FINANCIAL SERVICES INSTITUTE

VOICE OF THE INDEPENDENT CONTRACTOR BROKER-DEALER

VIA ELECTRONIC MAIL

March 5, 2007

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. 3

Dear Ms. Morris:

The Financial Services Institute[1] ("FSI") has significant concerns with Amendment No. 3 to SR-NASD-2004-183 ("Proposed Rule") filed by the National Association of Securities Dealers, Inc. (NASD) on November 15, 2006. The NASD's proposal would result in the adoption of new Conduct Rule 2821 in order to impose recommendation requirements (including a suitability obligation), principal review and approval requirements, supervisory procedure requirements, and training requirements tailored specifically to transactions in deferred variable annuities ("VAs").

Improvements from Earlier Versions of the Proposed Rule

We 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. 2. In particular, we want to commend the NASD for making the following improvements to the Rule Proposal:

- Clarifying that the customer must be informed of the standard features of a generic VA product.
- Removing the inaccurate references to "the unique" features of VA products.
- Clarifying the recommendation requirements for VA exchange transactions.
- Providing additional time for the registered principal to review VA transactions when contact with the customer or financial advisor is necessary.
- Providing a procedure for the authorization of unsolicited VA transactions without registered principal approval should the client persist in their desire to invest in the product.
- Clarifying that supervisory review of rates of VA exchanges is to occur periodically.

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

[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 102 Broker-Dealer members have more than 128,000 registered representatives serving more than 14 million American households and generating in excess of $11.3 billion in annual revenues. FSI also has more than 5,400 Financial Advisor members.

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 efforts to enhance investor protection. However, FSI members are concerned that the Proposed Rule will result in unintended consequences for those investors, financial advisors, registered principals, and broker-dealers.

Concerns Related to the Proposed Rule

FSI is concerned that the SEC may move to adopt Amendment 3 to the Proposed Rule without the benefit of additional industry comment. We believe this would be a grave error. Despite considerable effort by the NASD to improve the Proposed Rule, many of the concerns raised by FSI and other industry commentators still have not been adequately addressed. These concerns include the following:

- Raising the suitability standard to an unreasonable level.
- Obligating financial advisors to inform clients of "various" unspecified features of all VA products without providing sufficient clarity as to those features that are considered material.
- 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.
- 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 valuable features, thereby reducing investor choice.

As a result of these concerns, FSI urges the NASD and SEC to obtain additional industry input prior to adoption of Conduct Rule 2821.

Detailed Comments

FSI respectfully provides the following additional comments for consideration by the NASD and SEC prior to adoption of Conduct Rule 2821:

1. Suitability Standard – Paragraph (b)(1)(A) of the Proposed Rule prohibits a registered representative from recommending the purchase or exchange of a VA unless he/she "has **determined** that the transaction is suitable in accordance with Rule 2310…" This new language raises the bar for suitability determinations by requiring the registered representative to determine his recommendation is suitable, rather than simply having "reasonable grounds for believing that the recommendation is suitable" as required by Rule 2310. As a result, FSI believes the language in this paragraph should be amended to read as follows:

> **(b) Recommendation Requirements**
>
> (1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has ~~determined~~ a reasonable basis to believe
>
> (A) that the transaction is suitable in accordance with Rule 2310…

2. Obligation to Inform Customers of Various Features VA Products – Subsection (b)(1)(A)(i) 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, in general terms, of "various" features of VAs including specific features which are delineated in the Proposed Rule. The use of the word "various" in this provision creates an unacceptable level of ambiguity. The prior proposal required the disclosure of "material" features of VAs. This language is preferable and should be reinserted into the Proposed Rule. As a result, FSI believes the language in this paragraph should be amended to read as follows:

> (i) the customer has been informed, in general terms, of ~~various~~ the material features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

3. Product Specific Suitability Criteria – 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 it apply to the VA itself, the sub-accounts or both? Without some guidance, the industry is exposed to future interpretation without precedent or notice. Further, is it the

NASD's perspective that no prior investment experience renders a purchase recommendation unsuitable?

- Intended Use of the Deferred Variable Annuity – FSI remains concerned about the use of the term "intended use of the VA?" How is this 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 asks that the NASD further elaborate on the meaning of this term or remove it completely from the rule.
- Existing Assets – The Proposed Rule has been amended to require the financial advisor to make reasonable efforts to obtain information concerning the customer's "existing assets (including investment and life insurance holdings)…" This language is overly broad in that it could potentially require representatives to obtain information about assets that have no impact on the suitability of their recommendation (e.g., automobiles or jewelry owned by the customer). FSI recommends that the requirement be amended to obligate the representative to make reasonable efforts to obtain information concerning the customer's "investable assets."

