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VIA EMAIL

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

Re: NASD NTM 04-45 -- Request for Comment on Proposed Rule
Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities

Dear Sir or Madam:

I am writing in response to the Request for Comment on Notice to Members 04-45, the Proposed Rule governing deferred variable annuity sales practices. My comments are based on this law firm's experience, since July 1998, in investigating, filing, and prosecuting class actions on behalf of purchasers of deferred variable annuities against the life insurance companies that issued and sold the annuities, for fraud and other claims.¹

¹ Recent litigation decisions include *Nelson v. Pacific Life Insurance Co.*, 2004 U.S. Dist. LEXIS 13499 (S.D. Ga. July 12, 2004) (holding that plaintiffs may proceed with federal securities fraud claims against life insurance company that marketed variable annuities to investors funding IRAs and other qualified plans without adequate point-of-sale disclosures; insurance company's duty to disclose based on its role as principal for the solicitation and sale of variable annuities through its agents); *Drnek v. The Variable Annuity Life Insurance Co.*, 2004 U.S. Dist. LEXIS 9490 (D. Ariz. May 4, 2004) (denying insurance company's motion for summary judgment and holding that there was sufficient evidence of breach of duty of fair dealing by the insurer's sales agents, including the duty to disclose the information described in NASD NTM 99-35, to support claims of securities fraud); and *American United Life Ins. Co. v. Douglas*, 808 N.E.2d 690 (Ind. App. 2004) (unanimously affirming trial court ruling, on interlocutory appeal from denial of insurance

Deferred variable annuities, which are essentially mutual funds sold through insurance companies,² are prone to abusive sales practices. Because of the special tax and securities law treatment of the product, insurers can capture, through opaque pricing,³ the additional charges collectible in the market due to the tax advantages of the product, and share that benefit with their sales agents and distribution partners, while evading numerous important investor protections of the federal securities law through the use of the “insurance company” exemption found in Section 3(c)(3) of the Investment Company Act of 1940 (“1940 Act”).⁴ *See* 15 U.S.C. § 80a-3(c)(3).⁵

company’s motion for summary judgment on plaintiffs’ fraud claims, that defendants had a duty of fair dealing under state common law to disclose that the tax advantages of a variable annuity are unnecessary for qualified plan investors). For further information, see www.milbergweiss.com.

² *See generally*, Thompson, “Nonqualified Deferred Variable Annuities: A Product in Search of a Coherent Theory,” 79 North Dakota Law Rev. 439 (2003) (showing how deferred variable annuities are “completely at odds with sound behavioral economic principles”).

³ On an actuarial basis, the main insurance charge, *i.e.* the mortality and expense risk charge, is nearly all profit to the insurer. The insurance feature that conveys the tax deferral advantage, the pre-determined contract rates for purchasing an annuity payout, *see* 26 U.S.C. § 817(g), have nil economic value and no cost to the insurer. We have seen in litigation that the insurers’ risk of paying benefits is considered immaterial and ignored by company pricing actuaries and valuation actuaries, as well as by reinsurers and the state insurance regulators. The “expense risk,” *i.e.* the solemn promise by the insurer that it will bear the loss if the contract charges paid by the annuity owner to the insurer are insufficient to cover the insurer’s expenses, is illusory, in light of the enormous revenues the insurers typically obtain from the underlying mutual funds in the annuity (ultimately paid by the annuity owner), through revenue sharing, directed brokerage, soft dollar and other arrangements with mutual fund management companies, which are ethically dubious (and of questionable legality, given that the money from the mutual funds is invariably used for distribution expenses, without conforming to the requirements of SEC Rule 12(b)(1)).

⁴ *See, e.g.*, NASD NTM 97-48 (discussing in detail the “ineffectual” efforts of both the SEC and the NASD to conform variable annuities to the limits on excessive distribution charges and other conventions of the securities laws, due to the claims of the insurance industry that the insurance

We applaud the leadership the NASD has demonstrated in addressing deferred variable annuity sales abuses, including in NTM 96-86, NTM 97-27, and NTM 99-35, and the major enforcement actions NASD has undertaken in this area, such as *American Express Financial Advisors*, No. CAF020057 (NASD Letter of Acceptance, Waiver and Consent) (Nov. 19, 2002) (sanctions for omissions of material facts in variable annuity sales where “tax deferral, which is one of the primary benefits of variable annuities, is already provided by the qualified plan or account,” including sales transactions occurring prior to the promulgation of NASD NTM 99-35 in May 1999, and stating that NTM 99-35 is a reminder of pre-existing duties).

