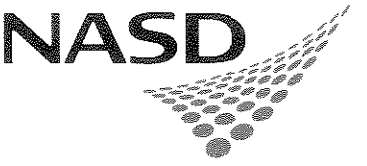
James S. Wrona
Associate Vice President and
Associate General Counsel

Direct: (202) 728-8270
Fax: (202) 728-8264



August 31, 2006

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE – 10th Floor
Washington, DC 20549-1090

Re: File No. SR-NASD-2004-183—Proposed Rule Covering Members' Responsibilities for Deferred Variable Annuities: Response to Comment

Dear Ms. Morris:

ACLI, a national life insurance trade association, argues that NASD has not established a need for a proposed rule covering deferred variable annuities and has not adequately considered the potential costs and burden on competition presented by the proposal. Contrary to ACLI's argument, NASD has shown that investor-protection concerns surrounding the purchase and exchange of this complex product require a formal regulatory response after more than a decade of informal attempts at addressing the problems. In developing the proposed rule, NASD has sought and received extensive feedback from participants in the securities and insurance industries, complied with all statutory obligations governing its rulemaking process, and, in addition, has weighed any burdens on competition and considered potential costs.[1] The current rulemaking record convincingly supports the Commission's approval of NASD's proposed rule.

Need for the Proposed Rule

ACLI argues that the Commission should reject the proposed rule because NASD has not provided quantifiable proof of serious problems with transactions in deferred variable annuities. ACLI's argument is not supported by the Securities Exchange Act of

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[1] NASD has reviewed and analyzed a number of other comments filed in response to the Securities and Exchange Commission's publication in the *Federal Register* of NASD's Amendment No. 2 to SR-NASD-2004-183 (Members' Responsibilities Regarding Deferred Variable Annuities). However, those comments generally raised issues that NASD previously analyzed and addressed as part of the rulemaking process and, therefore, NASD is not addressing them further here. *See, e.g.*, NASD's Original Rule Filing, SR-NASD-2004-183, at 14-19 (Dec. 14, 2004) (Original Rule Filing); NASD's Amendment No. 1 to SR-NASD-2004-183, at 17-22 (July 8, 2005) (Amendment No. 1); Amendment No. 2 to SR-NASD-2004-183, at 36-48 (May 4, 2006) (Amendment No. 2).

RPO, Office of General Counsel
1735 K Street, NW
Washington, DC
20006

tel 202 728 8071
fax 202 728 8264
www.nasd.com

1934 (Act) or the rulemaking record in this matter. As an initial matter, neither the Act nor public policy considerations require quantifiable harm before NASD can engage in rulemaking. NASD can and should be proactive whenever possible. In any event, as NASD stated in its rule filing documents, there are significant and persistent problems with transactions in deferred variable annuities. In part, these problems stem from the unique complexities of deferred variable annuities, which can cause confusion both for the individuals who sell them and for the customers who purchase or exchange them.

Deferred variable annuities are hybrid investments containing both securities and insurance features. As the Commission and NASD explained in a joint report, variable annuities offer choices among a number of complex contract features. For example, variable annuity contracts may offer various types of death benefits, 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. *See* Joint SEC and NASD Staff Report of Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint Report); *see also NASD Notice to Members 99-35* (May 1999). Investors also can be subject to a wide variety of fees and charges, such as surrender charges, mortality and expense risk charges, administrative fees, underlying fund expenses, and charges for special features and riders. Moreover, an investor's withdrawal of earnings before he reaches the age of 59½ is generally subject to a 10-percent penalty under the Internal Revenue Code.

