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August 9, 2004

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

Notice to Members 04-45
Proposed Rule Governing the Purchase,
Sale, or Exchange of Deferred Variable Annuities

Dear Ms. Sweeney:

In its Notice to Members 04-45, the NASD¹ invited its members and other interested persons to submit comments on a proposed rule that would impose new supervision requirements for solicitations of variable annuity purchases (the "Proposed Rule").

These comments are submitted on behalf of clients of our firm that provide investment products and administrative services to employer-sponsored defined contribution retirement plans, many of which are funded through deferred annuity contracts issued by our clients or affiliates of our clients. We have principally advised these clients regarding the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code") applicable to such retirement plans. Over the course of these representations, we have become very familiar with the manner in which these plans are established and administered, including the manner in which investment options are selected for such plans and how the investment directions of plan participants are implemented.

¹ For convenience, this letter refers to both the National Association of Securities Dealers, Inc. and NASD Regulation as the "NASD".

For purposes of this letter, we use the term “tax-qualified plan” as encompassing pension and profit-sharing plans qualified under section 401(a) of the Code, annuity plans meeting the requirements of sections 403(a) and 403(b) of the Code, and eligible deferred compensation plans under section 457(b) of the Code. Many of these plans are subject to the requirements of Title I of ERISA, as well as the Code, but some are subject only to the applicable requirements of the Code.

Among these plan types, there are many differences in applicable compliance requirements, plan design, categories of employer and employee contributions, administrative and funding structures, and the manner in which annuity contracts are used as funding vehicles. In some cases, the employers sponsoring the plans have chosen annuity contracts, or a particular company’s annuity contracts, as the exclusive funding vehicles for their plans, while in other cases eligible employees have a choice between annuity contracts and other qualifying funding vehicles that the employer has approved. It would not be practical to separately address each of these variations in this comment letter, and we do not undertake to do so. However, inasmuch as our clients only distribute annuity contracts to tax-qualified plans that are defined contribution plans, these comments are not intended to address the funding of defined benefit plans with annuity contracts.

As a preliminary matter, we point out that an employer-sponsored retirement plan provides tax-deferred accumulations for participating employees only if it is funded through an annuity contract or other qualifying funding vehicle (*i.e.*, a trust or custodial account with a qualifying custodian). That is, the investment of plan assets in an annuity contract is one means of achieving tax deferral for such a plan, not of replicating tax deferral that inheres in the plan itself. Therefore, the statement in the preamble to the Proposed Rule, that annuity contracts do not provide any tax-deferral benefits that are “additional” to those provided by “the tax-qualified plan itself,” rests on a basic legal misconception. This is equivalent to saying that a diesel engine provides no “additional” performance than a car “itself;” different engines are more or less suitable for different cars, but without any engine, a car itself does not perform. This point was addressed in detail in a letter that we sent to the NASD on September 30, 1999, in response to Notice 99-35, a copy of which is attached.

Although these comments are not intended to dwell on this point, we would hope the NASD will correct this misconception when the Proposed Rule is adopted and in any future pronouncements addressing the tax consequences of annuity contracts held under tax-qualified retirement plans. Nor is it the purpose of these comments to contend that variable annuity contracts are always appropriate investments for tax-qualified retirement plans or for all participants in such plans. Rather, our principle purpose is to address the legal and administrative requirements associated with the establishment and administration of employer-sponsored tax-qualified retirement plans. These requirements, which are not adverted to in the Proposed Rule, are one of the main reasons why many employers have chosen to fund their retirement plans through annuity contracts. By addressing these requirements, we hope to

explain why much of the Proposed Rule has no meaningful or workable application to sales of annuity contracts as funding vehicles for employer-sponsored plans, including the fact that broker approval of plan participants' investment decisions would conflict with qualification and compliance requirements under the Code and ERISA that are applicable to many such plans.

