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NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, D.C. 20006-1500

Re: NASD Notice to Members 04-45 relating to
Deferred Variable Annuity Sales Practices

The Securities Industry Association (SIA) [1] is pleased to submit comment on the referenced Notice to Members ("Notice") which seeks input regarding proposed new rules governing deferred variable annuity sales practices and supervisory procedures ("Rule Proposal"). In general, the Rule Proposal attempts to codify certain guidance previously issued in NASD Notice to Members 99-35, as well as impose new requirements governing written disclosure and principal review of variable annuity transactions. Notably, although NASD recognizes that a large segment of the industry offers deferred variable annuities in a manner consistent with NASD's existing rules and guidance, NASD nevertheless points to an increased number of disciplinary actions and regulatory examination deficiencies in the area of variable annuity sales among the justifications for the Rule Proposal.

I. Executive Summary

SIA commends NASD for undertaking to provide the investing public with more comprehensive, user-friendly disclosure regarding the operation, market risks and costs associated with variable annuity transactions. SIA has long espoused improved investor disclosure, which we believe to be vital to the industry's ongoing commitment to ensuring public trust and confidence in our markets. Accordingly, SIA supports and welcomes regulatory efforts to strengthen and build upon already existing sound business practices in order to ensure that investors are provided with clear, meaningful information regarding the unique features of variable annuity products.

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

SIA also understands and shares NASD's concerns about certain firms' unsuitable recommendations and inadequate supervision of transactions in deferred variable annuities. In that regard, SIA applauds NASD's vigorous enforcement program in this area. We suggest, however, that NASD's enforcement success demonstrates that the existing rules are effective and that an aggressive enforcement program is the appropriate regulatory tool to address issues that arise with regard to specific violations. Broad-brush rules that would have a significant adverse economic impact on the broker-dealer community without measurable improvement in the ability of investors to make informed decisions is not the proper solution.

SIA cannot support the current form of the proposal because we believe it to be duplicative, expensive and potentially counterproductive to investors seeking relevant, clear, and easy to understand information about the material aspects of an investment in variable annuities. As detailed below, we have serious concerns about the proposed separate disclosure document, principal review provision, and suitability parameters, all of which we respectfully request that NASD reconsider. Instead, we ask NASD to give consideration to SIA's suggested alternatives, which we believe satisfy the NASD's important objectives without producing the disadvantages of the Rule Proposal. In all events, we welcome the opportunity to assemble a Joint Industry Advisory Group representing a cross-section of firms to assist the NASD staff in exploring any or all of the issues we raise herein.

II. Disclosure and Prospectus Delivery

Among the most problematic aspects of the Rule Proposal is the requirement that members create and deliver to their clients, together with the prospectus, a separate risk disclosure document (the "Risk Disclosure") describing the main features of the particular variable annuity transaction. This Risk Disclosure, which is to be "brief" and in "plain-English," must include, among other things, the various fees and costs, market risks, and tax implications of the specific deferred variable annuity transaction. In addition, prior to any exchange or replacement of a deferred variable annuity, the firm must also provide customers, in writing, (i) a summary of all significant differences between the existing and proposed annuity; (ii) a description of the surrender charges that may be assessed on the existing contract and those applicable to the proposed contract; (iii) a description of the costs associated with purchasing a new contract; and (iv) an explanation of the possibility of modifying or adjusting the existing contract to meet the customer's objectives rather than replacing the contract (the "Replacement Disclosure").

A. The Risk Disclosure May Distract Investors From Other Important Information Contained in the Prospectus

Although clearly well intended, the mandatory Risk Disclosure misses the mark and indeed, may be detrimental to the Rule Proposal's principle goal of enhanced, pointed disclosure to investors. As proposed, the Risk Disclosure must contain a litany of complex, fairly detailed information, ranging from product specific fees and charges, to potential market risks, to federal, state and local tax information with regard to the specific deferred variable annuity transaction. Notwithstanding firms' best efforts to simplify and condense the disclosures, the Risk Disclosure -- even when written in plain English-- will naturally evolve into a lengthy and redundant recitation of prospectus information that certainly will present its

own challenges to investors trying to gain a better understanding of the product. In the end, instead of improving the quality of disclosure to investors, the Risk Disclosure may overwhelm and confuse investors.