We believe the Proposed Rule will enhance NASD enforcement of existing standards, but we are skeptical that the new mandatory supervisory procedures (including principal review of a suitability analysis document) will deter inappropriate recommendations. Variable annuity commissions are too high, relative to mutual fund commissions, for compliance procedures to be effective in deterring unsuitable or abusive sales.⁶ Similarly, the economic incentives for life insurance companies to focus their efforts on selling “insurance” that rarely pays any claims are

components of variable annuities are outside the jurisdiction of the securities laws). The 1996 Amendments to the 1940 Act, requiring representations in separate account registration statements that variable annuity fees are reasonable in the aggregate, do not purport to resolve the jurisdictional issues, and have been an ineffective regulatory tool. *See* 15 U.S.C. § 80a-26(f)(2)(A).

⁵ An “insurance company” is defined to be a company “whose primary and predominant business activity is the writing of insurance.” 15 U.S.C. § 80a-2(a)(17).

⁶ “So when a client walks in with a \$1 million inheritance, you earn \$320 to stick it in a T-Bill, \$2,500 in your average mutual fund, or \$50,000 in a variable annuity. You make the call.” Greta, “For Brokers, It Pays to Be Honest,” *TheStreet.com* (Dec. 4, 1997) (observations of a former stockbroker).

too alluring.⁷ *Variable annuity sellers will continue to have the upper hand in the investment marketplace so long as the product has exemptions from many of the investor protections of the federal securities laws that are applicable to mutual funds.*⁸ Effective reform would appear to require that the tax laws treat mutual funds sold through insurance companies the same as mutual funds sold directly,⁹ and the treatment of all components of variable annuities as securities, with the issuers subject to the same 1940 Act regulation as mutual funds.

Comment on the Proposed Rule

Roughly half of variable annuities are sold to fund qualified plans, and there is little indication that such investors understand that they are paying a premium price for a tax shelter feature they already enjoy automatically in their qualified plan. This is an area of flagrant investor deception and abuse.

⁷ “[O]ur products have little mortality risk.” Eli Broad, then chairman and CEO, SunAmerica Inc., quoted in Charles E. Schmidt, Jr., “Industry Leaders Heeding Wake Up Call,” *Best’s Review - Life/Health Edition*, February 1996 at 34.

⁸ “On a balmy evening earlier this month in Rancho Mirage, Calif., near Palm Springs, [talk show host Jay Leno, featured speaker at the National Association for Variable Annuities’ annual marketing conference] asked people in the audience what kind of car they drive. To contented laughter, one after another called out: ‘Mercedes, Mercedes, Mercedes.’ ‘This is truly the Golden Age of variable annuities,’ beamed Mark J. Mackey, NAVA President and CEO.” Parrish, “Variable Annuity Business Moves Into the Fast Lane,” *Investment News*, February 14, 2000 at 19.

⁹ The public policy rationale that supports providing tax incentives to persons who elect lifetime income payments would be better advanced by allowing any investor, not just persons investing through deferred annuities, the right to purchase a payout annuity in a tax-free transaction with a carryover of tax basis. If the purpose of tax deferral for deferred annuities is to encourage retirement savings generally (as it seems to be, since annuitization is not required), it would be far more rational for lawmakers to relax the existing eligibility limitations and contribution limits on existing qualified plans, than to squander those tax subsidies on providing the insurance industry with a costly monopoly in tax deferred mutual funds.