Selection of Annuity Contracts as Funding Vehicles for Employer-Sponsored Defined Contribution Plans

In most instances, the deferred annuity contracts used as funding vehicles for employer-sponsored defined contribution plans are combination fixed and variable contracts, *i.e.*, contracts that enable plan participants to allocate and reallocate their account balances among a menu of investment options that the employer has approved for its plan, including the issuing company's general asset account (under which interest is credited to account balances at specified rates) and a range of variable investment options. The deferred annuity contracts may be in the form of group annuity contracts issued to the sponsoring employer as group contractholder (with participation certificates issued to participating employees) or individual contracts issued in the name of participating employees. In every case, it is the sponsoring employer's responsibility to decide whether the plan will be funded through deferred annuity contracts, whether exclusively or in part, and if so, the type or types of annuity contracts to be used.

In our experience, an employer's decision to fund a defined contribution plan through deferred annuity contracts, rather than establishing a trust (or, in those instances where it is permissible under the Code and ERISA, a custodial account with an approved custodian) reflects a variety of considerations. The pure insurance features of deferred annuity contracts, *i.e.*, the right to annuitize for lifetime income payments and the guarantee of death benefits, are one consideration, and we expect this consideration will become increasingly important. That is, as more and more employers have established defined contribution plans as primary retirement plans for their employees, there is growing awareness of the challenges associated with converting defined contribution accumulations into a source of retirement income that plan participants cannot outlive. In addition, the Code and ERISA require certain types of defined contribution plans to provide life annuities (joint and survivor annuities in the case of married participants) as the normal form of benefit, and the funding of such plans through annuity contracts assures that the plan fiduciary does not have to shop for annuities when participants who do not elect out of that normal benefit form retire and commence receiving distributions.

In many instances, however, we believe the non-insurance features of funding a plan with annuity contracts are of equal or greater importance to employers, and legitimately so. One major reason why employers choose to fund tax-qualified defined contribution plans with annuity contracts is to facilitate plan administration and regulatory compliance, with a regulated institution bearing responsibility for account maintenance, recordkeeping, and many

aspects of regulatory compliance. The overwhelming majority of employers lack the expertise, staffing, systems, and other resources needed to administer a tax-qualified retirement plan. The necessary plan services provided by our clients include participant education and enrollment, allocating payroll-based contributions among the accounts of participating employees and their selected investment options, monitoring contribution limits and processing corrective distributions of excess contributions, processing transfers between investment options, ongoing account maintenance and recordkeeping, preparation of account statements for participants, nondiscrimination testing, loan administration, processing benefit distributions in accordance with plan terms, including monitoring compliance with the distribution restrictions and minimum distribution requirements of the Code obtaining spousal waivers as required by the Code and ERISA, review of qualified domestic relations orders, tax withholding and reporting, preparation of account statements for participants, preparation of required annual reports and/or certified financial information to be reflected in annual reports to enable plans to perform limited scope audits pursuant to ERISA, and the preparation of original and amended plan documents that satisfy the applicable requirements of the Code and ERISA.

For many plans funded with annuity contracts, most, and in some cases substantially all, of these administrative and compliance requirements are woven into the terms of the annuity contracts themselves, and thus it is the responsibility of the issuing life insurance company to carry out these requirements as part of its contractual undertakings under the annuity contracts. In addition to the plan administration and compliance requirements that are embedded in the terms of annuity contracts, life insurance companies and their affiliates commonly provide many of these plan services at no incremental cost, or at a cost that is much lower than what other service providers would charge. The benefit of such no-cost or low-cost administrative services inures to the benefit of participating employees, not just sponsoring employers. Under ERISA, costs incurred in the administration of a plan may be paid out of plan assets, with the consequence of reducing the rates of investment return credited to participants. Furthermore, an employer that would otherwise pay administrative costs out of its own assets, might be economically constrained to make a lower level of employer contributions to the plan, or choose not to maintain a plan at all. Therefore, even if an employer's selection of an investment vehicle for its plan was governed wholly by rate-of-return and cost considerations, it would be irrational for an employer not to consider the administrative economies that are commonly achieved when a plan is funded through annuity contracts.

However, there are often less tangible, but no less significant, reasons why employers choose to fund their tax-qualified retirement plans with annuity contracts issued by life insurance companies. An employer that chooses to fund its plan with annuity contracts issued by a single life insurance company may do so to obtain a "turnkey" package of investments products and plan administration services from a single, reputable, financially sound institution, rather than having to shop for multiple product and service providers, with the attendant risk that no single provider is squarely responsible for administrative problems that

may arise. Similarly, an employer may choose to fund its plan with the annuity contracts of a particular life insurance company because of the quality of service that the life insurance company and its affiliates are known to provide. In the plan context it matters, and most employers know that it matters, whether providers can reliably answer the questions that they and their employees have and are available to do so.

