SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54023; File No. SR-NASD-2004-183)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing Amendment No. 2 to Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities

June 21, 2006

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on December 14, 2004, NASD filed with the Securities and Exchange Commission ("SEC" or "Commission"), the proposed rule. NASD filed amendment No. 1 on July 8, 2005, which replaced and superseded the text of the original rule filing. The proposed rule, as amended by Amendment No. 1, was published for comment in the Federal Register on July 21, 2005.[3] The Commission received approximately 1500 comments on the proposal.[4] NASD filed Amendment No. 2 on May 4, 2006, which addressed the comments and proposed responsive amendments. Amendment No. 2 is described in Items I, II and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on Amendment No. 2 to the proposed rule from interested persons.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Exchange Act Rel. No. 52046A (July 19, 2005); 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183).

4 Approximately 1300 of these comments were virtually identical.

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

NASD is proposing a new rule, NASD Rule 2821, that would set forth recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. Below is the amended text of the proposed rule.

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2821. Members' Responsibilities Regarding Deferred Variable Annuities

(a) General Considerations

(1) Application

This Rule applies to the purchase or exchange of a deferred variable annuity and the subaccount allocations. This Rule does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the Securities Exchange Act of 1934 or meets the requirements of Internal Revenue Code Sections 403(b), 457(b) or 457(f), unless, in the case of any such plan, a member 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 makes such recommendations.

(2) Creation, Storage and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

(A) the customer has been informed of the material features of a deferred variable annuity, such as the potential surrender period and surrender charge; potential tax penalty if the customer sells or redeems the deferred variable annuity before he or she reaches the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of a deferred variable annuity; and market risk;

(B) the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit); and

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

These determinations shall be documented and signed by the associated person recommending the transaction.

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

(c) Principal Review and Approval

(1) No later than two business days following the date when a member or person associated with a member transmits a customer's application for a deferred variable annuity to the issuing insurance company for processing and irrespective of whether the transaction has been recommended, a registered principal shall

review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider

(A) the extent to which the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit);

(B) the extent to which the customer's age or liquidity needs make the investment inappropriate;

(C) the extent to which the amount of money invested would result in an undue concentration in a deferred variable annuity or deferred variable annuities in the context of the customer's overall investment portfolio; and

(D) if the transaction involves an exchange of a deferred variable annuity, the extent to which (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose death or existing benefits, or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees and charges for riders and similar product enhancements), (ii) the customer would benefit from any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

These considerations shall be documented and signed by the registered principal who reviewed and approved the transaction.

(2) When a member or a person associated with a member has recommended the purchase or exchange of a deferred variable annuity, a registered principal, taking into account the underlying supporting documentation described in paragraph (b)(2) of this Rule, shall review, determine whether to approve and, if approved, sign the suitability determination document required by paragraph (b)(1) of this Rule no later than two business days following the date when the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company for processing.

(d) Supervisory Procedures

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012, 3013 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen the transaction and require a registered principal to consider those items enumerated in paragraph (c) of this Rule, as well as whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.

(e) Training

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

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

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

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

1. Purpose

a. Background

On December 14, 2004, NASD filed with the Commission proposed Rule 2821 (SR-NASD-2004-183). NASD filed with the Commission Amendment No. 1 to the proposed rule on July 8, 2005. The Commission published the proposed rule, as amended by Amendment No.1, in the Federal Register on July 21, 2005.[5] The comment period closed on September 19, 2005. Based on comments received in response to the publication of the proposed rule in the Federal Register, NASD filed Amendment No. 2 to SR-NASD-2004-183 to address the comments and to make certain changes to the proposed rule as discussed herein.

b. Proposed Rule

As described in the original and amended rule filings, NASD is proposing new NASD Rule 2821, which would impose specific sales practice standards and supervisory

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[5] See supra note 3.

requirements on members for transactions in deferred variable annuities.[6] In general, NASD's guidelines on deferred variable annuity transactions, developed with substantial input from industry participants and published in Notice to Members 99-35, served as the basis for the proposed rule.

The proposed rule would apply to the purchase or exchange of a deferred variable annuity and the initial subaccount allocations.[7] The proposed rule would not apply to

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6 A variable annuity, in general, is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) ("Joint Report"); NASD Notice to Members 99-35 (May 1999). The proposed rule focuses exclusively on transactions in deferred variable annuities. NASD recognizes that transactions involving immediate variable annuities have begun to increase recently, and NASD will continue to monitor sales practices relating to these products. Currently, however, deferred variable annuities make up the majority of variable annuity transactions. Moreover, to date, most of the problems associated with transactions in variable annuities that NASD has uncovered involve the purchase or exchange of deferred variable annuities.

