

September 19, 2005

**VIA E-MAIL**

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

**Re: File Number SR-NASD-2004-183; Release No. 34-52046A  
Proposed Rule Relating to Sales Practice Standards and Supervisory  
Requirements for Transactions in Deferred Variable Annuities**

Dear Mr. Katz:

We are submitting this letter on behalf of our client, the Committee of Annuity Insurers (the "Committee").<sup>1</sup> The letter responds to a request for comments by the Securities and Exchange Commission (the "SEC" or "Commission") on a rule recently proposed by the National Association of Securities Dealers, Inc. ("NASD"). The proposed rule, which would be codified in the NASD's Conduct Rules as Rule 2821 ("Rule 2821" or the "Proposed Rule"), would create recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements that would apply solely to sales and exchanges of deferred variable annuity contracts.<sup>2</sup>

The Committee supports the provisions of Rule 2821 that would codify recognized, justifiable suitability standards and supervision and training requirements that would provide customers of NASD member firms who purchase or exchange variable annuities (collectively, "transactions") with protections equivalent to those provided to customers who purchase other securities such as mutual funds or general securities products. However, the Committee strongly opposes certain vague and overly-broad

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<sup>1</sup> The Committee of Annuity Insurers is a coalition of 30 life insurance companies that issue fixed and variable annuities. The Committee was formed in 1981 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent over half of the annuity business in the United States. A list of the Committee's member companies is attached as Appendix A.

<sup>2</sup> See *Self-Regulatory Organizations; National Association of Securities Dealers; Notice of Filing of Proposed Rule and Amendment No. 1 Thereto Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities; Corrected*, Securities Exchange Act Release No. 52046A; File No. SR-NASD-2004-183 (July 19, 2005), 70 Fed. Reg. 42,126 (July 21, 2005) (the "Proposing Release").

suitability requirements imposed by paragraph (b) of Rule 2821 and the principal pre-approval requirement imposed by paragraph (c) of the rule. These provisions of the Proposed Rule would impose compliance obligations on broker-dealers selling variable annuities that are significantly more burdensome than requirements governing the sales of most other securities, including mutual funds and general securities products, without a commensurate benefit to investors.

Specifically, Rule 2821 would establish vague and unprecedented suitability requirements, including a prohibition on recommending a variable annuity unless the NASD member firm or its registered representative, and then again a registered principal of the firm, determine that the contract is *more* suitable for the customer than *other* investment vehicles. The principal pre-approval requirement of Rule 2821 would require the variable annuity industry to fundamentally alter existing sales processing systems at indeterminate, but potentially enormous, costs.

The Committee is extremely concerned that that the overbroad suitability and principal pre-approval requirements of Rule 2821 will make it significantly more burdensome for NASD members to sell—and for investors to purchase—deferred variable annuity contracts. The requirements would also potentially expose NASD members to an increased level of litigation and regulatory enforcement actions. The end result may be that some firms simply stop selling variable annuities. The Committee does not believe that NASD has provided objective data regarding disciplinary actions that would support singling out variable annuities for the application of uniquely burdensome regulatory requirements, nor has it identified specific commensurate benefits to investors or assessed the burdens associated with any benefits in any cost-benefit study where the results have been published. In short, the Committee believes that these provisions of Rule 2821 represent an unfortunate example of regulatory over-reaching that is simply not the right way to regulate sales of an important financial product providing millions of Americans with unique protections and guarantees.

Section I below summarizes Rule 2821's administrative history in order to provide context. Section II explains which of Rule 2821's "Recommendation Requirements" the Committee opposes and the reasons for such opposition. Section III provides a similar explanation regarding Rule 2821's principal pre-approval requirements. Section IV requests clarification on Rule 2821's applicability to subsequent purchase payments on deferred variable annuities.

