

100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-BSE-2007-43. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the BSE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-BSE-2007-43 and should be submitted on or before October 4, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-56375; File No. SR-NASD-2004-183]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc. (n/k/a Financial Industry Regulatory Authority, Inc.); Notice of Filing of Amendment Nos. 3 and 4 and Order Granting Accelerated Approval of the Proposed Rule, as Amended, Related to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities

September 7, 2007.

#### I. Introduction

On December 14, 2004, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934<sup>1</sup> ("Exchange Act" or "Act") and Rule 19b-4<sup>2</sup> thereunder, proposed new Rule 2821 ("Proposed Rule 2821") relating to the sales practice standards and supervisory and training requirements applicable to transactions in deferred variable annuities.<sup>3</sup> Proposed Rule 2821, as amended by Amendment No. 1, was published for comment in the **Federal Register** on July 21, 2005.<sup>4</sup> The Commission received approximately 1500 comments on the proposal.<sup>5</sup> NASD filed Amendment No. 2 on May 4, 2006, which addressed the comments and proposed responsive amendments. Amendment No. 2 was published for comment in the **Federal Register** on June 28, 2006.<sup>6</sup> The Commission received approximately 1950 comments

on Amendment No. 2.<sup>7</sup> To further explain and modify certain provisions of Proposed Rule 2821 in response to comments, NASD filed Amendment No. 3 on November 15, 2006 and Amendment No. 4 on March 5, 2007. Amendment No. 4 supersedes all of the previous amendments in their entirety. All of the comments that the Commission has received are available on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). This order provides notice of Amendment Nos. 3 and 4 to the proposed rule and approves the proposed rule as amended on an accelerated basis.<sup>8</sup>

#### II. Description of the Proposal

Proposed Rule 2821 would create recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. It is intended to supplement, not replace, NASD's other rules relating to suitability, supervisory review, supervisory procedures, and training. Thus, to the extent Proposed Rule 2821 does not apply to a particular transaction, NASD's general rules on suitability, supervisory review, supervisory procedures, and training continue to govern when applicable.<sup>9</sup> The text of the proposed rule is available on FINRA's Web site (<http://www.finra.org>), at FINRA's principal office, and at the Commission's Public Reference Room.

Proposed Rule 2821 would apply to the purchase or exchange of a deferred variable annuity and to an investor's initial subaccount allocations.<sup>10</sup> It

<sup>7</sup> Approximately 1700 of these comments, primarily from licensed insurance professionals and variable product salespersons, are virtually identical. These letters are referred to herein as "Letter Type B."

<sup>8</sup> NASD granted consent for the Commission to approve the proposed rule beyond the timeframes set forth in section 19(b)(2) of the Act.

<sup>9</sup> The general suitability obligation requires a broker-dealer to consider its customer's ability to understand the security being recommended, including changes in the customer's ability to understand, monitor, and make further decisions regarding securities over time.

<sup>10</sup> As NASD noted in Amendment No. 2, the proposed rule focuses on customer purchases and exchanges of deferred variable annuities, areas that, to date, have given rise to many of the sales practice abuses associated with variable annuity products. See Exchange Act Release No. 52046A, at 3-5 (discussing various questionable sales practices that NASD examinations and investigations have uncovered and the actions NASD has taken to address those practices). The proposed rule would thus cover a standalone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another deferred variable

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Exchange Act Release No. 56146 (July 26, 2007); 72 FR 42190 (Aug. 1, 2007).

<sup>4</sup> See Exchange Act Release No. 52046A (July 19, 2005); 70 FR 42126 (July 21, 2005) (SR-NASD-2004-183).

<sup>5</sup> Approximately 1300 of these comments, primarily from licensed insurance professionals and variable product salespersons, are virtually identical. These letters are referred to herein, and on the list of comments on the Commission's Web site as "Letter Type A." The Commission also received multiple copies of other letters, which we refer to as Letters Type B, C, D, E, F, G and H, below.

<sup>6</sup> See Exchange Act Release No. 54023 (June 21, 2006); 71 FR 36840 (June 28, 2006) (SR-NASD-2004-183).

<sup>13</sup> 17 CFR 200.30-3(a)(12).

would not apply to reallocations of subaccounts or to subsequent premium payments made after the investor's initial purchase or exchange.<sup>11</sup> It also generally would not apply when an investor's purchase or exchange of a deferred variable annuity is made within a tax-qualified, employer-sponsored retirement or benefit plan.<sup>12</sup> If, however, a member recommends a deferred variable annuity to an individual plan participant, then Proposed Rule 2821 would apply to that purchase (or exchange) and to the initial subaccount allocations.

Proposed Rule 2821 has four main requirements. First, in order to recommend the purchase or exchange of a deferred variable annuity, a member would be required to have a reasonable basis to believe that the transaction is suitable in accordance with NASD's general suitability rule, Rule 2310.<sup>13</sup> In particular the member must have a reasonable basis to believe that:

- The customer has been informed, in general terms, of various features of deferred variable annuities;<sup>14</sup>
- The customer would benefit from certain features of deferred variable annuities, such as tax deferred growth, annuitization, or a death or living benefit;<sup>15</sup> and
- The particular deferred variable annuity that the member is recommending, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and the riders and similar

annuity. For purposes of the proposed rule, an "exchange" of a product other than a deferred variable annuity (such as a fixed annuity) for a deferred variable annuity would be covered by the proposed rule as a "purchase." The proposed rule would not cover customer sales of deferred variable annuities, including the sale of a deferred variable annuity in connection with an "exchange" of a deferred variable annuity for another product (such as a fixed annuity). However, recommendations of customer sales of deferred variable annuities are covered by Rule 2310, NASD's general suitability rule.

