

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52046A; File No. SR-NASD-2004-183)

July 19, 2005

Self-Regulatory Organizations; National Association of Securities Dealers; Notice of Filing of Proposed Rule and Amendment No. 1 Thereto Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities; Corrected

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, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), the proposed rule as described in Items I, II, and III below, which Items have been prepared by NASD. On July 8, 2005, NASD filed Amendment No. 1 to the proposed rule.³ The Commission is publishing this notice to solicit comments on the proposed rule from interested persons.

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

NASD is proposing to adopt a new rule, proposed NASD Rule 2821, to create recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. The text of the proposed rule is available on NASD’s Web site (www.nasd.com), at NASD’s principal office, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The amendment clarified the rule’s text and provided additional explanations of that text.

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 any 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

NASD is proposing a new rule, proposed Rule 2821, that would impose specific sales practice standards and supervisory requirements on members for transactions in deferred variable annuities.⁴ NASD has been concerned about deferred variable annuity transactions for some time. In part, this concern stems from the complexities of the products, which can cause confusion both for persons associated with members who sell deferred variable annuities and for customers who purchase or exchange them.

Deferred variable annuities are hybrid investments containing both securities and insurance features. They offer choices among a number of complex contract features (e.g., deferred variable annuity contracts may offer various types of death benefits,

⁴ In general, a variable annuity 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.

rebalancing features, dollar cost averaging options, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options).⁵ The amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses. Investors also can be subject to the following fees or charges: surrender charges (which the investor owes if he or she withdraws money from the annuity before a specified period); mortality and expense risk charges (which the insurance company charges for the insurance risk it takes under the contract); administrative fees (which are used for recordkeeping and other administrative expenses); underlying fund expenses (which relate to the investment options); and charges for special features and riders. Moreover, an investor's withdrawal of earnings before he or she reaches the age of 59½ is generally subject to a 10-percent penalty under the Internal Revenue Code.

In addition to the complexity of the product—and perhaps, in part, because of it—NASD examinations and investigations have uncovered various questionable sales practices. In some instances, associated persons sold deferred variable annuities to elderly customers for whom such long-term, illiquid products were not suitable. In others, associated persons sold deferred variable annuities without explaining (and, in some cases, without knowing) the characteristics of the products. On a number of occasions, associated persons recommended that customers exchange one deferred variable annuity for another without ensuring that such exchanges were beneficial for their customers or properly disclosing costs. NASD also determined that a number of

⁵ See Joint Report, supra, note 4.

firms had, in general, failed to adequately train and supervise associated persons regarding deferred variable annuity sales.

When NASD first began noticing these problems, it acted quickly and persistently to address them on several fronts. NASD issued Notices to Members that provided guidelines and reminders about members' suitability and supervisory obligations regarding variable annuities.⁶ NASD also issued Investor Alerts and Regulatory & Compliance Alerts, strengthened its examination program and brought a number of significant enforcement actions concerning deferred variable annuities.⁷

Despite these efforts, problematic sales practices continued. At present, NASD is still seeing some of the same problems that it first noticed in the late 1990s. In June 2004, NASD and the SEC issued a Joint Report on examination findings regarding broker-dealer sales of variable insurance products.⁸ As discussed in the Joint Report, recent NASD and SEC examinations uncovered a number of problem areas, including suitability, disclosure, supervision, books/records and training. In addition to the NASD and SEC examinations discussed in the Joint Report, NASD's Variable Annuity Task

⁶ See, e.g., NASD Notice to Members 99-35 (May 1999) (providing guidance to assist members in developing appropriate procedures relating to variable annuity transactions); Notice to Members 96-86 (Dec. 1996) (reminding members of their suitability obligations regarding variable annuity transactions).

⁷ In 2001, NASD issued an Investor Alert entitled "Should You Exchange Your Variable Annuity?" highlighting important issues that investors should consider before agreeing to exchange a variable annuity. In 2002, NASD issued a Regulatory & Compliance Alert, entitled "NASD Regulation Cautions Firms for Deficient Variable Annuity Communications," that, among other things, discussed NASD's discovery of unacceptable sales practices regarding variable annuities. In another Regulatory & Compliance Alert in 2002, entitled "Reminder—Suitability of Variable Annuity Sales," NASD emphasized, in part, that an associated person must be knowledgeable about a variable annuity before he or she can determine whether a recommendation to purchase, sell or exchange the variable annuity is appropriate. In 2003, NASD issued an Investor Alert, entitled "Variable Annuities: Beyond the Hard Sell," which cautioned investors about certain inappropriate sales tactics and highlighted the unique features of these products. For a discussion of some of the disciplinary cases that NASD has brought involving deferred variable annuities, see Joint Report, supra, note 4.

