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

File No. SR - 2004 - 183
Amendment No. 2

Proposed Rule Change by National Association of Securities Dealers
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☐	Amendment ☒	Withdrawal ☐	Section 19(b)(2) ☒	Section 19(b)(3)(A) ☐	Section 19(b)(3)(B) ☐
			Rule		
Pilot ☐	Extension of Time Period for Commission Action ☐	Date Expires 	☐ 19b-4(f)(1) ☐ 19b-4(f)(2) ☐ 19b-4(f)(3)	☐ 19b-4(f)(4) ☐ 19b-4(f)(5) ☐ 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document
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Exhibit 3 Sent As Paper Document
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Description

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

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 James Last Name Wrona
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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 05/04/2006

By Patrice M. Gliniecki

(Name)

Senior Vice President & Deputy General Counsel

(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.

PATRICE GLINIECKI,

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

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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 Sent As Paper Document

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Exhibit 3 - Form, Report, or Questionnaire

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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 Sent As Paper Document

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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

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 2 to SR-NASD-2004-183, proposed new NASD Rule 2821, that sets forth recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. The purpose of Amendment No. 2 is to address the comment letters that the Commission received in response to the publication of the proposed rule change in the Federal Register² and to propose amendments responsive to the comments where appropriate.

Below is the text of the proposed rule. Proposed new language is underlined.

* * * * *

2821. Members’ Responsibilities Regarding Deferred Variable Annuities

(a) General Considerations

(1) Application

This Rule applies to the purchase or exchange of a deferred variable annuity and the subaccount allocations. This Rule does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable

¹ 15 U.S.C. 78s(b)(1).

² See Exchange Act Rel. No. 52046A (July 19, 2005), 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183).

annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a “qualified plan” under Section 3(a)(12)(C) of the Securities Exchange Act of 1934 or meets the requirements of Internal Revenue Code Sections 403(b), 457(b) or 457(f), unless, in the case of any such plan, a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member makes such recommendations.

(2) Creation, Storage and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

(A) the customer has been informed of the material features of a deferred variable annuity, such as the potential surrender period and

surrender charge; potential tax penalty if the customer sells or redeems the deferred variable annuity before he or she reaches the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of a deferred variable annuity; and market risk;

(B) the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit); and

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

These determinations shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing investment and life insurance holdings,

liquidity needs, liquid net worth, risk tolerance, tax status and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(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 to the issuing insurance company for processing and irrespective of whether the transaction has been recommended, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider

(A) the extent to which the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit);

(B) the extent to which the customer's age or liquidity needs make the investment inappropriate;

(C) the extent to which the amount of money invested would result in an undue concentration in a deferred variable annuity or deferred variable annuities in the context of the customer's overall investment portfolio; and

(D) if the transaction involves an exchange of a deferred variable annuity, the extent to which (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose

death or existing benefits, or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees and charges for riders and similar product enhancements), (ii) the customer would benefit from any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

These considerations shall be documented and signed by the registered principal who reviewed and approved the transaction.

(2) When a member or a person associated with a member has recommended the purchase or exchange of a deferred variable annuity, a registered principal, taking into account the underlying supporting documentation described in paragraph (b)(2) of this Rule, shall review, determine whether to approve and, if approved, 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, 3013 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen the transaction and require a registered principal to consider those items enumerated in

paragraph (c) of this Rule, as well as whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.

(e) Training

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

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

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

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

effective date will be 180 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**

(a) Purpose

Rule Filing History

On December 14, 2004, NASD filed with the Commission proposed Rule 2821 (SR-NASD-2004-183). NASD filed with the Commission Amendment No. 1 to the proposal on July 8, 2005. The Commission published the proposal in the Federal Register on July 21, 2005.³ The comment period closed on September 19, 2005. Based on comments received in response to the publication of the proposal in the Federal Register, NASD is filing Amendment No. 2 to SR-NASD-2004-183 to address the comments and to make certain changes as discussed herein.

Proposal

As described in the original rule filing and Amendment No. 1, NASD is proposing new NASD Rule 2821, which would impose specific sales practice standards and supervisory requirements on members for transactions in deferred variable annuities.⁴ In general, NASD's guidelines on deferred variable annuity transactions,

³ See supra note 2.

⁴ A variable annuity, in general, is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) ("Joint Report"); NASD Notice to Members 99-35 (May 1999). The proposed rule focuses exclusively on transactions in deferred variable annuities. NASD recognizes that transactions involving immediate variable annuities have

developed with substantial input from industry participants and published in Notice to Members 99-35, served as the basis for the proposed rule.

The proposed rule would apply to the purchase or exchange of a deferred variable annuity and the subaccount allocations.⁵ The proposed rule would not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange

begun to increase recently, and NASD will continue to monitor sales practices relating to these products. Currently, however, deferred variable annuities make up the majority of variable annuity transactions. Moreover, to date, most of the problems associated with transactions in variable annuities that NASD has uncovered involve the purchase or exchange of deferred variable annuities.

⁵ NASD notes that the proposed rule focuses on customer purchases and exchanges of deferred variable annuities, areas that, to date, have given rise to many of the problems NASD has uncovered. The proposed rule would thus cover a standalone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another deferred variable annuity. For purposes of the proposed rule, an “exchange” of a product other than a deferred variable annuity (such as a fixed annuity) for a deferred variable annuity would be covered by the proposed rule as a “purchase.” The proposed rule would not cover customer sales of deferred variable annuities, including the sale of a deferred variable annuity in connection with an “exchange” of a deferred variable annuity for another product (such as a fixed annuity). However, recommendations of customer sales of deferred variable annuities are fully and adequately covered by Rule 2310, NASD’s general suitability rule. Rule 2310 requires that, when recommending that a customer purchase, sell or exchange a security, an associated person determine whether the recommendation is suitable for the customer. In general, deferred variable annuities are suitable only as long-term investments and are inappropriate short-term trading vehicles. As part of any analysis under Rule 2310 regarding the suitability of a recommendation that a customer sell a deferred variable annuity, the associated person must consider significant tax consequences, surrender charges and loss of death or other benefits. As NASD emphasized in a Regulatory & Compliance Alert in 2002, entitled “Reminder—Suitability of Variable Annuity Sales,” members and their associated persons “must keep in mind that the suitability rule applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor.”

of a deferred variable annuity. However, other NASD rules would continue to apply. For instance, NASD's suitability rule, Rule 2310, would continue to apply to any recommendations to reallocate subaccounts.⁶

The proposed rule also would not apply to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans but would apply to the purchase or exchange of deferred variable annuities to fund IRAs. In part, NASD determined not to exclude IRAs from the proposal's coverage because, unlike transactions for tax-qualified, employer-sponsored retirement or benefit plans, investors funding IRAs are not limited to the options provided by a plan.⁷ However, even in the case of a tax-qualified, employer-sponsored retirement or benefit plan, if a member makes recommendations to individual plan participants regarding a deferred variable annuity, the proposed rule 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 has four main requirements. First, the proposal has requirements governing recommendations, including a suitability obligation, specifically

⁶ Indeed, except to the extent that specific provisions in the proposed rule would 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 would be applicable to transactions in deferred variable annuities.

⁷ NASD notes as well that a deferred variable annuity purchased to fund an IRA does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA itself. Accordingly, where a customer is purchasing a deferred variable annuity to fund an IRA, firms must ensure that the deferred variable annuity's features other than tax deferral make the purchase of the deferred variable annuity for the IRA appropriate.

tailored to deferred variable annuity transactions.⁸ Second, the proposal includes various principal review and approval obligations.⁹ Third, the proposal specifically requires members to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule.¹⁰ Fourth, the proposal has a training component.¹¹

As noted in Item 2 of this filing, NASD will announce the effective date of the proposed rule in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 180 days following publication of the Notice to Members announcing Commission approval.