<sup>11</sup> NASD's general suitability rule, Rule 2310, would continue to apply to reallocations of subaccounts.

<sup>12</sup> Proposed Rule 2821 defines such plans as either a "qualified plan" under section 3(a)(12)(C) of the Act or a plan that meets the requirements of Internal Revenue Code sections 403(b), 457(b), or 457(f).

<sup>13</sup> See Proposed Rule 2821(b)(1)(A).

<sup>14</sup> See Proposed Rule 2821(b)(1)(A)(i). The proposed rule lists the following features as examples for purposes of this requirement: (1) Potential surrender period and surrender charge; (2) potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; (3) mortality and expense fees; (4) investment advisory fees; (5) potential charges for and features of riders; (6) the insurance and investment components of deferred variable annuities; and (7) market risk.

<sup>15</sup> See Proposed Rule 2821(b)(1)(A)(ii).

product enhancements are suitable (and in the case of an exchange, the transaction as a whole also is suitable) for the customer based on the information the person associated with the member is required to make a reasonable effort to obtain pursuant to subparagraph (b)(2) of the proposed rule.<sup>16</sup>

Prior to recommending that a customer exchange a deferred variable annuity, a registered representative must not only have a reasonable basis to believe that the exchange is consistent with the suitability determinations in subparagraph (b)(1)(A) of the proposed rule, but must also consider whether:

- The customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, or be subject to increased fees or charges;<sup>17</sup>
- The customer would benefit from product enhancements and improvements;<sup>18</sup> and
- The customer's account has had another deferred variable annuity exchange within the preceding 36 months.<sup>19</sup>

The associated person recommending the transaction would be required to document these considerations and sign this documentation. He or she would also have to make reasonable efforts to obtain from the customer information regarding the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.<sup>20</sup>

Second, a registered principal would have to review the transaction and determine whether he or she approves of it prior to transmitting the customer's application to the issuing insurance company for processing, but no later than seven business days after the customer signs the application.<sup>21</sup> The

<sup>16</sup> See Proposed Rule 2821(b)(1)(A)(iii).

<sup>17</sup> See Proposed Rule 2821(b)(1)(B)(i).

<sup>18</sup> See Proposed Rule 2821(b)(1)(B)(ii).

<sup>19</sup> See Proposed Rule 2821(b)(1)(B)(iii).

<sup>20</sup> See Proposed Rule 2821(b)(2).

<sup>21</sup> See Proposed Rule 2821(c). NASD has determined that relief is needed to allow certain broker-dealers to complete their review of deferred variable annuity transactions as required by proposed NASD Rule 2821 without becoming fully subject to Exchange Act Rule 15c3-3 and being required to maintain higher levels of net capital in accordance with Exchange Act Rule 15c3-1. Consequently, NASD has requested relief from

registered principal may approve the transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on all of the factors contained in paragraph (b) ("Recommendation Requirements") of the proposed rule.<sup>22</sup>

For purposes of reviewing deferred variable annuity purchases and exchanges, a registered principal must treat all transactions as if they have been recommended.<sup>23</sup> However, if a registered principal determines that a transaction, which is not suitable based on the factors contained in paragraph (b), was not recommended, he or she may nonetheless authorize the processing of it if the customer has been informed of the reason why the transaction has not been approved and the customer affirms that he or she wants to proceed with the transaction.<sup>24</sup>

The registered principal that reviews the transaction must document and sign the determinations that the proposed rule requires him to make.<sup>25</sup> He or she must complete this documentation regardless of whether he or she approves, rejects, or authorizes the transaction.<sup>26</sup>

Third, Proposed Rule 2821 would require members to develop and maintain supervisory procedures that are reasonably designed to achieve compliance with the proposed rule.<sup>27</sup> Members would be required to implement surveillance procedures to determine if 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 rule], other applicable NASD rules, or the federal securities laws ('inappropriate exchanges')." <sup>28</sup> Members would also be required to have policies and

Rules 15c3-3 and 15c3-1 for these broker-dealers. In conjunction with the Commission's approval or proposed rule 2821, it is also granting exemptions from Rules 15c3-1 and 15c3-3 of the Exchange Act to allow NASD members to comply with proposed Rule 2821 without becoming fully subject to Exchange Act Rule 15c3-3 and being required to maintain higher levels of net capital in accordance with Rule 15c3-1.

NASD initially submitted a request for relief to the staff prior to the consolidation of its member firm regulatory functions with NYSE Regulation, Inc. This request was replaced by a subsequent request from the consolidated entity, FINRA. For readability, this second request is referred to as an NASD request throughout this order.

<sup>22</sup> See Proposed Rule 2821(c).

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> See Proposed Rule 2821(d).

<sup>28</sup> *Id.*

procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.<sup>29</sup>

Fourth, Proposed Rule 2821 would require members to develop and implement training programs that are tailored to educate registered representatives and registered principals on the material features of deferred variable annuities and the requirements of the proposed rule.<sup>30</sup>

### III. Summary of Comments on Amendment No. 2

In its solicitation of comments on Amendment No. 2, the Commission stated that it would consider the comments it previously received,<sup>31</sup> and that commenters could reiterate or cross-reference previously submitted comments.<sup>32</sup> The Commission has considered all of the comments it received, including commenters' reiterations of and cross-references to previously submitted comments. While the summary below refers to some comments previously submitted, it primarily discusses new comments on portions of the proposed rule that Amendment No. 2 did not change and comments on those provisions of the proposed rule that Amendment No. 2 modified. It also discusses comments received in response to Amendment No. 1 that are relevant to the timing of principal review provision in paragraph (c) of the proposed rule.

