NSCP

July 19, 2006

VIA EMAIL TO rule-comments@sec.gov

Ms. Nancy M. Morris
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-NASD-2004-183
Comment on Amendment No. 2 to Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities

Dear Ms. Morris:

The National Society of Compliance Professionals ("NSCP") appreciates the opportunity to submit comments on the above-referenced Amendment No. 2 to Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities (the "Amended Proposal").

The Amended Proposal is of considerable interest to the NSCP and its members. NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, effective supervision, and oversight. The principal purpose of NSCP is to enhance compliance in the securities industry, including firms' compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. An important mission of NSCP is to instill in its members the importance of developing and implementing sound compliance programs across-the-board.

Since its founding in 1987, NSCP has grown to almost 1,600 members, and the constituency from which its membership is drawn is unique. NSCP's membership is drawn principally from broker-dealer firms, investment advisers, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel, drawn in roughly equal numbers from broker-dealer, investment advisory and integrated broker-dealer/adviser firms. The NSCP's members represent the entire spectrum of the industry, including employees from the largest brokerage and investment management firms to those operations with only a handful of employees. The diversity

of our membership allows the NSCP to represent a large variety of perspectives in the financial services and asset management industry.

NSCP fully supports the Commission's goal of ensuring that recommended transactions in new and complex products are suitable and that customers are protected from unscrupulous sales and exchange practices in the variable annuity arena, and further acknowledges the important role that supervisory and compliance personnel play in these efforts. However, NSCP remains gravely concerned about the Amended Proposal's unprecedented imposition of affirmative duties upon supervisory and compliance personnel to make individualized suitability determinations, in contravention of the letter and spirit of Section 15(b)(4)(E) of the Securities and Exchange Act of 1934 (the "Act"), 15 U.S.C. § 78o(b)(4)(E), the NASD's existing supervisory rules, and the Commission's own recent decision on supervisory liability in an enforcement action involving similar issues. The NSCP further is very concerned about the undue burden, expense and time imposed on member firms and their supervisory personnel across the entire spectrum of the industry, from large firms to small firms, by the Amended Proposal's requirements concerning the nature and timing of the supervisory review for deferred variable annuity transactions, and the substantial cost and burden of the systems and procedures that would have to be developed and implemented to meet those requirements.

As currently drafted, proposed NASD Conduct Rule 2821(c) purports to require a registered principal to review and determine whether he or she approves of the purchase or exchange of a deferred variable annuity no later than two (2) business days after a member transmits a customer's application for a deferred variable annuity to the issuing company. This time frame is unreasonable and unworkable. The Amended Proposal does not differentiate between transactions that have been recommended and those that have not been recommended. Also, the Amended Proposal does not distinguish between an initial purchase of a variable annuity product or an exchange. Instead, the Amended Proposal purports to impose a mandatory and rigid model that disparately impacts certain sectors of the industry, unduly burdens registered principals and member firms, and unfairly and unjustifiably exposes registered principals and their firms to hindsight criticism and increased exposure to civil and regulatory liability.

For these reasons, the NSCP respectfully submits that the Commission decline to approve the Amended Proposal, and require the National Association of Securities Dealers, Inc. ("NASD") to reconsider whether the rule is even necessary in light of the existing supervisory rules and enforcement provisions, and only if appropriate and necessary, revamp the proposed rules to conform with the letter and spirit of the Act's supervisory obligations, and substantially reduce the burden, expense and time to be imposed by any rules on member firms and the registered principals responsible for supervision of deferred variable annuity transactions.

1. The Amended Proposal Is Inconsistent with the Supervisory Responsibilities Imposed by Section 15(b)(4)(E) of the Act, the NASD's Existing Supervisory Rules, and the Commission's Own Recent Decision Concerning the Scope and Fulfillment of Supervisory Duties.

In derogation of the plain terms and established parameters of § 15(b)(4)(E) of the Act, subsection (c) of the Amended Proposal, "Principal Review and Approval," purports to impose on registered principals the unprecedented obligation to independently determine the suitability of each and every deferred variable annuity transaction. The Amended Proposal by its terms appears to require the principal to "know" the customer at least as well as the registered representative. Subsection (c) of the Amended Proposal mandates that the supervising principal evaluate a host of customer-specific and product-specific factors that go well beyond the well-established parameters for supervisory review and approval of transactions in existing NASD Conduct Rules and long-standing and well-established supervisory systems and procedures throughout the industry.