## **I. Administrative History of Rule 2821**

NASD initially proposed Rule 2821 in June of last year.<sup>3</sup> As proposed, the rule would have imposed a series of new requirements on NASD member firms and their

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<sup>3</sup> The rule was published for comment by NASD in Notice to Members 04-45 (June 2004) ("NTM 04-45").

associated persons selling variable annuities. After NASD proposed Rule 2821, it received over 1,100 comment letters, including one from the Committee. Commenters overwhelmingly opposed certain provisions of the rule as unworkable and unnecessary. NASD significantly revised the rule, scaling it back in several respects.<sup>4</sup> Then, in December of 2004, NASD filed the revised rule with the SEC for publication for public comment as required by Section 19(b) of the Securities Exchange Act of 1934 (the “1934 Act”) and Rule 19b-4 thereunder.

Although Rule 2821 was filed with the SEC last December, the SEC did not publish that version of the Proposed Rule for public comment. On July 8, 2005, the NASD filed an amended rule proposal reflecting yet additional revisions to the rule.<sup>5</sup> In the intervening seven months, we understand that NASD staff continued to engage in a dialogue with the industry and the staff of the SEC. On July 21, 2005, the Proposed Rule was published in the Federal Register for public comment.<sup>6</sup>

## **II. Paragraph (b) of Rule 2821—Requirements Relating To Recommended Transactions**

The Proposed Rule contains specific requirements that a member firm or its associated persons must have a “reasonable basis to believe” have been satisfied prior to recommending a purchase or exchange of a deferred variable annuity. These requirements would be specific requirements that are applicable to a registered representative recommending the purchase of a deferred variable annuity, in addition to the “general” suitability requirements that are already applicable under NASD Conduct Rule 2310. While the Committee is aware that such express suitability requirements for particular types of securities are not unprecedented, they are relatively unique.<sup>7</sup>

NASD insists that the reasons for the “extra” suitability requirements are that “problematic sales practices” have continued despite their efforts to address those sales practices through the issuance of two notices to members,<sup>8</sup> *Investor Alerts, Regulatory and Compliance Alerts*, enforcement actions and strengthening its examination program.

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<sup>4</sup> NASD eliminated prospectus delivery, risk disclosure document, and mandatory exchange form requirements from the Proposed Rule.

<sup>5</sup> The text of the Proposed Rule can be found at:  
[http://www.nasd.com/web/groups/rules\\_regs/documents/rule\\_filing/nasdw\\_014678.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_014678.pdf).

<sup>6</sup> The notice of the filing the proposed rule can be found at:  
<http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/pdf/E5-3903.pdf>.

<sup>7</sup> See, e.g., NASD Conduct Rule 2810(b)(2)(B) requiring that a member firm or associated person have reasonable grounds to believe that the participant in a direct participation program will be in a position to be able to realize the benefits of such a program, including the tax benefits.

<sup>8</sup> See NASD Notice to Members 96-86; NASD Notice to Members 99-35.

However, NASD does not provide any hard data on the number of deferred variable annuity contracts that are sold, the number of registered representatives that are selling such contracts, and the number of enforcement actions and customer complaints that resulted from such sales. NASD's case would be much stronger if it identified, quantitatively, how the variable annuity market compared to the market for other types of securities, thus identifying why there is a need for "special" treatment for deferred variable annuities. The fact that (1) NASD is bringing enforcement actions in the deferred variable annuity arena, and (2) customer complaints exist, could also be viewed as a natural evolutionary development of a growing market.

The Committee does not believe that the scope and prevalence of the alleged sales practices issues with the sale of deferred variable annuities merit special suitability rules. One recent and prominent example of an area where NASD felt there were significant sales practice issues, and **did not** respond by imposing more substantive suitability rules is the sale of Class B mutual fund share ("B-Shares"). NASD addressed the sales practice issues of B-Shares simply by providing guidance to members on the issues, and bringing enforcement actions with what it believed to be appropriate fines.<sup>9</sup>

While the Committee does not agree with NASD's assessment that the marketplace for deferred variable annuity sales is in need of specific suitability requirements, the Committee has recommendations below to improve the clarity and fairness of such requirements should they be found to be necessary.