#### A. General Comments

A number of commenters reiterated their general opposition to the proposed rule, viewing it as unnecessary, arguing that NASD has not demonstrated a need for it, and stating that strong enforcement against broker-dealer sales practice abuses provides the best deterrent to negative market conduct.<sup>33</sup> Some commenters also stated that existing NASD rules and the prospectus

adequately inform and protect investors.<sup>34</sup>

A few commenters suggested that the proposed rule must take into account an estimate of its competitive and economic impact and asserted that the proposed rule must be subject to a cost/benefit analysis.<sup>35</sup> One commenter took the position that the proposed rule would impose economic and competitive burdens upon broker-dealers.<sup>36</sup> The commenter stated that the rule would require expensive new systems and operation changes that could initially total more than \$200,000 for broker-dealers to implement and monitor enterprise-wide.<sup>37</sup> It also maintained that the ongoing costs of complying with the proposed rule would be significant and immeasurable.<sup>38</sup> That commenter did not, however, provide any specific information about the system changes it foresaw, or how it arrived at its \$200,000 estimate.

Some commenters stated that the proposed rule would impose a burden on competition.<sup>39</sup> One of these commenters stated that the proposed rule would disparately impact smaller companies without state-of-the-art technological resources.<sup>40</sup> In its view, small to mid-sized companies may be forced out of the annuity market, thereby reducing competition and eliminating consumer options.<sup>41</sup> One commenter posited three ways in which the proposed rule would burden competition, stating:

- The proposed rule would disrupt enterprise-wide uniformity of compliance procedures. Compliance with the proposed rule would cost more than compliance procedures for other

products, and thus would make variable annuities more expensive to sell than other products.

- Conversion to the proposed rule would provide openings for inadvertent and transitional violations and may dampen distributors' enthusiasm for selling a product with suitability and supervision standards that are different from all other securities.

- Other products have had greater incidences of disciplinary actions and do not have specific supervision and suitability standards "that would dampen distributors' sales enthusiasm for fear of regulatory reprisals or technical violations."<sup>42</sup>

This commenter also argued that the rule targets deferred variable annuities in a discriminatory and burdensome fashion without appropriate rationale.<sup>43</sup>

Some commenters stated that implementation of the proposed rule would have unintended consequences.<sup>44</sup> For example, two commenters asserted that the proposed rule would raise barriers to access for investors who could benefit from owning a deferred variable annuity.<sup>45</sup> A few commenters also believed that the product-specific requirements of the proposed rule would signal to investors that something is wrong with the product.<sup>46</sup> One commenter stated that the proposed rule would cause expenses and fees to rise, which in turn would lead consumers to look to other, less expensive investment products that may not be as appropriate for their needs.<sup>47</sup>

NASD responded to concerns regarding the need for the proposed rule, the process by which it developed and revised the proposed rule, and the statutory requirements for its rulemaking in a letter to the Commission.<sup>48</sup> With respect to concerns

<sup>29</sup> *Id.*

<sup>30</sup> See Proposed Rule 2821(e).

<sup>31</sup> See Exchange Act Release No. 54023 (June 21, 2006); 71 FR at 36846 n.84.

<sup>32</sup> *Id.*

<sup>33</sup> See, e.g., Letters from Stephen A. Batman, CEO, 1st Global Capital Corp. (July 19, 2006) ("1st Global Letter II"); Carl B. Wilkerson, Vice President and Chief Counsel, American Council of Life Insurers (July 19, 2006) ("ACLI Letter IV"); Gary A. Sanders, Senior Counsel, Law and Government Relations, National Association of Insurance and Financial Advisors and Thomas F. Korb, Vice President of Policy and Public Affairs, Association for Advanced Life Underwriting (July 19, 2006) ("NAIFA/AALU Letter II"); Letter Type B. See also Letter Type D. Unless otherwise noted, all letters are addressed to the Commission.

<sup>34</sup> See, e.g., Letters from Dale E. Brown, CAE, Executive Director and CEO, Financial Services Institute (July 19, 2006) ("FSI Letter II"); Ari Burstein, Associate Counsel, Investment Company Institute (July 19, 2006) ("ICI Letter II"); 1st Global Letter II; ACLI Letter IV; Letter Type B. Two commenters suggested that the Commission delay action on the proposed rule until there is some resolution to the Commission's point-of-sale proposal. See ACLI Letter IV; FSI Letter II. Another commenter stated that it is not clear how the proposed rule would work with the Commission's point-of-sale proposal, especially with regard to the disclosure of material features. See Letter from W. Thomas Conner and Eric A. Arnold, Sutherland Asbill and Brennan LLP on behalf of Committee of Annuity Insurers (July 19, 2006) ("CAI Letter II").

<sup>35</sup> See Letter from Joan Hinchman, Executive Director, President and CEO, National Society of Compliance Professionals, Inc. (July 19, 2006) ("NSCP Letter"); ACLI Letter IV; NAIFA/AALU Letter II.

<sup>36</sup> ACLI Letter IV.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> See e.g., ACLI Letter IV; NAIFA/AALU Letter II; NSCP Letter.

<sup>40</sup> NSCP Letter.

<sup>41</sup> *Id.*

<sup>42</sup> ACLI Letter IV. Another commenter agreed that the proposed rule would place those that sell variable annuities at a competitive disadvantage in comparison with those who market other types of investments. See NAIFA/AALU Letter II. Two commenters also stated that adopting product specific suitability requirements and supervisory procedures would inhibit sales because registered representatives would be less inclined to sell the product. See Letter from Michael P. DeGeorge, General Counsel, National Association for Variable Annuities (July 19, 2006) ("NVA Letter III"); FSI Letter II.

<sup>43</sup> ACLI Letter IV.

<sup>44</sup> See, e.g., Letter from Rick Dahl, CCO, Sorrento Pacific Financial LLC (July 19, 2006) ("Sorrento Letter"); FSI Letter II; NAVA Letter III; NAIFA/AALU Letter II.