⁸ See Joint Report, supra, note 4.

Force, an organization-wide initiative, is in the process of conducting special exams of various members and, although the analyses of those exams are not complete, NASD has discovered problems similar to those reported in the Joint Report at some members. Moreover, NASD has received a number of customer complaints indicating that the customers did not understand the unique features of the deferred variable annuities and raising suitability concerns based on the customers' investment objectives and liquidity needs.

In light of these issues, NASD determined that it needed to create a rule specifically covering deferred variable annuities. 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 (May 1999), 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 subaccount allocations.⁹ The proposed rule would not apply to reallocations of subaccounts made after the initial purchase or exchange of a deferred

⁹ 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 does not include requirements for customer sales of deferred variable annuities because NASD believes that such transactions 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 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." NASD, however, will continue to monitor customer sales of deferred variable annuities and will pursue additional rulemaking or other action as necessary.

variable annuity. However, other NASD rules would continue to apply. For instance, NASD's suitability rule, Rule 2310, would apply to any recommendations to reallocate subaccounts.

The proposed rule also would not apply to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans but would apply to the purchase or exchange of deferred variable annuities to fund IRAs. In part, NASD determined not to exclude IRAs from the proposal's coverage 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. However, even in the case of a tax-qualified, employer-sponsored retirement or benefit plan, if a member makes recommendations to individual plan participants regarding a deferred variable annuity, the proposed rule would apply as to the individual plan participants to whom the member makes such 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).

The proposed rule has four main requirements. First, the proposal has requirements governing recommendations, including a suitability obligation, specifically tailored to deferred variable annuity transactions.¹⁰ Second, the proposal includes various principal review and approval obligations.¹¹ The proposal would require that a registered principal review and approve the transaction prior to transmitting a customer's application for a deferred variable annuity contract to the issuing insurance company for

¹⁰ See proposed Rule 2821(b); and Part C, infra.

¹¹ See proposed Rule 2821(c).

processing.¹² However, the timeframe for principal review and approval would depend on whether the principal's review occurs before or after the customer provides the member with the purchase payment for the deferred variable annuity. That is, if principal review occurs after payment has been made, additional rules may be implicated. NASD Rule 2820(d), for instance, requires members to promptly transmit the application and the purchase payment for a variable contract to the issuing insurance company. Similarly, various financial responsibility obligations under SEC Rules 15c3-1 and 15c3-3 require certain members to promptly transfer/forward funds. On the other hand, if principal review and approval occurs before payment has been made, NASD Rule 2820(d) and SEC Rules 15c3-1 and 15c3-3 would not affect the principal review and approval obligations under the proposed new rule.

Third, members would be required to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule.¹³ Pursuant to the proposed supervisory-procedure requirements, members would need to establish certain standards that are reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised. NASD also emphasizes that the member must have policies and procedures in place that are reasonably designed to ensure that an associated person promptly sends the original application or a copy thereof to a principal for review, consistent with the requirements of proposed Rule 2821(c).

¹² As part of his or her review, a principal would be required to consider all of the factors listed in section (c)(1) of the proposed rule.

¹³ See proposed Rule 2821(d).

Fourth, the proposal has a training component.¹⁴ Members would be required to develop and document specific training policies or programs designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of the proposal and that they understand the material features of deferred variable annuities.

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 120 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must 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 members' 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 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.

¹⁴ See proposed Rule 2821(e).

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

The proposed rule was published for comment in NASD Notice to Members 04-45 (June 2004). A copy of the Notice to Members was submitted as part of the original rule filing as Exhibit 2a. NASD received 1,129 comments in response to the Notice. A copy of the index to comment letters received in response to the Notice was submitted as part of the original rule filing as Exhibit 2b (submitted in hard copy). Copies of the comment letters received in response to the Notice were submitted as part of the original rule filing as Exhibit 2c (submitted in hard copy). The overwhelming majority of commenters opposed the proposal. Fourteen commenters fully supported the proposal and an additional 20 commenters offered partial or qualified support for the proposal.