7 NASD notes that the proposed rule focuses on customer purchases and exchanges of deferred variable annuities, areas that, to date, have given rise to many of the problems NASD has uncovered. The proposed rule would thus cover a standalone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another deferred variable annuity. For purposes of the proposed rule, an "exchange" of a product other than a deferred variable annuity (such as a fixed annuity) for a deferred variable annuity would be covered by the proposed rule as a "purchase." The proposed rule would not cover customer sales of deferred variable annuities, including the sale of a deferred variable annuity in connection with an "exchange" of a deferred variable annuity for another product (such as a fixed annuity). However, recommendations of customer sales of deferred variable annuities are fully and adequately covered by Rule 2310, NASD's general suitability rule. Rule 2310 requires that, when recommending that a customer purchase, sell or exchange a security, an associated person determine whether the recommendation is suitable for the customer. In general, deferred variable annuities are suitable only as long-term investments and are inappropriate short-term trading vehicles. As part of any analysis under Rule 2310 regarding the suitability of a recommendation that a customer sell a deferred variable annuity, the associated person must consider significant tax consequences, surrender charges and loss of death or other

reallocations of subaccounts or to funds paid after the initial purchase or exchange of a deferred variable annuity. However, other NASD rules would continue to apply. For instance, NASD's suitability rule, Rule 2310, would continue to apply to any recommendations to reallocate subaccounts.[8]

The proposed rule also would not apply to sales of deferred variable annuities to certain tax-qualified, employer-sponsored retirement or benefit plans. It would, however, apply if a member makes recommendations to individual plan participants regarding a deferred variable annuity.[9] In addition, the rule would apply to the purchase or exchange of deferred variable annuities to fund individual retirement accounts (IRAs). In part, NASD determined not to exclude IRAs from the scope of the proposed rule because, unlike transactions for tax-qualified, employer-sponsored retirement or benefit plans, investors funding IRAs are not limited to the options provided by a plan.[10]

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benefits. As NASD emphasized in a Regulatory & Compliance Alert in 2002, entitled "Reminder—Suitability of Variable Annuity Sales," members and their associated persons "must keep in mind that the suitability rule applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor."

8 Indeed, except to the extent that specific provisions in the proposed rule would govern, or unless the context otherwise requires, the provisions of the by-laws and rules and all other interpretations and policies of the NASD Board of Governors would be applicable to transactions in deferred variable annuities.

9 In other words, the proposed rule would apply as to the individual plan participants to whom the member makes recommendations, but would not apply as to the plan sponsor, trustee or custodian regarding the plan-level selection of investment vehicles and options for such plans.

10 NASD notes as well that a deferred variable annuity purchased to fund an IRA does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA itself. Accordingly, where a customer is

The proposed rule has four main provisions: (1) requirements governing recommendations, including a suitability obligation, specifically tailored to deferred variable annuity transactions;[11] (2) principal review and approval obligations;[12] (3) a specific requirement for members to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule;[13] and (4) a targeted training requirement for members' associated persons, including their registered principals.[14]

NASD will announce the effective date of the proposed rule in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 180 days following publication of the Notice to Members announcing Commission approval.

c. Comments on the Proposed Rule

The Commission received nearly 1500 comment letters in response to the publication of the proposed rule in the Federal Register. These comments are available on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). A summary of the comments and NASD's response is set forth below.

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purchasing a deferred variable annuity to fund an IRA, firms must ensure that the deferred variable annuity's features other than tax deferral make the purchase of the deferred variable annuity for the IRA appropriate.

11 See Proposed Rule 2821(b).

12 See Proposed Rule 2821(c).

13 See Proposed Rule 2821(d).

14 See Proposed Rule 2821(e).

While some commenters expressed support for the proposed rule,[15] most opposed it.[16] Reasons for their opposition varied. Several commenters stated that the proposal should be withdrawn, viewing it as unnecessary and arguing that NASD has not demonstrated a need for it.[17] While NASD disagreed with the suggestion that there must be demonstrable harm before it can engage in rulemaking, in its response to comments it also noted the numerous Notices to Members, Regulatory & Compliance Alerts and Investor Alerts that it has issued regarding deferred variable annuities. NASD also noted that notwithstanding those efforts, a recent joint review with the Commission, NASD examinations and NASD enforcement actions indicate NASD's prior efforts have not been sufficiently effective at curbing problems in this area.

