

OMB APPROVAL

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

File No. SR - 2004 - 183
Amendment No. 3

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
☐

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
Title Associate Vice President and Associate General Counsel
E-mail jim.wrona@nasd.com
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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 11/15/2006

By Stephanie Dumont

(Name)

Vice President and Associate 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.

Stephanie Dumont,

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. 3 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. 3 is to modify further certain provisions in response to comments. 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 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

¹ 15 U.S.C. 78s(b)(1).

requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

(2) Creation, Storage, and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

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

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the

potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

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

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

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

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

fees, investment advisory fees, or charges for riders and similar product enhancements);

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

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

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

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

(c) Principal Review and Approval

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 or five business days from the transmittal date if additional contact with the customer or person associated with the member is necessary in the course of the review, a registered

principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. Subject to the exception in this paragraph, and treating all transactions as if they have been recommended for purposes of this principal review, a registered principal shall approve the transaction only if the registered principal has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule. Notwithstanding the foregoing, a registered principal may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and approved, rejected or authorized the transaction.

(d) Supervisory Procedures

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

procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

(e) Training

Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in subparagraph (b)(1)(A)(i) 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 for the first time on July 21, 2005.² The comment period closed on September 19, 2005. Based on comments received in response to the publication of the proposal in the Federal Register, on May 4, 2006, NASD filed Amendment No. 2 to SR-NASD-2004-183 to address the comments and to make certain changes. The Commission published Amendment No. 2 in the Federal Register on June 28, 2006.³ The comment period closed on July 19, 2006. NASD filed a response to comments on August 31, 2006. NASD is filing Amendment No. 3 to further explain and modify certain provisions in response to comments.

² See Exchange Act Rel. No. 52046A (July 19, 2005), 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183). The Commission did not publish the original proposal.

³ See Exchange Act Rel. No. 54023 (June 21, 2006), 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

Proposal

As described in the original rule filing and Amendments Nos. 1 and 2, NASD is proposing new NASD Rule 2821 to impose specific sales practice standards and supervisory requirements on members for transactions in deferred variable annuities, which are hybrid investments containing both securities and insurance features. 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.⁴ Second, the proposal includes principal review obligations.⁵ 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.⁶ Fourth, the proposal has a training component.⁷

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.

Additional Response to Comments and Modification of the Proposed Rule

In response to the Commission's publication in the Federal Register of NASD's Amendment No. 2 to NASD-2004-183, numerous commenters requested that NASD modify the "Principal Review and Approval" section to allow principals more than two

⁴ See Proposed Rule 2821(b).

⁵ See Proposed Rule 2821(c).

⁶ See Proposed Rule 2821(d).

⁷ See Proposed Rule 2821(e).

business days after transmittal of the application to the insurance company to review the transaction. In large part, these commenters argued that principals may require more than two business days to perform an appropriate review, especially when they need to contact customers or associated persons for additional information. In its most recent response to comments, filed on August 31, 2006, NASD did not separately address this issue because NASD had addressed it previously. Upon further consideration, however, NASD agrees that more time may be appropriate under such circumstances.

Accordingly, NASD modified the timing provision so that it now states that a principal must review and approve the transaction “[n]o 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 or five business days from the transmittal date if additional contact with the customer or person associated with the member is necessary in the course of the review .

...”⁸

A number of commenters also objected to the application of the proposed rule’s “Principal Review and Approval” requirements to non-recommended transactions (i.e.,

⁸ See Proposed Rule 2821(c). During the rulemaking process, some commenters asked whether principals must complete or simply begin their review within the timeframe established by the proposal. The principal review must be completed within the designated timeframe. A number of commenters also asked whether the timing of principal review would be impacted by a firm’s status as a “captive broker-dealer” (i.e., a broker-dealer that is owned by, a subsidiary of, or affiliated with an insurance company). NASD does not interpret Rule 2821 to mean that the application has been transmitted to the insurance company at the same time it is obtained by a person registered as a representative or principal with a “captive broker-dealer.” Rather, NASD would view transmittal as occurring when the registered representative or principal actually sends the application to the insurance company.