Comments on the Proposed Rule

The Commission received nearly 1,500 comment letters in response to the publication of the proposed rule in the Federal Register. The commenters raise several issues that are addressed below.

First, a number of commenters argue that the proposed rule should be withdrawn because it is unnecessary and because NASD has not provided quantifiable proof of serious problems with transactions in deferred variable annuities.¹² As an initial matter,

⁸ See Proposed Rule 2821(b).

⁹ See Proposed Rule 2821(c).

¹⁰ See Proposed Rule 2821(d).

¹¹ See Proposed Rule 2821(e).

¹² At least one commenter also argued that the proposal would create an undue burden on competition. NASD disagrees. As further discussed herein, NASD believes there is a sound basis for the proposed rule and, as stated in Item 4, does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

NASD disagrees with the suggestion that there must be demonstrable harm before NASD can engage in rulemaking. NASD can and should be proactive whenever possible.¹³ Neither the Act nor public policy considerations require NASD to refrain from taking action until quantifiable data evidencing the seriousness of a problem is available.

In any event, NASD has discovered significant and reoccurring problems with transactions in deferred variable annuities and has taken an extremely measured approach in responding to them. These problems include unsuitable recommendations, misrepresentations and omissions and inadequate supervision and training. Over the course of nearly a decade, NASD has addressed these and other problems involving deferred variable annuities through non-rulemaking means on several fronts. For instance, NASD issued Notices to Members,¹⁴ Regulatory & Compliance Alerts¹⁵ and

¹³ In fact, along those lines, NASD created the “Ahead of the Curve” program that is dedicated to identifying and responding at the earliest possible stage to problems that can cause harm to investors or market integrity.

¹⁴ See, e.g., NASD Notice to Members 99-35 (May 1999) (providing guidance to assist members in developing appropriate procedures relating to variable annuity transactions); NASD Notice to Members 96-86 (Dec. 1996) (reminding members of their suitability obligations regarding variable annuity transactions).

¹⁵ In 2002, NASD issued a Regulatory & Compliance Alert, entitled “NASD Regulation Cautions Firms for Deficient Variable Annuity Communications,” that, among other things, discussed NASD’s discovery of unacceptable sales practices regarding variable annuities. In another Regulatory & Compliance Alert in 2002, entitled “Reminder—Suitability of Variable Annuity Sales,” NASD emphasized, in part, that an associated person must be knowledgeable about a variable annuity before he or she can determine whether a recommendation to purchase, sell or exchange the variable annuity is appropriate.

Investor Alerts.¹⁶ These various publications included, among other things, “best practice” guidelines, suitability reminders and warnings about certain sales tactics.

Notwithstanding those efforts, many of the same problems that NASD initially sought to address through non-rulemaking means persist today. Recent joint reviews with the Commission,¹⁷ NASD examinations¹⁸ and NASD enforcement actions¹⁹ indicate

¹⁶ In 2001, NASD issued an Investor Alert entitled “Should You Exchange Your Variable Annuity?” highlighting important issues that investors should consider before agreeing to exchange a variable annuity. In 2003, NASD issued an Investor Alert entitled “Variable Annuities: Beyond the Hard Sell,” which cautioned investors about certain inappropriate sales tactics and highlighted the unique features of these products.

¹⁷ See Joint Report, supra, note 4.

¹⁸ NASD completed 216 routine examinations involving the review of variable annuities from July 2004 to July 2005. These examinations resulted in forty-five Letters of Caution and eleven Compliance Conferences. While the majority of these actions involved the failure to establish or follow written supervisory procedures, a number of actions related to the failure to obtain and maintain customer account information, unsuitable recommendations, and the failure to comply with standards relating to communications with the public. These findings do not include cause examinations, many of which result in formal action that is captured by enforcement actions, discussed below. Nor do the findings include information from special examination initiatives.

¹⁹ Just within the last few years, NASD has brought a number of important cases involving failures to supervise, suitability concerns and misrepresentation in connection with purchases and exchanges of deferred variable annuities. See, e.g., Michael Lancaster, No. E8A20040995-01 (Nov. 30, 2005) (making unsuitable recommendations regarding variable annuity subaccounts); Lawrence LaBine, No. C3A20040045 (Nov. 22, 2005) (unsuitable recommendations to five customers involving variable annuity subaccounts and mutual funds); Mansell R. Spedding, No. E0220030907 (Sept. 21, 2005) (unsuitable subaccount allocation recommendation for variable annuity); Rita N. Raymer, No. E0520030131 (Aug. 16, 2005) (unsuitable recommendations of variable annuities); NYLife Sec., Inc., No. E0520040104 (July 22, 2005) (failing to adequately supervise sales of variable annuities and mutual funds); Paul Olsen, No. E3A20030539 (June 23, 2005) (negligently failing to tell customers about fees associated with variable annuity exchanges); Bambi Holzer, No. E0220020787 (June 17, 2005) (negligently misrepresenting certain aspects of variable annuities); Ilene L.

that NASD's non-rulemaking approach has not been sufficiently effective at curbing problems in this area. Rulemaking clearly is needed.

Second, some commenters request clarification of the provision providing an exclusion from the proposed rule's coverage in certain circumstances. That provision

Sonnenberg, No. C0520050024 (May 11, 2005) (recommending unsuitable variable annuity); Raymond James & Assocs., Inc., No. C0520050020 (May 10, 2005) (finding that registered representative made unsuitable recommendations and firm failed to maintain and enforce written supervisory procedures regarding sales of variable annuities); Issetten Hanif, No. C9B20040086 (Apr. 6, 2005) (unsuitable recommendations regarding variable annuity and mutual fund exchanges); Lawrence Labine, No. E02020513 (Nov. 19, 2004) (unsuitable variable annuity recommendation); Edward Sadowski, No. C9B040102 (Nov. 17, 2004) (unsuitable variable annuity recommendation); James B. Moorehead, No. C05040073 (Nov. 11, 2004) (failing to gather suitability information for variable annuity sales); Juan Ly, No. C07040094 (Nov. 9, 2004) (unsuitable variable annuity switches and misrepresentations); Jenny Chin, No. E04030619 (Oct. 29, 2004) (misrepresentation and omissions regarding variable annuities); Glenn W. Ward, No. C05040075 (Oct. 14, 2004) (recommending unsuitable variable annuity); Bernard E. Nugent, No. C11040031 (Sept. 1, 2004) (unsuitable recommendation involving the liquidation of mutual fund shares to purchase a variable annuity); Samuel D. Hughes, No. C07040067 (Aug. 19, 2004) (unsuitable variable annuity switches, unauthorized sub-account allocations, and misrepresentations); SunAmerica Sec., Inc., No. C05040051 (July 12, 2004) (lacking adequate written supervisory procedures concerning review of variable annuity and variable universal life contracts); Jamie Engelking, No. E3A020441 (July 2, 2004) (unsuitable variable annuity recommendation); Pan-American Fin. Advisers, No. C05040034 (June 15, 2004) (failing to have adequate supervisory procedures for variable annuity sales); Scott Weier, No. E04010714 (May 27, 2004) (unsuitable variable annuity recommendations); Gregory Jurkiewicz, No. E3A030436 (May 4, 2004) (unsuitable variable annuity recommendation); Michael H. Tew, No. C05040010 (Apr. 7, 2004) (unsuitable recommendations regarding variable annuities); Steve Morgan, No. E3A020410 (Mar. 12, 2004) (unsuitable variable annuity recommendation); Donald Lacavazzi, No. C11040009 (Feb. 24, 2004) (recommending unsuitable variable annuity switching); Michael Blandchard, No. C11040005 (Feb. 16, 2004) (unsuitable variable annuity recommendations); Prudential Inv. Mgmt. and Prudential Equity Group, Inc., No. C05040008 (Jan. 29, 2004) (failing to supervise and maintain accurate records relating to variable annuity replacement sales); Waddell & Reed, Inc., No. CAF040002 (Jan. 14, 2004) (failing to ascertain suitability of recommended variable annuity exchanges and failure to supervise).

states that the proposal would “not apply to deferred variable annuity transactions made in connection with tax-qualified, employer-sponsored retirement or benefit plans that either are 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 an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member makes such recommendations.”