i. Comments on Proposed Rule 2821(a)(1) -- Application

Numerous commenters argued that the rule should not apply to tax-qualified, employer-sponsored retirement or benefit plans. One commenter believed, however, that the rule should apply to those plans in which the plan sponsor, trustee, or custodian is

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15 See, e.g., North American Securities Administrators Association ("NASAA"), Patricia D. Struck, President and Wisconsin Securities Administrator (9/20/05); Pace Investor Rights Project ("Pace"), Barbara Black, Director (9/19/05); and Public Investors Arbitration Bar Association ("PIABA"), Rosemary J. Shockman, President (9/9/05).

16 See, e.g., America Council of Life Insurers ("ACLI"), Carl B. Wilkerson, Vice President & Chief Counsel (9/19/05); Committee of Annuity Insurers ("CAI"), W. Thomas Conner and Eric A. Arnold, Sutherland Asbill & Brennan LLP (9/19/05), National Association for Variable Annuities ("NAVA"), Michael P. DeGeorge, General Counsel (9/19/05); Securities Industry Association ("SIA"), Ira D. Hammerman, Senior Vice President and General Counsel (9/19/05); T. Rowe Price Investment Securities, Inc. ("T. Rowe Price"), Henry H. Hopkins, Darrell N. Braman and Sara McCafferty (9/19/05); and Wachovia Securities, LLC ("Wachovia"), Ronald C. Long, Senior Vice President (9/19/05).

17 See, e.g., ACLI; CAI; NAVA; and SIA.

either "unsophisticated" or primarily relied on the recommendation of the member.[18] NASD disagreed. In its response to comments, NASD stated that the rule should not apply to plan-level decisions. In NASD's view, the factors that can be important to understanding the appropriateness of a recommendation to a sponsor, trustee or custodian of a qualified retirement or benefit plan can be distinct from those that are important regarding the determination of the appropriateness of a recommendation to a retirement-plan participant.

One commenter suggested that, in addition to transactions in connection with "qualified plans" as defined in Section 3(a)(12)(C) of the Act and plans that meet the requirements of Internal Revenue Code Sections 403(b) and 457(b), the rule should not apply to transactions with plans that meet the requirements of Section 457(f) of the Internal Revenue Code, unless the member makes a recommendation to an individual plan participant.[19] NASD agreed and proposes to exclude transactions in connection with these plans from the rule. Another commenter argued that the rule should not apply to transactions with individual plan participants if the only funding vehicle for a tax-qualified employer sponsored plan is a deferred variable annuity.[20] NASD disagreed and in its response to comments stated that the proposed rule would apply if a registered representative recommends the deferred variable annuity in the plan to an individual plan participant. It noted, however, that only communications constituting a

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[18] NASAA.

[19] NAVA.

[20] Lincoln Investment Planning ("Lincoln"), Deirdre B. Koerick, Vice President (9/19/05).

"recommendation" would trigger application of the rule.

A number of commenters asked NASD to clarify that the rule would not apply to premiums paid into a deferred variable annuity after the initial purchase and to subsequent purchase payments.[21] As it noted in its response to comments, NASD has modified the proposed rule to specify that it "does not apply . . . to funds paid after the initial purchase or exchange."

One commenter asserted that the NASD has no basis for excluding an investor's reallocation of his or her subaccounts from the scope of the proposed rule.[22] This commenter believed that specific attention should be paid to the broker's obligation to oversee and reallocate sub-accounts because broker's do not pay attention or fail to follow-up on a customer's subaccount investments, often allowing these account to flounder in unsuitable investments. NASD declined to take this suggestion, but noted that NASD Rule 2310 continues to apply to a customer's subaccount investments.

Another commenter stated that the rule should also apply to the sale of immediate variable annuities.[23] In response, NASD stated that the majority of variable annuity transactions currently are in deferred variable annuities, and that most of the problems NASD has uncovered have been associated with the purchase or exchange of deferred variable annuities. However, NASD also stated that it will continue to monitor sales

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[21] CAI; Massachusetts Mutual Life Insurance Company ("Mass Mutual"), Jennifer B. Sheehan, Assistant Vice President and Counsel (9/19/05); NAVA; and Northwestern Mutual Investment Services ("NMIS"), Daniel A. Riedl, Senior Vice President and Chief Operating Officer (9/16/05).

[22] PIABA.

