FINANCIAL SERVICES INSTITUTE

VOICE OF THE INDEPENDENT CONTRACTOR BROKER-DEALER

VIA ELECTRONIC MAIL

July 19, 2006

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

RE: SEC File Number SR-2004-283, Amendment No. 2

Dear Ms. Morris:

The Financial Services Institute[1] ("FSI") appreciates this opportunity to comment on Amendment No. 2 to SR-NASD-2004-183 ("Proposed Rule") filed by the National Association of Securities Dealers, Inc. (NASD) on May 4, 2006. The NASD is proposing to adopt a new rule, Conduct 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 ("VAs").

Improvements from Earlier Versions of the Proposed Rule

FSI wishes to acknowledge the thoughtful consideration the NASD has given to comments provided by industry participants in response to the earlier proposal contained in SR-2004-283, Amendment No. 1. In particular, FSI wishes to commend the NASD for making the following improvements to the Rule Proposal:

- The NASD has clarified that the rule only applies to the original purchase or exchange of a deferred variable annuity and does not apply to either reallocations or additional fund contributions.
- The recommendation requirements of section (b) have been modified in several important respects, including:
    - the requirement that customers be informed of product-specific material features has been modified to require the disclosure of the material features of VA products in general;
    - the requirement that the customer have a long-term investment objective has been eliminated; and
    - the requirement that the customer have a "need" for the features of the variable annuity as compared with other investment vehicles has been modified to require the representative to have a reasonable basis upon which to believe that "the customer would benefit from the unique features of a deferred variable annuity."

[1] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed in 2004. Our members are broker-dealers, often dually registered as federal investment advisors, and their independent contractor registered representatives. FSI's 96 member firms have more than 124,000 registered representatives and over $8.3 billion in total revenues. FSI also has more than 3,100 individual members.

- The principal review and approval requirements of section (c) have been modified in several important respects, including:

    - the requirement that the principal review the transaction "prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing..." has been modified to require review and approval of the purchase or exchange of the VA within two days following the transmission of the customer's application to the issuing insurance company for processing;
    - the requirement that the principal consider whether "the customer appears to have a need for the features of a deferred variable annuity as compared with other investment vehicles..." has been modified to require the principal to consider the extent to which the customer would benefit from the unique features of the VA; and
    - the requirement that the member establish specific principal review criteria concerning age, liquidity, percentage of net worth and invested dollar amounts has been eliminated.

These amendments bring greater clarity to the rule while recognizing the complex nature of the principal review process and the variety of available VA products. However, despite these changes, FSI is still concerned about the potential unintended consequences of certain aspects of the Proposed Rule.

Background on FSI Members

The Proposed Rule is of particular interest to FSI and its members. Our independent broker-dealer (IBD) members have a number of similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of mutual funds and variable insurance products by "check and application" direct with the mutual fund or insurance companies; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment advisory firms and/or such firms owned by their registered representatives.

Our registered representative members are independent contractors, rather than employees of the IBD firms. These financial advisors are typically located in communities where they know their clients personally and provide them investment advice in face-to-face meetings – often times over the client's kitchen table. Most of their new clients come through referrals from existing clients or other centers of influence. Due to their close ties to the community in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI members agree that VA products have many features that make them complex investments. We applaud the NASD's effort to enhance investor education and protection. However, FSI members are concerned that the Proposed Rule will inhibit the sale of this important investment product to clients who could benefit from its unique features and, therefore, result in other unintended consequences for those investors.

Consequences of the Proposed Rule

In principle, FSI supports the concept of adapting existing best practice guidelines into a principles based rule that would allow member firms to adopt policies and procedures that are reasonable in light of their firm's business model. However, we believe the Proposed Rule will result in serious consequences for investors, IBDs, and their affiliated financial advisors by:

- Failing to coordinate the Proposed Rule with the final version of the SEC's pending point-of-sale disclosure rule, thereby creating duplicative disclosures that serve to confuse customers.
- Imposing vague product specific suitability criteria that will confuse financial advisors and their customers.
- Imposing an unrealistic and arbitrary period in which to complete the principal review and approval of VA transactions using vague review criteria, thereby emphasizing speed over diligent suitability review.
- Obligating financial advisors to inform clients of the material features of all VA products without providing sufficient clarity as to those features that are considered material.
- Interfering with IBDs' ability to allocate their training resources in the most efficient and effective manner possible, thus depriving some financial advisors of training that may be more relevant to their practice and clientele.
- Increasing barriers to the sale of VAs to customers who would benefit from their unique features, thereby potentially reducing investor choice.

Due to these concerns, FSI respectfully provides the following additional comments for consideration by the NASD and SEC prior to adoption of Conduct Rule 2821.