situations where the member is acting solely as an order taker). Some of these commenters argued that customers should be free to decide on their own whether they want to purchase or exchange a deferred variable annuity. NASD agrees that Proposed Rule 2821 should not prevent a fully informed customer from making his or her own investment decision. Accordingly, NASD is modifying the proposed rule so that a registered principal “may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity.”⁹

⁹ As with NASD’s general suitability rule, Rule 2310, Proposed Rule 2821 does not define the term “recommendation.” However, NASD has issued relevant guidance in the context of Rule 2310. For instance, in NASD For Your Information: Clarification of Notice to Members 96-60 (March 1997), NASD explained that the general suitability rule, NASD Rule 2310, applies only to securities that a broker-dealer or its associated persons “recommend” to customers. Rule 2310 does not apply when the broker-dealer is acting as a mere order taker. The Notice also stated that “recommendations may be made in a variety of ways” and “the determination of whether a recommendation has been made in any given case does not depend on the mode of communication.” The Notice concluded that the determination of “[w]hether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances. . . .” NASD For Your Information: Clarification of Notice to Members 96-60 (March 1997).

In NASD Notice to Members 01-23 (April 2001), NASD reiterated that simply effecting a trade that a customer initiated does not trigger application of the general suitability rule. NASD also reiterated that the determination of whether a particular communication constitutes a “recommendation” remains a “facts and circumstances” test. Nonetheless, Notice to Members 01-23 announced several principles that should be considered when determining whether a particular transaction could be deemed a “recommendation.” The Notice explained that a communication’s “content, context, and presentation” will inform most determinations of whether a particular communication is a “recommendation.” In addition, the Notice stated that the more individually tailored a communication to

This change allows a customer to decide to continue with the non-recommended purchase or exchange of a deferred variable annuity notwithstanding the broker-dealer's belief that the transaction would be viewed as unsuitable if it had been recommended. Nonetheless, the new requirement that the principal independently determine that the transaction was not recommended adds another layer of protection. For example, this should discourage salespersons from attempting to bypass compliance requirements for recommended sales by simply checking the "not recommended" box on a form.¹⁰ The additional requirement that customers must indicate an explicit intent to continue with the non-recommended transaction notwithstanding the unsuitability determination will help to ensure that the customer's decision is an informed one.¹¹

Some commenters also asked that we eliminate the requirement that registered principals consider "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." These commenters indicated that

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" that triggers suitability obligations. The Notice further cautioned that a series of actions that may not constitute "recommendations" when considered individually may amount to a "recommendation" when considered in the aggregate. Additionally, the Notice stated that it did not matter whether the communication was initiated by a person employed by the broker-dealer or by a computer software program used by the broker-dealer.

¹⁰ NASD's analysis indicates that the vast majority of transactions in deferred variable annuities are recommended. NASD thus expects that it will be the extremely rare case where the transaction is viewed as not recommended.

¹¹ NASD notes that Proposed Rule 2821 would not require firms to effect trades that they determine are not suitable; rather, the new provision would permit them to do so under the narrow circumstances discussed above.

the requirement was unclear and could cause confusion. Because NASD believes that other provisions already capture the important aspects of this “undue concentration” determination, NASD has eliminated it as superfluous.¹²

A number of commenters further suggested that NASD make changes to some of the language located in the “Recommendation Requirements” section of the proposed rule. For instance, a number of commenters asked NASD to clarify in the rule text that the type of disclosure required is generic and not product specific. NASD now makes that point explicit in the rule text by stating that the member or person associated with a member must have a reasonable basis to believe that “the customer has been informed, in general terms, of various features of deferred variable annuities. . . .”¹³

Numerous commenters also requested that NASD modify the requirement in the “Recommendation Requirements” section that the associated person 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).” These commenters stated that there are some other products that have features similar to those of a deferred variable annuity and they suggested that NASD eliminate the reference to

¹² For instance, the “Recommendation Requirements” section requires a determination of the suitability of the recommendation on the basis of, among other factors, the customer’s age, investment time horizon, liquidity needs, and existing assets (including investment and life insurance holdings). An associated person thus necessarily must consider whether placing all or a large percentage of a customer’s wealth in a deferred variable annuity is appropriate in light of a number of factors, including whether the investment product is liquid and whether it is foreseeable that the customer might need some or all of the funds being invested in the near future. Of course, consideration of the diversification of the subaccount investments also is subsumed within a suitability analysis involving deferred variable annuities.