**A. Rule 2821(b)(1)(B)—"Long Term Investment Objective" Requirement**

The Proposed Rule requires that the member firm or its associated persons have a reasonable basis for believing that the customer has a long term investment objective. The Committee believes that this finding is not appropriate in all cases, and believes that a more appropriate formulation to address NASD's apparent concern with the characteristics of the deferred variable annuity customer would be to focus on the liquidity needs and objectives of the customer. Deferred variable annuities have a variety of pricing and expense structures which could render the requirement to find a "long term" investment objective unhelpful and inappropriate. As an example, certain deferred variable annuity contracts are offered without contingent deferred sales charges, so there would not necessarily need to be a long term investment objective in all cases with those

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<sup>9</sup> For example, NASD issued guidance to its members reminding them of their responsibility to inform their customers of the differences between mutual fund share classes and to consider the suitability of share class when making recommendations to customers (*see* NASD Notice to Members 95-80 and Regulatory & Compliance Alert, Summer 2000). Similarly, NASD attempted to educate investors on the issue of share class suitability (*see* NASD Investor Alert, "Class B Mutual Fund Shares: Do They Make the Grade?" (Jun. 25, 2003); *see also*, NASD Investor Alert, "Understanding Mutual Fund Classes" (Jan. 14, 2003)). NASD brought nearly three dozen enforcement cases against broker-dealers for unsuitable share class sales from 2000 to 2004 (*see* Speech of Elise B. Walter before 27th Annual Securities Industry Association Sales and Marketing Conference, September 28, 2004).

types of deferred variable annuity contracts. Moreover, there may be cases where the age and retirement plans of the customer would militate against a finding of a “long term” investment objective, but such customer may still have a funding need that would be an extremely good match for a deferred variable annuity. The Committee is also concerned with attempts to determine what constitutes a “long term” objective, and believes that this nebulous standard needs clarification. For example, many investors who have long term investment objectives nonetheless want access to their invested dollars (in the case of a variable annuity, contract value). In addition, some variable annuities also have surrender charge waivers for a certain specified level of withdrawals, which weakens the need to have a “long term” objective. It is not clear under Rule 2821’s “long term objective” standard whether a variable annuity applicant expressing this preference would cause a registered representative and his or her firm to be unable to conclude that the investor has a long term objective.

The Committee believes that a more appropriate approach would be to focus on the liquidity needs of the customers, and not to provide any “bright line” rule about the customer profile for a deferred variable annuity contract. The Committee recommends the following as language that could be substituted that would address the NASD’s apparent concerns related to the investment’s time horizon in deferred variable annuity contracts:

(B) the deferred variable annuity contract is not inconsistent with the liquidity needs and objectives of the customer.

**B. Rule 2821(b)(1)(C)—“Comparative Need” Requirement**

The Committee has significant concerns regarding the requirement under Rule 2821(b)(1)(C): “the customer has a need for the features of a deferred variable annuity as compared with other investment vehicles.” The Committee believes strongly that this requirement is both unnecessary and unprecedented. The Committee is not aware of any other NASD Conduct Rule under which a member firm is required to make a finding that the features of the investment product is “needed” by the customer, or that requires the member firm to compare the product to other investment vehicles. NASD should not be in the business of requiring its firms to make a determination that a customer “needs” a particular feature of an investment, nor should a member firm be forced to compare a deferred variable annuity with the purchase of other investment products. It is unprecedented, and contrary to significant concerns NASD has expressed about product comparisons in other contexts, to require a member firm to compare the purchase of a deferred variable annuity with other products. While NASD has made qualitative references that “problematic sales practices”<sup>10</sup> exist for variable annuities, it certainly has not come close to making a quantitative case that sales practices and customer complaints

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<sup>10</sup> See Proposing Release at 42,127.

related to deferred variable annuities merit unprecedented treatment by requiring a comparison against other products, and essentially a requirement that the variable annuity product be somehow “better” than any other investment vehicle that a customer might choose.