Most commenters questioned the need for the proposal described in the Notice, stating that the proposal is duplicative of existing rules and that NASD should simply enforce those existing rules. NASD disagrees. Certainly, NASD can and does vigorously pursue those who engage in misconduct, but after-the-fact enforcement actions simply do not appear to be sufficiently effective at combating the problems NASD has uncovered.

Moreover, the proposed rule does not merely aggregate existing requirements. The proposed rule is tailored to deferred variable annuities and addresses issues not currently covered by existing rules. For instance, the proposed rule explicitly requires that an associated person have reasonable grounds for believing that the customer has been informed of the material features of the deferred variable annuity.¹⁵ The proposed

¹⁵ See proposed Rule 2821(b)(1)(A). Pursuant to this requirement, the associated person should, at a minimum, highlight for the customer the following material features of the deferred variable annuity: (1) the surrender period; (2) potential surrender charge; (3) potential tax penalty if the customer sells or

rule describes the type of information that an associated person must consider in determining the suitability of an investment in a deferred variable annuity. The proposed rule highlights the important factors that registered principals must consider before approving a deferred variable annuity transaction. The proposed rule also requires members to provide training to associated persons and registered principals regarding the unique features of deferred variable annuities.

A number of commenters also questioned the need for point-of-sale disclosures, stating in particular that the transaction-specific, written-disclosure requirements proposed in the Notice were unhelpful and unworkable. NASD has not included the written-disclosure requirements contained in its Notice in the current proposed rule, but will continue to explore this issue and will separately consider whether to propose such requirements in the future. NASD notes, however, that proposed Rule 2821(b) (Recommendation Requirements) continues to provide, as in the Notice, that no member or associated person shall recommend to a customer the purchase or exchange of a deferred variable annuity unless the member or associated person has a reasonable basis to believe that, among other things, the customer has been informed of the material features of the deferred variable annuity.¹⁶ This provision will promote increased customer awareness of the material terms and features of the deferred variable annuity,

redeems the deferred variable annuity before he or she reaches the age of 59½; (4) mortality and expense fees; (5) investment advisory fees; (6) charges for and features of enhanced riders, if any; (7) the insurance and investment components of the deferred variable annuity; and (8) market risk. Cf. Joint Report, supra, note 4 ("Registered representatives should discuss with the customer all relevant facts such as fees and expenses . . . , the lack of liquidity of these products . . . , and market risk"); NASD Notice to Members 99-35 (May 1999) (same); see also Larry Ira Klein, 52 S.E.C. 1030, 1036 (1996) ("Klein's delivery of a prospectus to Towster does not excuse his failure to inform her fully of the risks of the investment package he proposed.").

¹⁶ See proposed Rule 2821(b)(1)(A).

although, unlike the written-disclosure requirements contained in the Notice, the "Recommendation Requirements" do not prescribe the specific form of disclosure.¹⁷ NASD further notes that the Commission has proposed a rule that would require point-of-sale disclosure of certain fee information regarding, among other products, variable annuities.¹⁸ Numerous commenters argued that the timing of principal review in the Notice was unreasonable and could actually prohibit principals from thoughtfully reviewing transactions. The Notice stated that a principal had to review and approve the transaction no later than one business day following the date when the customer signed the application. NASD has modified the timing of principal review. The proposed rule now would require principal review and, if appropriate, approval before the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company. NASD believes that this requirement provides members with some flexibility while at the same time ensuring that a principal reviews the application before a contract is issued.

NASD disagrees with those commenters who suggested that state-required "free look" periods make early principal review unnecessary. In general, a "free look" period allows the customer to terminate the contract without paying any surrender charges and receive a refund of the purchase payments or the contract value, as required by applicable state law. Free-look periods, which vary by state law, typically range from 10 to 30 days.

¹⁷ See proposed Rule 2821(b)(1)(A).

¹⁸ See SEC Proposed Rule Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. Nos. 33-8358, 34-49148, IC-26341 (Jan. 29, 2004), 69 FR 6438 (Feb. 10, 2004); SEC Proposed Rule, Reopening of Comment Period and Supplemental Request for Comment Regarding Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. Nos. 33-8544, 34-51274, IC-26778 (Feb. 28, 2005), 70 FR 10521 (Mar. 4, 2005).

