PACE INVESTOR RIGHTS PROJECT

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September 19, 2005

Jonathan G. Katz, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549-9303

Re: File No. SR-NASD-2004-183

To Whom It May Concern:

We are writing in response to the SEC's request for comments concerning NASD's Proposed Rule and Amendment Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities. We are commenting on behalf of the Pace Investor Rights Project ("PIRP") in furtherance of its mission to advocate for the rights of individual investors. We appreciate the opportunity to comment on this proposal and on the importance of increasing the supervision of deferred variable annuity transactions generally.

We support the proposed rule because it seeks to curtail persistent, problematic sales practices of NASD members by imposing specific sales practice standards and supervisory requirements on its members for transactions in deferred variable annuities. However, we are not convinced that adoption of the proposed rule would have prevented harm to the investors victimized in recent enforcement actions.[1] Thus, we do not believe that the proposed rule is sufficient, by itself, to deter the worst offenders who are apparently willing to forge signatures,[2] falsify confirmation documentation,[3] sell products to ineligible customers,[4] or even implement company-wide annuity exchange campaigns in apparent disregard of existing NASD conduct rules.[5] Nevertheless, we believe that adoption of the proposed rule will have a beneficial effect on those registered personnel who normally operate within the rules and regulations, by reducing the unfair selling pressure they face to stay competitive with those in the industry who put only their own financial interests first. In regard to the latter, we recommend that NASD step up its

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[1] *See* NASD News Release, "NASD Disciplines Three Firms, Three Brokers for Variable Annuity Abuses — Total Fines Exceed $500,000, With Two Brokers Permanently Barred," May 20, 2004 (Three Firms News Release), *available at* http://www.nasdr.com/news/pr2004/release_04_034.html; NASD News Release, "NASD Charges Waddell & Reed with Suitability Violations Relating to Thousands of Variable Annuity Exchanges and Seeks Customer Compensation; Two Senior Execs Also Charged," Jan. 14, 2004 (W&R News Release), *available at* http://www.nasdr.com/news/pr2004/release_04_004.html. *See also* Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2004), *available at* http://www.nasdr.com/pdf-text/sec_nasd_report_060804.pdf.

[2] *See* Three Firms News Release, *supra* note 1.

[3] *Id.*

[4] *Id.*

[5] *See* W&R News Release, *supra* note 1.

intensity of enforcement and exact far stiffer penalties. Currently, it is not apparent that brokers are facing a difficult cost-benefit choice before proceeding with a questionable transaction.[6]

For recommended transactions, we endorse the requirement that a member not only undertake an appropriateness/suitability analysis but also document and sign any such analysis. This requirement not only provides a regulatory paper trail but also reminds the member that the analytical undertaking is a serious obligation. We also agree with the requirement that a registered principal conduct a review and approval of applications and exchanges before the customer's application is transmitted to the issuing insurance company. This is an improvement over the current "best practices" guidelines that specify no fixed turnaround time.

We strongly disagree with NASD's decision to drop from its rule proposal a requirement originally proposed in Notice to Members 04-45 that members provide to customers purchasing a deferred variable annuity a current prospectus and a "plain English" risk disclosure document whether or not the member recommends the transaction. While commenters to the proposal in Notice to Members 04-45 called this requirement "unhelpful" and "unworkable," we believe that such written disclosure is warranted by the complexity of variable annuity transactions. NASD implies[7] that its decision to omit the written disclosure requirement from its final rule proposal was justified in part by the SEC's proposal to require additional disclosures for certain products, including variable annuities.[8] We disagree. Although we support the disclosure of information that enhances investor protection, we do not believe that disclosures emphasizing point-of-sale transaction costs and conflicts of interest are a substitute for NASD's proposed rule that would have given investors "plain English" risk disclosure. Elimination of this additional disclosure lessens the likelihood that disclosure-receptive customers will have an opportunity to make a self-informed decision to resist or forego a suspect transaction in the face of improper selling pressure. Hence, not only does disclosure have this prophylactic appeal, it may assist enforcement efforts by shrinking the number of suspect transactions and their victims.

Since NASD indicated that it would continue to "explore" the written disclosure requirement, we recommend that any risk disclosure document, in addition to the information originally proposed to be included in the Notice to Members, also include examples that illustrate the negative effect of surrender charges, tax penalties, sales charges, recurring expenses, etc. A table might show the year-by-year surrender charges for a hypothetical $10,000 investment, assuming that the investment remained flat. In our opinion, the disclosure of sales loads and conflicts of interest is not a satisfactory substitute for disclosure on post-transaction event-triggered charges and fees because, for example, disclosure of a conflict of interest at the time of sale does not convey to a potential customer any risk of significant surrender charges and tax penalties. However, the latter disclosures could, if provided, assist a customer in determining

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[6] *Id*. It is not clear from the W&R News Release that the brokers who effected the inappropriate annuity exchanges will face NASD discipline despite having had no reasonable grounds for recommending an exchange. On average, each exchanged contract generated more than $5,500 in commissions and more than $100 per year in ongoing fee sharing.

[7] *See* NASD Rule Filing, Amendment No. 1, at 18-19.

[8] *See* SEC Proposed Rule — Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans and Other Securities, 70 Fed. Reg. 10521 (Mar. 4, 2005); Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Rel. No. 34-49148 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004).

whether surrender charges or tax penalties are likely to come into play under a proposed transaction. As a final point on disclosure, the document should warn investors that purchasing variable annuities within tax-advantaged accounts is not necessary to defer taxes on any gains.

While we generally support the need for principal review and supervisory procedures, we urge the SEC to consider strengthening the language of the proposed rule's provisions in this area to add more concrete standards. Based on supervisory problems documented at Waddell & Reed, we believe that permitting firms to individually set their own standards would invite abuse and provide an "it met the standard" defense to abusers. We recommend that familiar and objective factors such as age, income, liquidity needs, and net worth be used to create uniform standards of review.

We envision that the framework for such a system would assign each customer with an eligibility score that would slot each customer into a category such as "solidly eligible," "maybe eligible" or "solidly ineligible." In this simplified example, a score based on the factor of age alone might designate someone over 100 years old as solidly ineligible and someone in his thirties as solidly eligible. Some range of ages in between would represent the "maybe eligible" category. We believe that some firms would choose not to pursue business outside of the solidly eligible category. However, other firms would likely try to maximize their business generation in all feasible categories. We recommend that the latter treat "maybe eligible" customers as exceptions who would be subject to (1) additional pre-transaction documentation requirements; and (2) post-transaction tracking and monitoring. Comparisons between the track records of the "solidly eligible" and "maybe eligible" customers could be used to refine the standards and the scoring system.

We appreciate the ability to voice our concerns and approval of NASD's efforts to protect the investor. Thank you for your consideration of these comments. Please do not hesitate to contact us if you would like to discuss these issues further.

Respectfully submitted,

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