In addition to the inherent complexity of deferred variable annuities—and perhaps, in part, because of it—NASD's examinations, investigations, and informal discussions with its members have uncovered numerous questionable sales practices. These problems include unsuitable recommendations, misrepresentations and omissions, and inadequate supervision and training.[2] It is for these reasons, as NASD has clearly

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[2] *See* Original Rule Filing, *supra* note 1, at 9-11; Amendment No. 1, *supra*, at 10-13; Amendment No. 2, *supra*, at 13-15; *see also* Joint Report, *supra*; *NASD Notice to Members 99-35* (May 1999). ACLI claims that other investment products, such as mutual funds, have resulted in a greater number of formal NASD disciplinary actions. Even disregarding the fact that NASD need not wait until pervasive wrongdoing exists in order to promulgate rules aimed at protecting investors and assuming, arguendo, the accuracy of ACLI's statistics, ACLI's focus on formal disciplinary actions fails to consider all other avenues of gathering information, such as examinations, committee meetings, informal discussions with industry members, etc. In addition, NASD cited in its rule filing myriad, recent formal disciplinary actions involving deferred variable annuities. *See* Amendment No. 2, *supra*, at 14-15 n.19. Although ACLI brushes aside these dozens of recent cases, NASD does not find them insignificant, especially in light of NASD's previous efforts to reduce the problems in this area. Perhaps more important, ACLI's focus on formal enforcement actions, which necessarily occur after violations have been committed, misses the point. The proposed rule is largely intended to prevent sales-practice abuses by fostering improved communications between registered representatives and customers and better training and supervision of registered representatives who sell, and registered principals who review transactions in, deferred variable annuities. The proposal is not intended

[Footnote continued on next page]

articulated throughout the rulemaking process, that a rule tailored specifically to transactions in deferred variable annuities is needed.[3]

Regulatory Process

Over the course of a decade, NASD has addressed problems involving deferred variable annuities through non-rulemaking means on several fronts. For instance, NASD has issued *Notices to Members*, *Regulatory & Compliance Alerts*, and *Investor Alerts* in an attempt to reduce the misconduct in deferred variable annuity sales.[4] Despite those efforts, many of the same problems persist today. Recent joint reviews with the Commission, as well as NASD examinations and enforcement actions, demonstrate that an informal approach has not been sufficiently effective at curbing the problems in this area.[5]

Even after correctly determining that a rule was necessary and appropriate, NASD took a measured approach. As it frequently does in connection with its rulemaking process, NASD presented this particular proposed rule to the public and solicited comments prior to submitting the proposed rule to the Commission. *See NASD Notice to Members 04-45* (June 2004). NASD collected and reviewed all comments and made appropriate changes. In addition, the proposal went to five NASD standing committees (including two committees that possess subject matter expertise regarding variable annuities) for consultation and comment. As it did with the comments received in response to the *Notice*, NASD carefully considered the committees' comments and

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[Footnote cont'd]

as simply another arrow in NASD's enforcement quiver. Thus, the fact that some sales-practice violations are actionable under existing NASD rules does not diminish the need for this prophylactic measure.

[3] In several places, ACLI's comment letter asserts that "[a]ll other securities face the NASD's traditional suitability and supervision rules, while a separate suitability and supervision rule would apply for variable annuities." ACLI's position is inaccurate. From time to time, as appropriate, both the Commission and NASD have created rules focused on specific types of securities or strategies. For instance, the Commission adopted account-opening rules and special suitability and disclosure obligations for recommended penny stock transactions. *See* SEC Rule 15g-9(b)(1) & (2). NASD adopted stringent account-opening procedures and heightened suitability standards for options and futures products. *See* NASD Rules 2860(b)(16)(B); 2860(b)(19)(A) & (B); 2865(b)(16)(B); 2865(b)(19)(A) & (B). NASD also requires special account approval and risk disclosures regarding the use of day-trading strategies. *See* NASD Rules 2360; 2361.

[4] *See* Amendment No. 2, *supra,* at 13-14 & nn.14-16.

[5] *Id.* at 14-15 & nn.17-19.

further modified the proposal in light of those comments. Before NASD filed the proposal with the Commission, the NASD Regulation, Inc. Board of Directors approved it, and the NASD Board of Governors had an opportunity to review it. Both of these Boards have members from inside and outside the securities industry, including representatives from the insurance industry.[6] Moreover, the Commission has published the proposal in the *Federal Register* twice, and NASD has amended the rule twice in response to comments since filing it with the Commission.