More importantly, because the prospectus already identifies and explains many of the specified product features that would be the subject of the Risk Disclosure, a duplicative "summary" document also may have the unintended consequence of suggesting that the supplemental information deserves more weight and consideration than other prospectus information. Such a result not only runs afoul of the Rule Proposal's intended purpose, it undermines the role of the prospectus as the principal disclosure document intended to inform investors in making an investment decision.

In fact, SIA strongly questions the value of yet another disclosure document in light of recent regulatory initiatives that would also mandate additional written disclosures to purchasers of variable annuities. For example, the Securities and Exchange Commission (the "SEC") recently proposed new rules and rule amendments to require broker-dealers to provide customers with disclosures at the point-of sale and in transaction confirmations regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares and unit investment trust interests (including insurance securities).[2] Similarly, NASD also proposed amendments to Rule 2830 to require written disclosure of revenue sharing and differential cash compensation arrangements upon account opening or client purchase of investment company shares.[3] In that regard, NASD is also contemplating expansion of the proposal to require disclosure of such arrangements with respect to the sale of variable annuities.

When viewed together with the current Rule Proposal, therefore, these recent regulatory initiatives could result in a potential purchaser of variable annuities receiving the following:

- a current variable annuity prospectus;
- a disclosure of expected sales loads and fees, revenue sharing and special compensation;
- the Risk Disclosure;
- a summary of revenue sharing and differential compensation arrangements;
- a disclosure form for qualified annuities, if applicable; and
- a Replacement Disclosure and State/Firm-required replacement disclosure form, if applicable.

These disclosures, of course, do not take into account information already contained in other required documents, such as the new account documentation, the annuity application and possible replacement and exchange documents, where applicable. Therefore, while SIA wholeheartedly supports regulatory efforts that ensure investors have the necessary tools to make informed investment decisions, we see little benefit in inundating investors with redundant disclosures. Simply put, it is the quality, not the quantity, of disclosure that matters. Accordingly, we respectfully request that the NASD reconsider the current proposal and pursue some or all of the alternatives described below, which we believe offer more effective

[2] Release Nos. 33-8358 and 34-49148 (January 29, 2004) 69 FR 6438 (February 10, 2004).
[3] Notice to Members 03-54 (September 2003).

and direct solutions that increase the likelihood that investors actually will read and understand the disclosure material.

B. Economic and Administrative Difficulties Associated With the Proposed Additional Disclosures

Equally troublesome is the considerable economic and administrative burden to member firms associated with a stand-alone Risk Disclosure. Particularly for financial institutions that offer numerous annuities, the cost and effort involved in creating, delivering and updating Risk Disclosures for each product could be significant. Moreover, some firms simply are not in a position to have their advisors manually calculate transaction-based expenses at the point of sale. Nor do they have integrated systems that capture all permutations of all available products in order to calculate the expenses for the advisor at the point of sale.

The Replacement Disclosure likewise is problematic and may present additional challenges particularly in instances where the current contract originated with another company. In these cases, the broker-dealer may not be able to provide the product comparison required by the Rule Proposal. Moreover, any slight inaccuracy or inadvertent omission could subject the broker-dealer to a potential tortious interference claim if the sponsor of the previous contract believes that its product is being misrepresented. Certain unscrupulous companies therefore could abuse the Rule Proposal to gain an unfair competitive advantage.

C. SIA Proposed Alternatives

A more practical, cost-effective and meaningful alternative to NASD's proposal is one that seeks to enhance and highlight the information contained within the principal disclosure document investors already receive – namely, the prospectus. Because many of the specified disclosure items already appear in the body of the prospectus, we believe that it is much more useful for investors to receive integrated risk disclosure in the prospectus. NASD can accomplish this by working with the SEC to require issuers to place the risk disclosures required under the Rule Proposal prominently and in plain English at the front of the prospectus. Such an approach, we believe, appropriately focuses investors' attention on key disclosure information without detracting from other equally important information in the prospectus.