¹³ See Proposed Rule 2821(b)(1)(A)(i).

“unique” features. Some also suggested that NASD include “living benefits” and not merely death benefits. After further analysis, NASD generally agrees with these suggestions and has modified the language so that it now states that the associated person must have “a reasonable basis to believe that . . . the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.”

Furthermore, a number of commenters asked that NASD clarify the provision in the “Supervisory Procedures” section dealing with associated persons who have particularly high rates of effecting deferred variable annuity exchanges. In particular, commenters wanted to know whether a principal needed to consider this factor in connection with each transaction. The answer is no. The provision stated that “the member must implement procedures to screen the transaction and require a registered principal to consider . . . whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.” The provision was intentionally placed in the “Supervisory Procedures” section rather than the “Principal Review and Approval” section to signal that a firm could perform this type of review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction. To make this point clearer, however, NASD modified the provision, which now reads as follows:

The member also must (1) implement surveillance procedures to determine if the member’s associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws (“inappropriate exchanges”) and (2) have policies and procedures reasonably designed to implement corrective measures to

address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.¹⁴

Finally, some commenters asked NASD to clarify its position regarding automated supervisory systems. 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 proposed rule or any other NASD rule. Of course, firms that intend to rely on automated supervisory systems for compliance with NASD rules, including Proposed Rule 2821, must remember that the use of an automated system does not alter a firm's responsibility for regulatory compliance—both to comply with the rules and to have systems and procedures reasonably designed to achieve compliance with NASD rules and the federal securities laws. Thus, when using an automated system, at a minimum, a principal or principals must (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, and (3) review exception reports that the automated supervisory system creates. Of course, the firm and the relevant associated persons remain responsible for each transaction's compliance with the rules and statutory provisions. A principal or principals relying on such an automated supervisory system would be responsible for any deficiency in the system's criteria that would result in such system's not being reasonably designed to comply with applicable rules and statutory provisions.¹⁵

¹⁴ See Proposed Rule 2821(d).

¹⁵ The firm also 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.

NASD notes, however, that a firm need not designate only one principal to perform these tasks. Consistent with NASD Rules 3010 and 3012, a firm generally is free to allocate supervisory responsibilities among its qualified, registered principals as appropriate (whether in the context of automated or manual supervisory reviews). Thus, a firm may, for example, designate several principals to be responsible for various parts of an automated supervisory system.

Firms must ensure, however, that they provide training for (1) the firm's relevant associated persons on how to correctly input information into the firm's automated supervisory systems and (2) the firm's principals responsible for reviewing and approving deferred variable annuity transactions on how to utilize and interpret the reports generated by the firm's automated supervisory systems in order to properly review and monitor deferred variable annuity transactions.

The foregoing discussion is not meant to imply that automated surveillance, when conducted as noted, is an inferior form of supervision. To the contrary, NASD believes that automated surveillance can be very beneficial. Nor is the discussion meant to impose a standard for review of deferred variable annuities only. NASD believes that the principles discussed above generally should inform determinations of whether a particular automated supervisory system is appropriate regardless of the rule at issue.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁶ which requires, among other things, that NASD rules

¹⁶ 15 U.S.C. 78o-3(b)(6).

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.

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 proposed Rule has been published for comment on three occasions—once in an NASD Notice to Members before NASD filed the proposal with the Commission and twice in the Federal Register after NASD filed it with the Commission.¹⁷ Most recently, NASD reviewed and analyzed a number of comments filed in response to the Commission's publication in the Federal Register of NASD's Amendment No. 2 to SR-NASD-2004-183.¹⁸ In brief, NASD has sought and received extensive feedback from

¹⁷ See NASD Notice to Members 04-45 (June 2004); Exchange Act Rel. No. 52046A (July 19, 2005), 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183); Exchange Act Rel. No. 54023 (June 21, 2006), 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

¹⁸ See Exchange Act Rel. No. 54023 (June 21, 2006), 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

participants in the securities and insurance industries, as well as the public at large, and NASD has analyzed and addressed numerous issues as part of that process.¹⁹ Indeed, the significant changes that NASD has made to the proposed rule at each step in the process, including here via Amendment No. 3, evidence NASD's careful and thoughtful consideration of the issues that commenters have raised.