One commenter asked in particular whether the proposed rule would apply if a registered representative recommended a deferred variable annuity to an individual plan participant and the annuity was the only funding vehicle for the employer’s retirement plan. If the registered representative “recommends” the deferred variable annuity, then the proposed rule would apply.²⁰ It is important to remember, however, that not all communications about a deferred variable annuity would constitute a “recommendation” that triggers application of the rule.

As NASD has often emphasized in the context of its general suitability rule (Rule 2310), “Whether a particular transaction is in fact recommended depends on an analysis

²⁰ Another commenter stated that the rule also should apply if the qualified plan sponsor, trustee or custodian is either unsophisticated or relies upon the firm’s recommendation regarding plan-level decisions. NASD continues to believe that the rule should not apply to plan-level decisions made by sponsors, trustees or custodians of qualified retirement or benefit plans. The factors that can be important to an understanding of the appropriateness of a recommendation to a sponsor, trustee or custodian of a qualified retirement or benefit plan regarding plan-level decisions can be distinct from those that are important regarding the determination of the appropriateness of a recommendation to a retirement-plan participant.

of all the relevant facts and circumstances.”²¹ Nonetheless, NASD previously has announced several principles that should be considered when determining whether a particular communication could be deemed a “recommendation.”²² For instance, a communication’s content, context and presentation will inform most determinations of whether a particular communication is a “recommendation.” Furthermore, because the determination is an objective rather than a subjective inquiry, an important consideration is whether the communication reasonably would be viewed as a “call to action,” or suggestion that the customer engage in a particular transaction. In addition, the more individually tailored a communication to a specific customer or targeted group of customers about a security or group of securities, the more likely the communication will be viewed as a “recommendation.”

Thus, a firm’s or an associated person’s individualized recommendation of a deferred variable annuity to a particular plan participant would trigger application of the proposed rule, even if the annuity were the only funding vehicle for the employer’s retirement plan. However, a firm’s generic communication to all plan participants indicating that the employer has chosen a deferred variable annuity as the funding vehicle for its retirement plan likely would not constitute a “recommendation” triggering application of the proposed rule.

Third, some commenters argue that, as with Internal Revenue Code (“IRC”) Section 457(b) plans (which, as mentioned above, are excluded from the proposal’s

²¹ NASD Notice to Members, For Your Information: Clarification of NASD Notice to Members 96-60 (Mar. 1997).

²² NASD Policy Statement Regarding Application of the NASD Suitability Rule to Online Communications, NASD Notice to Members 01-23 (Apr. 2001).

coverage under certain circumstances), Section 457(f) plans should be excluded from the proposal's coverage. NASD agrees. Similar to Section 457(b) plans, Section 457(f) plans are non-qualified deferred executive compensation arrangements created by government or tax-exempt organizations that can utilize a variable annuity as a funding instrument.²³ The same justifications for excluding Section 457(b) plans, discussed in previous filings with the Commission, are present with regard to Section 457(f) plans. NASD therefore has amended the proposal to exclude such plans under certain circumstances described in the proposed rule's text.

Fourth, some commenters ask NASD to clarify whether the rule proposal would apply only to the initial premiums. NASD now makes this point clear in the proposal's "Application" section. The proposal has been changed as follows: the rule "does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity."²⁴

Fifth, numerous commenters question whether the proposal should require principal review prior to transmittal of the deferred variable annuity application to the issuing insurance company. Some of these commenters note that the interaction of other Commission and NASD rules potentially could limit a firm's ability to review

²³ Section 457(b) and (f) plans are deferred compensation plans available for certain state and local governments and non-governmental entities tax exempt under IRC Section 501 (non-profit organizations). The main difference between 457(b) and 457(f) plans is that the former usually are available to the general workforce while the latter are normally offered to upper level management.

²⁴ See Proposed Rule 2821(a)(1) (emphasis added).

applications thoroughly.²⁵ After reconsidering this issue, NASD has modified the proposal so that firms would have two business days after transmitting the application to complete their principal review.²⁶

²⁵ The version of the proposal that was published in the Federal Register in July 2005 would have required a principal to review and approve the transaction prior to transmitting a customer's application for a deferred variable annuity contract to the issuing insurance company for processing. NASD noted, however, that the timeframe for principal review and approval would have further depended on whether the principal's review occurs before or after the customer provides the member with the purchase payment for the deferred variable annuity. That is, if principal review occurred after payment had been made, additional rules may have been implicated. NASD Rule 2820(d), for instance, requires members to promptly transmit the application and the purchase payment for a variable contract to the issuing insurance company. Similarly, various financial responsibility obligations under SEC Rules 15c3-1 and 15c3-3 require certain members to promptly transfer/forward funds.

²⁶ Some commenters also ask whether the principal review needs to start but not necessarily be completed by the time specified in the rule. Under the proposed rule, the principal review must be completed within two business days of the firm's transmittal of the application to the insurance company. NASD believes that requiring completion of the principal review within this time period is necessary for the protection of investors. Requiring a thorough principal review at the early stages of the process also should promote efficiency. In most circumstances, firms would be able to determine the appropriateness of the transactions before the insurance company issues the contract.

NASD also notes that proposed Rule 2821 does not preclude firms from using automated supervisory systems (or a mix of automated and manual supervisory systems) to facilitate compliance with the Rule. Of course, firms that intend to rely on automated supervisory systems for compliance with proposed Rule 2821 must remember that, at a minimum, a principal would need to (1) approve the criteria that the automated supervisory system uses, (2) audit and update the automated supervisory system as necessary to ensure compliance with the Rule, (3) review exception reports that the automated supervisory system creates, and (4) remain responsible for each transaction's compliance with the Rule. A principal relying on such an automated supervisory system is responsible for any deficiency in the system's criteria that would result in such system not being reasonably designed to comply with proposed Rule 2821 and any other applicable rules. In addition, the firm would need to maintain and preserve the electronic analysis of the transactions in a manner consistent with NASD Rule 3110 and SEC Rules 17a-3 and 17a-4 and interpretations thereof.

Sixth, numerous commenters argue that the requirement that the firm have a reasonable basis to believe that the customer has been informed of the material features of the particular deferred variable annuity at issue should be eliminated. NASD has modified this provision so that it no longer requires product-specific disclosure. Instead, the proposal now requires that a firm and its associated persons have a reasonable basis to believe that the customer has been informed of the material features of a deferred variable annuity in general. This modification does not mean that a firm and its associated persons may ignore product-specific features, however. For instance, a customer, upon learning of the generic features of a deferred variable annuity, might very well ask the firm for additional information specific to the deferred variable annuity that he or she is considering purchasing. The firm and its associated persons must be capable of discussing the specific features of the deferred variable annuity under consideration. Furthermore, the firm and its associated persons could not adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question.²⁷

²⁷ NASD has noted in other contexts that reasonable-basis suitability is akin to a due diligence requirement. In NASD Notice to Members 03-71 (Nov. 2003), NASD stated as follows:

[P]erforming appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis. A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination . . . which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.