[23] NASAA.

practices relating to immediate variable annuities.

ii. Comments on Proposed Rule 2821(b) – Recommendation Requirements

(a) General Comments

Several commenters urged NASD to eliminate the specific suitability requirements from paragraph (b) of the proposed rule.[24] Some commenters asserted that deferred variable annuities are too varied and complex to mandate specific criteria for determining suitability.[25] Others stated that NASD would need to clarify the level of knowledge that would be sufficient to support a registered representative's "reasonable basis" for believing the standards of paragraph (b) have been met with respect to a particular customer.[26]

(b) Comments on Proposed Rule 2821(b)(1)(A) – Deferred Variable Annuity's Material Features

The rule, as originally proposed, would have required members to have a reasonable basis to believe that the customer has been informed of the material features of a specific deferred variable annuity before recommending it. Commenters criticized this provision, arguing that it would amount to a de facto requirement to provide written

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[24] See, e.g., Association for Advanced Life Underwriting/National Association of Insurance and Financial Advisers ("AALU/NAIFA"), Gary A. Sanders, Senior Counsel (9/19/05); ACLI; Intersecurities, Inc. ("Intersecurities"), Thomas R. Moriarty, President (9/16/05); NAVA; SIA; and World Group Securities, Inc. ("World Group"), Leesa M. Easley, Chief Legal Officer (9/8/05).

[25] HD Vest Financial Services ("HD Vest"), Roger C. Ochs, President (9/20/05); Investment Company Institute ("ICI"), Frances M. Stadler, Deputy Senior Counsel (9/19/06); and T. Rowe Price.

[26] Associated Securities Corporation ("Associated Securities"), Denise M. Evans, General Counsel (9/19/05); Lincoln; and Pacific Select Distributors, Inc. ("Pacific Distributors"), John L. Dixon, President (9/16/05).

disclosure to customers.[27] Commenters asserted that this disclosure along with the other disclosures already provided to investors in deferred variable annuities would be redundant and would overwhelm investors.[28]

A few commenters supported a mandatory plain English summary and an industry-wide or product specific Q&A that would answer basic questions about fees, taxes, liquidity and other issues.[29] While one commenter requested that NASD wait and consider the proposed rule after the Commission acts on its "point of sale" rule proposal,[30] another stated that the "point of sale" disclosure form would not be a substitute for a "plain English" risk disclosure.[31]

Some commenters opined that the rule would be more effective if it required a registered representative to direct the customer to the variable annuity synopsis, fee table

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[27] See, e.g., American Bankers Insurance Association/ABA Securities Association ("ABIA/ABASA"), Beth L. Climo, Executive Director (9/20/06); ACLI; A.G. Edwards & Sons, Inc. ("A.G. Edwards"), Thomas M. Vacovino, Vice President (9/20/05); HD Vest; ING; Intersecurities; NAVA; SIA; and Wachovia.

[28] AALU/NAIFA; ACLI; Intersecurities; NAVA; SIA; and World Group. Commenters pointed out that investors already receive a prospectus and state-mandated disclosures and may in the future receive an SEC-mandated point of sale disclosure form.

[29] MWA Financial Services ("MWA"), Pamela S. Fritz, Chief Compliance Officer (3/18/05); NASAA; and Pace.

[30] National Planning Holdings, Inc. ("National Planning"), M. Shawn Dreffein, President and Chief Executive Officer (9/9/05). For details regarding the Commission's point of sale rule proposal, see Securities Exchange Act Release No. 49148, (January 29, 2004), 69 Fed. Reg. 6438 (February 10, 2004) and Securities Exchange Act Release No. 51274 (Feb. 28, 2005), 70 Fed. Reg. 10521 (March 1, 2005).

Securities Exchange Act Release No. 51274 (Feb. 28, 2005), 70 Fed. Reg. 10521 (March 1, 2005) ("Supplemental Release").

[31] Pace.

and risk disclosure in the prospectus.[32] Others argued that if NASD and the Commission believe that the prospectus is inadequate, the solution would be to revise the prospectus rather than to require additional disclosures.[33]

While noting in its response to comments that numerous commenters sought to eliminate this provision, NASD modified it to no longer require product-specific disclosure. As revised, the proposed rule would require a registered representative to have a reasonable belief that the customer has been informed of the material features of deferred variable annuities in general. NASD cautioned, however, that this modification would not mean that a firm and its associated person may ignore product-specific features. It noted that the firm and its associated person must be capable of discussing the specific features of the deferred variable annuity under consideration, and must know these features in order to adequately perform a suitability analysis.