Further, a life insurance company that issues an annuity contract is permanently obligated to carry out its contractual obligations to plan participants and beneficiaries as long as any of them remain alive, even if the employer no longer maintains the plan or continues to exist. Unlike a trustee or custodian, a life insurance company cannot resign or agree to continue to hold plan assets only if it receives higher compensation. In other words, the employer knows that it does not have to do anything to assure that the annuity contract will remain in place and that the life insurance company will remain legally obligated to plan participants and beneficiaries thereunder. We note in this regard that there is a widespread problem with so-called “orphan” plans established by employers that have gone out of business or abandoned their fiduciary responsibilities, leaving directed trustees and custodians without direction or legal authority to make distributions to plan participants; while some of the same problems can arise with certain plans that are funded with annuity contracts, there are many other cases where the life insurance company’s obligations to plan participants are fully spelled out in the annuity contract, directly enforceable by plan participants against the life insurance company, and not subject to the control of a plan fiduciary.

Lastly, an employer may choose to fund its plan exclusively with annuity contracts because no other providers are willing to commit to compliance with tax-qualification requirements. In particular, public school systems that maintain retirement savings plans under section 403(b) of the Code commonly require providers of investment products to provide “hold harmless” agreements, under which the sponsoring employers and participating employees are held harmless and indemnified against adverse tax consequences resulting from failures to satisfy applicable tax qualification requirements. Although section 403(b) programs may be funded with mutual funds held in custodial accounts by qualifying custodians, as well as with annuity contracts, it is not unusual for section 403(b) program to be funded exclusively with annuity contracts because other potential product providers decline to enter into “hold harmless” agreements.

Key Distinctions Between Plan Sales and Individual Sales of Variable Annuity Contracts

Against this background, we would like to focus on three key respects in which the sale of variable annuity contracts to fund employer-sponsored tax-qualified retirement plans differs from sales to individual investors. Each of these distinctions, in our view, bears materially on whether the Proposed Rule would have meaningful or workable application to sales for employer-sponsored plans.

1. The decision to fund a tax-qualified retirement plan with annuity contracts, rather than through investments held in a trust or custodial account, rests with the employer sponsoring the plan, and it is appropriate for the employer to make that decision by reference to considerations beyond the investment and insurance features of annuity contracts. A tax-qualified retirement plan is never funded with annuity contracts unless the employer makes that decision. Under certain types of plans, an employer may allow eligible employees to have their (or the employer's) plan contributions made to annuity contracts or to other funding vehicles, but it is never possible for a participating employee to choose to have contributions made to an annuity contract unless the employer has approved such contracts as one of the funding vehicles for its plan. Beyond deciding whether its plan will be funded with annuity contracts, sponsoring employers typically approve, and under ERISA-covered plans have a fiduciary obligation to approve, the particular investment options under the variable annuity contracts that are available to eligible employees under the employer's plan. That is, while eligible employees are generally given the right to decide how plan contributions on their behalf will be allocated among the investment options available under employer-sponsored defined contribution plans, the investment vehicles and menu of underlying investment options are subject to the control of the sponsoring employer.

The Proposed Rule does not appear to contemplate the employer's plan-level funding decisions, and it is completely unclear whether or how the Proposed Rule is intended to apply to variable annuity transactions at the plan level. A number of questions arise. Are such plan-level funding decisions within the scope of the Proposed Rule? If so, is an employer that sponsors a tax-qualified plan considered a "customer"? If the employer is a customer, do the suitability criteria listed in paragraph (a)(2) of the Proposed Rule have any applicability to the employer or should other criteria apply? In the case of a plan-level transaction, is there intended to be a requirement that a broker "look through" the employer and seek to obtain the demographic and personal financial information listed in paragraphs (a)(2) with respect all or a cross-section of eligible employees? If so, how would this be done, and if such information could be obtained, how would the differing personal circumstances of different employees be taken into account in reviewing the appropriateness of the employer's plan level funding decision?