Statutory Requirements for SRO Rulemaking

NASD has complied with all rulemaking obligations imposed by the Act, and the Commission is well-positioned to fulfill its oversight role and approve the proposed rule on the current record. There is nothing in Section 15A, Section 19, or elsewhere in the Act that requires NASD to generate a competitive impact statement or otherwise engage in a cost/benefit analysis in its rulemaking of the type suggested by ACLI. The Commission, moreover, need only find that the SRO proposal is "consistent with the requirements of [the Act] and the rules and regulations thereunder applicable to such organization." *See* Section 19(b)(2) of the Act.

Pursuant to Section 19(b)(1) of the Act, NASD submitted to the Commission a "concise general statement of the basis and purpose" of the proposed rule. *See* NASD's Amendment No. 2 to SR-NASD-2004-183, at 9-25 (May 4, 2006). The proposed rule is consistent with Section 15A(b)(6) of the Act and is "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." As stated in its rule filing, NASD believes that the proposed rule will enhance firms' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities. As a result, the proposed rule will decrease the likelihood of fraud and manipulative acts, promote just and equitable principles of trade, and increase investor protection. In addition, the proposed rule does not create a "burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]." *See* Section 15A(b)(9) of the Act. Like all regulation, NASD's rules often impose compliance obligations on the regulated entities. In every case, the compliance burdens associated with a new rule will vary from firm to firm depending upon the firm's customer base, business model, and a variety of other factors. Section 15A(b)(9) of the Act does not, therefore, require that NASD rules impose no economic burden on NASD members or burden on competition, but rather that any such burdens are necessary and

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[6] The NASD Board of Governors is composed of both industry and non-industry members, and one member must be a "representative of an insurance company." *See* NASD By-Laws, Art. VII, Sec. 4(a). Similarly, the NASD Regulation, Inc. Board of Directors is composed of both industry and non-industry members, and one member must be a representative of "an insurance company or an affiliated NASD member." *See* NASD Regulation, Inc. By-Laws, Art. IV, Sec. 4.3(a).

appropriate to further the purposes of the Act. For the reasons discussed above, NASD believes that the proposed rule is consistent with, and promotes the goals of, the Act.

Similarly, the Commission is not required to engage in a formal, detailed cost/benefit analysis before it can approve an SRO proposal. Indeed, to require such an analysis would frustrate the efficiencies that make self-regulation an attractive system. In general, when promulgating a rule or reviewing a proposed SRO rule, the Commission, as part of its public interest analysis, must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[7] In the SRO context, the Commission must find that a proposal is consistent with the requirements of the Act. *See* Section 19(b)(2) of the Act. As the Commission is aware, moreover, rulemaking in the SRO context is somewhat distinct from that of the Commission. NASD, as a securities industry self-regulator, benefits from extensive industry input even before the proposed rule is filed with the Commission. Industry members are keenly aware of the potential costs and burdens that can result from rulemaking and, as is often the case, they raised and NASD considered such issues at multiple stages of the rulemaking process regarding this proposal.[8] To the extent that the instant proposed rule would impose an economic or competitive burden and associated costs on ACLI's members or others, NASD believes for the reasons stated in its rulemaking and reiterated in this letter that any such costs and/or burdens are amply

