FINRA
Financial Industry Regulatory Authority

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November 12, 2008

Ms. Florence Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-FINRA-2008-019; Response to Comments

Dear Ms. Harmon:

On May 21, 2008, FINRA filed an amendment to Rule 2821 that proposed a number of substantive changes to the rule.[1] Those proposed changes included, *inter alia*, the following:

- Limiting the Rule's application to "recommended" transactions,
- Modifying the beginning of the period within which the principal must review and determine whether to approve or reject an application, and
- Adding a Supplementary Material ("SM") section following the Rule's text to examine issues that potentially could have a significant impact on how members sell or process deferred variable annuities.

On June 10, 2008, the Securities and Exchange Commission ("SEC" or "Commission") published FINRA's proposed changes in the *Federal Register* and sought public comment.[2] The public comment period closed on July 1, 2008.[3] This letter responds to the substantive comments that were submitted.[4] The main issues that commenters addressed are discussed separately below.

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1 *See* Notice of Filing of Proposed Rule Change Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities, Securities Exchange Act Release No. 57920 (June 4, 2008), 73 FR 32771 (June 10, 2008) (SR-FINRA-2008-019).

2 *Id.*

3 *Id.*

4 Fourteen comment letters were submitted.

Limiting the Rule's Application to "Recommended" Transactions

Numerous commenters responded positively to FINRA's proposal to limit the Rule's application to "recommended" transactions.[5] These commenters agreed with FINRA that focusing on recommended transactions would make Rule 2821 consistent with other rules that have a suitability component; promote competition by allowing a wide variety of business models to exist, including those premised on keeping costs low by, in part, eliminating the need for a sales force and large numbers of principals; and not detract from the Rule's effectiveness because most deferred variable annuity transactions are recommended. Two commenters disagreed, arguing that it will be too easy for registered representatives to avoid the Rule by falsely asserting that unsuitable transactions were not recommended.[6] Although FINRA initially shared

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[5] *See* ACLI Letter, Dated August 20, 2008; Committee of Annuity Insurers Letter, Dated July 1, 2008; Investment Company Institute Letter ("ICI Letter"), Dated July 1, 2008; NAVA, Inc. Letter, Dated July 1, 2008; Vanguard Letter, Dated June 30, 2008; T. Rowe Price Letter, Dated June 23, 2008.

[6] *See* Cornell Securities Law Clinic Letter ("Cornell Letter"), Dated July 1, 2008; Public Investors Arbitration Bar Association Letter ("PIABA Letter"), Dated June 26, 2008. The Cornell Letter also questioned FINRA's contention that applying the Rule to non-recommended transactions might inhibit lower-cost variable annuity providers from offering these products. The Cornell Letter states that "FINRA cites no evidence to back up this assertion. Investment companies such as Fidelity and Vanguard, among others, already offer lower cost alternatives to broker-sold variable annuities, so the current Rule has not impeded competition." *Id.* at 2. The Cornell Letter fails to recognize, however, that the part of the Rule requiring principal review of non-recommended transactions, paragraph (c) of Rule 2821, has never taken effect. *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Delay the Effective Date of Certain FINRA Rule Changes Approved in SR-NASD-2004-183, Securities Exchange Act Release No. 57769 (May 2, 2008), 73 FR 26176 (May 8, 2008) (SR-FINRA-2008-015). As a result, the "lower-cost providers" have not yet faced such requirements. Moreover, a number of "lower-cost providers," including one that the Cornell Letter explicitly references, previously submitted comment letters stating that applying Rule 2821 to non-recommended transactions "would adversely affect the ability of [Vanguard] to offer a low cost variable annuity alternative." Vanguard Letter, *supra* note 5, at 5. *See also* T. Rowe Price Letter, Dated January 23, 2008, at 2 ("[T]he principal review requirements in Rule 2821 adversely impact certain broker-dealers whose business models do not include making customer recommendations about deferred variable annuities.").

The PIABA Letter, moreover, argues that Rule 2821 should apply to more than simply "initial" subaccount allocations. According to PIABA, "[u]nder the proposed rule, the broker is free to ignore investor suitability determinations after the initial purchase." PIABA Letter, at 4. The fact that Rule 2821 would not apply to reallocations among subaccounts made after the initial purchase or exchange of a deferred variable annuity does not mean that a broker is free to ignore investor suitability determinations after the initial purchase. As FINRA has stated all along, FINRA's general suitability rule, Rule 2310, would continue to apply to such transactions. *See* Amendment No. 1 to Proposed Rule Relating to Sales Practice Standards

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similar concerns, the requirement to implement reasonable measures to detect and correct circumstances in which brokers mischaracterize recommended transactions as non-recommended should minimize such misconduct. FINRA also reiterates that where the transaction truly is initiated by the customer rather than having been recommended by the broker, there generally is less concern regarding potential or actual conflicts of interest and less need for heightened sales-practice requirements. Accordingly, FINRA believes that the better approach is to limit the Rule's application to recommended transactions.