<sup>45</sup> See FSI Letter II; Sorrento Letter.

<sup>46</sup> See Letter from W. Burk Rosenthal, President, Rosenthal Retirement Planning, LP (July 19, 2006); FSI Letter II; NAVA Letter III.

<sup>47</sup> See NAIFA/AALU Letter II.

<sup>48</sup> See Letter from James S. Wrona, Associate Vice President, NASD (Aug. 31, 2006) ("NASD Response Letter").

that the proposed rule is not necessary, NASD reiterated that its examinations, investigations, and informal discussions with its members have uncovered numerous instances of questionable sales practices in connection with the purchase or exchange of deferred variable annuities, including unsuitable recommendations, and misrepresentations and omissions.<sup>49</sup> It also stated that member supervision and training procedures are inadequate.<sup>50</sup> NASD noted that these problems stem from the unique complexities of deferred variable annuities, which can cause confusion both for the individuals who sell them and for the customers who purchase or exchange them.<sup>51</sup> Despite issuing Notices to Members, Regulatory and Compliance Alerts, and Investor Alerts, NASD found that these problems continue to exist.<sup>52</sup> NASD stated that recent joint reviews with the Commission, as well as NASD examinations and enforcement actions, demonstrate that an informal approach has not been sufficiently effective at curbing the sales practice abuses in this area.<sup>53</sup>

NASD also discussed its “measured approach” to the rulemaking process.<sup>54</sup> After NASD determined that a rule specific to deferred variable annuities was necessary and appropriate, it issued *Notice to Members* 04–45 (June 2004) to solicit comments from the public prior to submitting the proposed rule to the Commission.<sup>55</sup> In addition, NASD sought input on the proposal from five NASD standing committees, including two committees with subject matter expertise in variable annuities.<sup>56</sup> NASD Regulation, Inc.’s Board of Directors then approved the proposal and NASD’s Board of Governors had an opportunity to review it.<sup>57</sup> NASD modified the proposed rule in light of comments it received from all of these sources prior to filing it with the Commission.<sup>58</sup>

In addition, NASD stated that nothing in section 15A, Section 19, or any other provision of the Act requires it to

generate a competitive impact statement or otherwise engage in a cost/benefit analysis.<sup>59</sup> It also noted that, as required under section 19(b)(1) of the Act,<sup>60</sup> NASD submitted to the Commission a concise general statement of the basis and purpose of the proposed rule.<sup>61</sup>

As discussed in Part IV below, in approving a proposed NASD rule, the Commission must find that the rule is consistent with the requirements of sections 15A(b)(6) and 15A(b)(9) of the Act. Section 15A(b)(6) requires, among other things, the rules of a national securities association to be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>62</sup> Section 15A(b)(9) provides that proposed rules may not create a “burden on competition not necessary or appropriate in furtherance of the purposes of [the Act].”<sup>63</sup> NASD addressed the consistency of the proposed rule with these requirements, stating:

NASD believes that the proposed rule will enhance firms’ compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding fraud and manipulative acts, promote just and equitable principles of trade, and increase investor protection \* \* \*. Like all regulation, NASD’s rules often impose compliance obligations on the regulated entities. In every case, the compliance burdens associated with a new rule will vary from firm to firm depending on the firm’s customer base, business model, and a variety of other factors. Section 15A(b)(9) of the Act does not, therefore, require that NASD rules impose no economic burden on NASD members or burden on competition, but rather that any such burdens are necessary and appropriate to further the purposes of the Act \* \* \*. NASD believes that the proposed rule is consistent with, and promotes the goals of the Act.<sup>64</sup>

#### *B. Comments on Proposed Rule 2821(b)—Recommendation Requirements*

##### *1. Comments on Proposed Rule 2821(b)(1)(A)—Renumbered Proposed Rule 2821(b)(1)(A)(i)*

As proposed in Amendment No. 2, Proposed Rule 2821(b)(1)(A) would have required registered representatives to have a reasonable belief that the

customer has been informed of the material features of deferred variable annuities in general prior to recommending a particular variable annuity to a customer.<sup>65</sup> One commenter stated that the rule should clarify what constitutes the material features of a deferred variable annuity, and should have a safe harbor to protect good faith attempts to disclose the required information.<sup>66</sup> Some commenters reiterated their support for a plain-English disclosure document to be provided to investors in addition to the prospectus.<sup>67</sup>

The substance of this provision remained the same in Amendment No. 3, but in response to comments NASD explicitly stated that the type of disclosure required is generic and not specific to the particular deferred variable annuity being recommended. The provision now provides that the member or person associated with the member must have a reasonable basis to believe that “the customer has been informed, in general terms, of various features of deferred variable annuities \* \* \*.”

##### *2. Comments on Proposed Rule 2821(b)(1)(B)—Renumbered Proposed Rule 2821(b)(1)(A)(ii)*

As proposed in Amendment No. 2, Proposed Rule 2821(b)(1)(B) would have required a registered representative to

<sup>49</sup> In response to Amendment No. 1, commenters stated this provision would amount to a *de facto* requirement to provide written disclosure to customers. See, e.g., Letters from Beth L. Climo, Executive Director, American Bankers Insurance Association/ABA Securities Association (Sept. 20, 2005); Carl B. Wilkerson, Vice President and Chief Counsel, America Council of Life Insurers (Sept. 19, 2005) (“ACLI Letter I”); Thomas M. Yacovino, Vice President, A.G. Edwards & Sons, Inc. (Sept. 20, 2005); Roger C. Ochs, President, HD Vest Financial Services (Sept. 20, 2005); Michael P. DeGeorge, General Counsel, National Association for Variable Annuities (Sept. 19, 2005) (“NAVA Letter I”); Thomas R. Moriarty, President, Intersecurities, Inc. (Sept. 16, 2005) (“Intersecurities Letter”); Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association (Sept. 19, 2005) (“SIA Letter I”); Ronald C. Long, Senior Vice President, Wachovia Securities, LLC (Sept. 19, 2005) (“Wachovia Letter”). Commenters also asserted that this disclosure, along with the other disclosures already provided to investors who purchase or exchange deferred variable annuities, would be redundant and would overwhelm investors. See e.g., Letter from Leesa M. Easley, Chief Legal Officer, World Group Securities, Inc. (Sept. 8, 2005); ACLI Letter II; Intersecurities Letter; NAIFA/AALU Letter II; NAVA Letter II; SIA Letter I.