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.²⁰

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 Act²¹ for approving the proposed rule prior to the 30th day after its publication in the Federal Register. NASD is filing Amendment No. 3 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. 3 is responsive to commenters' concerns, NASD requests that the Commission accelerate the effectiveness of the proposed rule prior to the 30th day after its publication in the Federal Register.

¹⁹ See NASD's Response to Comments, dated August 31, 2006, Filed in Response to Publication of Amendment No. 2. See also NASD's Original Rule Filing, SR-NASD-2004-183, at 14-19 (Dec. 14, 2004); NASD's Amendment No. 1 to SR-NASD-2004-183, at 17-22 (July 8, 2005); Amendment No. 2 to SR-NASD-2004-183, at 36-48 (May 4, 2006).

²⁰ 15 U.S.C. 78s(b)(2).

²¹ 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. 3.]

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. 3.]

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. 3.]

Exhibit 3. Not applicable.

Exhibit 4. This exhibit shows changes proposed in Amendment No. 3 of this filing with the language proposed in the initial rule filing and Amendments Nos. 1 and 2 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 Change 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, May 4, 2006, and November 15, 2006,³ the proposed rule change 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 change from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

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. Amendment No. 3 to SR-NASD-2004-183 further modified certain provisions in response to comments.

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

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 specifically to transactions in deferred variable annuities. Below is the text of the proposed rule change. 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 or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant

to whom the member or person associated with the member makes such recommendations.

(2) Creation, Storage, and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

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

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

insurance and investment components of deferred variable annuities; and market risk;

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

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

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

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

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

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

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

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

(c) Principal Review and Approval

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 or five business days from the transmittal date if additional contact with the customer or person associated with the member is necessary in the course of the review, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. Subject to the exception in this paragraph, and treating all transactions as if they have been recommended for purposes of this principal review, a registered principal shall approve the

transaction only if the registered principal has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule. Notwithstanding the foregoing, a registered principal may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and approved, rejected or authorized the transaction.

(d) Supervisory Procedures

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

(e) Training

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

* * * * *

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

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

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

1. Purpose

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 for the first time on July 21, 2005.⁴ The comment period closed on September

⁴ See Exchange Act Rel. No. 52046A (July 19, 2005), 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183). The Commission did not publish the original proposal.

19, 2005. Based on comments received in response to the publication of the proposal in the Federal Register, on May 4, 2006, NASD filed Amendment No. 2 to SR-NASD-2004-183 to address the comments and to make certain changes. The Commission published Amendment No. 2 in the Federal Register on June 28, 2006.⁵ The comment period closed on July 19, 2006. NASD filed a response to comments on August 31, 2006. NASD filed Amendment No. 3 on November 15, 2006 to further explain and modify certain provisions in response to comments. The modifications proposed by Amendment No. 3 are detailed in the following discussion.

Proposal

As described in the original rule filing and Amendments Nos. 1 and 2, NASD is proposing new NASD Rule 2821 to impose specific sales practice standards and supervisory requirements on members for transactions in deferred variable annuities, which are hybrid investments containing both securities and insurance features. 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.⁶ Second, the proposal includes principal review obligations.⁷ Third, the proposal specifically requires members to establish and maintain

⁵ See Exchange Act Rel. No. 54023 (June 21, 2006), 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

⁶ See Proposed Rule 2821(b).

⁷ See Proposed Rule 2821(c).

written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule.⁸ Fourth, the proposal has a training component.⁹

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.