In In the Matter of IFG Network Securities, Inc., et al., Release No. 34-54127 (July 11, 2006), the Commission expressly declined to impose liability on the supervisor and brokerage firm of a registered representative who negligently omitted to disclose material information to his customers that made the disclosures relating to his recommendation of Class B mutual fund shares misleading. In doing so, the Commission rejected the Enforcement Division's argument that the Class B mutual fund share purchases at issue should have received closer inspection by the supervisor and the firm, and that a more stringent transaction review policy should have been in place to comply with the supervisory duties provided in § 15(b)(4)(E) of the Act. The Commission had no difficulty delineating between more limited supervisory duties and systems reasonably designed to achieve compliance with applicable laws and rules, and the duties and legal obligations of registered representatives who have the account relationship and are in direct contact with their customers. The Amended Proposal, however, ignores this well-established delineation and unjustifiably purports to impose on registered principals the obligation and liability exposure for individual suitability determinations, without due regard for the legal, policy or practical considerations of doing so.

The Amended Proposal further appears to be inconsistent with the NASD's existing supervisory obligations, reflected primarily in NASD Conduct Rule 3010, and goes too far by imposing upon the registered principal the obligation to make independent suitability determinations for all variable annuity transactions, whether solicited or unsolicited, new purchases or exchanges. Nowhere else in the NASD Conduct Rules or in legal precedent does the obligation to supervise go so far.

The limited duties owed by a registered representative handling a non-discretionary account are well-established. The courts have uniformly recognized that

the legal duties owed by a registered representative handling a non-discretionary account are limited to:

> (1) the duty to recommend [an investment] only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) the duty to perform the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing …; (5) the duty not to misrepresent any material fact to the transaction; and (6) the duty to transact business only after receiving approval from the customer.

Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987); accord, Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), aff'd, 647 F.2d 165 (6th Cir. 1981). These limited duties are intentionally and markedly different from traditional fiduciary duties owed by a person who acts as a trustee, conservator or attorney-in-fact.

Importantly, the existing NASD suitability rule, 2310, fully recognizes and accounts for the differing levels of legal duties because it concerns only solicited transactions and requires registered representatives to make suitable *recommendations* to his or her clients. Rule 3010 requires appropriate supervision of the registered representative's activity. These rules do not require the representative to conduct a suitability analysis for unsolicited transactions made by the client.

Moreover, in the context of deferred variable annuity new-cash sales and exchanges, the NASD has discussed requirements for the supervision of the deferred variable annuity products generally in the context of registered representatives *recommending* these investments. See NASD Notices to Members 99-35 and 00-44. To now place the onus entirely on the registered principal to conduct an independent, individualized suitability analysis for unsolicited transactions goes well beyond the previous guidance of the NASD and runs counter to well-established legal principles and the rules, systems and divisions of responsibility already in place. Moreover, adding this burden onto a principal's review of his firm's clients' unsolicited activity creates additional liability, in particular where accounts are neither discretionary nor custodial.

The Amended Proposal further has the improper effect of dramatically expanding the fiduciary obligations owed to customers by registered representatives, and even more surprisingly, registered principals, by mandating real-time, individualized and granular suitability determinations. The Amended Proposal further shifts all responsibility and liability for each and every variable annuity transaction from the customer to the

registered principal by requiring the same level of review and approval for unsolicited transactions as solicited transactions, and exchanges as well as initial purchases.

Finally, the NASD has acknowledged that deferred variable annuities are complex products that require extensive analysis by registered representatives. In recognition of this issue and response to numerous comments, the NASD has backed away from its initial proposal that the registered representative make detailed, accurate product-specific disclosures to each customer in connection with each and every transaction, and has now proposed a rule that allows the registered representative to ensure that the customer has been informed of the material features of deferred variable annuities in general. Nevertheless, the NASD persists in requiring the registered principal to perform an independent, full-blown, customer-specific suitability determination for each transaction, even though in virtually all situations, the registered principal has had no personal relationship or direct communication with the customer, and lacks the practical ability to have same in the short time frame mandated by the Amended Proposal. These dichotomies reveal the confused rationale underlying the Amended Proposal and the improper shifting of all responsibility for a variable annuity purchase decision away from the customer.