<sup>66</sup> FSI Letter II.

<sup>67</sup> See, e.g., Letters from Patricia Struck, President, North American Securities Administrators Association (July 21, 2006) (“NASAA Letter I”); Jill I. Gross, Director of Advocacy, Pace Investor Rights Project (July 19, 2006) (“Pace Letter I”); Robert S. Banks, Jr., President, Public Investors Arbitration Bar Association (July 20, 2006).

<sup>49</sup> *Id.* at 2.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* at 3.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 4.

<sup>57</sup> *Id.* at 4. NASD noted that its Board of Governors is composed of both industry and non-industry members and that one member must be a representative of an insurance company. *Id.* at 4, nt. 6. Similarly, NASD Regulation, Inc.’s Board of Directors is composed of both industry and non-industry members, and one member must be a representative of an insurance company or an affiliated NASD Member. *Id.* at 4, nt. 6.

<sup>58</sup> *Id.* at 4.

<sup>59</sup> *Id.*

<sup>60</sup> 15 U.S.C. 78s(b)(1).

<sup>61</sup> NASD Response Letter at 4.

<sup>62</sup> 15 U.S.C. 78o–3(b)(6). See also 15 U.S.C. 78c(f) (the Commission must consider whether the action will promote efficiency, competition and capital formation when it is required to consider whether an action is necessary or appropriate in the public interest).

<sup>63</sup> 15 U.S.C. 78o–3(b)(9).

<sup>64</sup> NASD Response Letter at 4–5.

have a reasonable basis to believe that a customer would benefit from the unique features of a deferred variable annuity prior to recommending the purchase or exchange of one. Amendment No. 2 included tax-deferred growth, annuitization and death benefits as a non-exhaustive list of unique features.

Some commenters stated that the standard should be that the customer "could" benefit from the features because stating that the customer would benefit implies a level of certainty and guarantee that cannot be known at the time of the purchase or exchange.<sup>68</sup> Other commenters also suggested deleting the modifier "unique," stating that the features NASD lists as examples are not unique to deferred variable annuities.<sup>69</sup> In the alternative, one of these commenters suggested that NASD expand the list of features it gives as examples to include features such as living benefits.<sup>70</sup>

NASD agreed that some other products have features similar to those of a deferred variable annuity, and in Amendment No. 2 deleted the reference to "unique." NASD also adopted commenters' suggestion to include "living benefits" in the list of features and modified the proposed rule accordingly in Amendment No. 3.

### 3. Comments on Proposed Rule 2821(b)(2)

The proposed rule would require registered representatives to make reasonable efforts to obtain a variety of information about a customer, including age, financial situation and needs, liquid net worth and intended use of the deferred variable annuity, prior to recommending a purchase or exchange of a deferred variable annuity to that customer.<sup>71</sup> A number of commenters

raised interpretive issues about or questioned the relevance of particular information.<sup>72</sup> NASD declined to amend this provision in response to these comments.

### 4. Comments on Proposed Rule 2821(c)—Principal Review and Approval

#### a. General Comments

As proposed in Amendment No. 2, the principal review and approval requirements of paragraph (c) would have applied to both recommended and non-recommended transactions.<sup>73</sup> Commenters stated that the factors a registered principal considers should adequately reflect the differences between recommended and non-recommended transactions.<sup>74</sup> These commenters noted that if a transaction is not recommended, a principal may not have information regarding a customer's overall investment portfolio

and would need to request that information from the customer.<sup>75</sup>

In Amendment No. 3, NASD noted some commenters stated that customers should be free to decide whether they want to purchase a deferred variable annuity, and thus the proposed rule's principal review requirements should not apply to non-recommended transactions.<sup>76</sup> NASD agreed that a fully informed customer should be able to make his or her own investment decision and modified this portion of the proposed rule. As amended, a registered principal "may authorize the processing [of a non-recommended transaction] if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity."<sup>77</sup>

Two commenters took the position that the supervisory requirements of the proposed rule would run counter to established legal principles and the rules, systems, and divisions of responsibility already in place.<sup>78</sup> One of these commenters stated that the proposed rule would impose 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 Act.<sup>79</sup>

Another commenter stated that the proposed rule should provide specific standards for principal review of age, liquidity needs, and the dollar amount involved.<sup>80</sup> In that commenter's view, permitting firms to set their own standards would invite abuse.<sup>81</sup> NASD's initial filing<sup>82</sup> with the Commission and Amendment No. 1<sup>83</sup> would have

<sup>68</sup> See, e.g., Letter from Ira D. Hammerman, General Counsel, Securities Industry Association (July 19, 2006) ("SIA Letter II"); ACLI Letter IV; NAVA Letter III. These commenters noted that this comment is also applicable to Proposed Rule 2821(c)(1)(A). See *supra* note 120.

<sup>69</sup> See, e.g., ACLI Letter IV; CAI Letter II; FSI Letter II; NAVA Letter III. These commenters noted that this comment is also applicable to Proposed Rule 2821(c)(1)(A). See *supra* note 120.