Seventh, some commenters question whether NASD should continue to require a showing that the customer has a long-term investment objective. NASD believes that, in general, deferred variable annuities are appropriate only for customers with long-term investment objectives who intend to take advantage of tax-deferred accumulation and annuitization. NASD recognizes, however, that some newer deferred variable annuities have shorter holding periods and smaller surrender fees than did traditional deferred variable annuities. As such, it is conceivable that, in very limited circumstances, a deferred variable annuity could be appropriate for someone who has a shorter investment horizon. Accordingly, although NASD believes it will be the rare case when a deferred variable annuity is appropriate for someone without a long-term investment objective, NASD agrees that it should not create a bright line test under the circumstances. The definitive requirement in the “Recommendation” section (paragraph (b)) that the customer must have a long-term investment objective has been deleted. In addition, the references to long-term objectives in the “Principal Review and Approval” (paragraph (c)) and “Supervisory Procedures” (paragraph (d)) sections have been eliminated. Firms are strongly cautioned, however, that they should scrutinize any deferred variable annuity transactions involving customers without long-term investment objectives and should carefully document any analysis in favor of recommending such a transaction.

Eighth, a number of commenters urge the elimination of the requirement that a firm or associated person have a reasonable basis to believe that the customer has “a need for the features of a deferred variable annuity as compared with other investment vehicles.” These commenters argue that compliance with this requirement would be very difficult. Commenters assert, for instance, that it is unclear to which other product(s) the

deferred variable annuity would need to be compared. Commenters also argue that it would be nearly impossible to determine whether a customer “needs” a particular investment vehicle. NASD did not intend to require firms to perform a side-by-side comparison of a deferred variable annuity with other investment vehicles. Nor did NASD intend to require firms to prove that the customer needed the deferred variable annuity at issue to the exclusion of all other investments. Instead, NASD intended to require firms to perform an analysis of whether the customer would benefit from the unique features of a deferred variable annuity. To clarify this issue, NASD has eliminated the references in the proposed rule to “need” and “as compared with other investment vehicles” and delineated the factors that firms should consider. The revised provision now states that a member or associated person must have a reasonable basis to believe that “the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit).”²⁸

Ninth, the requirements that members establish standards regarding age, liquidity needs or the dollar amount involved in the transaction²⁹ elicited two types of comments. Some commenters argue that NASD should mandate specific standards rather than allowing firms to create their own standards for these principal-review and supervisory

²⁸ See Proposed Rule 2821 (b)(1)(B) and (c)(1)(A).

²⁹ For example, one provision at issue required a registered principal to consider whether “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 (standard established by the member).” Another provision required the principal to consider whether “the amount of money invested exceeds a stated percentage of the customer’s net worth (standard established by the member) or is more than a stated dollar amount (standard established by the member).”

requirements.³⁰ Others question the need for such standards, whether established by firms or NASD, apparently interpreting the language as mandating creation of arbitrary lines of demarcation. The particular provisions at issue were never intended to require the adherence to bright-line standards. While conceptually appealing, the establishment of specific thresholds in these instances would unnecessarily limit a firm's discretion in establishing procedures that adequately address its overall operations. NASD did not intend to require a firm to reject all deferred variable annuity transactions involving persons over a particular age or dollar amounts over a particular level. Rather, NASD intended only that principals consider the highlighted factors as part of their review, which is a facts and circumstances inquiry. To clarify this point, NASD has deleted the language that had required firms to establish standards for age, liquidity needs and dollar amounts.

Tenth, some commenters 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 proposed rule creates requirements that will ensure that firms perform a consistent, baseline analysis of transactions, irrespective of whether the customer purchased the deferred variable annuity as a result of an associated person's recommendation, thereby enhancing investor protection for all customers.

³⁰ NASD notes that, as is true with supervisory procedures, the requirement that the standards must be reasonably designed to ensure that transactions are appropriately supervised generally prevents a firm from creating ineffective standards.

Eleventh, numerous commenters request more time to prepare for the proposed rule if the Commission approves it. NASD had previously stated that the effective date of the proposal, if approved by the Commission, would be 120 days following publication in the Notice to Members announcing Commission approval. Because some firms likely will have to make operational changes, NASD believes it is appropriate to provide additional time before the proposal would become effective if approved. As a result, NASD now provides in this amendment that, if approved by the Commission, the proposed rule's effective date will be 180 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,³¹ 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 is consistent with the provisions of the Act noted above in that it will enhance firms' compliance and supervisory systems and provide more comprehensive and targeted protection to investors in deferred variable annuities. As such, the proposed rule will decrease the likelihood of fraud and manipulative acts, promote just and equitable principles of trade and increase investor protection.

³¹ 15 U.S.C. 78o-3(b)(6).

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

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

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

The Commission published proposed Rule 2821 (SR-NASD-2004-183) in the Federal Register on July 21, 2005. The comment period closed on September 19, 2005. The Commission received nearly 1,500 comment letters in response to the Federal Register publication of the proposal. The comments are summarized above.

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.³²

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

NASD requests that the Commission find good cause pursuant to Section 19(b)(2) of the Act³³ for approving the proposed rule prior to the 30th day after its publication in the Federal Register. NASD is filing Amendment No. 2 to address comments it received after the publication of the notice of filing of the proposed rule and to amend the proposed rule. Because Amendment No. 2 is responsive to commenters' concerns and because it does not present any novel issues, NASD requests that the Commission accelerate the effectiveness of the proposed rule prior to the 30th day after its publication in the Federal Register.

³² 15 U.S.C. 78s(b)(2).

³³ 15 U.S.C. 78s(b)(2).

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

Not applicable.

9. Exhibits

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

Exhibit 2a. NASD Notice to Members 04-45 (June 2004). [Note: Exhibit 2a was submitted as part of the original rule filing and is not being resubmitted for purposes of this Amendment No. 2.]

Exhibit 2b. Index to comments received in response to NASD Notice to Members 04-45 (June 2004), submitted in hard copy. [Note: Exhibit 2b was submitted as part of the original rule filing and is not being resubmitted for purposes of this Amendment No. 2.]

Exhibit 2c. Comments received in response to NASD Notice to Members 04-45 (June 2004), submitted in hard copy. [Note: Exhibit 2c was submitted as part of the original rule filing and is not being resubmitted for purposes of this Amendment No. 2.]

Exhibit 3. Not applicable.

Exhibit 4. This exhibit shows changes proposed in Amendment No. 2 of this filing with the language proposed in the initial rule filing and Amendment No. 1 shown as if previously adopted.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

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

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule 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”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 14, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), and amended on July 8, 2005 and May 4, 2004,³ the proposed rule as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule.

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

NASD is proposing to adopt a new rule, proposed NASD Rule 2821, that sets forth recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 to SR-NASD-2004-183 replaced and superseded the text of the original rule filing filed on December 14, 2004, except Exhibit 2a, Exhibit 2b, and Exhibit 2c. Amendment No. 2 to SR-NASD-2004-183 addressed the comment letters that the Commission received in response to the publication of the proposed rule in the Federal Register and proposed amendments responsive to the comments where appropriate.

specifically to transactions in deferred variable annuities. Below is the text of the proposed rule. Proposed new language is in italics.

* * * * *

2821. Members' Responsibilities Regarding Deferred Variable Annuities

(a) General Considerations

(1) Application

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

(2) Creation, Storage and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

(A) the customer has been informed of the material features of a deferred variable annuity, such as the potential surrender period and surrender charge; potential tax penalty if the customer sells or redeems the deferred variable annuity before he or she reaches the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of a deferred variable annuity; and market risk;

(B) the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit); and

(C) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity and riders and similar product enhancements, if any, are suitable (and, in the case of an

exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by paragraph (b)(2) of this Rule.