4. Principal Review Standard – Paragraph (c) of the Proposed Rule requires a registered principal to "review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity." The Proposed Rule goes on to say that "a registered principal shall approve the transaction only if the registered principal has determined that there is a reasonable basis to believe that the transaction would be suitable" based upon the suitability criteria delineated in the recommendation requirements of the rule. This language obligates the registered principal to make a separate suitability determination thereby placing him/her in the same shoes as the financial advisor making the sale without the benefit of meeting with the client to discuss their financial situation and objectives. This appears to be a significant deviation from the requirements of 3010(d)(1) which states in relevant part:

> Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions... Such procedures should be in writing and be designed to reasonably supervise each registered representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available to the Association upon request.

As a result, FSI believes the language in the Proposed Rule paragraph should be amended to read as follows:

> (c) …a registered principal shall ~~review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. Subject to the exception provided below, and treating all transactions as if they have been recommended for purposes of this principal review, a registered principal shall approve the transaction only if the registered principal has determined that there is a reasonable basis to believe the transaction would be suitable based upon~~ consider the factors delineated in paragraph (b) of this rule in considering whether to approve or disapprove of the purchase or exchange of the deferred variable annuity…

5. Time Frame for Principal Review and Approval – The Proposed Rule requires a registered principal to review and determine whether he/she approves of a VA purchase or

exchange within two business days of the date the member transmits the customer's application to the issuing insurance company. The registered principal is granted three additional business days, for a total of five business days, if it is necessary in the course of the review to contact the customer or financial advisor. This limited review period is problematic for FSI members and seems to have been arbitrarily adopted. While FSI understands that the NASD believes that requiring completion of the principal review within this time frame is necessary for the protection of investors, we fail to understand how investors would be harmed if another appropriate time frame were adopted. Should the Proposed Rule be adopted, FSI anticipates many independent broker-dealer firms (IBDs) may require original VA applications, client checks, and other transaction documents to be forwarded to their home office compliance department for review and approval prior to transmission to the issuing insurance company. This procedure would provide the home office with greater control over the principal review process and the ability to insure compliance with the time frame for such review. This procedure, however, has the potential to cause IBD firms who act as introducing broker-dealers to run afoul of custody of funds rules if they attempt to make use of the full principal review time frame. As a result, IBD firms adopting this procedure are limited to a single business day for principal review. This appears entirely unreasonable and contrary to the investor protection goals of the Proposed Rule. In addition, compliance with the Proposed Rule will require member firms to track the date of transmittal and approval thus creating additional recordkeeping burdens. As a result, FSI suggests that the Proposed Rule be revised to require the "prompt" completion of principal review. If the NASD insists upon a more specific review period, FSI suggests that the Proposed Rule be revised to require completion of the 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.

6. Variable Annuity Exchange Supervisory Procedures – Paragraph (d) of the Proposed Rule requires member firms to "implement surveillance procedures to determine if the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions" of the Proposed Rule. FSI objects to this requirement because the information may be unavailable to our members due to a client's reluctance to share such information or the legitimate privacy policy concerns of the prior broker-dealer or insurance company. As a result of these concerns, the NASD should amend the Proposed Rule by stating that it is the registered principal's obligation to consider prior VA exchange information if it is available to him at the time of his review. However, if the SEC and NASD choose not to amend the Proposed Rule in this fashion, FSI asks that they provide additional clarification concerning its requirements. Specifically, 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? Finally, this provision is particularly troublesome to FSI members as it seems to suggest that broker-dealers have the technology available to be able to monitor this exchange activity. Many of FSI's members simply do not.

7. Training – In general terms, FSI supports the NASD's desire to increase the knowledge and awareness of financial advisors and principals who are involved in the sale or

approval of VA transactions. These are complex products and their features and internal costs vary widely. It is important for representatives and principals to fully understand the product features to ensure they meet the client's specific needs. Nevertheless, FSI remains concerned about the Proposed Rule's training requirements 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. Unfortunately, even the best training policies and materials will not "ensure" such understanding. Instead 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 for this 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 allows NASD member firms to evaluate and prioritize their financial advisors' training needs and design a program that is appropriate to the task. 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 would be required to focus significant attention to the general investment features and risk factors associated with these products. If, however, the firm's financial advisors do not sell VA products, or have not been the subject of VA related complaints or arbitrations, training assets could be dedicated to training on more relevant topics. In this way, IBD firms can more effectively allocate their training resources to address the unique needs of their firms.

8. Unintended Consequences – FSI fears that the Proposed Rule will ultimately harm customers by raising 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 NASD 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,

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Executive Director & CEO

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