The proposed rule would have required a registered representative to document and sign the determinations that he or she has made pursuant to the proposed rule's recommendation requirements. Some commenters criticized this requirement, noting that neither the rule nor the release described what the documentation should look like or how detailed it should be.[34] Another commenter supported this requirement, opining that it would serve the dual purpose of creating a regulatory paper trail and reminding NASD members of the serious analytical undertaking involved in recommending a deferred

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[32] ABIA/ABASA; ACLI; A.G. Edwards; HD Vest; ING; NAVA; SIA; Wachovia; and World Group.

[33] ACLI and World Group.

[34] See, e.g., ACLI; HD Vest; ING; NAVA; and SIA.

variable annuity.[35] After considering the comments, NASD has determined to retain the requirement.

(c) Comments on Proposed Rule 2821(b)(1)(B) – Long-Term Investment Objective

The rule, as originally proposed, would have required members recommending a deferred variable annuity to have a reasonable belief that the customer had a long-term investment objective. Commenters asserted that an investor's time horizon does not have to be long-term in all circumstances for a deferred variable annuity to be suitable, noting that some deferred variable annuities have features that can benefit a customer regardless of age and potential for a long term investment.[36] Some commenters stated that an investor's time horizon should be one factor in a suitability analysis, but that a deferred variable annuity should not be deemed per se unsuitable based on that factor alone.[37]

In response to comments, NASD deleted this provision from paragraph (b) of the proposed rule and all references to long-term investment objectives in paragraph (c) ("Principal Review and Approval") and paragraph (d) ("Supervisory Procedures"). In addition, NASD stated that in general, deferred variable annuities are appropriate only for

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35 Pace.

36 A.G. Edwards; CAI; Fintegra Financial Solutions ("Fintegra"), Kenneth M. Cherrier, Chief Compliance Officer (8/11/05); HD Vest; ING; Intersecurities; Lincoln; NMIS; NAVA; New York Life Insurance and Annuity Corporation ("NY Life"), John R. Meyer, Senior Vice President (9/19/05); SIA; United Planners Financial Services of America ("United Planners), Julie Gebert, Vice President and Chief Compliance Officer (9/19/06); and World Group.

37 Fintegra; Financial Services Institute ("FSI"), Dale E. Brown, Executive Director (9/19/05); Great American Advisors ("Great American"), Shawn M. Mihal, Chief Compliance Officer (9/19/05); HD Vest; MWA; NMIS; National Planning; Pacific Select; United Planners; and World Group.

customers with long-term investment objectives who intend to take advantage of tax-deferred accumulation and annuitization. Although NASD recognized that some deferred variable annuities have shorter holding periods and smaller surrender fees than traditional deferred variable annuities, it stated that a deferred variable annuity is suitable for an investor without a long-term investment objective only in rare cases. NASD also "strongly cautioned" firms to scrutinize any deferred variable annuity transaction involving customers without long-term investment objectives and to carefully document any analysis in favor of recommending such a transaction.

(d) Comments on Proposed Rule 2821(b)(1)(C) – Need for the Product as Compared with Other Investment Vehicles

As originally proposed, the rule would have required members to have a reasonable belief that the customer had a need for the deferred variable annuity as compared with other investment vehicles. Many commenters criticized this provision.[38] Some stated that while customers may "benefit" from a deferred variable annuity, no customer "needs" one.[39] Some viewed the standard as subjective and overreaching, stating that it would require a determination that a deferred variable annuity is the sole, unique investment to satisfy the needs of a customer.[40] Commenters also questioned what other investment vehicles would have to be compared with the deferred variable

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38 See, e.g., ACLI; CAI; HD Vest; NAVA; Pacific Select; United Planners; and World Group.

39 ACLI; CAI; NAVA; and ICI. Some commenters also stated that these provisions conflict with NASD's longstanding concerns about product comparisons.

40 A.G. Edwards; Intersecurities; NMIS; NY Life; SIA; and World Group.

annuity[41] and whether a registered representative would have to compare the deferred variable annuity to products that he or she is not licensed to sell.[42]

NASD noted in its response to comments that it did not intend to require firms to perform a side-by-side comparison of a deferred variable annuity with other investment vehicles or require firms to prove that the customer needed the deferred variable annuity to the exclusion of all other investments. Instead, NASD intends to require firms to analyze whether the customer would benefit from the unique features of a deferred variable annuity. To clarify this, NASD eliminated the references in the proposed rule to "need" and "as compared with other investment vehicles." As revised, the rule would require a member or associated person to have a reasonable basis to believe that "the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit)".