Detailed Comments

FSI urges the NASD and SEC to use existing mechanisms to involve the insurance industry in this rulemaking process to ensure that the outcome is truly meaningful to the investing public. On May 5, 2006, the Annuity Roundtable, co-sponsored by the NASD and the Minnesota Department of Commerce, opened an important dialogue concerning the regulatory framework under which annuity products are marketed and sold.[2] Shortly thereafter, the Annuity Roundtable began forming working groups to compare annuity (i.e., fixed, variable, and equity index annuity products) regulatory standards in five crucial areas - supervision, suitability, advertising, sales force training, and disclosure requirements. These working groups are expected to be comprised of insurance and securities regulators, and financial services industry executives. The working groups have been tasked with promoting the establishment of comparable rules for annuity sales among all regulators to better serve the interests of investors. FSI believes these working groups offer a great opportunity for the development of a comprehensive solution to the sales, supervision, and education challenges presented by VA and other annuity products. In light of these important developments, FSI believes that the NASD and SEC would do well to table the Proposed Rule until these working groups have had an opportunity to complete their work.

One of the benefits of this approach is that it will provide the opportunity to coordinate the Proposed Rule with the final version of the SEC's pending point-of-sale disclosure rule.[3] The SEC's proposed rule would require broker-dealers to provide investors with targeted information at the "point of sale" and in transaction confirmations regarding the costs and conflicts of interest that arise from the distribution of variable insurance and other products. By its very nature, this proposal contemplates the disclosure of certain material features of VA products. Thus, some of its provisions overlap with the NASD's Proposed Rule. FSI believes that the Annuity Roundtable working groups should work with the NASD and SEC to coordinate the requirements of Conduct Rule 2821 with the final version of the SEC's point-of-sale proposal. We hope the result will be a concise, accurate, and easy to understand disclosure document that summarizes the material

[2] See http://www.nasd.com/RulesRegulation/IssueCenter/VariableAnnuities/NASDW_016465 for more information concerning The Annuity Roundtable, including video of the panel discussions that occurred at this event.
[3] See SEC File No. S7-06-04 – Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities.

features of VA products along with the costs and conflicts of interest that can arise from the distribution of the products. Failure to follow this approach is likely to result in duplicative and confusing disclosures that do not serve the purposes of either the Proposed Rule or the needs of the customer. Therefore, FSI would respectfully urge the NASD and SEC to consider these preliminary steps before imposing the costly and burdensome obligations contemplated by the Proposed Rule.

However, should the NASD and SEC insist upon moving forward with the Rule Proposal, we urge the consideration of the following specific comments:

1. Product Specific Suitability Criteria – FSI is concerned that the Proposed Rule goes far beyond the suitability criteria contained in its general suitability rule (NASD Conduct Rule 2310) to establish a product specific suitability rule directed only at VAs. Although the NASD has imposed product specific suitability tests for options, currency warrants, index warrants and securities futures (see Conduct Rules 2860 and 2865), the suitability standards for these products are not as onerous as those proposed for VAs. If Rule 2310 provides satisfactory suitability standards for all products other than the volatile, high-risk products mentioned above, it should be appropriate for determining the suitability of VAs. If, however, the NASD believes that additional product specific suitability criteria is necessary for VAs, it should develop those criteria through the Annuity Roundtable working groups or other discussions with manufacturers and distributors of these products and either add the product specific criteria through an amendment to Conduct Rule 2310 or add the criteria by Interpretative Memoranda.

   In addition to these general concerns, FSI has a number of issues with the specific suitability criteria outlined in the Proposed Rule. Subsection (b)(1)(B) of the Proposed Rule would require the member firm to have a reasonable basis to believe the "customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit)." Since one or more of the features of a VA are found in other products as well (e.g., fixed annuities or variable universal life insurance), FSI believes the phrase "unique features" is misleading. Therefore, FSI would request that the word "unique" be deleted from the Proposed Rule.

   Paragraph (b)(2) of the Proposed Rule provides that a member must make reasonable efforts to obtain certain product specific suitability information about the customer prior to recommending a VA purchase or exchange. Although we support the NASD's listing of the specific suitability criteria necessary to support a recommendation, we are concerned that certain product specific criteria listed by the NASD are either unclear or irrelevant to a suitability determination. FSI has the following specific concerns about the suitability criteria delineated by the rule:

   - Investment Experience – NASD's inclusion of "investment experience" as a criterion for determining suitability should be clarified. Is it the NASD's intention that investment experience be determined by investments in a VA itself, the sub-accounts, other products including mutual funds, fixed, or equity indexed annuities, or a combination of one or more of these options? Further, is it the NASD's perspective that no prior investment experience renders a VA purchase recommendation unsuitable? Without some guidance, the industry is exposed to future interpretation without precedent or notice.
   - Intended Use of the Deferred Variable Annuity – FSI is concerned about the use of the term "intended use of the VA." How is this term different from the customer's

investment objective? Is either estate planning or tax deferral a legitimate "intended use" or would the NASD require a more detailed analysis? FSI would ask that the NASD further elaborate on the meaning of this term and its anticipated application, or remove it completely from the rule.