Furthermore, by placing the disclosure in the front of the current variable annuity prospectus, SIA's recommended approach ensures that investors will receive consistent, comprehensive, up-to-date information. This point cannot be overstated, since the absence of uniformity -- which is a likely outcome of the current proposal -- could conceivably result in a potential investor receiving different disclosure information about an identical variable annuity product from different broker-dealers. By linking the disclosure to the prospectus, NASD ensures that all investors receive exactly the same information from the entity most familiar with the product. Moreover, a more standardized approach to disclosure of risks, fees and features would make comparisons significantly easier for investors. Accordingly, we recommend that NASD pursue this approach instead, since it not only addresses NASD's goal of a consistent, comprehensive product specific disclosure, but also avoids the burdens of

having broker-dealers generate a separate, unique disclosure document for each variable annuity sold by each firm, which could be a significant undertaking.

Alternatively, should NASD conclude that an additional disclosure statement is necessary, we strongly recommend that the Risk Disclosure be generic in nature (i.e. applicable generally to all deferred variable annuity products sold at the firm) and not one that is transaction specific, since the latter is highly problematic and raises practical implementation issues.[4] For example, it is our understanding that most annuity issuers prohibit their distributors from producing marketing material without prior approval. Since many issuers have multiple distribution channels, approval of the proposed broker-dealer Risk Disclosure for each transaction could delay completion of the sales process by days or weeks, thereby negatively impacting investors. This requirement would also impose a significant cost burden on insurers in terms of the man-hours required for marketing material reviews. Thus, we believe that a generic disclosure document is significantly more manageable and effective.

Moreover, due to the diversity of NASD members' business, size and structure, we also urge NASD to afford firms maximum flexibility to determine the most effective way to deliver the additional disclosure information to their clients. For example, firms could provide the generic disclosure document upon account opening, or shortly thereafter, via electronic mail or a link to their public web site. Firms could also deliver the document to customers on an annual basis. Since a prospectus would be provided at the time of sale (as well as a comparison document in the case of a replacement sale), the client would have the relevant product-specific information necessary to make an informed buying decision related to the particular deferred variable annuity under consideration.

As discussed above, the SEC has proposed in Release No. 34-49148 rules and amendments that would require disclosure of fee information concerning, among other products, variable annuities. NASD also may require additional revenue sharing disclosures related to variable annuities. Certainly, there should be a complementary approach with all of these disclosure documents as they relate to variable annuities. If variable annuity risk disclosure as well as variable annuity fee and revenue disclosure is necessary, then members should be able to combine the information into a rider to other important disclosure documents, or into a single disclosure booklet.

III. Principal Review

SIA also has serious concerns about subjecting deferred variable annuity sales to a special, separate supervisory review process as contemplated by the Rule Proposal. Currently, NASD Rule 3010(d) requires a registered principal to review and endorse, in writing, all securities transactions. The Proposed Rule would expand this requirement for deferred variable annuities transactions and require a registered principal to review and approve all deferred variable annuity transactions, whether recommended or not, not later than one business day following the "date of execution" of the deferred variable annuity application. In

[4] There is also concern that a product-specific disclosure document, such as the one proposed by NASD, could be construed either as "sales material" requiring filing with the NASD, or as a non-conforming prospectus required to be filed with the SEC in order to comply with federal securities laws. Broker-dealers are not in a position to make or request such filings on behalf of their insurance company issuers.

addition, where the transaction has been recommended, or involves an exchange or replacement, the registered principal would be required to review, approve and sign the suitability determination document or the exchange or replacement analysis form, also within one business day of the execution of the application.

SIA firmly believes that one business day for principal review, approval and sign-off in this context is unrealistic and would negatively impact a client's ability to invest in a deferred variable annuity in a timely fashion. Especially for firms that have agents in remote locations, a 24-hour window is simply too short a timeframe within which to comply and indeed may be inconsistent with the NASD's overriding objective to improve the quality of supervisory review. Consider, for example, the steps involved in the actual review and approval process. This could include, among other things, a review of the client file, review of appropriate corporate compliance reports, and in some instances, discussions with staff in order to obtain clarification or additional information as needed for the transaction approval. In such instances, we think it both impractical and imprudent to impose a 24-hour rule and urge NASD to reconsider this aspect of the Rule Proposal.

