

# ICI Comment Letter on NASD's Deferred Variable Annuity Proposal, September 2005

September 19, 2005

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-9303

**Re: NASD Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities (File No. SR-NASD-2004-183)**

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on proposed NASD Rule 2821, relating to sales practice standards and supervisory requirements for transactions in deferred variable annuities.<sup>2</sup> With \$1.03 trillion in assets in variable annuities as of July 2005, our members have a significant interest in the sound regulation of variable annuity sales.

The Institute supports NASD's goal of ensuring that deferred variable annuities are sold only to purchasers for whom they are suitable. We agree that it is important to address sales practice problems in this area.<sup>3</sup> At the same time, we believe that NASD's proposed approach, which establishes a separate regulatory framework for one particular product, sets a bad precedent. It could lead to a patchwork of different standards that will needlessly complicate compliance efforts. The proposal also prescribes detailed, one-size-fits-all requirements that do not recognize the variety of NASD members' business models and, in some cases, will be unworkable. The Institute recommends that, rather than adopting the proposed rule, NASD rely on and enforce its existing rules. In addition, we recommend that NASD issue updated guidance on sales of deferred variable annuities.

These and our other comments on NASD's proposal are set forth below.

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## General Approach

The Institute shares NASD's view that more can be done to improve variable annuity sales practices. We are concerned, however, that a suitability rule tailored to a specific product could have unintended consequences. While we agree that deferred variable annuities are complex investment products, so too are other investment company products, such as variable life insurance, funds of funds, interval funds and master-feeder arrangements, and other types of securities, such as hedge funds. Tailoring a suitability rule for a particular type of investment product raises concerns that this could lead to the adoption of separate and distinct suitability rules for other complex products. The result will be a patchwork of standards that will exacerbate already complicated compliance efforts of broker-dealers, without providing any clear benefits to investors.

Not only is a separate rule for deferred variable annuities undesirable for this reason, but also it is not needed to accomplish NASD's

goals. NASD identified “questionable practices” related to the sale of deferred variable annuities as one of the reasons for the proposed rulemaking. We believe that such questionable practices are a compliance issue, and are better addressed through member firm compliance programs and NASD enforcement efforts than through a product-specific suitability rule. In recent years, NASD has brought a number of cases challenging the suitability of annuity sales, and Rule 2310 has proven a useful and adequate remedy to support NASD’s enforcement efforts. In addition, new NASD requirements designed to bolster attention to compliance issues and strengthen member compliance programs have recently taken effect.<sup>4</sup> These initiatives reduce any perceived need for a customized rule for deferred variable annuities.

To supplement reliance on enhanced compliance programs and increased enforcement of existing rules, the Institute recommends that NASD, with industry assistance and input, update its previous guidance on suitability issues for variable annuity contracts.<sup>5</sup> Various features of deferred variable annuities, such as principal protection guarantees, income guarantees, and withdrawal guarantees, have evolved considerably since 1999, the last time NASD published guidelines on the sale of variable annuities. With this kind of rapid product evolution, a detailed, tailored rule could soon become obsolete. By contrast, suitability and compliance rules of general applicability, along with updated guidance addressing specific concerns related to sales of deferred variable annuities, can more easily be adapted to reflect product innovations or other developments.

Importantly, our recommended approach also will provide greater flexibility to recognize and accommodate different business models and other variables that differ from firm to firm. This, in turn, will allow firms to develop robust and effective compliance and supervisory procedures and training programs that appropriately take into account their particular circumstances. We would be pleased to work with NASD on such an initiative.

## Specific Provisions

In connection with issuing updated guidance, as we recommend above, or to the extent NASD determines to go forward with its rule proposal, NASD should address the issues discussed below.

## Comparison to Other Investment Vehicles

Under the proposed rule, a broker-dealer recommending a deferred variable annuity must believe that the customer has a need for the features of a deferred variable annuity “as compared with other investment vehicles.” NASD has not shown that this requirement, which is a departure from current standards, would benefit investors. We find it troubling for the following reasons.