Additional Response to Comments and Modification of the Proposed Rule

In response to the Commission's publication in the Federal Register of NASD's Amendment No. 2 to NASD-2004-183, numerous commenters requested that NASD modify the "Principal Review and Approval" section to allow principals more than two business days after transmittal of the application to the insurance company to review the transaction. In large part, these commenters argued that principals may require more than two business days to perform an appropriate review, especially when they need to contact customers or associated persons for additional information. In its most recent response to comments, filed on August 31, 2006, NASD did not separately address this issue because NASD had addressed it previously. Upon further consideration, however, NASD agrees that more time may be appropriate under such circumstances. Accordingly, NASD modified the timing provision so that it now states that a principal must review and approve the transaction "[n]o 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 or five

⁸ See Proposed Rule 2821(d).

⁹ See Proposed Rule 2821(e).

business days from the transmittal date if additional contact with the customer or person associated with the member is necessary in the course of the review”¹⁰

A number of commenters also objected to the application of the proposed rule’s “Principal Review and Approval” requirements to non-recommended transactions (i.e., situations where the member is acting solely as an order taker). Some of these commenters argued that customers should be free to decide on their own whether they want to purchase or exchange a deferred variable annuity. NASD agrees that Proposed Rule 2821 should not prevent a fully informed customer from making his or her own investment decision. Accordingly, NASD is modifying the proposed rule so that a registered principal “may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity.”¹¹

¹⁰ See Proposed Rule 2821(c). During the rulemaking process, some commenters asked whether principals must complete or simply begin their review within the timeframe established by the proposal. The principal review must be completed within the designated timeframe. A number of commenters also asked whether the timing of principal review would be impacted by a firm’s status as a “captive broker-dealer” (i.e., a broker-dealer that is owned by, a subsidiary of, or affiliated with an insurance company). NASD does not interpret Rule 2821 to mean that the application has been transmitted to the insurance company at the same time it is obtained by a person registered as a representative or principal with a “captive broker-dealer.” Rather, NASD would view transmittal as occurring when the registered representative or principal actually sends the application to the insurance company.

¹¹ As with NASD’s general suitability rule, Rule 2310, Proposed Rule 2821 does not define the term “recommendation.” However, NASD has issued relevant guidance in the context of Rule 2310. For instance, in NASD For Your Information: Clarification of Notice to Members 96-60 (March 1997), NASD

This change allows a customer to decide to continue with the non-recommended purchase or exchange of a deferred variable annuity notwithstanding the broker-dealer's belief that the transaction would be viewed as unsuitable if it had been recommended. Nonetheless, the new requirement that the principal independently determine that the transaction was not recommended adds another layer of protection. For example, this should discourage salespersons from attempting to bypass compliance requirements for

explained that the general suitability rule, NASD Rule 2310, applies only to securities that a broker-dealer or its associated persons "recommend" to customers. Rule 2310 does not apply when the broker-dealer is acting as a mere order taker. The Notice also stated that "recommendations may be made in a variety of ways" and "the determination of whether a recommendation has been made in any given case does not depend on the mode of communication." The Notice concluded that the determination of "[w]hether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances. . . ." NASD For Your Information: Clarification of Notice to Members 96-60 (March 1997).

In NASD Notice to Members 01-23 (April 2001), NASD reiterated that simply effecting a trade that a customer initiated does not trigger application of the general suitability rule. NASD also reiterated that the determination of whether a particular communication constitutes a "recommendation" remains a "facts and circumstances" test. Nonetheless, Notice to Members 01-23 announced several principles that should be considered when determining whether a particular transaction could be deemed a "recommendation." The Notice explained that a communication's "content, context, and presentation" will inform most determinations of whether a particular communication is a "recommendation." In addition, the Notice stated that 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" that triggers suitability obligations. The Notice further cautioned that a series of actions that may not constitute "recommendations" when considered individually may amount to a "recommendation" when considered in the aggregate. Additionally, the Notice stated that it did not matter whether the communication was initiated by a person employed by the broker-dealer or by a computer software program used by the broker-dealer.

recommended sales by simply checking the “not recommended” box on a form.¹² The additional requirement that customers must indicate an explicit intent to continue with the non-recommended transaction notwithstanding the unsuitability determination will help to ensure that the customer’s decision is an informed one.¹³

Some commenters also asked that we eliminate the requirement that registered principals consider “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.” These commenters indicated that the requirement was unclear and could cause confusion. Because NASD believes that other provisions already capture the important aspects of this “undue concentration” determination, NASD has eliminated it as superfluous.¹⁴

A number of commenters further suggested that NASD make changes to some of the language located in the “Recommendation Requirements” section of the proposed

¹² NASD’s analysis indicates that the vast majority of transactions in deferred variable annuities are recommended. NASD thus expects that it will be the extremely rare case where the transaction is viewed as not recommended.