We strongly urge alteration of terminology in the Proposed Rule in its references to variable annuities sold as an investment for any “tax-qualified retirement account” (which appear in connection with considerations for principal review and the criteria for broker/dealer supervisory procedures to screen for and require a registered principal’s review) (this “account” terminology has also appeared in NASD NTM 99-35 and other NASD pronouncements). Use of this technically inaccurate or imprecise terminology, while understandable, has inspired some variable annuity sellers to contend, in litigations and arbitrations with buyers, that NASD is only concerned about the sale of variable annuities inside “custodial accounts.” Custodial accounts are required for mutual funds, bank CDs, and other investments, but the tax code provides, with respect to all qualified plans, that an endorsement to an annuity contract (and other forms of contracts issued by life insurance companies) that satisfies the requirements of the qualified plan is treated the same as a custodial arrangement.¹⁰ Accordingly, insurance companies do not need to place variable annuities sold to fund qualified plans in separate custodial accounts, since the insurance company itself is the custodian.¹¹

¹⁰ Congress has provided, with respect to each of the qualified retirement plans, that *either* custodial accounts administered by certain non-natural persons *or* certain contracts administered by life insurance companies will satisfy the form requirements. *See* 26 U.S.C. § 401(f) (“a custodial account, an annuity contract, or a contract (other than a life, health or accident, property, casualty, or liability insurance contract) issued by an insurance company qualified to do business in a State shall be treated as a qualified trust”); 26 U.S.C. §403(b), 403(b)(7) (providing for annuity contracts or custodial accounts); 26 U.S.C. § 408(a), (b) and (h) (annuity contracts, endowment contracts, and custodial accounts); 26 U.S.C. § 457(g)(3) (“custodial accounts and contracts described in section 401(f) shall be treated as trusts under rules similar to the rules under section 401(f)”).

¹¹ Payout annuities are a form of distribution option for all qualified plans, and thus it is not remarkable that the tax code needs to, and does, specifically address the custodial arrangements for commercially sold annuities. Naturally, IRS approval of the custodial form as meeting the

NASD's intent in NTM 99-35, and the NASD enforcement actions following NTM 99-35, would be effectively nullified if the NASD's terminology ("tax-qualified retirement account") is taken to refer only to custodial accounts (because qualified plan investors with variable annuities do not have separate custodial accounts).

Accordingly, *the Proposed Rule should use the terminology "tax-qualified plan or arrangement," rather than "account,"* to avoid this ambiguity. Moreover, it would be useful for NASD to clarify, at some point in the promulgation of the Proposed Rule, its intent that the use of the word "account" in earlier NASD pronouncements was a generic reference to qualified plans and arrangements, without regard to the custodial form.¹²

statutory requirements has no bearing on the merits of the investment. *See* 26 C.F.R. § 1.408-6(d)(4)(iii)(B)(11) ("The Internal Revenue Service approval is a determination only as to the form of the account, annuity, or endowment contract, and does not represent a determination of the merits of such account, annuity, or endowment contract.").

¹² The NASD should also consider clarifying the ambiguities created by NASD Investor Alert -- "Variable Annuities: Beyond the Hard Sale" (May 27, 2003) -- which refers to IRAs funded by variable annuities as "Individual Retirement Accounts," which is not technically accurate, since the tax code provides that insurers do not use custodial accounts (annuities, endowments, and other contracts with insurance companies that have an IRA endorsement are referred in the tax code as Individual Retirement Annuities). The Investor Alert goes on to warn that "[s]ome variable annuity providers sell what is termed an Individual Retirement Annuity (IRA). You should be aware that this "IRA" is not an Individual Retirement Account (IRA). The Internal Revenue Service sets specific restrictions regarding Individual Retirement Annuities, which are not met by all annuity products." This is puzzling because (i) there does not appear to be any market problem with variable annuity companies failing to get the proper approval from the IRS for their contract endorsements to sell variable annuities for funding IRAs; and (ii) it is not just "some" insurers that sell annuities for Individual Retirement Annuities, that is the usual arrangement for annuities sold for IRAs. The Investor Alert is subject to an interpretation that NASD is only concerned by variable annuities inside Individual Retirement Accounts (i.e. custodial accounts), when in fact the custodial arrangements have no bearing on the harm to investors of using an expensive tax shelter product to fund an IRA.