SIA recommends instead that the registered principal review parameters for variable annuities conform to those for other recommended security transactions. This approach, which is equally effective and considerably more manageable, would recognize firm size, structure, business and customers, particularly with regard to remote office locations. In all events, we strongly urge NASD to define "date of execution" as no earlier than the date when a funded application is transmitted to the issuing insurance company. "Funding" in this regard would mean either cash or a 1035 exchange document. Principal review and approval prior to transmittal to the insurance company may delay the process and disadvantage investors who, for example, may have withdrawn funds from other investments in order to purchase the annuity.

IV. Additional Comments

SIA also offers the following additional comments with respect to other aspects of the Rule Proposal. We note that as with the other comments in this letter, the below list is not intended to be all-inclusive, but a starting point of an ongoing regulatory dialogue with the NASD as it moves forward with this initiative.

A. Scope of the Rule

Under the Rule Proposal, the current prospectus and a separate Risk Disclosure must be provided "prior to effecting any purchase, sale or exchange of a deferred variable annuity." We believe that this requirement should apply to the initial sale of the variable annuity and not to in-force transactions or the exercise of contractual rights, such as reallocation of the annuity sub-accounts or add-on purchases. We do not believe any additional benefit to the consumer results by providing additional prospectuses or disclosures with every sub-account reallocation or premium investment. Accordingly, SIA recommends that NASD replace the words "any purchase" with "the initial purchase" in the rule.

SIA also requests clarification that, where a retirement plan is structured as a variable annuity, the Rule Proposal would apply at the plan sponsor – not the plan participant – level. It would be impractical to require broker-dealers to provide disclosure and suitability reviews at the plan participant level and could subject broker-dealers to additional liability that is inappropriate under these circumstances.

B. NASD's Proposed "Free Look" Provision

Under the Rule Proposal, the risk disclosure document must inform customers whether a "free look" period applies to the contract "during which the customer can terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments." As a general matter, the laws of the state of issue govern free look rules. While some states do permit a return of premium, the majority of states allow the investor to receive contract value (or the greater of the two) where the investor elects to terminate the contract within the allotted time period. Accordingly, we recommend that NASD clarify that customers who terminate their contracts during the free look period will receive a refund of the contract value *or* the purchase payment, as required by state law.

C. Signature and Documentation Requirement

The Rule Proposal would also require that a suitability determination document be prepared and signed by both the associated person making a recommendation for the purchase, sale or exchange of a deferred variable annuity and by a registered principal. The registered principal would also be required to sign the analysis form prepared in the case of an exchange or replacement of a deferred variable annuity. As written, the Rule Proposal does not specify what type of signature is required or expressly provide for an electronic process.

As a threshold matter, SIA requests that NASD clarify that a "wet" or ink signature is not necessary and instead include language in the Rule Proposal to the effect that "the signature requirements may be satisfied if a firm adopts as a signature an electronic identification consisting of a symbol(s) or code(s) contained within an electronic transmission sufficient to verify that the required associated person and/or registered principal reviewed, approved and/or originated the transmission."[5] This approach, we believe, better accommodates the various methods by which approval and sign-off are, or could be, made in the marketplace.

With regard to the requirement that the suitability determinations be "documented" we also recommend that section (c) (2) of the Rule Proposal be revised or annotated to indicate that the appropriateness/suitability determination "document" can be created and stored electronically, and that registered principal review and approval can be indicated electronically as well. These comments also apply to section (c) (3) of the Rule Proposal concerning registered principal review and approval of an exchange/replacement analysis document related to each replacement sale of a deferred variable annuity.

[5] This is entirely consistent with the Electronic Signature in Global and National Commerce Act (ESIGN) and the Uniform Electronic Transactions Act (UETA), which provide that a record or signature may not be denied legal effect or enforceability solely because it is in electronic form.

D. Suitability Requirement

As a threshold matter, SIA seeks clarification that a General Securities Principal qualification (Series 9/10 or Series 8) may satisfy the "registered principal" supervision requirement since this interpretation will enable firms to integrate already existing supervisory structures.