¹³ NASD notes that Proposed Rule 2821 would not require firms to effect trades that they determine are not suitable; rather, the new provision would permit them to do so under the narrow circumstances discussed above.

¹⁴ For instance, the “Recommendation Requirements” section requires a determination of the suitability of the recommendation on the basis of, among other factors, the customer’s age, investment time horizon, liquidity needs, and existing assets (including investment and life insurance holdings). An associated person thus necessarily must consider whether placing all or a large percentage of a customer’s wealth in a deferred variable annuity is appropriate in light of a number of factors, including whether the investment product is liquid and whether it is foreseeable that the customer might need some or all of the funds being invested in the near future. Of course, consideration of the diversification of the subaccount investments also is subsumed within a suitability analysis involving deferred variable annuities.

rule. For instance, a number of commenters asked NASD to clarify in the rule text that the type of disclosure required is generic and not product specific. NASD now makes that point explicit in the rule text by stating that the member or person associated with a member must have a reasonable basis to believe that “the customer has been informed, in general terms, of various features of deferred variable annuities. . . .”¹⁵

Numerous commenters also requested that NASD modify the requirement in the “Recommendation Requirements” section that the associated person 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).” These commenters stated that there are some other products that have features similar to those of a deferred variable annuity and they suggested that NASD eliminate the reference to “unique” features. Some also suggested that NASD include “living benefits” and not merely death benefits. After further analysis, NASD generally agrees with these suggestions and has modified the language so that it now states that the associated person must have “a reasonable basis to believe that . . . the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.”

Furthermore, a number of commenters asked that NASD clarify the provision in the “Supervisory Procedures” section dealing with associated persons who have particularly high rates of effecting deferred variable annuity exchanges. In particular, commenters wanted to know whether a principal needed to consider this factor in connection with each transaction. The answer is no. The provision stated that “the

¹⁵ See Proposed Rule 2821(b)(1)(A)(i).

member must implement procedures to screen the transaction and require a registered principal to consider . . . whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.” The provision was intentionally placed in the “Supervisory Procedures” section rather than the “Principal Review and Approval” section to signal that a firm could perform this type of review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction. To make this point clearer, however, NASD modified the provision, which now reads as follows:

The member also must (1) implement surveillance procedures to determine if the member’s associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws (“inappropriate exchanges”) and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.¹⁶

Finally, some commenters asked NASD to clarify its position regarding automated supervisory systems. 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 proposed rule or any other NASD rule. Of course, firms that intend to rely on automated supervisory systems for compliance with NASD rules, including Proposed Rule 2821, must remember that the use of an automated system does not alter a firm’s responsibility for regulatory compliance—both to comply with the rules and to have systems and procedures reasonably designed to achieve compliance with

¹⁶ See Proposed Rule 2821(d).

NASD rules and the federal securities laws. Thus, when using an automated system, at a minimum, a principal or principals must (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, and (3) review exception reports that the automated supervisory system creates. Of course, the firm and the relevant associated persons remain responsible for each transaction's compliance with the rules and statutory provisions. A principal or principals relying on such an automated supervisory system would be responsible for any deficiency in the system's criteria that would result in such system's not being reasonably designed to comply with applicable rules and statutory provisions.¹⁷

NASD notes, however, that a firm need not designate only one principal to perform these tasks. Consistent with NASD Rules 3010 and 3012, a firm generally is free to allocate supervisory responsibilities among its qualified, registered principals as appropriate (whether in the context of automated or manual supervisory reviews). Thus, a firm may, for example, designate several principals to be responsible for various parts of an automated supervisory system.