First, the scope of the requirement is unclear. For example, it is unclear whether it would be sufficient for a broker-dealer to compare a deferred variable annuity to a “retail” mutual fund, or whether it must go further and compare it to a bank CD, variable life insurance, or a fixed annuity. We are concerned that this provision potentially could require comparison to an unlimited number of investment vehicles. The parameters of the comparison also are unclear. For example, would a comparison of expenses and tax treatment suffice, or would a broker need to go further and consider the effect of different vehicles on retirement income?

In addition, it would be unreasonable and impractical to require firms to make comparisons with products that they do not distribute. Perhaps for this reason, to our knowledge, no similar requirement applies to the sale of any other type of security.

According to the Proposing Release, the proposal does not require NASD members to perform a side-by-side comparison of different investment vehicles in the case of a purchase of a deferred variable annuity.<sup>6</sup> By contrast, it does require such a comparison for an exchange transaction.<sup>7</sup> This requirement demonstrates the problem of a one-size-fits-all approach. It will be difficult, if not impossible, for many broker-dealers to implement. For example, some NASD members do not receive a copy of the contract being exchanged.<sup>8</sup> Similarly, where the broker-dealer is not making a recommendation, they will not have any information about the contract being exchanged.

## Principal Review

The proposed rule calls for review of deferred variable annuity applications by a registered principal, even where a transaction has not been recommended by an associated person of the broker-dealer. Thus, the rule requires principal review even where an investor has decided on an investment on his or her own.

The proposal is a drastic departure from current standards, and is problematic for several reasons. First, it suggests that the principal must second-guess an investment decision made by an investor in all instances. We are concerned about the policy implications of such a requirement, particularly where the investor has not requested or otherwise invited that opinion.

Many investors have the capacity and ability to make their own investment decisions and have access to many sources of information to assist them in doing so, from prospectuses to analyst reports and financial publications. The idea that a principal

needs to second-guess an investor who is relying on the broker-dealer only to effect a transaction requested by the investor contradicts the notion that investors may be able to make informed investment decisions on their own. Traditionally, the federal securities laws have honored investment decisions made by investors. We believe that this approach remains appropriate, and that NASD should refrain from adopting provisions that will have the practical effect of applying suitability requirements in situations where they would not otherwise apply.

Second, the proposal seems to contemplate a traditional platform where full service broker-dealers and their customers transact business in a face-to-face environment. As mentioned above, many firms today offer platforms that permit investors to make informed investment decisions, under which the broker-dealer makes no recommendation. These platforms often allow investors to conduct transactions by phone or via the Internet and may not involve interaction between the investor and a registered representative.<sup>9</sup>

Under the proposed rule, broker-dealers that do not make recommendations will need to build an infrastructure for approval of deferred variable annuities, and perhaps other securities that become the subject of future tailored suitability requirements, resulting in additional costs. We question whether any possible benefits of the proposed requirement in this context would outweigh these costs.

As justification for requiring principal review in the absence of a recommendation, the Proposing Release states that NASD is aware of instances where associated persons have told their firms that deferred variable annuity transactions were not recommended in order to bypass compliance requirements for solicited sales.<sup>10</sup> To the extent there are concerns about improper conduct by associated persons seeking to evade compliance requirements, those concerns are the same across all products and current rules already provide effective ways to address them.

For the reasons discussed above, the Institute believes that NASD should not apply the proposed principal review requirement where no recommendation is made. We further note that, whether applied only to transactions involving a recommendation or more broadly, the proposed principal review requirement is overly detailed and prescriptive. It will require the principal to replicate what a registered representative has already done.

Given the various roles and levels of involvement of NASD member firms in the variable annuity business, instead of prescribing a laundry list of items that a registered principal must consider, NASD should provide firms with flexibility to design principal review procedures that fit their particular circumstances and business models. For example, different procedures likely are appropriate for a firm that offers a single or small number of variable annuity products and does not make recommendations as compared to a firm that distributes multiple variable annuity products and makes recommendations.