These determinations shall be documented and signed by the associated person recommending the transaction.

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

(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 to the issuing insurance company for processing and irrespective of whether the transaction has been recommended, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider

(A) the extent to which the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit);

(B) the extent to which the customer's age or liquidity needs make the investment inappropriate;

(C) the extent to which the amount of money invested would result in an undue concentration in a deferred variable annuity or deferred variable annuities in the context of the customer's overall investment portfolio; and

(D) if the transaction involves an exchange of a deferred variable annuity, the extent to which (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose death or existing benefits, or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees and charges for riders and similar product enhancements), (ii) the customer would benefit from any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

These considerations shall be documented and signed by the registered principal who reviewed and approved the transaction.

(2) When a member or a person associated with a member has recommended the purchase or exchange of a deferred variable annuity, a registered principal, taking into account the underlying supporting documentation

described in paragraph (b)(2) of this Rule, shall review, determine whether to approve and, if approved, 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, 3013 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen the transaction and require a registered principal to consider those items enumerated in paragraph (c) of this Rule, as well as whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.

(e) Training

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

* * * * *

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

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule and discussed any comments it received on the proposed rule. 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

1. Purpose

Rule Filing History

On December 14, 2004, NASD filed with the Commission proposed Rule 2821 (SR-NASD-2004-183). NASD filed with the Commission Amendment No. 1 to the proposal on July 8, 2005. The Commission published the proposal in the Federal Register on July 21, 2005.⁴ The comment period closed on September 19, 2005. Based on comments received in response to the publication of the proposal in the Federal Register, NASD filed Amendment No. 2 to SR-NASD-2004-183 to address the comments and to make certain changes as discussed herein.

Proposal

As described in the original and amended rule filings, NASD is proposing new NASD Rule 2821, which would impose specific sales practice standards and supervisory

⁴ See Exchange Act Rel. No. 52046A (July 19, 2005), 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183); see also supra note 3.

requirements on members for transactions in deferred variable annuities.⁵ In general, NASD's guidelines on deferred variable annuity transactions, developed with substantial input from industry participants and published in Notice to Members 99-35, served as the basis for the proposed rule.

The proposed rule would apply to the purchase or exchange of a deferred variable annuity and the subaccount allocations.⁶ The proposed rule would not apply to

⁵ A variable annuity, in general, is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) ("Joint Report"); NASD Notice to Members 99-35 (May 1999). The proposed rule focuses exclusively on transactions in deferred variable annuities. NASD recognizes that transactions involving immediate variable annuities have begun to increase recently, and NASD will continue to monitor sales practices relating to these products. Currently, however, deferred variable annuities make up the majority of variable annuity transactions. Moreover, to date, most of the problems associated with transactions in variable annuities that NASD has uncovered involve the purchase or exchange of deferred variable annuities.

⁶ NASD notes that the proposed rule focuses on customer purchases and exchanges of deferred variable annuities, areas that, to date, have given rise to many of the problems NASD has uncovered. The proposed rule would thus cover a standalone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another deferred variable annuity. For purposes of the proposed rule, an "exchange" of a product other than a deferred variable annuity (such as a fixed annuity) for a deferred variable annuity would be covered by the proposed rule as a "purchase." The proposed rule would not cover customer sales of deferred variable annuities, including the sale of a deferred variable annuity in connection with an "exchange" of a deferred variable annuity for another product (such as a fixed annuity). However, recommendations of customer sales of deferred variable annuities are fully and adequately covered by Rule 2310, NASD's general suitability rule. Rule 2310 requires that, when recommending that a customer purchase, sell or exchange a security, an associated person determine whether the recommendation is suitable for the customer. In general, deferred variable annuities are suitable only as long-term investments and are inappropriate short-term trading vehicles. As part of any analysis under Rule 2310 regarding the suitability of a recommendation that a customer sell a deferred variable annuity, the associated person must consider significant tax consequences, surrender charges and loss of death or other

reallocations of subaccounts made or to funds paid 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 continue to apply to any recommendations to reallocate subaccounts.⁷

The proposed rule also would not apply to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans but would apply to the purchase or exchange of deferred variable annuities to fund IRAs. In part, NASD determined not to exclude IRAs from the proposal's coverage because, unlike transactions for tax-qualified, employer-sponsored retirement or benefit plans, investors funding IRAs are not limited to the options provided by a plan.⁸ However, even in the case of a tax-qualified, employer-sponsored retirement or benefit plan, if a member makes recommendations to individual plan participants regarding a deferred variable annuity, the proposed rule would apply as to the individual plan participants to whom the

benefits. As NASD emphasized in a Regulatory & Compliance Alert in 2002, entitled "Reminder—Suitability of Variable Annuity Sales," members and their associated persons "must keep in mind that the suitability rule applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor."

⁷ Indeed, except to the extent that specific provisions in the proposed rule would 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 would be applicable to transactions in deferred variable annuities.

⁸ NASD notes as well that a deferred variable annuity purchased to fund an IRA does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA itself. Accordingly, where a customer is purchasing a deferred variable annuity to fund an IRA, firms must ensure that the deferred variable annuity's features other than tax deferral make the purchase of the deferred variable annuity for the IRA appropriate.

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 has four main requirements. First, the proposal has requirements governing recommendations, including a suitability obligation, specifically tailored to deferred variable annuity transactions.⁹ Second, the proposal includes various principal review and approval obligations.¹⁰ Third, the proposal specifically requires members to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule.¹¹ Fourth, the proposal has a training component.¹²

NASD will announce the effective date of the proposed rule in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 180 days following publication of the Notice to Members announcing Commission approval.

Comments on the Proposed Rule

The Commission received nearly 1,500 comment letters in response to the publication of the proposed rule in the Federal Register. The commenters raise several issues that are addressed below.

⁹ See Proposed Rule 2821(b).

¹⁰ See Proposed Rule 2821(c).

¹¹ See Proposed Rule 2821(d).

¹² See Proposed Rule 2821(e).

First, a number of commenters argue that the proposed rule should be withdrawn because it is unnecessary and because NASD has not provided quantifiable proof of serious problems with transactions in deferred variable annuities.¹³ As an initial matter, NASD disagrees with the suggestion that there must be demonstrable harm before NASD can engage in rulemaking. NASD can and should be proactive whenever possible.¹⁴ Neither the Act nor public policy considerations require NASD to refrain from taking action until quantifiable data evidencing the seriousness of a problem is available.

In any event, NASD has discovered significant and reoccurring problems with transactions in deferred variable annuities and has taken an extremely measured approach in responding to them. These problems include unsuitable recommendations, misrepresentations and omissions and inadequate supervision and training. Over the course of nearly a decade, NASD has addressed these and other problems involving deferred variable annuities through non-rulemaking means on several fronts. For instance, NASD issued Notices to Members,¹⁵ Regulatory & Compliance Alerts¹⁶ and

¹³ At least one commenter also argued that the proposal would create an undue burden on competition. NASD disagrees. As further discussed herein, NASD believes there is a sound basis for the proposed rule and, as stated in Item 4, does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

¹⁴ In fact, along those lines, NASD created the “Ahead of the Curve” program that is dedicated to identifying and responding at the earliest possible stage to problems that can cause harm to investors or market integrity.

¹⁵ See, e.g., NASD Notice to Members 99-35 (May 1999) (providing guidance to assist members in developing appropriate procedures relating to variable annuity transactions); NASD Notice to Members 96-86 (Dec. 1996) (reminding members of their suitability obligations regarding variable annuity transactions).