Firms must ensure, however, that they provide training for (1) the firm's relevant associated persons on how to correctly input information into the firm's automated supervisory systems and (2) the firm's principals responsible for reviewing and approving deferred variable annuity transactions on how to utilize and interpret the reports

¹⁷ The firm also 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.

generated by the firm's automated supervisory systems in order to properly review and monitor deferred variable annuity transactions.

The foregoing discussion is not meant to imply that automated surveillance, when conducted as noted, is an inferior form of supervision. To the contrary, NASD believes that automated surveillance can be very beneficial. Nor is the discussion meant to impose a standard for review of deferred variable annuities only. NASD believes that the principles discussed above generally should inform determinations of whether a particular automated supervisory system is appropriate regardless of the rule at issue.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁸ 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.

¹⁸ 15 U.S.C. 78o-3(b)(6).

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

The proposed Rule has been published for comment on three occasions—once in an NASD Notice to Members before NASD filed the proposal with the Commission and twice in the Federal Register after NASD filed it with the Commission.¹⁹ Most recently, NASD reviewed and analyzed a number of comments filed in response to the Commission's publication in the Federal Register of NASD's Amendment No. 2 to SR-NASD-2004-183.²⁰ In brief, NASD has sought and received extensive feedback from participants in the securities and insurance industries, as well as the public at large, and NASD has analyzed and addressed numerous issues as part of that process.²¹ Indeed, the significant changes that NASD has made to the proposed rule at each step in the process, including here via Amendment No. 3, evidence NASD's careful and thoughtful consideration of the issues that commenters have raised.

¹⁹ See NASD Notice to Members 04-45 (June 2004); Exchange Act Rel. No. 52046A (July 19, 2005), 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183); Exchange Act Rel. No. 54023 (June 21, 2006), 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

²⁰ See Exchange Act Rel. No. 54023 (June 21, 2006), 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

²¹ See NASD's Response to Comments, dated August 31, 2006, Filed in Response to Publication of Amendment No. 2. See also NASD's Original Rule Filing, SR-NASD-2004-183, at 14-19 (Dec. 14, 2004); NASD's Amendment No. 1 to SR-NASD-2004-183, at 17-22 (July 8, 2005); Amendment No. 2 to SR-NASD-2004-183, at 36-48 (May 4, 2006).

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

NASD has requested that the Commission find good cause pursuant to Section 19(b)(2) of the Act²² for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Commission finds that the proposed rule change 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 change prior to the 30th day after the date of publication of notice of filing thereof in that accelerated approval is warranted because Amendment No. 3 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 change, or

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

²² 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 change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. 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 change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for

inspection and copying in the Commission's Public Reference Room. 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.²³

Nancy M. Morris

Secretary

²³ 17 CFR 200.30-3(a)(12).

EXHIBIT 4

Exhibit 4 shows changes proposed in Amendment No. 3 of this filing with the language proposed in the initial rule filing and Amendments Nos. 1 and 2 shown as if previously adopted. The new language proposed in Amendment No. 3 is underlined; deletions proposed in Amendment No. 3 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 that either is defined as a “qualified plan” under Section 3(a)(12)(C) of the Securities Exchange Act of 1934 or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

(2) Creation, Storage, and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

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

(i[A]) the customer has been informed, in general terms, of [the material] various features of [a] deferred variable annuities[y], such as the potential surrender period and surrender charge; potential tax penalty if [the] customers sell[s] or redeem[s] the deferred variable annuities[y] before [he or she] reaching[es] 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 annuities[y]; and market risk;

(ii[B]) the customer would benefit from certain [the unique] features of [a] deferred variable annuities[y], such as [(e.g.,] tax-deferred growth, annuitization, or a death or living benefit[]]; and

(iii[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 subparagraph (b)(2) of this Rule; and

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

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

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

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

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

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

(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 or five business days from the transmittal date if additional contact with the customer or person associated with the member is necessary in the course of the review, [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. Subject to the exception in this paragraph, and treating all transactions as if they have been recommended for

purposes of this principal review, a registered principal shall approve the transaction only if the registered principal has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule. Notwithstanding the foregoing, a registered principal may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and approved, rejected or authorized the transaction. [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,] [t]The member also must (1) implement surveillance procedures to [screen the transaction] determine if the member's associated persons have [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] rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

(e) Training

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

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