One commenter asked FINRA "to clarify that a 'non-recommended transaction' is a direct sale, i.e., one where no sales-related compensation is paid and no registered representative is involved."[7] The determination of whether a particular communication could be viewed as a recommendation, however, ordinarily would not turn on whether sales-related compensation is paid or a registered representative is involved. The commenters' description of a transaction that is *not* recommended is at once too broad and too narrow. It is too broad because some firms use Web-based computer programs that make recommendations to customers without assistance by or transaction-based compensation paid to registered representatives. It is too narrow because some firms that pay registered representatives transaction-based compensation may on occasion process transactions that were solely initiated by customers rather than having been recommended by the firm's registered representatives.

As FINRA emphasized in an earlier filing, "Whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances."[8] Nonetheless, FINRA previously has announced several principles that should be considered when determining whether a particular communication could be deemed a recommendation.[9] For example, a communication's content, context, and presentation will inform most determinations of whether a particular

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and Supervisory Requirements for Transactions in Deferred Variable Annuities, File No. SR-NASD-2004-183, filed with the SEC on July 8, 2005, at 13-14; Amendment No. 2 to Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities ("Amendment No. 2"), File No. SR-NASD-2004-183, filed with the SEC on May 4, 2006, at 35.

7 Pacific Life Insurance Company Letter, Dated July 1, 2008.

8 Amendment No. 2, *supra* note 6, at 40-41 (quoting *NASD Notice to Members*, For Your Information: Clarification of *NASD Notice to Members 96-60* (March 1997)).

9 *Id.* at 41 (citing NASD Policy Statement Regarding Application of the NASD Suitability Rule to Online Communication, *NASD Notice to Members 01-23* (April 2001)).

communication is a recommendation.[10] In addition, the more individually tailored a communication is to a specific customer or targeted group of customers about a particular security or group of securities, the more likely the communication will be viewed as a recommendation.[11] Moreover, a series of actions that may not constitute recommendations when considered individually may amount to a recommendation when considered in the aggregate.[12] Additionally, the determination of whether a recommendation has been made "does not depend on the mode of communication," and it does not matter whether the communication was initiated by a person employed by the member or by a computer software program used by the member.[13]

Another commenter asked FINRA to clarify under what circumstances the Rule applies to recommendations regarding retirement plans. The rule text explicitly states that Rule 2821 "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."[14]

FINRA also previously stated that a member's "generic communication to all plan participants indicating that the employer has chosen a deferred variable annuity as the funding vehicle for its retirement plan likely would *not* constitute a 'recommendation' triggering application of the proposed rule."[15] FINRA has stated, moreover, that, even where a member has made a recommendation to an individual

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10 *Id.*

11 *Id.*

12 Amendment No. 3 to Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities ("Amendment No. 3"), File No. SR-NASD-2004-183, filed with the SEC on Nov. 15, 2006, at 13 n.9 (citing *NASD Notice to Members 01-23* (April 2001)).

13 Id. at 12-13 n.4 (quoting *NASD Notice to Members*, For Your Information: Clarification of *NASD Notice to Members 96-60* (March 1997), and citing *NASD Notice to Members 01-23* (April 2001)).

14 NASD Rule 2821(a)(1).

15 Amendment No. 2, *supra* note 6, at 41.

plan participant, the Rule would not apply to plan-level discussions with sponsors, trustees, or custodians of qualified retirement or benefit plans.[16]

Modifying Starting Point for the Seven-Business-Day Review Period

A number of commenters applauded FINRA's modification of the triggering event that begins the period within which a principal must review the transaction (changing it from the time when the customer signs the application to the time when an office of supervisory jurisdiction ("OSJ") receives a complete and correct application),[17] but one commenter stated that it goes too far and gives firms too much time.[18] Still others thought that the period should be longer[19] or that an exception to the time limitations should exist where the customer consents to the delay.[20] A number of commenters also requested that FINRA interpret the proposed new language to mean that the time begins not when *any* OSJ receives the application but rather only when the OSJ that the member designates as the proper OSJ receives the application.[21]

The views were thus many and varied. In the end, FINRA believes that the current proposal strikes the proper balance. Seven business days from the time when *any* OSJ of the member receives a complete and correct copy of the application will provide firms with sufficient time to perform a thorough review, building in time for readily foreseeable delays while still maintaining a definite period within which the principal must make a final decision.[22] Once a complete and correct copy of the

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16 *Id.* at 40 n.21.