Alternative Approaches

NTM 04-45 requests comments on alternative approaches to regulation. We offer the following suggestions:

- *Place Responsibility on the Insurance Company's Distributor.* The variable annuity industry is highly concentrated.¹³ It would be more efficient and effective to regulate the small number of insurance companies that account for nearly all variable annuities sales, through their broker/dealer distributors. These broker/dealers are the appropriate parties to ensure that policies and procedures are in place throughout the distribution system that will prevent, detect and correct sales practices abuses.¹⁴ The insurance company has superior knowledge about the economic values of its products, and the financial resources to enforce its sales compliance requirements. Indeed, the rationale that the life insurance companies give for high commissions is that the product has a complicated selling process and it is difficult to find suitable buyers. So, as a matter of contract right, buyers can reasonably expect that the life insurance company,

¹³ Recent industry statistics show that the top 25 variable annuities issuers have 94.8% of all sales. The top 10 issuers have 69% of the market. Based on assets, the top 25 issuers have a 93.04% market share.

¹⁴ Under state insurance law, all parties involved in the solicitation and sale of variable annuities are acting on an agency basis on behalf of the life insurance company. Also, most life insurance companies selling variable annuities are members of the Insurance Marketplace Standards Association, pursuant to which their ultimate sales supervisory responsibilities are affirmed.

that was paid for providing the service of a suitable sale, actually has effective procedures in place to ensure suitable sales, and it is appropriate for the NASD to require it.¹⁵

- *Require Individualized Dollar Disclosure of Insurance Charges.* Americans are the best shoppers in the world, and the people who travel across town to save three cents a gallon on gasoline are often the very same individuals who are paying thousands to variable annuity companies for annuity insurance of no relevance to them. It is the regulatory framework that has failed investors; the people are capable of excellent shopping skills when the facts are meaningfully disclosed. The reform most consistent with market regulation is disclosure. The current disclosures are inadequate because asset-based fees are not treated as a shareholder expense, which confuses buyers into believing that they are not paying with their own money (a belief encouraged by net performance reporting). Insurance charges are essentially unregulated by the federal securities laws. Accordingly, it is therefore appropriate for NASD to single out the insurance charges as unregulated charges to be subject to enhanced disclosure at the point of sale, as an annualized individual dollar amount based on the investment, and depicted

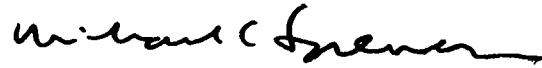
¹⁵ When they seek to divert attention from their sales and marketing activities, the insurance companies refer to themselves as “product manufacturers” and “issuers.” But the fact is that the bulk of the activity at the insurance company level is marketing and sales promotion. These activities often reflect a pure sales culture (i.e. teaching the registered representatives how to look for large 401(k) plan rollovers when people change jobs to get a “big ticket” variable annuity sale), that is incompatible with the suitable recommendations duties of the registered representatives. Accordingly, it is also appropriate that the NASD recognize that no broker/dealer distribution activity should be immune from scrutiny. The current arrangements, whereby the insurance company’s distributor broker/dealer often claims not to be responsible for sales compliance, notwithstanding their role in conceiving, orchestrating, ratifying, affirming and benefiting from improper sales strategies, is unacceptable.

as a shareholder expense as a dollar deduction annually on account statements. An investor with \$750,000 in a rollover IRA and 1.4% in variable annuity insurance charges would see a deduction on their account statement for roughly \$10,500 for “insurance” at the end of each year, which would likely cause some questions to be asked that otherwise never get addressed.

- *Promulgate Mandatory Standards of Suitability by Product.* Since the insurance companies know the economic values of their products, it makes most sense for the insurers to implement standards of suitability. For instance, a variable annuity with a death benefit might have a suitability standard that says the product is most suitable for someone who plans who own it for more than 20 years, to reach a cross-over point where the tax deferral advantage exceeds the high fees (well in excess of the actuarial value of the death benefit), and has a need for the death benefit, perhaps because they are terminally ill and cannot purchase life insurance (that would pay a tax free death benefit). Recommendations that do not meet these suitability factors for persons who would benefit from the product would be subject to “exception” handling and enhanced scrutiny. In the case of annuities with guaranteed minimum income benefits (GMIB), the standard of suitability would include a determination that the person intended to annuitize (which might be news to most of the people sold these products). The NASD should require such standards of suitability, to be maintained by the insurers’ broker/dealer distributor, and standardized suitability factors communicated to sales agents, and

suitability exceptions recorded in writing and made part of the application for the contract to the insurance company.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Michael C. Spencer". The signature is fluid and cursive, with a long horizontal stroke at the end.

Michael C. Spencer