¹⁶ In 2002, NASD issued a Regulatory & Compliance Alert, entitled “NASD Regulation Cautions Firms for Deficient Variable Annuity Communications,” that, among other things, discussed NASD’s discovery of unacceptable sales

Investor Alerts.¹⁷ These various publications included, among other things, “best practice” guidelines, suitability reminders and warnings about certain sales tactics.

Notwithstanding those efforts, many of the same problems that NASD initially sought to address through non-rulemaking means persist today. Recent joint reviews with the Commission,¹⁸ NASD examinations¹⁹ and NASD enforcement actions²⁰ indicate

practices regarding variable annuities. In another Regulatory & Compliance Alert in 2002, entitled “Reminder—Suitability of Variable Annuity Sales,” NASD emphasized, in part, that an associated person must be knowledgeable about a variable annuity before he or she can determine whether a recommendation to purchase, sell or exchange the variable annuity is appropriate.

¹⁷ In 2001, NASD issued an Investor Alert entitled “Should You Exchange Your Variable Annuity?” highlighting important issues that investors should consider before agreeing to exchange a variable annuity. In 2003, NASD issued an Investor Alert entitled “Variable Annuities: Beyond the Hard Sell,” which cautioned investors about certain inappropriate sales tactics and highlighted the unique features of these products.

¹⁸ See Joint Report, supra, note 5.

¹⁹ NASD completed 216 routine examinations involving the review of variable annuities from July 2004 to July 2005. These examinations resulted in forty-five Letters of Caution and eleven Compliance Conferences. While the majority of these actions involved the failure to establish or follow written supervisory procedures, a number of actions related to the failure to obtain and maintain customer account information, unsuitable recommendations, and the failure to comply with standards relating to communications with the public. These findings do not include cause examinations, many of which result in formal action that is captured by enforcement actions, discussed below. Nor do the findings include information from special examination initiatives.

²⁰ Just within the last few years, NASD has brought a number of important cases involving failures to supervise, suitability concerns and misrepresentation in connection with purchases and exchanges of deferred variable annuities. See, e.g., Michael Lancaster, No. E8A20040995-01 (Nov. 30, 2005) (making unsuitable recommendations regarding variable annuity subaccounts); Lawrence LaBine, No. C3A20040045 (Nov. 22, 2005) (unsuitable recommendations to five customers involving variable annuity subaccounts and mutual funds); Mansell R. Spedding, No. E0220030907 (Sept. 21, 2005) (unsuitable subaccount allocation recommendation for variable annuity); Rita N. Raymer, No. E0520030131 (Aug. 16, 2005) (unsuitable recommendations of variable annuities); NYLife Sec., Inc.,

that NASD's non-rulemaking approach has not been sufficiently effective at curbing problems in this area. Rulemaking clearly is needed.

No. E0520040104 (July 22, 2005) (failing to adequately supervise sales of variable annuities and mutual funds); Paul Olsen, No. E3A20030539 (June 23, 2005) (negligently failing to tell customers about fees associated with variable annuity exchanges); Bambi Holzer, No. E0220020787 (June 17, 2005) (negligently misrepresenting certain aspects of variable annuities); Ilene L. Sonnenberg, No. C0520050024 (May 11, 2005) (recommending unsuitable variable annuity); Raymond James & Assocs., Inc., No. C0520050020 (May 10, 2005) (finding that registered representative made unsuitable recommendations and firm failed to maintain and enforce written supervisory procedures regarding sales of variable annuities); Issetten Hanif, No. C9B20040086 (Apr. 6, 2005) (unsuitable recommendations regarding variable annuity and mutual fund exchanges); Lawrence Labine, No. E02020513 (Nov. 19, 2004) (unsuitable variable annuity recommendation); Edward Sadowski, No. C9B040102 (Nov. 17, 2004) (unsuitable variable annuity recommendation); James B. Moorehead, No. C05040073 (Nov. 11, 2004) (failing to gather suitability information for variable annuity sales); Juan Ly, No. C07040094 (Nov. 9, 2004) (unsuitable variable annuity switches and misrepresentations); Jenny Chin, No. E04030619 (Oct. 29, 2004) (misrepresentation and omissions regarding variable annuities); Glenn W. Ward, No. C05040075 (Oct. 14, 2004) (recommending unsuitable variable annuity); Bernard E. Nugent, No. C11040031 (Sept. 1, 2004) (unsuitable recommendation involving the liquidation of mutual fund shares to purchase a variable annuity); Samuel D. Hughes, No. C07040067 (Aug. 19, 2004) (unsuitable variable annuity switches, unauthorized sub-account allocations, and misrepresentations); SunAmerica Sec., Inc., No. C05040051 (July 12, 2004) (lacking adequate written supervisory procedures concerning review of variable annuity and variable universal life contracts); Jamie Engelking, No. E3A020441 (July 2, 2004) (unsuitable variable annuity recommendation); Pan-American Fin. Advisers, No. C05040034 (June 15, 2004) (failing to have adequate supervisory procedures for variable annuity sales); Scott Weier, No. E04010714 (May 27, 2004) (unsuitable variable annuity recommendations); Gregory Jurkiewicz, No. E3A030436 (May 4, 2004) (unsuitable variable annuity recommendation); Michael H. Tew, No. C05040010 (Apr. 7, 2004) (unsuitable recommendations regarding variable annuities); Steve Morgan, No. E3A020410 (Mar. 12, 2004) (unsuitable variable annuity recommendation); Donald Lacavazzi, No. C11040009 (Feb. 24, 2004) (recommending unsuitable variable annuity switching); Michael Blandchard, No. C11040005 (Feb. 16, 2004) (unsuitable variable annuity recommendations); Prudential Inv. Mgmt. and Prudential Equity Group, Inc., No. C05040008 (Jan. 29, 2004) (failing to supervise and maintain accurate records relating to variable annuity replacement sales); Waddell & Reed, Inc., No. CAF040002 (Jan. 14, 2004) (failing to ascertain suitability of recommended variable annuity exchanges and failure to supervise).

Second, some commenters request clarification of the provision providing an exclusion from the proposed rule's coverage in certain circumstances. That provision states that the proposal would "not apply to deferred variable annuity transactions made in connection with tax-qualified, employer-sponsored retirement or benefit plans that either are 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 an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member makes such recommendations." One commenter asked in particular whether the proposed rule would apply if a registered representative recommended a deferred variable annuity to an individual plan participant and the annuity was the only funding vehicle for the employer's retirement plan. If the registered representative "recommends" the deferred variable annuity, then the proposed rule would apply.²¹ It is important to remember, however, that not all communications about a deferred variable annuity would constitute a "recommendation" that triggers application of the rule.

As NASD has often emphasized in the context of its general suitability rule (Rule 2310), "Whether a particular transaction is in fact recommended depends on an analysis

²¹ Another commenter stated that the rule also should apply if the qualified plan sponsor, trustee or custodian is either unsophisticated or relies upon the firm's recommendation regarding plan-level decisions. NASD continues to believe that the rule should not apply to plan-level decisions made by sponsors, trustees or custodians of qualified retirement or benefit plans. The factors that can be important to an understanding of the appropriateness of a recommendation to a sponsor, trustee or custodian of a qualified retirement or benefit plan regarding plan-level decisions can be distinct from those that are important regarding the determination of the appropriateness of a recommendation to a retirement-plan participant.

of all the relevant facts and circumstances.”²² Nonetheless, NASD previously has announced several principles that should be considered when determining whether a particular communication could be deemed a “recommendation.”²³ For instance, a communication’s content, context and presentation will inform most determinations of whether a particular communication is a “recommendation.” Furthermore, because the determination is an objective rather than a subjective inquiry, an important consideration is whether the communication reasonably would be viewed as a “call to action,” or suggestion that the customer engage in a particular transaction. In addition, the more individually tailored a communication to a specific customer or targeted group of customers about a security or group of securities, the more likely the communication will be viewed as a “recommendation.”