The Committee is also concerned with the confusing guidance related to the performance of a product comparison.<sup>11</sup> The guidance in footnote 20 of the Proposing Release is particularly vexing in light of NASD’s longstanding concerns about product comparisons. NASD suggests that “a general comparison with other types of investment products” might be sufficient. With respect to variable annuity advertising, NASD takes the position that “[a]ny comparison in advertisements or sales literature between investments or services must disclose *all material differences* between them, including (as applicable) investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features.”<sup>12</sup> Moreover, NASD’s Advertising Regulation Department routinely finds fault with and rejects advertising and sales literature submitted for its review comparing variable annuities to other investment products by finding that it fails to appropriately convey all of the material differences between investment products. Therefore, the idea that NASD is requiring a comparison to other products be performed, seems on its face to conflict with the serious concern that NASD itself has about the utility of comparing different investment products.

The Committee does have language that it believes would appropriately address many of the concerns identified by NASD, while at the same time not placing deferred variable annuities in a completely unique position as compared to any other type of security by requiring a product comparison. The Committee recommends that the requirement may appropriately focus on the features available through a deferred variable annuity, but that no comparison to other investment vehicles should be required. The Committee recommends that Proposed Rule 2821(b) (1)(C) be revised to read as follows:

(C) the customer has a need for, or would benefit from, the features of a deferred variable annuity.

#### **C. Rule 2821(b)(2)—“Laundry List” Informational Requirement**

The Committee has concerns with part of the “laundry list” of items identified in Proposed Rule 2821(b)(2) that must be obtained prior to making a recommendation. In particular, the Committee is uncertain as to the relevance of the “insurance holdings” of a potential customer. The Committee believes that there are several problems with this item. First, it is not clear what “insurance holdings” are required to be reviewed. Is this a requirement that an individual’s car and homeowner’s insurance, and potentially personal

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<sup>11</sup> See Proposing Release at n. 20 and accompanying text.

<sup>12</sup> See NASD Conduct Rule 2210(d)(2)(B).

liability insurance, be reviewed before determining whether the recommendation of a deferred variable annuity may be made? The Committee believes that the focus here is likely on life insurance, and if that is the case, it would prefer clarification of that point. However, the Committee would also point out that the “insurance” feature of a deferred variable annuity should be viewed as a feature of the investment that is different than the death benefit feature of life insurance products. While both a life insurance policy and a deferred variable annuity’s death benefit will pay an amount to the beneficiary upon the death of the owner, the death benefit of the deferred variable annuity serves as a type of “financial guaranty” insurance; it provides a guarantee that, depending on the terms of the deferred variable annuity contract, the amount of premium invested will be returned despite the potential market downturns. The Committee feels that element of the “death benefit” feature is often over-looked, and misunderstood, with respect to variable annuities. For example, customers routinely insure their cars, homes and life; shouldn’t they also insure their retirement funding, to the extent they can?

The Committee recommends that the reference to “insurance holdings” be deleted from Proposed Rule 2821(b)(2), or, in the alternative, clarification ought to be provided as to what types of insurance holdings should be reviewed.

### **III. Paragraph (c) of Rule 2821—Principal Review and Pre-Approval Requirement**

As initially proposed by NASD in NTM 04-45, Rule 2821 required a registered principal to review and approve deferred variable annuity transactions no later than one business day following the date of execution of the contract application. Rule 2821 was revised when initially filed with the Commission to require principal review and approval no later than two business days following the date when the application is transmitted to the issuing insurance company. As proposed in final form by the Commission in the Proposing Release, Rule 2821 was revised yet again to prohibit registered representatives or broker-dealers from transmitting variable annuity contract applications to the issuing insurance company until after a registered principal has reviewed the transaction, considered certain enumerated factors including the “comparative need” assessment required also to be considered by the registered representative, and approved the transaction. The foregoing requirement applies regardless of whether the transaction was recommended. For recommended transactions, the principal, taking into account the underlying supporting documentation required to be obtained by the registered representative, is required to review, determine whether to approve, and if approved sign the suitability determination required to be made by the registered representative.