We do not mean to suggest that an employer making that decision should not consider the appropriateness of funding its plan through an annuity contract, taking account of the fees imposed under the annuity contracts, as well as the appropriateness of the investment options made available to eligible employees under the annuity contracts. On the contrary, at least in the case of ERISA-covered plans, the sponsoring employer has a fiduciary obligation to prudently select the investment vehicles and investment options available under its plan, and fees are properly part of the evaluation that a plan fiduciary must make. However, it would be unreasonable, and contrary to the best interests of plan participants and their beneficiaries, to suggest that an employer's plan-level investment decisions should be based exclusively on those considerations. As stated by the Department of Labor:

In this regard, the plan fiduciaries must consider, among other things, any costs or fees associated with investments, and their effect on investment returns to the plan participants and beneficiaries. If a particular group of funds managed by a single investment firm is offered as part of an arrangement that includes custodial, record-keeping or other administrative services that are charged to the plan, the plan fiduciaries must also consider the cost and quality of such services, and the cost of discontinuing such an arrangement, relative to other comparable programs or separately procured services and funds [PWBA Letter (11/26/1997).]

The fact remains, however, that the Proposed Rule does not address, and seems inapposite to, these plan-level funding decisions.

2. In general, applicable Code and ERISA rules require that all employees eligible to participate in a tax-qualified defined contribution plan be given the right to select any investment option available under the plan, and neither the employer nor any third party has discretionary authority to prevent an eligible employee from selecting a particular investment option. It is the longstanding position of the Internal Revenue Service that a tax-qualified retirement plan must be administered in accordance with the terms of the plan document. *See, e.g.,* Rev. Proc. 2003-44, 2003-25 I.R.B 1051, § 5.01(2)(b). Similarly, the fiduciary responsibility provisions of ERISA require the fiduciary of an ERISA-covered plan to administer the plan in accordance with the documents and instruments governing the plan. ERISA § 404(a)(1)(D). Thus, if investment options under a plan were made available only to certain participants or classes of participants, or available to any participant only if approved by the plan sponsor or a third party with administrative responsibilities under the plan, those conditions would need to be spelled out with particularity in the plan document.

However, even if the plan document expressly provided that participant investment selections were subject to approval by a plan representative or other third party, the existence of such a plan provision would pose significant compliance issues under the Code and ERISA. Under the nondiscrimination rules of 401(a)(4) of the Code, the rights of plan participants to direct investments and to particular forms of investment (which include particular investment options under variable annuity contracts as well as the right to have allocations directed to annuity contracts if other investment vehicles are available to plan participants) are “rights and features” that must be made available under the plan to a classification of employees that does not discriminate in favor of highly compensated employees. Treas. Reg. §§ 1.404(a)(4)-4(a), (b), and (e)(3)(iii)(B) and (C). Thus, for example, if a sponsoring employer or a third party exercising authority over investments on behalf of plan participants undertook to limit the utilization of certain investment options by lower paid and less sophisticated plan participants, there would be a significant risk that the nondiscrimination requirement would be violated. If a tax-qualified plan failed to satisfy this nondiscrimination requirement, the plan as a whole would be subject to disqualification, prejudicing the interests of all participants. For this

reason, we are not aware of any plan documents for tax-qualified plans subject to section 401(a)(4) that impose such a limitation on the right of participants to direct their investments under the plan.

Section 401(a)(4) is not the only nondiscrimination requirement of the Code which constrains employers to give eligible employees the right to make contributions to annuity contracts without employer or third-party intervention. Under section 403(b)(12)(A)(ii), none of an eligible employer's employees may make tax-deferred salary reduction contributions under a section 403(b) arrangement unless all of the employer's employees are accorded that right. Therefore, in the numerous cases where employer-sponsors of section 403(b) plans have approved no funding vehicles other than annuity contracts, no employees would be permitted to make tax-deferred salary reduction contributions if any employees were denied the right to make salary reduction contributions to annuity contracts. The "universal availability" requirement of Code section 403(b)(12)(A)(ii), like the nondiscrimination requirement of section 401(A)(4), requires that eligible employees actually have the right to choose and to implement their choices. Thus, the fact that an employee's right to make the contribution to the annuity contract was interdicted by a third-party broker, rather than the employer, would not alter the consequences.