- Existing Investment and Life Insurance Holdings – Similarly, FSI is concerned about the Proposed Rule's requirement that members make reasonable efforts to obtain information about the customers "existing investment and life insurance holdings." Specifically, to what extent does the NASD expect "existing investment and life insurance holdings" to bear on the suitability determination? If the customer owns, or does not own, a life insurance policy, fixed annuity, equity index annuity, or similar product, how will the NASD use that information to determine whether or not a VA purchase is suitable? On what basis would either answer lead the NASD to believe the investment was not suitable?
- Failure to Obtain Information – The NASD should clarify that a customer's neglect, refusal, or inability to provide any of the required suitability information shall excuse the member from the need to obtain that information, consistent with SEC Rule 17a-3(a)(17)(i)(C).

2. Obligation to Inform Customers of the "Material Features" of the VA – Subsection (b)(1)(A) of the Proposed Rule prohibits a member from recommending the purchase or exchange of a VA to a customer unless, among other things, it has a reasonable basis to believe that "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…" (emphasis added). IBD firms understand and support the NASD's desire to provide investors with relevant information upon which to base their investment decisions. However, we disagree strongly with the method suggested here. FSI remains convinced that the best, most comprehensive vehicle for proper disclosure of material information is the prospectus. Therefore, we urge the NASD and SEC to focus their efforts on developing a simpler, more "user friendly" prospectus, rather than adopting additional rules that provide for another layer of disclosure. We believe that the Annuity Roundtable working groups provide a wonderful forum for the development of a more effective VA prospectus. However, should the NASD and SEC insist upon the adoption of the disclosure regime contained in the Proposed Rule, FSI members would urge them to provide greater clarity to the term "material features of a deferred variable annuity." The Proposed Rule's use of the qualifying phrase "such as" renders its description of this term incomplete, thereby subjecting our members to second-guessing by regulators and/or plaintiff's attorneys who enjoy the benefit of hindsight. Therefore, FSI would request that the NASD provide sufficient clarity to its definition of material features such that member firms can achieve a reasonable degree of certainty that their procedures comply with the Proposed Rule. In the alternative, FSI requests the inclusion of a safe harbor provision in the Proposed Rule that would protect NASD members who can document that they have made a good faith attempt to disclose the material features of a deferred variable annuity to their customers.

3. Principal Review and Approval – The Proposed Rule requires a registered principal to review each VA purchase or exchange within two business days of the date the member transmits the customer's application to the issuing insurance company. This limited

review period is problematic for FSI members, appears to be arbitrary, and values speed over diligent suitability review and approval. An example will help to illustrate the point. From time-to-time, it may be necessary for a registered principal to obtain additional information from a customer, financial advisor, or OSJ Manager to understand fully the customer's investment objectives or the nature of their complete investment portfolio. Unfortunately, the incidents of day-to-day life are likely to make compliance with the NASD's two business day period unworkable under these circumstances. Failures to properly complete required paperwork, slow mail delivery, vacations and business travel of the customer, financial advisor, OSJ Manager or other supervisor, and other routine daily occurrences could easily result in the failure to meet the Proposed Rule's time frame for review under these circumstances. This could result in unnecessary delays or other more serious problems in the processing of client VA purchases, while giving rise to technical violations of the Proposed Rule by a member firm without regard to the specific circumstances of each transaction. Since there appears to be no reason to prioritize speed over quality supervisory review, FSI would suggest that the Proposed Rule be revised to require the completion of principal review within a reasonable time-period (not to exceed the expiration of the free look period) following the date the member transmits the VA purchase or exchange to the issuing insurance company.

In addition to the foregoing, FSI has the following concerns about the review and approval process:

- Unique Features of a Deferred Variable Annuity – As stated above, FSI believes the many of the features of VAs are not unique to the product. As a result, we would also request that the word "unique" be removed from subsection (c)(1)(A) of the Proposed Rule.
- Undue Concentration as a Requirement of Supervisory Review – The very nature of this product -- the variety of features, sub-accounts, and the combination of insurance and investment features -- easily apply to significant proportions of an investor's assets. The absence of clear regulatory direction and case law on the definition of "undue concentration" in relation to VA products leaves far too much to after the fact interpretation. Therefore, the inclusion of undue concentration as a requirement for supervisory review is in need of additional clarification.
- Deferred Variable Annuity Exchanges – The Proposed Rule requires a registered principal to consider the extent to which "the customer's account has had another deferred variable annuity exchange within the preceding 36 months." FSI strongly objects to this requirement because the information may be unavailable to our members due to a client's reluctance to share such information or privacy policy concerns of the prior broker-dealer or insurance company. Even if this information can be obtained on a periodic and inconsistent basis, it may be difficult to do so within the allotted two-business day principal review period. Further, requiring a rolling 36-month look-back, presumably to include, but not be limited to, exchanges occurring at other member firms, is considerably burdensome and unrealistic. As a result, the NASD should eliminate this requirement from the Proposed Rule.
- Use of Automated Supervisory Systems – In its accompanying release to the Proposed Rule, the NASD states that member firms may use automated supervisory systems to achieve compliance with the Proposed Rules provisions. The release further states that "*a principal* would need to (1) approve the criteria that the automated supervisory system uses, (2) audit and update the automated