(e) Comments on Proposed Rule 2821(b)(2) – Customer Information

As originally proposed, the rule would have required members to make reasonable efforts to obtain from a customer a variety of information, including age, financial situation, liquid net worth and intended use of the deferred variable annuity. Some commenters urged NASD to delete this provision, stating that NASD Rules 2310 and 3110, as well as Rule 17a-3(17)(i)(A) of the Act, should govern the information that members are required to gather in making recommendations to purchase or exchange deferred variable annuities.[43]

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41 ACLI; CAI; ICI; ING; Mass Mutual; and NAVA.

42 Intersecurities and World Group.

43 National Planning; NAVA; NMIS; and Pacific Select.

Commenters also criticized a number of the terms used in this provision. Some viewed the terms "financial situation" and "liquid net worth" as vague and redundant.[44] Others questioned what constitutes a legitimate intended use of a deferred variable annuity[45] and whether "other insurance holdings" would be limited to life insurance or would also encompass automobile and health insurance.[46] One commenter also inquired whether a registered representative must look to liquidity needs at the time of the sale or in the future and whether investment experience means experience in deferred variable annuities or overall investment experience.[47] After considering the comments, NASD has determined to retain this paragraph with limited revisions.

iii. Comments on Proposed Rule 2821(c) – Principal Review and Approval

The rule, as originally proposed, would have required principals to review and approve the purchase or exchange of a deferred variable annuity before the customer's application was transmitted to the issuing insurance company for processing, regardless of whether the transaction was recommended.

(a) General Comments

Several commenters viewed the proposed principal review requirement as unduly

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[44] NAVA and NY Life.

[45] Associated Securities and FSI. Another commenter asked if these terms were the same as the investment objective. Lincoln.

[46] See, e.g., 1717 Capital Management Company and Nationwide Securities, Inc. ("1717 Capital"), Lance A. Reihl, President (9/19/05); AALU/AIFA; ACLI; CAI; NAVA; NMIS; and NY Life.

[47] Lincoln.

duplicative of NASD Rule 3110.[48] Some stated that the proposed timing requirement and additional standards for principal review would be disruptive for firms that use automated systems to approve transactions that meet established criteria,[49] and one suggested requiring manual principal review only when an application does not meet a firm's standard criteria.[50]

(b) Comments on Proposed Rule 2821(c)(1) – Timing of Principal Review

Two commenters supported the proposed provisions relating to the timing of principal review, stating that it would ensure that a principal would have sufficient time for a complete review while providing greater assurances that unsuitable transactions would not be consummated.[51] Numerous commenters, however, objected to the principal review deadline.[52] Some were concerned that members would be subject to liability for market changes during the delay for supervisory review.[53] Others stated that the timing deadline would require costly reprogramming of broker-dealers' electronic processing systems that forward contracts to the insurance company and the broker's home office at the same time.[54]

One commenter stated that the interaction of this provision with other

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48 See, e.g., ACLI; Lincoln; Mass Mutual; NAVA; and SIA.

49 CAI and NAVA

50 NAVA.

51 NASAA and PIABA.

52 See, e.g., ACLI; CAI; ING; and NAVA

53 Associated Securities; Pacific Direct; and United Planners.

54 CAI and NMIS.

Commission and NASD rules could limit a firm's ability to review applications thoroughly.[55] Another stated that time-linking the application process with supervisory review would impair the goal under the Investment Company Act of 1940's for timely processing.[56] Some commenters stated that a delay in pricing the contract would be unfair to investors.[57]

Two commenters recommended that NASD require the review to be completed prior to the insurance company issuing the contract.[58] One of these commenters noted that while this would require logistical coordination between the principal and the issuer, it would allow insurers to process applications coextensively with the supervisory review, but before the security is issued.[59] Others recommended requiring principals to conduct their review and approval promptly after the completion of the contract application and in accordance with procedures reasonably designed to ensure that problematic purchases are detected and disapproved.[60]

A few commenters stated that the time deadline would not work in the context of direct sales, in which an insurance company may not know of an applicant's interest in a deferred variable annuity until it receives the application.[61] Another stated that the timing

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55 ING.