In sum, subsection (c)(1) of the Amended Proposal appears to make the registered principal the trustee or fiduciary of each and every customer whose variable annuity transactions he or she reviews, whether or not:

- The transaction is solicited or unsolicited;
- The transaction is an initial purchase or an exchange; or
- The registered principal has ever met or spoken with the customer, or has the practical ability to do so under the severe time constraints (within two days after the customer's application is transmitted to the issuing insurance company) called for the Amended Proposal.

This unprecedented expansion of a registered principal's duties to customers is inconsistent with the supervisory duties contemplated by § 15(b)(4)(E) of the Act and implemented through existing NASD rules, and is contrary to the existing law on the scope of duties owed to a customer in a non-discretionary account setting.

2. The two-day proposal for principal review is unfair and unworkable.

Although the Amended Proposal purports to address comments concerning the NASD's originally proposed time requirements for principal review, approval and documentation, we respectfully submit that the revised version's two-day requirement remains unreasonable, unduly burdensome and impractical. In our view, there has been a failure to adequately consider the costs and burdens the Amended Proposal would impose

on member firms by mandating such a short time frame for the required principal review and approval.

As we stated in our original comments[1], in the vast majority of cases, variable annuity applications are still executed in paper, not electronically. Also, many variable annuity customers and producers are located in remote areas without access to easy electronic alternatives or overnight delivery. Moreover, failure to timely complete work, slow mail, vacations and business travel could easily lead to innocent or benign failures to comply with the proposed rules. The only apparent remedy to this problem would seem to be the substantial and disproportionate expansion of the number of registered principals available to conduct the proposed suitability reviews and the nature and capacity of each firm's existing supervisory systems and procedures.

Even so, the NASD, in its comments in Release 34-54023, then suggests that firms could use automated supervisory systems or a mix of automated and manual supervisory systems to facilitate compliance with the proposed rules. But the NASD warns that the registered principal would nevertheless be held directly responsible for any deficiency in the system that would result in the system no being reasonably designed to comply with the proposed rules. 71 F.R. 36840, Release No. 34-54023 at pp. 23-24.

Conceivably, the Amended Proposal purports to require the registered principal to second-guess the registered representative's suitability determination. The Amended Proposal further apparently contemplates, at the least, some independent conversation or communication between the registered principal and the customer in connection with each and every deferred variable annuity transaction, as well as extensive research and/or detailed knowledge regarding particular product sold compared to other investments to ensure that the most suitable investment was selected for the client. These new requirements would undoubtedly cause member firms to dramatically reduce, and in many cases, completely eliminate, their deferred variable annuity product offerings.

Moreover, this artificially short time frame in all likelihood would undermine the effectiveness and substantive value of any sort of principal review and approval. The unreasonably short time frame may very well cause registered principals to "fly" through the process without sufficient time to make the kind of evaluation that seems to be at the heart of the Amended Proposal. The imposition of such an abbreviated timeframe, coupled with the mandatory consideration of the specified factors, almost assuredly result in an imposition of form over substance. In addition, many legitimate transactions apparently may be unfairly and improperly exposed to criticism and regulatory action merely because review by a principal is not conducted within the proposed two-day principal review and approval period.

[1] National Society of Compliance Professionals, Inc. August 9, 2004 comment letter to the NASD regarding the Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities.

3. The rule disparately affects many member firms due to the dramatic cost and undue burden that would be required to comply with the new requirements of the Amended Proposal.

We believe that all companies, large and small, will feel the substantial burden and negative economic impact of the Amended Proposal because they will be forced to hire additional employees at virtually every level, including administrative, supervisory, compliance and systems, to comply with the rigid, time-consuming and cost-intensive requirements imposed by the Amended Proposal. While some companies such as the largest member companies might be better equipped than others to handle many of the new requirements through greater utilization of their existing technology and computer programs, smaller companies without state-of-the-art technological resources are disparately affected by the demands and burdens the Amended Proposal would impose.

While some very small companies might be able to handle the new requirements simply because they are so small and do not have very many annuity transactions. Other companies, including many mid-sized companies with more regional operations, have a substantial number of annuity transactions and yet do not have the technical capability and supervisory capacity to address these new burdens and obligations imposed by the Amended Proposal. The impact of this rule could force small to mid-sized companies out of the annuity market, thereby reducing competition and eliminating consumer options. Other companies, including, but not limited to the largest member companies, may elect to cease selling deferred annuities at all in light of increased costs and shrinking margins. The NSCP is very concerned that inadequate consideration has been given to the economic impact of the Amended Proposal.