The Committee recognizes that continued revision of Rule 2821’s principal review and approval requirement with respect to timing requirements may simply reflect an effort to identify an approach that is workable for broker-dealers and insurance companies. In its current form, however, Rule 2821 would effectively impose a principal

*pre-approval* requirement that represents a dramatic departure from the requirement proposed by NASD in NTM 04-45 on which the industry had an opportunity to comment.

The Committee supports a general requirement for registered principals to review and approve variable annuity transactions. The Committee also agrees with NASD that allowing a registered representative's suitability analysis to be reviewed long after an insurance company issues a deferred variable annuity contract would be inconsistent with the general requirement to have an adequate supervisory system reasonably designed to detect and prevent problematic sales.<sup>13</sup> However, rather than requiring principal pre-approval of deferred variable annuity transactions (which for the reasons discussed below the Committee strongly opposes), the Committee recommends that Rule 2821 require that principals conduct their review and approval promptly after the completion of the contract application or form of purchase order in accordance with procedures reasonably designed to ensure that problematic purchases are detected and disapproved.

The Committee strongly opposes Rule 2821's proposed principal *pre-approval* requirement. This pre-approval requirement appears to be internally inconsistent with the *regulatory goal of ensuring suitable deferred variable annuity sales*, in that on the one hand it expands the level of required transaction review, while on the other hand it shortens the time period permitted for such review. The complexity and burdens associated with a principal pre-approval requirement could also negatively impact deferred variable annuity sales by creating negative investor perceptions of the contract application process. Finally, implementing a principal pre-approval process requirement would require a radical and enormously costly reformatting of some existing variable annuity processing systems in order to delay transmission of applications until after principal review and approval, without a commensurate benefit to investors.

Rule 2821's proposed principal pre-approval requirement appears to be predicated on an erroneous and unjustified presumption that *variable annuities are so much more risky and complex an investment than other investments such as mutual funds and general securities that every transaction must be scrutinized and second-guessed by a principal before consideration by the issuing insurance company*. The Committee strongly disagrees with this premise. The Committee believes that its alternative proposal -- that principals be required to review and determine whether to approve transactions promptly after the completion of the application or form of purchase order-- would ensure that firms employ adequate supervisory systems reasonably designed to detect and prevent unsuitable sales while avoiding the enormous expense and uncertainty of a principal pre-approval requirement that lacks commensurate benefit to investors.

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<sup>13</sup> See Proposing Release at 42,129.

**A. Rule 2821's Principal Pre-Approval Requirement Would Limit the Opportunity for Careful Review**

Rule 2821 requires that after a broker-dealer's registered representative has conducted the extensive suitability review and determination process that would be imposed by the rule, the application and other supporting documentation for the proposed transaction (including the representative's written suitability determination) must then be reviewed and approved by a registered principal of the firm, *before* the application can be transmitted to the issuing insurance company. In reviewing the proposed transaction, the principal must consider whether:

- the customer appears to have a need for the features of a deferred variable annuity as compared with other investment vehicles;
- the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age (standard established by the member) or with a short-term investment objective (standard established by the member);
- the amount of money invested exceeds a stated percentage of the customer's net worth (standard established by the member) or is more than a stated dollar amount (standard established by the member); and
- the transaction involves an exchange of a deferred variable annuity and, if so, whether (i) the customer will incur a surrender charge, be subject to the commencement of a new surrender period, lose death or existing benefits or be subject to increased mortality and expense fees; (ii) the customer appears to have a need for any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

The factors specified by Rule 2821 that registered principals must consider in determining whether to approve a transaction unquestionably will lengthen the time required to conduct such inquiry. As discussed above, the comparison requirement alone may delay the process as principals "second-guess" registered representatives' suitability determinations and ask for additional supporting facts or analysis.<sup>14</sup> This second-