56 ACLI.

57 ACLI; Pacific Select; and United Planners.

58 ACLI and NY Life.

59 ACLI.

60 CAI and NMIS.

61 CAI; NAVA; and T. Rowe Price.

deadline would not take into account situations in which the registered principal is housed in the insurance company.[62]

A few commenters also stated that their current supervisory structure as an Office of Supervisory Jurisdiction would be incapable of dealing with the prior approval requirement and they would be forced to eliminate this form of supervisory structure.[63] One commenter stated the requirement could overwhelm principals,[64] and another stated that it would require members to allocate two to three times the supervisory staff for deferred variable annuities than for any other product.[65]

NASD responded to commenters' concerns by modifying the timeframe for principal review from "prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company" to "no later than two business days following the date when a member or person associated with a member transmits a customer's application for a deferred variable annuity to the issuing insurance company for processing." It stated that requiring completion of the principal review within two business days of the firm's transmittal of the application to the insurance company is necessary for the protection of investors and should promote efficiency. It also noted that the proposed rule would not preclude firms from using automated supervisory systems, or a mix of automated and manual supervisory systems, to facilitate compliance with the

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62 NMIS.

63 Great American and ING.

64 Wachovia.

65 Associated Securities.

rule. In addition, NASD delineated what, at a minimum, a principal would need to do if his or her firm intends to rely on automated supervisory systems to comply with the proposed rule. Specifically, a principal would need to (1) approve the criteria that the automated supervisory system uses, (2) audit and update the system as necessary to ensure compliance with the proposed rule, (3) review exception reports that the system creates, and (4) remain responsible for each transaction's compliance with the proposed rule. Finally, NASD noted that a principal would be responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed to comply with the rule.

NASD also noted that commenters asked whether the principal review would need to start, but not necessarily be completed, by the time specified in the rule. In most circumstances, NASD stated that under the revised timing requirement for principal review firms would be able to determine the appropriateness of the transactions before the insurance company issues the contract. In NASD's view, requiring completion of the principal review with this time period is necessary for the protection of investors. Moreover, it also believes that requiring a thorough principal review at the early stages of the process also should promote efficiency.

(c) Comments on Proposed Rule 2821(c)(1) – Specific Standards for Principal Review

Commenters objected to the proposed requirements for members to establish standards regarding age, liquidity needs and the dollar amount involved in the

transactions and questioned the need for such standards.[66] While some requested more clarification of appropriate standards, others stated that NASD should mandate specific standards.[67] One commenter criticized permitting firms to individually set their own standards, stating that firms would defend suitability challenges by asserting that the transaction met their own standards.[68] Others expressed concern that without defined standards, a firm's suitability decisions would be second guessed and there would be inconsistent regulation as different NASD districts establish and impose different standards.[69] One commenter stated that the provision would lead principals to emphasize two or three elements of a customer's profile rather than considering all of the facts and circumstances.[70]

In its response to comments, NASD stated that the particular provisions requiring members to establish standards were never intended to require the adherence to bright-line standards. It noted that the establishment of specific thresholds in these instances would unnecessarily limit a firm's discretion in establishing procedures that adequately address its overall operations. NASD intended for principals to consider these factors as part of their facts and circumstances review. As a result, NASD deleted the requirement

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66 See, e.g., Associated Securities; Dominion Investor Services, Inc. ("Dominion"), Kevin P. Takacs, Chief Compliance Officer (9/9/05); FSI; Great American; ING; Intersecurities; Pacific Select; and United Planners.

67 Associated Securities; Dominion; FSI; Fintegra; Great American; MWA; and Wachovia.

68 Pace.

69 See, e.g., ABIA/ABASA; Associated Securities; Dominion; FSI; Great American; and ING.

70 Intersecurities.

for firms to establish standards for age, liquidity needs and dollar amounts.

(d) Comments on Proposed Rule 2821(c)(1) – Non-Recommended Transactions

Some commenters objected to requiring principal review of transactions that are not recommended,[71] and one noted that the information that would be needed for a principal review is not currently required to be collected for non-recommended annuity transactions.[72] Another commenter stated that requiring review for non-recommended transactions would allow principals to second guess investors' decisions.[73]

NASD disagreed, noting that due to the complexity of the products, it is appropriate to require firms to review all deferred variable annuity transactions for problematic sales practices. It stated that the proposed rule would create requirements to ensure that firms perform a consistent, baseline analysis of transactions, irrespective of whether the customer purchased the deferred variable annuity as a result of an associated person's recommendation, thereby enhancing investor protection for all customers.