Independent of the Code's nondiscrimination requirements, section 404(c) of ERISA poses another serious obstacle to such intervention in employee investment directions. Section 404(c), which applies to participant-directed defined contribution plans, provides that no plan fiduciary shall be liable for any loss which results from a participant's or beneficiary's exercise of control over the investments allocated to his account. Understandably, a very high percentage of employer-sponsored defined contribution plans that are subject to ERISA are designed and administered to satisfy the requirements of section 404(c). Among other requirements, the regulations under section 404(c) unequivocally provide that section 404(c) applies only if the plan fiduciaries are obligated to comply with a participant's or beneficiary's investment directions and only with respect to transactions for which a participant or beneficiary has in fact exercised independent control over the investment in his individual account. DOL Reg. §§ 2550.404c-1(b)(2)(i)(A) and (c)(1)(i).

The Proposed Rule cannot be reconciled with these requirements of the Code and ERISA. If the Proposed Rule were confined to variable annuity transactions resulting from the recommendations of members, then eligible employees could exercise the investment rights accorded to them pursuant to the Code and ERISA without receiving member recommendations, and there would be no inherent conflict between the Proposed Rule and the requirements of the Code and ERISA. However, paragraph (c) of the Proposed Rule requires a registered principal to review and approve a variable annuity application "regardless of whether the transaction has been recommended." We urge the NASD to consider whether this aspect of the Proposed Rule can be applied to participant investment directions under employer-sponsored plans.

3. In the case of employer-sponsored tax-qualified plans, the broker is typically given no authority over employees' investment decisions, and it would be inappropriate for brokers to exercise control over employees' plan participation rights. In the context of the employer-sponsored plans addressed in this letter, a broker may have little or no direct contact with the plan participants for whom variable annuity contracts (or other securities) are purchased and no realistic access to the personal information that the Proposed Rule expects to have considered. Although purchases and sales of variable annuities are effected by broker-dealers, employer sponsored plans commonly give participants the opportunity to make investment selections from the plan's menu of investment electronically on a 24/7 basis, with investment directions taking effect each business day without human intervention or any opportunity for anyone to review or withhold approval. It is unclear to us whether the Proposed Rule would apply in such contexts and, if so, how it would apply. Once again, this is a particular quandary where no representative of a member has recommended the purchase of a variable annuity, but the Proposed Rule would nonetheless require supervisory approval.

Moreover, even in those circumstances where participating employees do have direct contact with representatives of a broker when applying for an annuity contract, the Proposed Rule does not address the circumstance where a plan is funded exclusively with annuity contracts, and thus an eligible employee must apply for an annuity contract to participate in the plan at all. Some such plans are funded solely through elective salary reduction contributions, while others call for nonelective employee contributions, employer matching contributions, or employer contributions based on a percentage of compensation. Apart from the Code and ERISA implications, it would be extraordinary if a broker was given or assumed the right to deny an eligible employee the opportunity to participate in such a plan. We can only assume that the Proposed Rule was not intended to go that far. However, because the Proposed Rule nowhere addresses the rights accorded to eligible employees under employer-sponsored plans, it fails to provide any guidance on how a broker should take such rights into account.

Conclusion

The principle purpose of this letter is to call attention to the problems that the Proposed Rule would pose for variable annuity sales in the context of employer-sponsored retirement plans, not to recommend specific modifications of the Proposed Rule. One reason that we are not making specific recommendations is that our expertise is rooted in the requirements of the Internal Revenue Code and ERISA applicable to employer-sponsored plans, not the requirements of the securities laws or the regulatory regime for broker-dealers.

From our vantage point, however, it appears that mere modification or fine-tuning of the Proposed Rule will not be sufficient to make it workable and meaningful in its application to most variable annuity sales in the context of employer-sponsored plans. For this reason, we would urge the

NASD to exclude variable annuity sales for employer-sponsored plans from the scope of this rule and solicit comments regarding suitability and review standards for such sales with a view toward adopting a separate rule for such sales.

Very truly yours,

A handwritten signature in black ink, appearing to read "R. Skillman", with a long, sweeping horizontal line extending to the right.

