rule also would create certain written disclosure and principal review requirements. The proposed rule's key provisions include:

- **Appropriateness/Suitability.** The proposed rule would require members and persons associated with members to make the following determinations when recommending a deferred variable annuity transaction: (1) the customer has been informed of the unique features of the deferred variable annuity, (2) the customer has a long-term investment objective, and (3) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer. These determinations would have to be documented and signed by the associated person who makes the recommendation and performs the required analysis.
- **Disclosure and Prospectus Delivery.** The proposed rule would require members and associated persons to provide the customer a current prospectus and a separate, brief, and easy-to-read (written in "plain English") risk disclosure document that highlights the main features of the particular variable annuity transaction, including, but not limited to, (1) liquidity issues, such as potential surrender charges and the IRS penalty; (2) sales charges; (3) fees, such as mortality and expense charges, administrative fees, charges for riders or special features and investment advisory fees; (4) federal tax treatment of variable annuities; (5) any applicable state and local government premium taxes; and (6) market risk. The risk disclosure document also would have to inform the customer whether a "free look" period applies to the variable annuity contract, during which the customer can terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments.<sup>13</sup> In addition, the risk disclosure document would require the member or associated person to inform the customer that all applications to purchase or exchange a deferred variable annuity contract are accepted subject to review and approval by a designated registered principal. The member would be required to provide the prospectus and risk disclosure document regardless of whether the transaction had been recommended.<sup>14</sup>

- ✦ **Principal Review.** No later than one business day following the date of execution of the deferred variable annuity application, a registered principal would be required to review and approve the transaction, regardless of whether the transaction had been recommended. In reviewing the transaction, the registered principal would need to take into account whether (1) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age or with a short-term investment objective; (2) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount; (3) the transaction involves an exchange or replacement of a deferred variable annuity contract; (4) the customer's account has a particularly high rate of deferred variable annuity exchanges or replacements; (5) the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; and (6) the purchase of the deferred variable annuity is for a tax-qualified retirement account (e.g., a 401(k) plan, IRA).<sup>15</sup>

In addition, when the member or an associated person has recommended the transaction, a registered principal would be required to review and approve the suitability analysis document no later than one business day following the date of execution of the deferred variable annuity application. Finally, when the transaction involves an exchange or replacement of a deferred variable annuity, regardless of whether the transaction has been recommended, a registered principal would need to review and approve a separate exchange or replacement document (which would cover issues specific to exchanges or replacements) no later than one business day following the date of execution of the deferred variable annuity application. The proposed rule would allow a member to use an existing exchange or replacement form authorized by a state insurance commission or other regulatory agency to satisfy the exchange or replacement disclosure provision to the extent that the regulatory agency's form requires disclosure of the information required by NASD's proposed rule. These principal review requirements would permit a customer to review, complete and execute an application for a deferred variable annuity in a one-step process, subject to a designated principal's subsequent review and approval no later than one business day following the date of execution of the deferred variable annuity application.

- ✦ **Supervisory Procedures.** Members would be required to establish and maintain specific written supervisory procedures reasonably designed to achieve and evidence compliance with the standards set forth in the proposed rule.
- ✦ **Training.** Members would need to develop and document specific training policies or programs designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of the proposed rule and that they understand the unique features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment, and market risks.

### Request for Comment

NASD is soliciting comment on its proposed rule covering the purchase, sale, or exchange of deferred variable annuities. NASD requests comment on whether the rule, in general, should be modeled after the "best practices" guidelines discussed in *NtM* 99-35, the current approach, or whether some alternative approach would be more appropriate. For instance, NASD considered, but decided against, modeling the proposal after certain provisions of the options and futures rules. See, e.g., NASD Rules 2860(16) and (19); 2865(16) and (19). Another approach might be to limit the sale of deferred variable annuities to certain categories of investors. Moreover, members could be required to provide a comparison that would indicate the results that comparable products might provide the investor. NASD also seeks feedback on whether the proposed rule should cover all variable annuity transactions, not just deferred variable annuity transactions. In responding to this issue, NASD requests that commenters discuss whether and to what extent certain requirements in the proposed rule would need to be modified.

In addition to seeking comment on NASD's general approach, NASD requests comment on the proposed rule's specific provisions. In this regard, NASD encourages comment on the proposed risk disclosure provision. The proposed rule would require members to provide a customer with a risk disclosure document regarding certain features of the specific deferred variable annuity that is the subject of the transaction. As currently drafted, the proposed rule would require, among other items, disclosure of product-specific fees and charges (such as mortality and expense charges, administrative fees, charges for riders or special features, and investment advisory fees), federal and state tax treatment for the deferred variable annuity, and potential market risks. NASD seeks comment in particular on whether the risk disclosure document should focus on information applicable to all deferred variable annuity products sold by the firm rather than product-specific information. If so, commenters should discuss the rationale for this alternative approach and the types of general information that the proposed rule should require members to disclose in order to effectively educate potential investors in deferred variable annuities. Commenters, moreover, should consider whether a combination of some product-specific and some general information would be an appropriate third option for the risk disclosure provision.