(e) Comments on Proposed Rule 2821(c)(1)(D) – Rate of Exchanges

Two commenters criticized the proposed provision that would require principals to consider whether the customer's account had a deferred variable annuity exchange within the preceding 36 months, stating it could signal to registered representatives that exchanges occurring more than 36 months apart are appropriate.[74] One commenter stated that, while a firm should generate reports and review a registered representative's sales

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71 See, e.g., ICI; NMIS; and T. Rowe Price.

72 T. Rowe Price.

73 ICI and NMIS.

74 Intersecurities and World Group.

activity for patterns of inappropriate replacements as part of its supervisory procedures, it should not be required to approve each transaction.[75] After considering the comments, NASD has determined to retain the requirement.

iv. Comments on Proposed Rule 2821(d) – Supervisory Procedures

The rule, as originally proposed, would require members to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the rule. Members would be required to implement procedures to screen transactions and require registered principals to consider all of the factors enumerated in paragraph (c) of the proposed rule. They would also have to consider whether the associated person effecting a transaction has a particularly high rate of effecting deferred variable annuity exchanges.

One commenter supported requiring registered principals to review the total production attributable to variable annuities of associated person.[76] One commenter requested guidance as to what a "particularly high rate" refers to and what must be compared to determine it.[77] After considering the comments, NASD determined to retain without modification the provision relating to high rates of exchange.

v. Comments on Proposed Rule 2821(e) – Training

Most of the commenters that addressed the training provision supported it.[78]

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75 Intersecurities.

76 NASAA.

77 Wachovia.

78 See, e.g., FSI; Great American; Lincoln; Mass Mutual; MWA; NAVA; and PIABA.

However, one commenter questioned the need for a specific training requirement and requested clarification regarding what additional training is contemplated.[79] Some suggested that the training obligations in the proposed rule could be met through existing "Firm Element" programs.[80] After considering the comments, NASD determined to retain this requirement.

(f) Comments on the Effective Date of Proposed Rule 2821

NASD stated that the effective date of the proposal would be 120 days following publication of its Notice to Members announcing Commission approval. Numerous commenters requested more time, from 180 days[81] to no less than one year,[82] to comply with the proposed rule. In its response to comments, NASD stated that because some firms likely will have to make operational changes, it would be appropriate to provide additional time for members to comply with the rule, if approved. As a result, NASD stated that the proposed rule's effective date would be 180 days following publication of the Notice to Members in which it announces Commission approval.

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79 ING.

80 See, e.g., Pacific Select; United Planners; and Wachovia. NASD Rule 1120(b) requires each member to establish a training plan that identifies certain minimum requirements. Each year the firm must prepare a written training plan after an analysis of its training needs. Firms must consider certain factors when conducting their analyses and in developing their training plans, such as the firm's size, organizational structure, scope and type of business activities, as well as regulatory developments. This training is referred to as the "Firm Element" portion of NASD's continuing education requirements.

81 ING and Intersecurities.

82 NAVA, SIA, and World Group.

2. Statutory Basis

NASD believes that the proposed rule is consistent with the provisions of Section 15A(b)(6) of the Act,[83] which requires, among other things, that NASD rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public interest. NASD believes that the proposed rule is consistent with the provisions of the Act noted above in that it will enhance firms' compliance and supervisory systems and provide more comprehensive and targeted protection to investors in deferred variable annuities. As such, the proposed rule will decrease the likelihood of fraud and manipulative acts, promote just and equitable principles of trade and increase investor protection.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

The Commission published proposed Rule 2821 (SR-NASD-2004-183) in the Federal Register on July 21, 2005. The comment period closed on September 19, 2005. The Commission received nearly 1500 comment letters in response to the Federal Register publication of the SR-NASD-2004-183. The comment letters and NASD's response to them are discussed in section II above.

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83 15 U.S.C. 78o-3(b)(6).

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule, or

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2, including whether the proposed rule is consistent with the Act.[84] We also invite interested persons to discuss how, if at all, the proposed rule's timing requirement for principal review would impact member firms' ability to efficiently review deferred variable annuity transactions. What changes, if any, would member firms need to make to their supervisory procedures and systems in order to comply with the proposed rule's timing requirement for principal review? If changes would be necessary, we invite interested persons to discuss how current supervisory procedures and systems operate and why those procedures and systems would not accommodate the proposed rule's timing requirement for principal review.

Comments may be submitted by any of the following methods:

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[84] The Commission will consider the comments we previously received. Commenters may reiterate or cross-reference previously submitted comments.

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2004-183 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2004-183. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-183 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[85]

Nancy M. Morris

Secretary

[85] 17 CFR 200.30-3(a)(12).