Allowing a suitability analysis, for instance, to be reviewed by a principal long after an insurance company issues a deferred variable annuity contract would be inconsistent with an adequate supervisory system (which must be reasonably designed to detect and prevent problematic sales). A delayed principal review would make it difficult for a member to quickly identify problematic trends, such as mini-replacement campaigns (a practice in which registered representatives exchange a high percentage of their customers' existing contracts for new contracts, in some cases to meet production requirements or to generate commissions). Allowing principal review to occur after a significant delay also would be contrary to the normal practice for review of transactions involving other types of investments. Moreover, NASD believes that members should contact customers as soon as possible if a principal discovers a problem with the transaction, and this prompt contact could not occur if the principal does not review the transaction for a prolonged period. Further, there may very well be disincentives to reject transactions as time elapses, especially if a contract has already been issued.¹⁹ Finally, some customers may not be aware of or fully comprehend free-look periods. For these reasons, it would be inappropriate to allow for principal review beyond the period stated in the current proposed rule.

A number of commenters also called for the elimination of the principal review requirements for non-recommended transactions. Due to the complexity of the products, NASD believes that it is appropriate to require firms to review both recommended and non-recommended deferred variable annuity transactions. The proposed rule creates

¹⁹ It has come to NASD's attention that some issuing insurance companies process applications for deferred variable annuities in a very short time period (one or two days). In addition, certain rules require relatively quick processing of certain aspects of deferred variable annuities. See SEC Rule 22c-1(c) under the Investment Company Act of 1940.

standards that will ensure that firms perform a consistent, baseline analysis of transactions, regardless of whether the particular transaction has been recommended, thereby enhancing investor protection for all customers. NASD, moreover, is aware of instances where associated persons have told their firms that deferred variable annuity transactions were not recommended in order to bypass their firms' compliance requirements for recommended or solicited sales. The proposed rule's principal-review requirements for non-recommended transactions should reduce the incentive for persons to engage in such conduct.

Finally, a number of commenters stated that the proposed rule should not apply to transactions involving tax-qualified, employer-sponsored retirement or benefit plans. After further analysis, NASD agrees with these commenters and has created an exception for transactions involving such plans under certain circumstances.

NASD emphasizes, however, that members should pay close attention to deferred variable annuity transactions in IRAs, which do not qualify for the proposed exception for tax-qualified, employer-sponsored retirement or benefit plans. A deferred variable annuity purchased for an IRA does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA itself. Moreover, unlike transactions for tax-qualified, employer-sponsored retirement or benefit plans, investors funding IRAs are not limited to the options provided by the plan. Sales of deferred variable annuities to unsophisticated customers in IRAs are of particular concern to NASD, especially in light of certain fees and charges associated with many deferred variable annuities. Thus, principals 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. In this

regard, members should note that paragraph (b)(1)(C) of the proposed rule requires associated persons and paragraphs (c)(1)(A) and (d)(1) of the proposed rule require principals to determine whether the customer appears to have a need for the features of a deferred variable annuity as compared with other investment vehicles.²⁰

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 the foregoing, including whether the proposed rule is consistent with the Act. Comments may be submitted by any of the following methods:

²⁰ NASD notes that, in the context of a customer's purchase of a deferred variable annuity, paragraphs (b)(1)(C), (c)(1)(A) and (d)(1) of proposed Rule 2821 do not require members to perform a side-by-side comparison of the deferred variable annuity with other investment vehicles. Instead, these provisions require associated persons and principals to make reasonable efforts to ensure that the customer has some need for the unique features of the deferred variable annuity (e.g., tax-deferred growth, a guaranteed future income stream, and/or death benefit protection). This, of course, might necessitate a general comparison with other types of investment products (if the customer does not need the insurance feature or tax deferral, for instance, then another product might be more appropriate for the customer, depending on his or her objectives and financial situation and needs), but it would not have to be a side-by-side comparison with other investment vehicles. A side-by-side comparison of two deferred variable annuity contracts being exchanged (or at least a side-by-side comparison of their material features, see, e.g., the factors discussed supra at note 15) would be necessary, however.

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 Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

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, 100 F Street, NE, Washington, DC 20549-9303. 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].

V. Conclusion

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

J. Lynn Taylor
Assistant Secretary

²¹ 17 CFR 200.30-3(a)(12).