NASD also recognizes that the SEC has proposed a rule that would require point of sale disclosure of certain fee information regarding, among other products, variable annuities. See SEC Proposed Rule Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. Nos. 33-8358, 34-49148, IC-26341 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004). NASD is interested in commenters' views of the potential interplay of NASD's proposal and the SEC's proposal.

Finally, NASD requests comment on certain standards discussed in the proposed rule's principal review and supervisory procedures provisions. Those provisions state, in part, that principals should analyze—and supervisory procedures should be established to screen for—among other things, transactions involving (1) a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age or with a short-term investment objective, and (2) an amount of money that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount. NASD considered imposing bright-line measures for these requirements, for example, a specific percentage of the customer's net worth or specific dollar amount, a specific age ceiling. NASD believes, however, that members are in a better position to determine appropriate standards based on their particular business models, salespeople and customers. As currently drafted, the proposed rule would require that the standards a member adopts be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised. Nonetheless, NASD seeks comment on whether NASD should revise the proposed rule so that the rule lists explicit, fixed standards developed by NASD. If so, NASD requests suggestions on the explicit standards that would be appropriate for each category.

NASD has found comments from member firms and the public, as well as state and federal regulators, to be a valuable resource in the decision-making process. NASD encourages all interested parties to comment on the concepts discussed above regarding the proposed rule. NASD will consider the comments it receives in determining whether to submit the proposed rule as a formal rule change to the SEC and, if so, the form that the rule change will take. As noted above, comments must be submitted by **August 9, 2004**.

## Endnotes

- 1 Generally speaking, a deferred variable annuity is a contract between an investor and an insurance company. The insurance company promises to make periodic payments to the contract owner or beneficiary at some future time and, should the contract owner die during the accumulation phase, to pay a death benefit to the beneficiary. Deferred variable annuities offer choices among a number of complex contract features. See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint SEC/NASD Staff Report), available at [www.nasdr.com/white\\_paper\\_0600804.asp](http://www.nasdr.com/white_paper_0600804.asp) ("For example, [variable annuity] contracts may offer various types of death benefits, rebalancing features, dollar cost averaging options, assorted payout structures, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options."). Deferred variable annuities, although issued by insurance companies, are securities under the federal securities laws and are sold through broker-dealers. *Id.*
- 2 See Joint SEC/NASD Staff Report, *supra* note 1 (discussing deficiencies found during examinations of and enforcement actions involving variable products, including suitability, marketing, supervision, disclosure, and maintenance of books and records).
- 3 See *NtM 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 4 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Section 19 of the Exchange Act and rules thereunder.
- 5 See *supra* note 2 and accompanying discussion.
- 6 See *supra* note 1 and accompanying discussion.
- 7 Joint SEC/NASD Staff Report, *supra* note 1 (citing Andrea Coombes, *Perfect Tool—For a Select Few: Variable Annuities Have Limited Use*, Schwab Study Finds, CBS MarketWatch.com, Nov. 8, 2002; John P. Huggard, *Investing with Variable Annuities* §703, at 27 (Parker-Thompson Pub. 2002)).
- 8 In addition to *NtM 99-35*, NASD issued *NtM 96-86* (Dec. 1996), which reminded members that sales of variable annuities are subject to NASD suitability requirements. NASD, moreover, has issued a number of *Investor Alerts* covering the unique features and potential risks of variable annuities. Recently, NASD also issued a *Member Alert* reminding members of their responsibilities regarding hypothetical tax-deferral illustrations in variable annuity communications.
- 9 See Joint SEC/NASD Staff Report, *supra* note 1 (discussing various NASD and SEC disciplinary actions involving variable annuity products).
- 10 *Id.* (explaining results of recent NASD and SEC examinations of broker-dealer sales of variable annuity products).
- 11 *Id.* (discussing customer complaints regarding variable annuity products).
- 12 A number of members helped create the guidelines discussed in *NtM 99-35*, and many have adopted them based on NASD's issuance of the *NtM*. The guidelines in *NtM 99-35*, however, are not mandatory, and some members have not adopted them. As a result, because of continued sales practice and supervision problems related to deferred variable annuities, NASD is proposing the rule described herein.

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- 13 The member or its associated persons would be responsible for providing the prospectus and separate, brief, and easy-to-read (written in "plain English") risk disclosure document to the investor. NASD does not regulate insurance companies, and the proposed rule applies to member firms. Nonetheless, members would be allowed to use a separate, brief and easy-to-read risk disclosure document prepared by the issuing insurance company if such document conformed to the requirements of the proposed rule. Again, however, it would be the responsibility of the member firm and its associated persons to ensure compliance with all aspects of the proposed rule, including the risk disclosure document.
- 14 Non-recommended transactions would include those for which the member acts only as an order taker. For instance, the proposed rule's requirements that apply to any transaction, regardless of whether the transaction had been recommended, would include a situation where a customer contacts the member and, without any input from the member, places an order on his or her own for XYZ deferred variable annuity.
- 15 A deferred variable annuity purchased for a tax-qualified retirement account does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified plan itself. Such transactions are of particular concern to NASD, especially in light of certain fees and charges associated with many deferred variable annuities. Thus, principals must ensure that the deferred variable annuity's other features make the purchase of the deferred variable annuity for the tax-qualified retirement account appropriate.
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**ATTACHMENT A****Text of Rule Change**

New language is underlined.