17 *See* ACLI Letter, *supra* note 5; Committee of Annuity Insurers Letter, *supra* note 5; Financial Services Institute Letter, Dated July 1, 2008; ICI Letter, *supra* note 5; NAVA Letter, *supra* note 5; Neal Nakagiri Letter, Dated July 2, 2008.

18 *See* Pacific Life Letter, *supra* note 7, at 2.

19 *See* Nakagiri Letter, *supra* note 17 (suggesting ten rather than seven business days).

20 *See* ACLI Letter, *supra* note 5; Committee of Annuity Insurers Letter, supra note 5.

21 *See* ACLI Letter, *supra* note 5; Committee of Annuity Insurers Letter, *supra* note 5; EquiTrust Marketing Services Letter, Dated June 11, 2008; NAVA Letter, *supra* note 5.

22 As FINRA and the Commission previously have noted, "Many broker-dealers are subject to lower net capital requirements under [SEC] Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under [SEC] Rule 15c3-3 because they do not carry customer funds or securities." SEC Order Granting Exemption to Broker-Dealers from Requirements in SEA Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks, Securities Exchange Act Release No. 56376 (September 7, 2007), 72 FR 52400 (September 13, 2007). Although some of these firms receive checks from customers

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application is received by an OSJ, the clock begins to run, regardless of whether the firm designates another OSJ to perform the actual review. No extensions of the period will be permitted.[23]

Clarifying Supplementary Material

Ability to Forward Checks/Funds

The rule change filed on May 21, 2008 stated in SM.03 that a member could forward a customer's check or funds to the insurance company prior to principal approval of the deferred variable annuity under certain conditions.[24] One of those conditions is that the insurance company agrees to "(1) segregate the member's customers' funds in a bank ... account ... (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account

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made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it "promptly transmits" the checks to third parties. The SEC has interpreted "promptly transmits" to mean that "such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities." In conjunction with its approval of Rule 2821, the Commission provided an exemption to the "promptly transmits" requirement as long as, among other things, the "principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with the rule." *Id.* FINRA believes that the Commission's exemption order would continue to apply if the Commission approved FINRA's proposed amendments to Rule 2821.

[23] To help ensure that the process remains efficient from the beginning, the proposal requires the *associated person* who recommended the annuity to promptly transmit the complete and correct application package to the OSJ. However, that provision, proposed paragraph (b)(3) of Rule 2821, would not preclude the *customer* from transmitting the complete and correct application package to the OSJ. For instance, there may be occasions where the application package is technically complete and correct but the customer wants to take it home and consider the purchase or exchange further before sending the application to the OSJ. Proceeding in such a manner is not inconsistent with the proposed provision.

[24] FINRA notes that it initially prohibited member firms from ever forwarding checks/funds prior to principal approval of the transaction. Most commenters favored allowing member firms to forward checks/funds, but they differed regarding their views of FINRA's proposed requirements for allowing it.

for the Exclusive Benefit of Customers . . . ." One commenter found such a requirement to be confusing because "the insurance company would necessarily have a claim for payment if an application is approved and a contract issued, while the member would necessarily have a claim for a return of the funds if the application is not approved and the contract is not issued."[25]

FINRA did not intend to suggest that the funds had to remain in a segregated bank account of the type referenced in SM.03 in perpetuity. To clarify the point, however, FINRA filed an amendment with the SEC today that proposes to modify that section in the following manner (brackets signify deleted text and underlining signifies added text): the member must "enter into a written agreement with the insurance company under which the insurance company agrees [to] that, until such time as it is notified of the member's principal approval or rejection, it will ([a]1) segregate the member's customers' funds . . . ."