In the same vein, subsection (d)'s supervisory procedures mandates impose on member firms substantial administrative and supervisory costs by requiring the implementation of cumbersome and expensive additional surveillance tools to meet a vague, unhelpful review standard of "a particularly high rate of . . . exchanges." This proposed standard is rife with potential for confusion and provides no real guidance or meaningful parameters that would enable member firms to realistically and reasonably meet the Amended Proposal's requirements.

We also believe that the rigid approach to the suitability review mandated by the Amended Proposal is troublesome. Many member firms will be pressed into utilizing resources in order to fit within a certain mold rather than using those resources to facilitate the deliberative and thoughtful supervision of advisors that should occur with not just variable annuity transactions, but with all securities and investment transactions. Furthermore, simply detailing further requirements only serves to "dumb down" the process, thereby encouraging "list-checking" rather than cognitive evaluation. Moreover, the desired result, i.e., more rigorous standards for potential enforcement against

inappropriate conduct, may well be watered-down by delineation of specific suitability elements and failure to account for other, less frequently-encountered circumstances.

Instead of the "cookie cutter" approach advocated by the Amended Proposal, we believe that the object of any regulatory initiative should be to encourage thoughtful, principle-based evaluation of the suitability determination and responsible monitoring of registered representatives. In light of its many deficiencies and the distorted rationale evidenced by its details, we do not believe the Amended Proposal will achieve the salutary objectives that should be the focus of the proposed regulations.

In addition, the substantial costs and burdens and onerous and time-consuming obligations that would be imposed by the Amended Proposal are grossly disproportionate to the amount of variable annuity transactions done by most firms in relation to transactions in other types of securities and investment products. Consequently, implementation of the Amended Proposal's requirements almost assuredly will go too far in causing firms and registered principals to divert supervisory time, effort, resources and priorities away from virtually all of the firms' other activities to an unjustified degree.

4. The proposed rule fails to take into account the many and varied business models of the member companies and therefore the triggering event for review as required by Rule 2821(c) creates ambiguity for member firms and registered principals alike.

Even as altered after the prior comment period, the Amended Proposal still fails to account for the many and varied business models in the industry. For example, in some instances, the registered principal who is to conduct the review is stationed at the issuing insurance company itself. If taken quite literally, those individuals might not be able to serve as the reviewing principal because the triggering event of the proposed rule's supervisory review is the transmission to the issuing insurance company. Thus, the Amended Proposal would create confusion regarding who can serve as the reviewing principal as well as what event triggers the need for the review in the first place.

Additionally, in many instances, with modern technology, an application is immediately transmitted to the issuing insurance company as well as the member firm, thereby triggering a simultaneous review and issuance process. As the Joint SEC/NASD Report recognizes, "one size" does not "fit all" when it comes to sound and/or weak practices.[2] The imposition of the identical two-day requirement for review by a registered principal does not factor in these differences among member firms. This "cookie cutter" approach to the timing of review does not advance the goal of thoughtful, cognitive, principles-based and consistent review of all securities transactions by a registered principal. Indeed, where a principal such as one who might serve on behalf of a

[2] *Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*, June 2004.

smaller member firm, has the responsibility for review of not only variable annuity transactions, but also other securities transactions, the two-day rule almost assuredly will cause deferred variable annuity transactions to consume a disproportionate amount of time and attention in comparison with all other securities transactions that do not have the same time constraints.

In conclusion, while the NSCP and its membership staunchly endorse the appropriate regulation to ensure that suitable investments are recommended to all customers, our review of the Amended Proposal leads us to the conclusion that the NASD's approach goes too far and puts far too much burden, cost and liability exposure on registered principals and their firms' supervisory systems and procedures. We therefore respectfully request that the Commission decline to approve the Amended Proposal.

We hope that these comments are useful in the Commission's consideration of the Amended Proposal. If and as appropriate, we would be pleased to discuss our views in more detail with the Commission and its staff.

Very truly yours,

Joan Hinchman
Executive Director, President and CEO

The National Society of Compliance Professionals, Inc.
22 Kent Road
Cornwall Bridge, Connecticut 06754
Phone: 860-672-0843, Fax: 860-672-3005
Email: jhinchman@nscp.org