Thus, a firm’s or an associated person’s individualized recommendation of a deferred variable annuity to a particular plan participant would trigger application of the proposed rule, even if the annuity were the only funding vehicle for the employer’s retirement plan. However, a firm’s generic communication to all plan participants indicating that the employer has chosen a deferred variable annuity as the funding vehicle for its retirement plan likely would not constitute a “recommendation” triggering application of the proposed rule.

Third, some commenters argue that, as with Internal Revenue Code (“IRC”) Section 457(b) plans (which, as mentioned above, are excluded from the proposal’s

²² NASD Notice to Members, For Your Information: Clarification of NASD Notice to Members 96-60 (Mar. 1997).

²³ NASD Policy Statement Regarding Application of the NASD Suitability Rule to Online Communications, NASD Notice to Members 01-23 (Apr. 2001).

coverage under certain circumstances), Section 457(f) plans should be excluded from the proposal's coverage. NASD agrees. Similar to Section 457(b) plans, Section 457(f) plans are non-qualified deferred executive compensation arrangements created by government or tax-exempt organizations that can utilize a variable annuity as a funding instrument.²⁴ The same justifications for excluding Section 457(b) plans, discussed in previous filings with the Commission, are present with regard to Section 457(f) plans. NASD therefore has amended the proposal to exclude such plans under certain circumstances described in the proposed rule's text.

Fourth, some commenters ask NASD to clarify whether the rule proposal would apply only to the initial premiums. NASD now makes this point clear in the proposal's "Application" section. The proposal has been changed as follows: the rule "does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity."²⁵

Fifth, numerous commenters question whether the proposal should require principal review prior to transmittal of the deferred variable annuity application to the issuing insurance company. Some of these commenters note that the interaction of other Commission and NASD rules potentially could limit a firm's ability to review applications thoroughly.²⁶ After reconsidering this issue, NASD has modified the

²⁴ Section 457(b) and (f) plans are deferred compensation plans available for certain state and local governments and non-governmental entities tax exempt under IRC Section 501 (non-profit organizations). The main difference between 457(b) and 457(f) plans is that the former usually are available to the general workforce while the latter are normally offered to upper level management.

²⁵ See Proposed Rule 2821(a)(1) (emphasis added).

²⁶ The version of the proposal that was published in the Federal Register in July 2005 would have required a principal to review and approve the transaction prior

proposal so that firms would have two business days after transmitting the application to complete their principal review.²⁷

Sixth, numerous commenters argue that the requirement that the firm have a reasonable basis to believe that the customer has been informed of the material features

to transmitting a customer's application for a deferred variable annuity contract to the issuing insurance company for processing. NASD noted, however, that the timeframe for principal review and approval would have further depended on whether the principal's review occurs before or after the customer provides the member with the purchase payment for the deferred variable annuity. That is, if principal review occurred after payment had been made, additional rules may have been implicated. NASD Rule 2820(d), for instance, requires members to promptly transmit the application and the purchase payment for a variable contract to the issuing insurance company. Similarly, various financial responsibility obligations under SEC Rules 15c3-1 and 15c3-3 require certain members to promptly transfer/forward funds.

²⁷ Some commenters also ask whether the principal review needs to start but not necessarily be completed by the time specified in the rule. Under the proposed rule, the principal review must be completed within two business days of the firm's transmittal of the application to the insurance company. NASD believes that requiring completion of the principal review within this time period is necessary for the protection of investors. Requiring a thorough principal review at the early stages of the process also should promote efficiency. In most circumstances, firms would be able to determine the appropriateness of the transactions before the insurance company issues the contract.

NASD also notes that proposed Rule 2821 does not preclude firms from using automated supervisory systems (or a mix of automated and manual supervisory systems) to facilitate compliance with the Rule. Of course, firms that intend to rely on automated supervisory systems for compliance with proposed Rule 2821 must remember that, at a minimum, a principal would need to (1) approve the criteria that the automated supervisory system uses, (2) audit and update the automated supervisory system as necessary to ensure compliance with the Rule, (3) review exception reports that the automated supervisory system creates, and (4) remain responsible for each transaction's compliance with the Rule. A principal relying on such an automated supervisory system is responsible for any deficiency in the system's criteria that would result in such system not being reasonably designed to comply with proposed Rule 2821 and any other applicable rules. In addition, the firm would need to maintain and preserve the electronic analysis of the transactions in a manner consistent with NASD Rule 3110 and SEC Rules 17a-3 and 17a-4 and interpretations thereof.

of the particular deferred variable annuity at issue should be eliminated. NASD has modified this provision so that it no longer requires product-specific disclosure. Instead, the proposal now requires that a firm and its associated persons have a reasonable basis to believe that the customer has been informed of the material features of a deferred variable annuity in general. This modification does not mean that a firm and its associated persons may ignore product-specific features, however. For instance, a customer, upon learning of the generic features of a deferred variable annuity, might very well ask the firm for additional information specific to the deferred variable annuity that he or she is considering purchasing. The firm and its associated persons must be capable of discussing the specific features of the deferred variable annuity under consideration. Furthermore, the firm and its associated persons could not adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question.²⁸

Seventh, some commenters question whether NASD should continue to require a showing that the customer has a long-term investment objective. NASD believes that, in

²⁸ NASD has noted in other contexts that reasonable-basis suitability is akin to a due diligence requirement. In NASD Notice to Members 03-71 (Nov. 2003), NASD stated as follows:

[P]erforming appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis. A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination . . . which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.

general, deferred variable annuities are appropriate only for customers with long-term investment objectives who intend to take advantage of tax-deferred accumulation and annuitization. NASD recognizes, however, that some newer deferred variable annuities have shorter holding periods and smaller surrender fees than did traditional deferred variable annuities. As such, it is conceivable that, in very limited circumstances, a deferred variable annuity could be appropriate for someone who has a shorter investment horizon. Accordingly, although NASD believes it will be the rare case when a deferred variable annuity is appropriate for someone without a long-term investment objective, NASD agrees that it should not create a bright line test under the circumstances. The definitive requirement in the “Recommendation” section (paragraph (b)) that the customer must have a long-term investment objective has been deleted. In addition, the references to long-term objectives in the “Principal Review and Approval” (paragraph (c)) and “Supervisory Procedures” (paragraph (d)) sections have been eliminated. Firms are strongly cautioned, however, that they should scrutinize any deferred variable annuity transactions involving customers without long-term investment objectives and should carefully document any analysis in favor of recommending such a transaction.

Eighth, a number of commenters urge the elimination of the requirement that a firm or associated person have a reasonable basis to believe that the customer has “a need for the features of a deferred variable annuity as compared with other investment vehicles.” These commenters argue that compliance with this requirement would be very difficult. Commenters assert, for instance, that it is unclear to which other product(s) the deferred variable annuity would need to be compared. Commenters also argue that it would be nearly impossible to determine whether a customer “needs” a particular

investment vehicle. NASD did not intend to require firms to perform a side-by-side comparison of a deferred variable annuity with other investment vehicles. Nor did NASD intend to require firms to prove that the customer needed the deferred variable annuity at issue to the exclusion of all other investments. Instead, NASD intended to require firms to perform an analysis of whether the customer would benefit from the unique features of a deferred variable annuity. To clarify this issue, NASD has eliminated the references in the proposed rule to “need” and “as compared with other investment vehicles” and delineated the factors that firms should consider. The revised provision now states that a member or associated person must have a reasonable basis to believe that “the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit).”²⁹

Ninth, the requirements that members establish standards regarding age, liquidity needs or the dollar amount involved in the transaction³⁰ elicited two types of comments. Some commenters argue that NASD should mandate specific standards rather than allowing firms to create their own standards for these principal-review and supervisory requirements.³¹ Others question the need for such standards, whether established by

²⁹ See Proposed Rule 2821 (b)(1)(B) and (c)(1)(A).