Richard W. Skillman

RWS/ih
Enclosure

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September 30, 1999

Mr. Thomas M. Selman
Vice President
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NASD Regulation
1735 K Street, N.W., 9th Floor
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Re: NASD Notice to Members 99-35

Dear Mr. Selman:

This letter is written to call your attention to certain misconceptions that appear to underlie the views set forth in NASD Notice to Members 99-35, as it relates to the suitability of variable annuity contracts as investments for tax-favored retirement plans. This letter is written from our perspective as tax and ERISA attorneys who have worked with a wide variety of retirement plans, including many that are funded with variable annuity contracts. It is not intended to comment generally on Notice 99-35 or to address suitability or disclosure standards applicable to broker/dealers under the securities laws.

We think that Notice 99-35 paints an oversimplified picture of the benefits provided by variable annuity contracts, and it does not deal at all with the considerable differences among the types of retirement arrangements sanctioned by the Internal Revenue Code, and the varying needs of the employers that sponsor and the employees who participate in

such plans. While we would scarcely contend that every form of variable annuity contract is a sensible investment for every form of retirement plan sanctioned by the Code, we think the one-size-fits-all form of disclosure urged by Notice 99-35 is potentially misleading and would be ill-advised in many cases.

As a threshold matter, Notice 99-35 reflects the mistaken premise that variable annuity contracts “do not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself.” That is just not correct. While deferral of income taxes is a core benefit of every form of funded retirement program that is sanctioned by the Internal Revenue Code, tax deferral is never provided by the “plan itself.” Tax deferral can only be achieved if plan assets are invested through an annuity contract or held under another investment vehicle that is authorized under the Code and, if applicable, ERISA. The Internal Revenue Code and ERISA generally mandate that the investments of a funded retirement plan be held in a trust or through an annuity contract. In certain cases, plan investments may instead be held in a custodial account with a bank or IRS-approved non-bank custodian.¹ Notably, however, the annuity contract is the only investment vehicle that Congress has authorized for every form of Code-sanctioned retirement plan.²

With reference to Notice 99-35, the key point is that the investment of plan assets in an annuity contract is a means of achieving tax deferral, not of replicating tax deferral that somehow inheres in the plan itself. If a plan establishes a trust which qualifies for tax exemption pursuant to Code, and if the trust in turn invests in an annuity contract, then the tax deferral provided by the annuity contract would be redundant of that of the trust; but except for that rather atypical situation, it is incorrect to say that annuity contracts do not provide tax

¹ Such custodial accounts are permitted for (i) IRAs, (ii) plans for the self-employed persons which are not subject to ERISA, and (iii) governmental and church plans not subject to ERISA.

² In the case of Section 403(b) plans for employees of educational and charitable organizations under section 403(b) of the Code, the only permissible investment vehicles are annuity contracts and custodial accounts that hold shares of regulated investment companies; except for certain church-sponsored plans under section 403(b), section 403(b) does not authorize a plan to be funded through a trust.

deferral for tax-qualified retirement plans. Therefore, if a registered representative were to “disclose . . . that the tax deferred accrual feature of the variable annuity is unnecessary,” as recommended by Notice 99-35, that disclosure could mislead or at least confuse the customer. It would be more accurate and helpful for a plan sponsor to understand that the purchase of an annuity contract is not the only way that tax-deferred investments may be made under a tax-qualified plan.

Our second major concern with Notice 99-35 is reflected in the statement that a registered representative should recommend a variable annuity “only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.” This seems to reflect the view that the choice of a variable annuity contract over other funding vehicles for a tax-qualified plan can be rationally justified only by reference to the annuity contract’s insurance features. While the insurance features of a variable annuity contract are valuable and certainly should be taken into account, Notice 99-35 completely ignores the significant administrative burdens associated with the operation of a tax-qualified retirement plan, which can have a material bearing on a plan sponsor’s decision to fund a plan through an annuity contract.