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**Members' Responsibilities Regarding Deferred Variable Annuities****(a) Appropriateness/Suitability**

(1) No member or person associated with a member shall recommend to any customer the purchase, sale or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that (A) the customer has been informed of the material features of the deferred variable annuity; (B) the customer has a long-term investment objective; and (C) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer based on the information set forth in paragraph (a)(2) of this rule. These determinations shall be documented and signed by the associated person recommending the transaction, in addition to being approved by a registered principal, as required by paragraph (c) of this Rule.

(2) Prior to recommending 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, liquidity needs, liquid net worth, marital status, number and age of dependents, occupation, risk tolerance, savings, 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.

**(b) Disclosure and Prospectus Delivery**

(1) Prior to effecting any purchase, sale or exchange of a deferred variable annuity, regardless of whether the transaction has been recommended, a member or person associated with a member must provide the customer:

(A) A current prospectus; and

(B) A separate, brief and easy-to-read (written in "plain English") risk disclosure document that highlights the main features of the particular variable annuity transaction, including (i) liquidity issues, such as potential surrender charges and tax penalties; (ii) sales charges; (iii) fees, such as mortality and expense charges, administrative fees, charges for riders or special features, and investment advisory fees; (iv) federal and state tax treatment for variable annuities; and (v) potential market risks. The risk disclosure document also must inform the customer whether a "free look" period applies to the deferred variable annuity contract, during which the customer can terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments. In addition, the risk disclosure document must inform the customer that all applications to purchase or exchange a deferred variable annuity are accepted subject to review and approval by a designated registered principal.

(2) Prior to effecting any exchange or replacement of a deferred variable annuity, a member or person associated with a member must, in addition to the information

required by paragraph (b)(1) and regardless of whether the transaction has been recommended, provide the customer with the following information in writing:

(A) A summary of all significant differences, if any, between the existing and proposed deferred variable annuities' contractual provisions, guarantees, death benefits, withdrawal provisions and/or tax treatment;

(B) Surrender charges, including both those that may be assessed on the surrender of the existing contract and those applicable to the proposed contract;

(C) Costs that are associated with purchasing a new contract, including new sales loads and other start-up expenses; and

(D) The possibility, if any, of modifying or adjusting the existing contract to meet the customer's objectives rather than exchanging or replacing the contract.

A member or person associated with a member may use an existing exchange or replacement form authorized by a state insurance commission or other regulatory agency to satisfy the disclosure requirements of this paragraph to the extent that the regulatory agency's form requires disclosure of the information required by this Rule. If the regulatory agency does not require disclosure of all of the information required by this Rule, a member or person associated with a member may create and use an addendum to the regulatory agency's form.

**(c) Principal Review**

(1) No later than one business day following the date of execution of the deferred variable annuity application, a registered principal shall review and approve the transaction, regardless of whether the transaction has been recommended. In reviewing the transaction, the registered principal shall consider whether (A) the customer's age or

liquidity needs make a long-term investment inappropriate, such as a customer over a specific age (standard established by the member) or with a short-term investment objective; (B) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member); (C) the transaction involves an exchange or replacement of a deferred variable annuity contract; (D) the deferred variable annuity transaction involves a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements; (E) the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; and (F) the purchase of the deferred variable annuity is for a tax-qualified retirement account (e.g., 401(k) plan, IRA). Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(2) When a member or a person associated with a member has recommended the transaction, a registered principal, taking into account the underlying supporting documentation described in paragraph (a)(2) of this Rule, shall review, approve and sign the appropriateness/suitability determination document required by paragraph (a)(1) of this Rule no later than one business day following the date of execution of the deferred variable annuity application. This principal review and approval requirement is in addition to the requirements of paragraph (c)(1) and, if applicable, paragraph (c)(3) of this Rule.

(3) When the transaction involves an exchange or replacement of a deferred variable annuity, regardless of whether the transaction has been recommended, a registered principal must review, approve and sign the exchange or replacement analysis

form or addendum described in paragraph (b)(2) of this Rule no later than one business day following the date of execution of the deferred variable annuity application. This principal review and approval requirement is in addition to the requirements of paragraph (c)(1) and, if applicable, paragraph (c)(2) of this Rule.

**(d) Supervisory Procedures**

In addition to the general supervisory and recordkeeping requirements of Rules 3010 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. In particular, the member must implement procedures to screen for and require a registered principal's review of the following:

(1) A deferred variable annuity investment for a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age (standard established by the member) or with a short-term investment objective;

(2) A deferred variable annuity investment that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);

(3) A deferred variable annuity exchange or replacement;

(4) A deferred variable annuity investment for a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements;

(5) A deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; or

(6) A deferred variable annuity investment for any tax-qualified retirement account (e.g., 401(k) plan, IRA).

Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

**(e) Training**

Members shall develop and document specific training policies or programs 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 liquidity issues, sales charges, fees, tax treatment, and market risks.

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