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<sup>14</sup> The Committee notes that its understanding of the Proposed Rule's provisions regarding the principal's review under Rule 2821(c) is that such review does not require that the principal independently verify the information collected by the registered representative. Moreover, the Committee also believes that given NASD's past statements regarding the utility of "red flag" review systems, that no objections would be raised where a principal's review was directed to specific factors (e.g., a customer's age) based on objective criteria determined by the member firm to identify which recommendations would require a relatively higher, or lower, level of scrutiny. See, e.g., Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2004) ("Joint Report") at p. 12 (stating that firms

guessing process inherent in the rule's heightened review and approval standards may, in turn, require representatives to go back to customers repeatedly for additional information.

At the same time, because Rule 2821 requires the heightened principal review and pre-approval requirement to occur before an application may be transmitted to the insurance company, it constricts the time for principals to conduct the review. The Proposing Release explains that the time frame for principal review and approval will depend on whether the principal's review occurs before or after the customer provides the member with the purchase payment for the deferred variable annuity. NASD notes that if principal review and approval occurs before payment has been made, applicable rules would not affect the principal review and approval obligations under the rule. However, since many variable annuities are purchased on a "check and app" basis, the proposed principal pre-approval requirement would appear to have the general effect of permitting less time for principals to review variable annuity purchases than purchases of other investments. The pre-approval requirement therefore seems to be fundamentally at odds with the regulatory goal of ensuring suitable variable annuity sales. The Committee has serious concerns that, as a result, some selling firms may conclude that a careful and thorough review is not feasible and instead sell other financial products such as mutual funds and general securities products.

**B. Rule 2821's Principal Pre-Approval Requirement May Negatively Impact Variable Annuity Sales By Creating Negative Investor Perceptions of the Contract Application Process**

As noted, many variable annuity purchases are conducted on a "check and app" basis where purchase payments are received from applicants along with their applications in order to receive timely pricing into contract investment options. Rule 2821's pre-approval requirement could pressure broker-dealers to fundamentally alter this accepted industry practice by not accepting checks with the application. Customers would instead need to be contacted by their registered representative or the firm's back office to obtain initial purchase payments. One can imagine an investor's perception of this drawn-out process as his financial representative informs him, "I can take your money now – my firm has approved your application for forwarding to the insurance company. Of course, your contract won't be issued until the insurance company receives your application and purchase payment and processes all the paperwork."

In short, the Committee has grave concerns that the variable annuity application process will begin to be perceived by broker-dealer customers as requiring a heavily underwritten review and approval process similar to the underwriting process for buying life insurance. Faced with this perception, many broker-dealers, their registered

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with "comprehensive policies and procedures" included "screen[ing] for specific suitability issues, including age, allocations that did not match investment objectives, variable product investments exceeding a certain percentage of a customer's liquid net worth . . .").

representatives, and their customers, may choose to buy other securities such as mutual funds or general securities, neither of which fulfill the critical role of guaranteeing lifetime income and providing other important protections to contract owners.

**C. Rule 2821's Principal Pre-Approval Requirement May Require Radical and Enormously Costly Reformatting of Existing Industry Processing Systems Without Commensurate Benefit To Investors**

The Committee believes Rule 2821's principal pre-approval requirement would not only impose unnecessary delays in processing and issuing variable annuity contracts, it would require a radical and enormously expensive reformatting of some existing variable annuity processing systems. This wholesale reformatting would be required by the fact that some systems are already "hard-wired" to transmit variable annuity applications directly to the issuing insurance company for processing at the same time the applications are forwarded internally to registered principals for review.

Variable annuity purchases are often effected on a "subscription way" basis that differs from typical securities transactions. For the typical transaction, the Commission's broker-dealer record-keeping rules require a broker-dealer to make and retain an order ticket for each brokerage order and any other instructions, given or received, for the purchase or sale of securities, whether executed or not.<sup>15</sup> Similar record-keeping rules apply in the case of each purchase or sale order for a customer effected on a principal basis from the account of the member firm.<sup>16</sup> In the case of a transaction effected on a subscription way basis directly with the issuer of the security, such as in the case of a variable annuity contract purchased through the completion and submission of an application directly to the insurer, the broker-dealer often only retains a copy of the subscription application and does not create a separate order ticket for the transaction. Variable annuity applications therefore form the core document used to effect a purchase (or exchange) transaction.