We further note that the timing requirement for principal review (i.e., prior to transmittal of an application to the insurance company) poses practical problems. For example, in the case of directly marketed products, the investor usually mails the application directly to the insurance company. In other situations, registered principals may need additional time for investigation.

The Institute understands NASD's concern that principal review occur sufficiently early in the process to address questionable or problematic transactions. To provide firms with some additional flexibility while still satisfying NASD's policy objective, we recommend that any guidance or rules in this area call for principal review before the contract is issued (i.e., before the contract is sent to the investor).<sup>11</sup>

\* \* \*

The Institute appreciates the opportunity to comment on NASD's proposal. If you have any questions concerning these comments, or would like additional information, please contact the undersigned by at 202/326-5822.

Sincerely,

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Deputy Senior Counsel

cc: William J. Kotapish  
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## ENDNOTES

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. The Investment Company Institute's membership includes 8,501 open-end investment companies (mutual funds), 662 closed-end investment companies, 144 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$8.370 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 87.7 million shareholders in more than 51.2 million households.

<sup>2</sup> SEC Release No. 34-52046A (July 19, 2005), 70 Fed. Reg. 42126 (July 21, 2005) ("Proposing Release").

<sup>3</sup> See *In the Matter of Waddell & Reed, Inc., Robert Hechler, and Robert Williams*, Case No. CAF040002 (Jan. 14, 2004); *In the Matter of CUNA Brokerage Services, Inc., Campbell McHugh, Daniel Bernal and Christian Zernich*, Case No. C05010054 (Dec. 5, 2001); *In the Matter of Mutual Service Corporation*, Case No. C05010053 (Dec. 5, 2001); *In the Matter of Conseco Securities, Inc. and Carlos Guevara*, Case No. C9B020058 (Aug. 12, 2002); *In the Matter of Tower Square Securities*, C05020003 (Jan. 18, 2002); *Lutheran Brotherhood Securities Corp., NASDR Letter of Acceptance, Waiver and Consent No. C0601003* (Feb. 15, 2001); *Allmerica Investments, Inc., NASDR Letter of Acceptance, Waiver and Consent No. C05010004* (Feb. 15, 2001); *First Union Brokerage Services, Inc., NASDR Letter of Acceptance, Waiver and Consent No. C05010010* (Feb. 15, 2001); *Prudential Securities, Inc., NASDR Letter of Acceptance, Waiver and Consent No. C05010005* (Feb. 15, 2001); *Pruco Securities Corp., Case No. CAF990010* (July 7, 1999).

<sup>4</sup> See, e.g., NASD Conduct Rule 3013 and IM-3013 (relating to chief executive officer compliance certification and chief compliance officer designation requirements). In addition, recent amendments to NASD Conduct Rule 3010 require that registered principals, in addition to registered representatives, attend annual compliance meetings.

<sup>5</sup> See, e.g., NASD Notice to Members 99-35 (May 1999), and Notice to Members 96-86 (December 1996).

<sup>6</sup> Proposing Release at n.20.

<sup>7</sup> *Id.*

<sup>8</sup> We understand that in some cases, the annuity to be exchanged is delivered directly to the insurance company issuing the new contract, not to the broker-dealer who took the order.

<sup>9</sup> See Frank Byrt, *Fidelity Launches New Products To Buoy Retirement Offerings*, *Wall St. J.*, Sept. 13, 2005, at D2. ("The firm's new annuities are available to retail customers through Fidelity's Web site, over the phone, at a registered investment adviser or at one of the firm's investor centers.")

<sup>10</sup> Proposing Release at 42129.

<sup>11</sup> It is our understanding that in most cases, this standard would provide firms with 1-2 additional days. See Rule 22c-1(c) under the Investment Company Act of 1940.