<sup>70</sup> CAI Letter II.

<sup>71</sup> In response to Amendment No. 1, some commenters urged NASD to eliminate this provision, stating that NASD Rules 2310 and 3110, as well as Rule 17a-3(a)(17)(i)(A) under the Act, should govern the information that members are required to gather in making recommendations to purchase or exchange deferred variable annuities. See e.g., Letters from Daniel A. Riedl, Senior Vice President and Chief Operating Officer, Northwestern Mutual Investment Services (Sept. 16, 2005) ("NMIS Letter"); M. Shawn Drefflein, President and Chief Executive Officer, National Planning Holdings, Inc. (Sept. 9, 2005); John L. Dixon, President, Pacific Select Distributors, Inc. (Sept. 16, 2005); NAVA Letter II.

<sup>72</sup> Three commenters stated that the proposed rule should not require a registered representative to obtain information if the customer declines to provide it upon request. Letter from Kerry Cunningham, Head of Risk Management, ING Advisors Network (July 20, 2006) ("ING Advisors Letter II"); ACLI Letter IV; FSI Letter II. One commenter stated that the information should be obtained during the sales process and not necessarily before any recommendation is made. ING Advisors Letter II. One commenter stated that the registered representative should make a reasonable effort to determine overall investment objectives but not intended use. *Id.* A number of commenters questioned the difference between the intended use of a deferred variable annuity and the customer's investment objective. See, e.g., Letters from Timothy J. Lyle, Senior Vice President and Chief Compliance Officer, Contemporary Financial Solutions (July 19, 2006) ("Contemporary Financial Letter"); Timothy J. Lyle, Senior Vice President and Chief Compliance Officer, Mutual Service Corporation (July 19, 2006) ("Mutual Service Letter II"); FSI Letter II; ING Advisors Letter II. Some commenters suggested that a customer's life insurance holdings are not relevant to a deferred variable annuity suitability analysis. See, e.g., CAI Letter II; Contemporary Financial Letter; FSI Letter II; Mutual Service Letter II; NAVA Letter III; Sorrento Letter; SIA Letter II.

<sup>73</sup> In response to Amendment No. 1, some commenters objected to requiring principal review of transactions that are not recommended. See, e.g., Letters from Frances M. Stadler, Deputy Senior Counsel, Investment Company Institute (Sept. 19, 2005) ("ICI Letter"); Henry H. Hopkins, Darrell N. Braman and Sara McCafferty, T. Rowe Price Investment Securities, Inc. (Sept. 19, 2005) ("T. Rowe Price Letter"); NMIS Letter. One commenter noted that the information that would be needed for a principal review is not currently required to be collected for non-recommended annuity transactions. See T. Rowe Price Letter. Some commenters also stated that requiring review for non-recommended transactions would allow principals to second guess investors' decisions. See, e.g., ICI Letter; NMIS Letter.

<sup>74</sup> See Letter from Darrell N. Braman, Vice President and Associate Legal Counsel and Sarah McCafferty, Vice President and Associate Legal Counsel, T. Rowe Price Associates, Inc. (July 19, 2006) ("T. Rowe Price Letter II"); ICI Letter II.

<sup>75</sup> ICI Letter II; T. Rowe Price Letter II.

<sup>76</sup> Amendment No. 3 is available on NASD's Web site at [http://www.finra.org/web/groups/rules\\_regs/documents/rule\\_filing/p017909.pdf](http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p017909.pdf).

<sup>77</sup> See Proposed Rule 2821(c).

<sup>78</sup> See NAIFA/AALU Letter II; NSCP Letter. In response to Amendment No. 1, several commenters stated that the proposed principal review requirement was unduly duplicative of NASD Rule 3110. See Letters from Deirdre B. Koerick, Vice President, Lincoln Investment Planning, Inc. (Sept. 19, 2005); Jennifer B. Sheehan, Assistant Vice President and Counsel, Massachusetts Mutual Life Insurance Comp. (Sept. 19, 2005); ACLI Letter IV; NAVA Letter II; SIA Letter II.

<sup>79</sup> NSCP Letter.

<sup>80</sup> Pace Letter II.

<sup>81</sup> *Id.*

<sup>82</sup> NASD's initial filing is available at [http://www.finra.org/web/groups/rules\\_regs/documents/rule\\_filing/p012780.pdf](http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p012780.pdf).

<sup>83</sup> See *supra* note 4.

required members to establish standards with respect to a variety of factors, including the customer's age and the extent to which the amount of money invested in the deferred variable annuity exceeds a stated percentage of the customer's net worth. NASD stated in Amendment No. 2 that "while conceptually appealing, the establishment of specific thresholds would unnecessarily limit a firm's discretion in establishing procedures that adequately address its overall operations. NASD did not intend to require a firm to reject all deferred variable annuity transactions involving person over a particular age or dollar amounts over a particular level. Rather, NASD intended only that principals consider the highlighted factors as part of their review, which is a facts and circumstances inquiry."<sup>84</sup>

#### b. Comments on the Timing of Principal Review

Amendment No. 2 would have required registered principals to review all purchases and exchanges of deferred variable annuities no later than two business days following the date when the customer's application is transmitted to the issuing insurance company.<sup>85</sup> Two commenters stated that the basis for the two-day timeframe is arbitrary and has not been explained or justified.<sup>86</sup> A few commenters viewed the proposed rule as prioritizing speed over diligence without adequate justification.<sup>87</sup> One commenter stated that the timeframe was intended to allow principals to catch unsuitable sales before a contract has been issued, but contracts may be issued before the principal's review is completed even under the revised timeframe.<sup>88</sup> One commenter stated that "free look" provisions that are available under some states' insurance laws offer a greater opportunity to redress unsuitable sales.<sup>89</sup>

<sup>84</sup> Amendment No. 2 is available on NASD's Web site at [http://www.finra.org/web/groups/rules\\_regs/documents/rule\\_filing/p016480.pdf](http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p016480.pdf).