Different systems for processing variable annuity applications have developed around this "subscription way" concept. At least two of these systems would become unworkable under Rule 2821's principal pre-approval requirement, requiring costly systems reformatting. The NASD has not identified what, if any, commensurate benefits investors would realize.

***Electronic Processing Systems.*** As with sales of other investments, including mutual funds, variable annuity sales are often effected through electronic processing systems. These systems permit a registered representative to submit an application for a

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<sup>15</sup> See Rule 17a-3(a)(6) under the 1934 Act.

<sup>16</sup> See Rule 17a-3(a)(7) under the 1934 Act.

variable annuity contract to the insurance company at the same time as submitting the application to the broker-dealer's home office or other appropriately designated office.

Many financial institutions employ electronic processing generally for securities transactions, whether mutual funds, stocks, bonds, or variable annuity contracts. Electronic processing offers significant advantages to contract purchasers, registered representatives, broker-dealers, and insurers. Fundamentally, electronic processing permits financial institutions to offer the same level of expeditious service to customers for all of their securities transactions. Timely processing is expected by today's consumers as well as by regulators.<sup>17</sup> In addition, electronic processing facilitates consistent recordkeeping. Customer applications can be transmitted electronically to the insurance company and at the same time transmitted to the firm's home office or other designated office for principal review and approval, simplifying the recordkeeping process and enhancing oversight capabilities. Electronic records and processing systems are, of course, cost efficient.

Some broker-dealers may *require* insurance companies to use electronic processing to issue variable annuity contracts. Customer information can then be passed through "filters," or electronic monitoring systems that generate exception reports.<sup>18</sup>

In short, the inability to use electronic processing would place the insurance industry at a significant competitive disadvantage in an era where technological advances and financial services modernization legislation have heightened competition among providers of financial products. This competition, of course, benefits consumers. For these "hard-wired" processing systems to continue to be used under a principal pre-approval requirement, they would need to be reprogrammed at a potential cost of millions, if not tens of millions, of dollars.

***Paper-Based Systems.*** Some broker-dealer firms employ paper-based processing systems. Since many variable annuity sales are made by registered representatives not collocated with the person or unit responsible for reviewing their transactions, these representatives forward applications and supporting materials to a central point (such as an office of supervisory jurisdiction, or the broker/dealer's home office) for suitability review and processing. To ensure timely processing and issuance of variable annuity contracts, some firms have developed the procedure of forwarding applications directly to the issuing insurance company at the same time they are sent to the firm's processing

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<sup>17</sup> The Securities and Exchange Commission, for example, requires a variable annuity contract to be issued within two business days of receiving an initial purchase payment and the necessary information to issue the contract; if the necessary information is not provided the company has only five days to obtain the information and issue the contract or obtain the purchaser's consent to a further extension of time. See Rule 22c-1(e) under the Investment Company Act of 1940.

<sup>18</sup> In the Joint Report, NASD and SEC staff noted in the context of supervision of sales of variable life insurance policies that employing automated systems to detect and prevent inappropriate sales constitutes a "sound practice."

point for principal review. If applications were instead required to be sent to the processing point for principal review and approval *before* being sent to the insurance company, these paper-based systems would require extensive and costly procedural modifications.