In the first place, if the alternative to an annuity contract is a trust, someone must agree to serve as trustee, with the attendant fiduciary responsibilities of that position. Since employers and their key employees are often unwilling to assume those responsibilities, that typically means that a bank or trust company must be engaged to serve as trustee.³ However, many banks and trust companies decline to serve as trustees for ERISA plans or will do so only for very large plans or only for certain customers. And while many of the mutual fund families have affiliated trust companies that are prepared to serve as passive trustees for small and medium-sized plans, they will generally do so only if plan assets are invested exclusively in the mutual funds of that family. By contrast, where a plan is funded through the purchase of a variable annuity contract, the law does not require a trustee, and the issuing life

³ In general, corporations other than banks and trust companies are prohibited by state law from exercising trust powers and thus may not serve as trustees, except for plans maintained for their own employees.

insurance company does not impose any fee under the annuity contract corresponding to the fees imposed by banks for the trusteeship or custody of plan assets. Moreover, for the fees that are imposed under a variable annuity contract, the issuing life insurance company may provide an array of other services that the employer would have to perform in-house or pay someone else to perform if it established a trustee plan. Those services include the processing of contributions, maintenance of individual accounts, processing participants' investment allocations, preparation of periodic statements for participants, disbursement of benefits, tax withholding and reporting on benefit disbursements, and administration of participant loans. In some cases, the value of those services may be far more significant to the employer and plan participants than the value of lifetime income payments and family protection through guaranteed death benefits that the annuity contract provides. However, as we read Notice 99-35, a registered representative who adhered to the notice would not advise his or her customer to give any weight to these considerations.

Notice 99-35 also fails to address the value of educational and advisory services that may be provided to plan sponsors and participants. It is easy to disparage or devalue the advisory services provided by insurance agents, as some do, on the ground that insurance agents are typically paid on a commission basis. However, that does not alter the fact that it is usually essential for the sponsoring employer and its employees to have access to some knowledgeable person who can explain how the plan works and what is and what is not allowed. We have seen cases in which employers have paid tens of thousands of dollars to consultants and/or other advisors in connection with the establishment and maintenance of their plans without considering whether they could get the same advisory and participant counseling services as part of the cost of a variable annuity contract. Of course, some insurance agents are much more knowledgeable and provide better educational services than others, but the same is true of consultants, attorneys, and all other service providers. However, those insurance agents who have a clear understanding of the relevant tax and ERISA rules and who are responsive to the questions and needs of the sponsoring employer and its employees can provide advice and information that is vital to the lawful and successful operation of a tax-favored retirement plan, and they generally do so without charging separate fees.

All of the points discussed in this letter revolve around the central fact that establishing and maintaining a tax-favored retirement plan involves much more than merely identifying the securities or other plan investments that are likely to provide the best investment yields or combination of investment yields and insurance benefits. The great majority of employers that sponsor tax retirement plans also need the supporting services of one or more qualified service providers, which may include life insurance companies, banks, consulting firms, recordkeepers, and third-party administrators. In those cases where a life insurance company (or its affiliates) is prepared to perform such services in conjunction with the issuance of a variable annuity contract, there are a number of reasons why an employer might reasonably choose to fund its plan through a variable annuity contract instead of establishing a trust and procuring administrative services from other third parties:

- the employer may prefer to contract with a single provider of investments and support services rather than having to select, monitor the performance, and review the contracts of multiple service providers;
- the employer and participants may want the security of dealing with a regulated entity and that will remain contractually obligated to pay benefits to employees even if the employer ceases to exist;
- the employer may want to give its employees the right to allocate all or part of their account balances to a fixed investment option backed by an insurance company's general asset account as well as to allocate their account balances among variable investment options;
- the employer may want to avoid the inconvenience and burden of "shopping" for annuity contracts from life insurance companies when participants elect to receive benefits in the form of life annuities and joint and survivor annuities;
- the employer may believe that the life insurance company's representatives will provide better or more attentive participant education services than other available service providers; or
- the overall cost of the investments and services provided by the life insurance company under the variable annuity contract may be equal to or less than the cost of obtaining comparable investment alternatives and services from any other qualified service provider or group of service providers.

Once again, our point is not that variable annuity contracts should necessarily be preferred over other investment vehicles for tax-favored plans. However, before rejecting a variable annuity contract as a funding vehicle for its tax qualified plan, we think a sponsoring employer would be well advised to give consideration to many more factors than countenanced by Notice 99-35.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard W. Skillman". The signature is fluid and cursive, with a large, stylized "R" and "S".

Richard W. Skillman

RWS/jk