<sup>85</sup> Pursuant to Amendment No. 1, registered principals would have been required to review all purchases and exchanges prior to transmitting a customer's application to the issuing insurance company for processing.

<sup>86</sup> See ACLI Letter IV; FSI Letter II.

<sup>87</sup> See, e.g., FSI Letter II; NAIFA/AALU Letter II; NSCP Letter. Another commenter stated that difficulty complying with the timeframe would force some broker-dealers to cancel contracts once the insurance company has already issued them. See CAI Letter II.

<sup>88</sup> CAI Letter II.

<sup>89</sup> ACLI Letter IV. In NASD's initial filing with the Commission, it disagreed with commenters who suggested that state-required "free look" periods make early principal review unnecessary. NASD explained that a "free look" period allows the

Numerous commenters stated that it would be difficult to comply with the revised timeframe.<sup>90</sup> Two commenters remarked that the supervisory review timeframe does not take into account the varied business models of member firms.<sup>91</sup> These commenters stated that in some instances, the registered principal who reviews transactions is stationed at the issuing insurance company.<sup>92</sup> In those instances, the commenters stated that those individuals might not be able to serve as the reviewing principal because the triggering event is the transmission to the insurance company.<sup>93</sup> One commenter also noted that the proposed rule would not accommodate instances in which the application is transmitted to the issuing insurance company and the member firm simultaneously.<sup>94</sup>

Commenters stated that it would be especially difficult to comply with the proposed timeframe when the principal needs to get additional information from the customer, registered representative, or Office of Supervisory Jurisdiction ("OSJ") manager.<sup>95</sup> One commenter stated that fear of missing the deadline may discourage principals from seeking this additional information.<sup>96</sup> Another commenter suggested that a review should be required to take place no later than two business days following the date the member transmits the application or no later than two business days after receipt by the insurance company to accommodate instances in which the customer sends the application directly to the insurance company.<sup>97</sup>

customer to terminate the contract without paying any surrender charges and receive a refund of the purchase payments or the contract value, as required by applicable state law. Free-look periods, which vary by state law, typically range from ten to thirty days. NASD went on to state that allowing a suitability analysis to be reviewed by a principal long after an insurance company issues a deferred variable annuity contract would be inconsistent with an adequate supervisory system and would make it difficult for a member to quickly identify problematic trends. NASD's initial filing is available on its Web site at [http://www.finra.org/web/groups/rules\\_regs/documents/rule\\_filing/p012780.pdf](http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p012780.pdf).

<sup>90</sup> See, e.g., CAI Letter II; Contemporary Financial Letter; FSI Letter II; ING Advisors Letter II; Mutual Service Letter II; NAVA Letter III; NSCP Letter; Sorrento Letter.

<sup>91</sup> See NSCP Letter; T. Rowe Price Letter II.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> NSCP Letter. This commenter noted that when this occurs, the application is reviewed by the insurance company and the member firm simultaneously.

<sup>95</sup> See, e.g., CAI Letter II; Contemporary Financial Letter; FSI Letter II; ING Advisors Letter II; Mutual Service Letter II; NAVA Letter III; NSCP Letter; Sorrento Letter.

<sup>96</sup> CAI Letter II.

<sup>97</sup> T. Rowe Price Letter II.

In Amendment No. 4, NASD modified the proposed rule to further address these comments.<sup>98</sup> As amended, the proposed rule would require a principal to review the transaction prior to transmitting a customer's application to the issuing insurance company for processing, but no later than seven business days after the customer signs the application.<sup>99</sup>

One commenter addressed the safeguarding of customer funds during the principal review and stated that "clarification is needed regarding the degree of flexibility afforded to firms with respect to the safekeeping of customer funds during the review period. Rather than dictating specific procedures, firms should be permitted

<sup>98</sup> NASD also amended the timing or principal review requirement in Amendment No. 3. That amendment would have required principals to review the transaction no later than two business days after the application was sent to the issuing insurance company if no additional contact was necessary with the customer or the registered representative. If additional contact was needed with either the customer or the registered representative, then review would have had to be completed within five business days of the application being sent to the issuing insurance company. The Commission received several comments on this timing provision, all of which are available on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Commenters stated that the limited review period in Amendment No. 3 was problematic and arbitrary. These commenters also suggested requiring principal review to be completed within a reasonable time period, not to exceed the expiration of the free look period, following the date the broker-dealer transmits the application to the issuing insurance company. See e.g., Letter from Dale E. Brown, Executive Director and CEO, Financial Services Institute (Mar. 5, 2007) ("FSI Letter III"); Letters Type E and F.

Comments addressing subparagraph (b)(1)(A) of Amendment No. 3 stated that requiring registered representatives to "determine" whether a transaction was suitable, rather than having a "reasonable basis to believe" it, raised the bar for suitability determinations. See e.g., FSI Letter III and Letters Type E and F. In Amendment No. 4, NASD revised this language to require registered representatives to have "a reasonable basis to believe" that the deferred variable annuity is suitable.

Commenters also stated the reference in subparagraph (b)(1)(A)(i) to the "various" features of deferred variable annuities created an "unacceptable level of ambiguity" and that the prior proposal's use of "material" features was preferable. See e.g., FSI Letter III and Letters Type E and F.