#### **D. The Committee's Recommendations for Principal Review and Approval**

In summary, the Committee supports a general requirement for registered principals to review and approve variable annuity transactions. The Committee also agrees with NASD that allowing a registered representative's suitability analysis to be reviewed long after an insurance company issues a deferred variable annuity contract is inconsistent with the general requirement to have an adequate supervisory system reasonably designed to detect and prevent problematic sales. The Committee believes, however, that Rule 2821's principal pre-approval requirement would decrease the opportunity for careful review, cause negative investor perception of the variable annuity application process, and require radical and costly reformatting of existing industry processing systems without commensurate benefit to investors. Accordingly, rather than requiring principal pre-approval of deferred variable annuity transactions, the Committee recommends that Rule 2821 require that principals conduct their review and approval promptly after the completion of the contract application or form of purchase order. The actual timing of a particular firm's principal review requirement would depend on individual facts and circumstances, including the nature of the firm's sales and registered representative suitability review procedures, but should be designed to reasonably ensure that unsuitable sales are detected and deterred.<sup>19</sup>

#### **IV. Subsequent Purchase Payments**

The Committee requests clarification on the treatment of subsequent purchase payments for *deferred variable annuity contracts*. While the *Proposing Release* clarifies that Rule 2310 would be applicable to any recommended subsequent purchase payments, and to any recommended "sales" of variable annuity contracts, the issue of subsequent purchase payments does not appear to be expressly addressed.

The Committee strongly urges that the Proposed Rule or guidance related to the rule clarifies that un-recommended subsequent purchase payments are not required to comply with Rule 2821. The most common example of this would be the customer who receives a statement related to their deferred variable annuity contract. Many times, such statements will include a simple "tear off strip" that would allow the customer to invest additional premiums into the deferred variable annuity by writing a check and including the check with the tear off strip for an additional payment. The Committee recommends

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<sup>19</sup> Regardless of when principal review and approval is ultimately required to occur under Rule 2821 if adopted, the Committee strongly recommends that the "comparative need" and "long-term investment objective" components of the required review be revised to reflect the Committee's recommendations in Section II of this letter relating to the required review process for registered representatives.

that the Proposed Rule clarify that subsequent purchase payments that are not recommended are beyond the scope of Rule 2821.

### CONCLUSION

The Committee is pleased to have the opportunity to provide comments to the Commission on proposed NASD Rule 2821 and hopes that our comments can assist NASD and the Commission in developing rules related to variable annuities that are fair, sensible and appropriate for all participants in the marketplace for these products. Given the importance of the Proposed Rule to the variable annuity industry, the Committee feels strongly that an in-person meeting to discuss the concerns articulated in this letter with the appropriate personnel from the Commission, and if appropriate, NASD, would be beneficial. We will be contacting Commission staff personnel shortly to request such a meeting.

Respectfully Submitted,

SUTHERLAND ASBILL & BRENNAN LLP

BY:



W. Thomas Conner

Eric A. Arnold

FOR THE COMMITTEE OF ANNUITY  
INSURERS

Cc: The Honorable Christopher Cox  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos  
The Honorable Cynthia A. Glassman  
The Honorable Annette L. Nazareth  
Catherine McGuire, Division of Market Regulation  
Meyer Eisenberg, Division of Investment Management

**APPENDIX A**

**THE COMMITTEE OF ANNUITY INSURERS**

Allmerica Financial  
Allstate Financial  
American General Life Insurance Company  
AmerUs Annuity Group Co.  
AXA Equitable Life Insurance Company  
F & G Life Insurance  
Fidelity Investments Life Insurance Company  
Genworth Financial  
Great American Life Insurance Co.  
Guardian Insurance & Annuity Co., Inc.  
Hartford Life Insurance Company  
ING North America Insurance Corporation  
Jackson National Life Insurance Company  
John Hancock Life Insurance Company  
Life Insurance Company of the Southwest  
Lincoln Financial Group  
Merrill Lynch Life Insurance Company  
Metropolitan Life Insurance Company  
Nationwide Life Insurance Companies  
New York Life Insurance Company  
Northwestern Mutual Life Insurance Company  
Ohio National Financial Services  
Pacific Life Insurance Company  
The Phoenix Life Insurance Company  
Protective Life Insurance Company  
Prudential Insurance Company of America  
Sun Life of Canada  
The Horace Mann Companies  
USAA Life Insurance Company