Some commenters requested that FINRA essentially eliminate all of the new requirements regarding a member's ability to forward checks/funds to the insurer prior to principal approval,[26] while another alternatively asked that an insurer be able to segregate funds in an account "similar in form and function to a Reserve Bank Account under [SEC] Rule 15c3-3(e)."[27] The latter commenter also suggested that FINRA should consider creating exemptions from the SM.03 requirements depending on the treatment particular states afford to insurance company suspense accounts.[28]

FINRA believes that, during the interim period before the member's principal has decided whether the transaction should be approved, it is important that a member have reasonable assurances when it forwards its customers' funds that the insurer will handle the funds in a manner providing at least as much protection as if they were being handled by a broker-dealer that is allowed to hold customer funds. Accordingly, FINRA will not modify or eliminate the proposed requirements because such suggestions inevitably call for less stringent standards.[29] Member firms can only forward checks/funds during the interim period before principal approval of the

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25 *See* NAVA Letter, *supra* note 5.

26 *See* ACLI Letter, *supra* note 5.

27 *See* Committee of Annuity Insurers Letter, *supra* note 5.

28 *Id.*

29 With regard to the suggestion that insurers be permitted to use an account similar in form to a "Reserve Bank Account under [SEC] Rule 15c3-3(e)," FINRA notes the importance of physically segregating the customers' funds from those of the insurance company, as described in 15c3-3(f) and (k)(2)(i).

transaction if the insurer agrees to segregate the funds in a bank account that is, *inter alia*, equivalent to a "Special Reserve Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)).

One commenter asked whether the "Special Account Requirement" of SM.03 requires the segregation by the insurer of customer funds for each member firm with which the insurer does business.[30] It does not. The insurer could use one special account for the customers of all the member firms with which it does business.

Finally, one commenter asked whether the insurer could send the checks/funds to the broker-dealer rather than directly to the customer if the broker-dealer's principal rejects the transaction.[31] The insurer could proceed in such a manner, which should not raise regulatory issues for a broker-dealer that is permitted to hold customer funds. Other broker-dealers must remember, however, that when an insurer sends them checks made payable to customers they must "promptly" forward such checks to their customers and must keep a record of the checks coming in and going out.

Members' Obligation to Inquire About Exchanges

One commenter strongly approved of FINRA's proposal to clarify in Rule 2821(b)(1)(B)(iii) and SM.05 that an analysis of whether the customer has had another recent exchange includes possible exchanges at other broker-dealers.[32] That same commenter, however, argued that member firms should be required to do more than simply ask the customer whether he or she has had another exchange.[33] The commenter explained that these transactions can be so complex and confusing that some customers might not understand that they had engaged in previous exchanges.[34]

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30 *See* NAVA Letter, *supra* note 5. NAVA also states that, in its experience, "unaffiliated broker-dealers do not forward customer funds prior to principal approval." *Id.* In this regard, FINRA notes that SM.03 allows a member firm to forward checks/funds under certain circumstances prior to principal approval; it does not require it. Moreover, as noted above, FINRA believes that the Commission's previous exemption order allowing firms to hold checks for up to seven business days to complete the principal review would apply under the proposed amendments.

31 *See* Committee of Annuity Insurers Letter, *supra* note 5.

32 *See* PIABA Letter, *supra* note 6. The rule currently states that the member firm must consider whether "the customer's account has had another deferred variable annuity exchange within the preceding 36 months." The proposal replaces the term "customer's account" with the word "customer."

33 *See* PIABA Letter, *supra* note 6.

34 *Id.*

Although FINRA appreciates the commenter's concern, FINRA believes that such instances would occur infrequently and that requiring member firms to perform an investigation into whether the customer has in fact had another exchange at another broker-dealer is simply too burdensome in comparison to the possible benefits. FINRA notes, moreover, that SM.05 states that a member firm must determine whether the customer has had another exchange at that firm and is only permitted to rely on an inquiry to the customer with regard to a possible exchange at another member firm. In addition, SM.05 states that member firms must document in writing both the nature of the inquiry and the response from the customer. This latter requirement should help ensure that member firms ask customers about exchanges in a manner reasonably calculated to elicit accurate responses.

Effective Date of Proposed Amendments

The amendment filed with the SEC on May 21, 2008 stated that its effective date would be 120 days following publication of the *Regulatory Notice* announcing Commission approval. Some commenters asked for a much longer delay—up to 18 months in one case.[35] In light of the length of time that firms have already had to prepare for the implementation of this Rule (and the most recent proposed changes thereto), as well as the importance of the most recent proposed changes, FINRA believes that an 18-month delay is unreasonable. FINRA will, however, increase the amount of time from 120 days to six months.

If you have any questions, please contact me at (202) 728-8270.

Very truly yours,

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35 *See* Committee of Annuity Insurers Letter, *supra* note 5.