³⁰ For example, one provision at issue required a registered principal to consider whether “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 (standard established by the member).” Another provision required the principal to consider whether “the amount of money invested exceeds a stated percentage of the customer’s net worth (standard established by the member) or is more than a stated dollar amount (standard established by the member).”

³¹ NASD notes that, as is true with supervisory procedures, the requirement that the standards must be reasonably designed to ensure that transactions are

firms or NASD, apparently interpreting the language as mandating creation of arbitrary lines of demarcation. The particular provisions at issue were never intended to require the adherence to bright-line standards. While conceptually appealing, the establishment of specific thresholds in these instances would unnecessarily limit a firm's discretion in establishing procedures that adequately address its overall operations. NASD did not intend to require a firm to reject all deferred variable annuity transactions involving persons over a particular age or dollar amounts over a particular level. Rather, NASD intended only that principals consider the highlighted factors as part of their review, which is a facts and circumstances inquiry. To clarify this point, NASD has deleted the language that had required firms to establish standards for age, liquidity needs and dollar amounts.

Tenth, some commenters 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 proposed rule creates requirements that will ensure that firms perform a consistent, baseline analysis of transactions, irrespective of whether the customer purchased the deferred variable annuity as a result of an associated person's recommendation, thereby enhancing investor protection for all customers.

Eleventh, numerous commenters request more time to prepare for the proposed rule if the Commission approves it. NASD had previously stated that the effective date of the proposal, if approved by the Commission, would be 120 days following

appropriately supervised generally prevents a firm from creating ineffective standards.

publication in the Notice to Members announcing Commission approval. Because some firms likely will have to make operational changes, NASD believes it is appropriate to provide additional time before the proposal would become effective if approved. As a result, NASD now provides in Amendment No. 2, if approved by the Commission, the proposed rule's effective date will be 180 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule is consistent with the provisions of Section 15A(b)(6) of the Act,³² 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 is consistent with the provisions of the Act noted above in that it will enhance firms' compliance and supervisory systems and provide more comprehensive and targeted protection to investors in deferred variable annuities. As such, the proposed rule will decrease the likelihood of fraud and manipulative acts, promote just and equitable principles of trade and increase investor protection.

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

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

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

The Commission published proposed Rule 2821 (SR-NASD-2004-183) in the Federal Register on July 21, 2005. The comment period closed on September 19, 2005.

³² 15 U.S.C. 78o-3(b)(6).

The Commission received nearly 1,500 comment letters in response to the Federal Register publication of the proposal. The comments are summarized above.

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

NASD has requested that the Commission find good cause pursuant to Section 19(b)(2) of the Act³³ for approving the proposed rule prior to the 30th day after publication in the Federal Register. The Commission finds that the proposed rule is consistent with the requirements of the Act and the rules and regulations thereunder applicable to NASD and, in particular, the requirements of Section 15A of the Act and the rules and regulations thereunder. The Commission finds good cause for approving the proposed rule prior to the 30th day after the date of publication of notice of filing thereof in that accelerated approval is warranted because Amendment No. 2 is responsive to commenters concerns and does not present any novel issues, and the proposed rule will enhance firms' compliance and supervisory systems and provide more comprehensive and targeted protection to investors in deferred variable annuities.

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, or

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

³³ 15 U.S.C. 78s(b)(2).

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule 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. Please include File Number SR-NASD-2004-183 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

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 that are filed with the Commission, and all written communications relating to the proposed rule 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. 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 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.³⁴

Nancy M. Morris

Secretary

³⁴ 17 CFR 200.30-3(a)(12).

EXHIBIT 4

Exhibit 4 shows changes proposed in Amendment No. 2 of this filing with the language proposed in the initial rule filing and Amendment No. 1 shown as if previously adopted. The new language proposed in Amendment No. 2 is underlined; deletions proposed in Amendment No. 2 are bracketed.

* * * * *

2821. Members' Responsibilities Regarding Deferred Variable Annuities

(a) General Considerations

(1) Application

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

(2) Creation, Storage and Transmission of Documents

For purposes of this Rule, documents may be created, stored and

transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

[(3) Application of Other Rules]

[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, recommendations that customers sell their deferred variable annuities and recommendations that customers reallocate their subaccounts.]

[(4)](3) Definitions

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

(b) Recommendation Requirements

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

(A) the customer has been informed of the material features of [the]a deferred variable annuity, such as the potential surrender period and surrender charge; potential tax penalty if the customer sells or redeems the deferred variable annuity before he or she reaches the age of 59½; mortality and expense fees; investment advisory fees; potential charges for

and features of riders; the insurance and investment components of a deferred variable annuity; and market risk;

[(B) the customer has a long-term investment objective,]

[(C)](B) the customer [has a need for the]would benefit from the unique features of a deferred variable annuity [as compared with other investment vehicles,] (e.g., tax-deferred growth, annuitization or a death benefit); and

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

These determinations shall be documented and signed by the associated person recommending the transaction.

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

considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(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 [Prior to transmitting] a customer's application for a deferred variable annuity to the issuing insurance company for processing and [regardless] irrespective of whether the transaction has been recommended, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider [whether:]

(A) the extent to which the customer [appears to have a need for] would benefit from the unique features of a deferred variable annuity [as compared with other investment vehicles](e.g., tax-deferred growth, annuitization or a death benefit);

(B) the extent to which the customer's age or liquidity needs make [a long-term] the investment inappropriate[, such as a customer over a specific age (standard established by the member) or with a short-term investment objective (standard established by the member)];

(C) the extent to which the amount of money invested [exceeds a stated percentage of the customer's net worth (standard established by the member) or is more than a stated dollar amount (standard established by the member)] would result in an undue concentration in a deferred

variable annuity or deferred variable annuities in the context of the customer's overall investment portfolio; and

(D) if the transaction involves an exchange of a deferred variable annuity [and, if so], the extent to which [whether] (i) the customer [will]would incur a surrender charge, be subject to the commencement of a new surrender period, lose death or existing benefits, or be subject to increased [mortality and expense] fees or charges (such as mortality and expense fees, investment advisory fees and charges for riders and similar product enhancements), (ii) the customer [appears to have a need for]would benefit from any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

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

These considerations shall be documented and signed by the registered principal who reviewed and approved the transaction.

(2) When a member or a person associated with a member has recommended the purchase or exchange of a deferred variable annuity, a registered principal, taking into account the underlying supporting documentation described in paragraph (b)(2) of this Rule, shall review, determine whether to approve and, if approved, sign the suitability determination document required by paragraph (b)(1) of this Rule [prior to transmitting] 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, 3013 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen the transaction and require a registered principal to consider those items enumerated in paragraph (c) of this Rule, as well as whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.

[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 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 (standard established by the member);]

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

[(4) A deferred variable annuity exchange, considering whether (i) the customer will incur a surrender charge, be subject to the commencement of a new surrender period, lose death or existing benefits, or be subject to increased mortality and expense fees, (ii) the customer appears to have a need for any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months; and]

[(5) A deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.]

[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 reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including [liquidity issues, sales charges, fees and market risks] those described in paragraph (b)(1)(A) of this Rule.