supervisory system as necessary to ensure compliance with the Rule, (3) review exception reports that the automated supervisory system creates, and (4) remain responsible for each transaction's compliance with the Rule." (emphasis added) These comments imply that member firms that utilize automated supervisory systems must have a single principal who performs each of these tasks. FSI believes that IBD firms should have the ability to designate several registered principals to handle these diverse functions in accordance with NASD Conduct Rule 3012. Therefore, we would request that the NASD clarify this language to allow members the ability to designate separate principals for these supervisory tasks.

4. Supervisory Procedures – Subsection (d) of the Proposed Rule requires member firms "to implement procedures to … require a registered principal to consider … whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges." This raises several questions for FSI member firms. For example, what does the term "rate of … exchanges" mean? Does the NASD mean to refer to a percentage of the financial advisor's total VA business or instead to a percentage of the financial advisor's customer base? What is the relevant period for measuring the rate of exchanges? What is the yardstick by which a financial advisor's rate of exchanges should be compared to determine whether it is high? What is a member to do if it believes the individual exchange transactions to be suitable although they have occurred at a high rate? Since this requirement is separate and apart from the principal review and approval requirements outlined in subsection (c) of the Proposed Rule, are we safe to assume that it can be performed on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction? Because of these concerns, we urge that this requirement be clarified or dropped from the Proposed Rule.

5. Training – FSI is concerned with the Proposed Rule's requirement that member firms develop training policies and programs reasonably designed to ensure that financial advisors and registered principals involved in the sale and supervision of VA products comply with the requirements of the Proposed Rule and understand the material features of VAs. FSI notes that the obligation to understand the material features of the product a financial advisor sells to his client is inextricably bound up in NASD Conduct Rule 2310's requirement that a member make suitable recommendations to his client. Therefore, there is no apparent need to impose an additional training requirement that will merely serve to create new books and records obligations for member firms. In addition, FSI notes that several recent NASD rule proposals (e.g., the gifts and business entertainment proposal contained in NtM 06-06) have sought to impose separate and unique training requirements. FSI believes that the NASD should refrain from educational mandates and instead rely upon the firm element continuing education provisions of NASD Conduct Rule 1120. This approach would allow NASD member firms to evaluate and prioritize their financial advisors' training needs and design a program that is appropriate to the member's business. The NASD would then have the opportunity to review the firm's training program for compliance with the minimum standards outlined in Rule 1120. If the firm's financial advisors engage in a significant volume of VA transactions, the training program developed by the member would presumably require enhanced attention to the general investment features and risk factors associated with these products. If, however, the firm's financial advisors do not sell a significant volume of VA products, training assets could be dedicated to training on more relevant topics applicable

to the member. In this way, IBD firms can more effectively allocate their training resources to address the unique needs of their firms without regulatory mandates.

6. Unintended Consequences – Finally, FSI is concerned that Proposed Rule 2821, applied in its present form, will have substantial unanticipated consequences. FSI fears that the Proposed Rule will ultimately harm customers by raising the barriers to their access to VA products. Singling out VAs for more stringent suitability requirements is likely to inhibit the sale of this important financial product. Financial advisors may unconsciously "choose" to offer less suitable products because of the additional paperwork, procedures, and supervisory review involved in the sale of VAs. The result may very well be that VAs become less available to those who could benefit from them as legitimate vehicles for tax-deferred savings, estate, and retirement planning. FSI recognizes that there have been some serious abuses involving the sale and exchanges of VAs. However, we do not believe the sales abuses have occurred because the NASD's rules and enforcement mechanisms were not strong enough to prevent them. Therefore, FSI urges the NASD to place additional emphasis on the enforcement of the existing Conduct Rules. In addition, FSI believes that more meaningful disclosures to customers via sponsor-created prospectuses or a disclosure document suggested by the Annuity Roundtable working groups will ultimately help to eliminate most sales practice abuses.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

Dale E. Brown, CAE
Executive Director & CEO

pc: Honorable Christopher Cox
Honorable Paul S. Atkins
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