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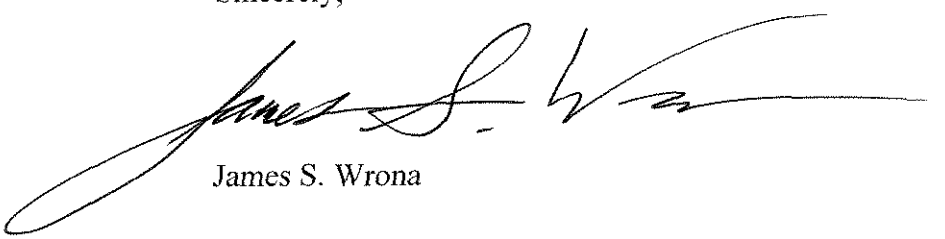
[7] *See* Section 3(f) of the Act. It is important to emphasize that Section 3(f) of the Act unambiguously requires only that the Commission think about or take into account—"consider"—whether a proposed rule fosters efficiency, competition, and capital formation. Thus, in making its finding that the proposed rule is consistent with the Act and in the public interest, the Commission must consider these factors but can always determine that, to the extent costs or burdens are imposed, they are necessary and appropriate in furtherance of the purposes of the Act.

[8] Indeed, the extensive changes that NASD has made to the proposed rule at each step in the process evidence NASD's careful and thoughtful consideration of these and other issues. For example, NASD created a broad exemption for certain transactions made in connection with tax-qualified, employer-sponsored retirement or benefit plans. NASD eliminated the requirement that firms provide a written, product-specific disclosure, which some commenters argued would have been too costly and burdensome. NASD also eliminated the requirement that firms have a reasonable basis to believe that the customer has a need for the deferred variable annuity in comparison with other investment products, in part because of concerns over costs and the burden on competition. Moreover, the requirement that a principal review deferred variable annuity transactions at the early stages of the process not only is necessary for the protection of investors, but it also should promote efficiency (e.g., problems will be caught early and fewer transactions will have to be unwound). In addition, NASD indicated in its rule filing that firms could use automated supervisory systems, under certain circumstances, to increase efficiency while ensuring investor protection. These are but a few examples of NASD's consideration of, and response to, commenters' concerns about costs, burdens, and efficiency.

justified by the necessity and appropriateness of the proposed rulemaking and that the rulemaking is consistent with the Act.[9]

In sum, NASD has carefully evaluated the proposed rule (including its potential economic impact) through a rational and vigorous process, and NASD has complied with all applicable statutory obligations in presenting the proposed rule to the Commission for approval. The fact that NASD is moving forward with the proposal does not, as ACLI has incorrectly suggested, mean that it has failed to consider all relevant factors. NASD properly concluded that investor protection outweighed any potential burdens in this instance. The proposed rule clearly is consistent with the requirements of the Act.[10] The Commission should approve it.

Sincerely,



James S. Wrona

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[9] The rulemaking process and, in particular, the comment process, has been effective. As discussed *supra*, NASD not only considered commenters' concerns about potential economic burdens, but it actually modified the proposal significantly to address those and other concerns. As a result, the most recent version of the proposal that was noticed for comment is more focused and efficient than the original proposal published in June 2004. Moreover, although the Commission need not make such a determination in order to approve an SRO proposed rule, the current NASD proposal also would promote efficiency, competition, and capital formation in a much broader sense. The proposed rule, if approved, will have the effect of increasing customers' understanding of a complicated investment product. This, in turn, will promote efficiency by reducing misunderstandings and confusion (and, ultimately, the need for litigation or arbitration). Moreover, capital formation will be enhanced as a result of customer capital flowing into an investment product in which the customer has more knowledge and confidence. Finally, the heightened and tailored suitability requirement—in addition to promoting efficiency for the same reason noted above—should increase competition as producers seek to offer customers better-designed investment products. These considerations lend further support for the Commission's approval of the proposed rule.

[10] ACLI also suggests in its comment that the proposed rule cannot be afforded "antitrust immunity" absent a more detailed NASD analysis of the potential costs and benefits of the proposed rule. ACLI fundamentally misunderstands the nature of the "antitrust immunity" applicable to SRO action. The comprehensive federal regulatory scheme that Congress has designed for the securities industry reflects its intention to remove SRO action from antitrust attack, so long as the SEC has an oversight role in reviewing the SRO conduct in question. *See United States v. NASD*, 422 U.S. 694, 733 (1975). That is the framework within which the current proposed rule, and all NASD rulemaking, is conducted.