SIA also finds problematic the one-size-fits-all model contemplated by the Rule Proposal with regard to principal review of six factors. Rather than specific fixed standards, we believe NASD should articulate general guidelines and grant firms maximum flexibility in developing those guidelines that are appropriate to their business operations. Such an approach better recognizes and accommodates the great diversity of firm size, distribution channels and business models. Furthermore, and in all events, we strongly urge NASD to avoid any bright-line requirements that the annuity not exceed a stated percentage of the customer's net worth or a stated dollar amount. Either test, we believe, ignores the reality that clients may have accounts at multiple broker-dealers and therefore such an analysis could produce an inaccurate picture of the client's actual suitability. The fact is, broker-dealers are inherently unable to answer certain questions required by the Rule Proposal in order to demonstrate suitability; specifically, attributes of previous contracts and investment allocations where the investor holds a contract sold by another broker-dealer or sponsored by an insurance company with which the broker-dealer has no relationship. In such cases, unless the investor provides the information (which they frequently do not have or do not care to share), the broker would be forced to refuse that investor's business.

Further to this point, the Rule Proposal states that no associated person shall recommend a deferred variable annuity unless he or she believes that the customer has a long-term investment objective. Although this is most certainly the norm, there may be product-specific circumstances that support the purchase of a deferred variable annuity without a long-term investment objective. For instance, deferred variable annuities can have fixed-rate investment options with relatively high interest rates and no surrender or asset-based charges. Some afford an immediate right to annuitize and therefore can be attractive to investors because of appealing annuity purchase rates. In such cases, if a client is appropriately informed of the material features of the product, and the associated person has made a good-faith determination that the product and the underlying sub-accounts are suitable for the customer, then the sale could be entirely appropriate. For these reasons as well, we request that NASD reconsider the Rule Proposal's suitability provisions and focus instead on standards that assess suitability based on a client's overall circumstances, without specific constraints.

Finally, we believe the suitability analysis process and principal review should apply to the initial sale of the deferred variable annuity only and not to in-force transactions or the exercise of contractual rights, such as reallocation of the annuity sub-accounts or add-on purchases. As noted above, to impose an ongoing obligation on advisors is redundant and impractical particularly since clients can exercise these rights without involving their registered representatives.

E. Federal and State Tax Information in the Risk Disclosure

The Rule Proposal also requires disclosure regarding the federal and state tax treatment for variable annuities. SIA requests clarification as to the scope of this disclosure. For example, it is unclear whether the "taxation treatment" disclosure requirement is limited to income taxation treatment of variable annuities or whether it extends to other areas as well, such as estate taxes, gift taxes, treatment of income with respect to a decedent, and generation skipping transfer taxes. In any case, inclusion of this type of information in a firm disclosure document is extremely burdensome and potentially could lead to unwarranted liability to member firms. Indeed, firms typically advise clients that their registered representatives are *not* tax advisors and that clients should consult their own tax advisors for information on the tax effects of a particular investment decision. Moreover, while firms could readily formulate a generic statement generally describing federal income tax treatment of annuity accumulation, payments, withdrawals and death benefits, a written description of all applicable state and local tax implications for each annuity the firm offers would prove much more difficult. Indeed, it is our understanding that state premium taxes vary from state to state, and most states do not levy a premium tax on annuities at all. Accordingly, we urge the NASD once again to consider our earlier recommendation that this type of disclosure is most effective coming from the issuer through an enhanced prospectus that can then be used by all broker-dealers that offer a particular product to investors.

IV. Conclusion

SIA appreciates the opportunity to provide comments on the Rule Proposal. While the SIA commends the NASD's efforts to improve the quality and usefulness of disclosure and sales practices within the context of variable annuity transactions, we believe that other, more workable solutions exist and would be happy to explore those or any others with NASD as it moves forward with this process. If you have any questions or would like to discuss our comments further, you can contact the undersigned at (202) 216-2000 or Amal Aly at (212) 618-0568.

Sincerely,

Ira D. Hammerman
SIA Senior Vice President and
General Counsel

cc: Mary Schapiro
Marc Menchel
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