<sup>99</sup> In response to Amendment No. 4, commenters requested that the Commission seek additional comment on the proposed rule. Letter from Clifford Kirsch, Sutherland Asbill and Brennan LLP on behalf of Committee of Annuity Insurers (April 9, 2007) ("CAI Letter III"); Letters Type G and H. One commenter stated that commenters have not had an opportunity to address whether Amendment No. 4 causes any unintended consequences regarding the safeguarding of customer funds at the broker-dealer for as many as seven days and to provide feedback regarding the contours of the proposed no-action relief from Exchange Act Rules 15c3-1 and 15c3-3. CAI Letter III. See also *infra* notes 101-112 and accompanying text.

to design procedures tailored to their business model.”<sup>100</sup> Exchange Act Rule 15c3–3 requires broker-dealers to safeguard customer funds and securities. While Rule 15c3–3 requires that a broker-dealer promptly forward checks and include as a credit in the reserve formula all customer free credit balances, it does not specify any specific procedures that a broker-dealer must use to be in compliance with the rule. Rather, it allows a broker-dealer to tailor its procedures to its particular business model. NASD Rule 2821 will not affect the applicability of Exchange Act Rule 15c3–3 with respect to the safeguarding of customer funds.

The Commission also received comments on the timeframe for principal review proposed in Amendment No. 4.<sup>101</sup> Some commenters addressed NASD’s requested no-action relief<sup>102</sup> and highlighted related implementation issues.<sup>103</sup>

One commenter addressed situations in which an insurer’s contract issuance unit is physically resident at the same location as one of the insurer’s captive broker-dealer offices, and both areas share personnel with one another.<sup>104</sup> It asked for clarification of whether receipt of customer applications by broker-dealer personnel for principal review in these co-located situations would be considered a transmittal to the issuing insurance company for processing under proposed Rule 2821(c).<sup>105</sup> NASD responded by stating that in these situations “[it] would consider the application ‘transmitted’ to the insurance company only when the broker-dealer’s principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer ensures that arrangements and safeguards exist to prevent the insurance company from issuing the contract prior to principal approval by the broker-dealer.”<sup>106</sup>

The Commission believes that NASD can address implementation issues, to the extent they arise, during the proposed six month implementation period. Notably, the revised timeframe in Amendment No. 4 is substantially similar to the timeframe that NASD proposed and that the Commission published for comment in Amendment

No. 1, which would have required a principal to review a transaction prior to sending the application to the insurance company for processing. The Commission received numerous comments on the timing of principal review provision as it was proposed in Amendment No. 1.<sup>107</sup> While some commenters supported it because they believed it would give principals sufficient time for a thorough review and provide greater assurances that unsuitable transactions would not be consummated,<sup>108</sup> others objected to it.<sup>109</sup> Some commenters were concerned that members would be subject to liability for market changes affecting the value of the deferred variable annuity during the delay for supervisory review.<sup>110</sup> Some commenters stated that a delay in pricing the contract would be unfair to customers.<sup>111</sup> Others stated that the timing deadline would require costly reprogramming of broker-dealers’ electronic processing systems that forward contracts to the insurance company and the registered representative’s home office at the same time.<sup>112</sup>

One commenter stated that the interaction of this provision with other Commission and NASD rules could limit a firm’s ability to review applications thoroughly.<sup>113</sup> Another stated that time-linking the application process with supervisory review would impair the goal under the Investment Company Act of 1940 of timely processing.<sup>114</sup>

A few commenters stated that the time deadline would not work in the context of direct sales because in those sales an insurance company may not know of an applicant’s interest in a

deferred variable annuity until it receives the application.<sup>115</sup> Another stated that the timing deadline would not take into account situations in which the registered principal is housed in the insurance company.<sup>116</sup>

A few commenters also stated that their current supervisory structure as an Office of Supervisory Jurisdiction would be incapable of dealing with the prior approval requirement and they would be forced to eliminate this form of supervisory structure.<sup>117</sup> One commenter stated the requirement could overwhelm principals,<sup>118</sup> and another stated that it would require members to allocate two to three times the supervisory staff for deferred variable annuities than for any other product.<sup>119</sup>

#### c. Proposed Rule 2821(c)—Principal Review and Approval

In Amendment No. 2, NASD listed a variety of factors that a registered principal would be required to consider in reviewing the purchase or exchange of a deferred variable annuity. In Amendment No. 3, NASD modified this provision to require registered principals to consider all of the factors that a registered representative must consider in Proposed Rule 2821(b) (“Recommendation Requirements”) and eliminated the references to the considerations in subparagraph (c)(1) (“Principal Review and Approval”) of the proposed rule. NASD also moved the considerations relating to exchanges

<sup>115</sup> CAI Letter I; NAVA Letter II; T. Rowe Price Letter I. In direct sales, customers may apply for an annuity contract by calling the insurance company or by completing an application on the Internet. NAVA Letter II. Receipt of the application is frequently the first time the insurance company even knows that the customer has filled out an application. *Id.*

<sup>116</sup> NMIS Letter.

<sup>117</sup> Letter from Shawn M. Mihal, Chief Compliance Officer, Great American Advisors (Sept. 19, 2005) and ING Letter I. These comments were submitted in response to Amendment No. 1, which would have required principals to review customers’ applications prior to transmitting them to the issuing insurance company for processing. The commenters assumed that there would be no relief from Rules 15c3–1 and 15c3–3, and thus broker-dealers would have to forward checks (along with applications) to the insurance company by noon of the next business day after receiving those checks. Based on this assumption, the commenters indicated that there would not be sufficient time for representatives to forward the paperwork to the OSJ manager and the OSJ manager to review the application within the time parameters required by Rules 15c3–1 and 15c3–3. These timing concerns have been addressed by the Commission’s exemptions from Rules 15c3–1 and 15c3–3 to allow NASD members to comply with the proposed rule without becoming fully subject to Exchange Act Rule 15c3–3 and being required to maintain higher levels of net capital in accordance with Rule 15c3–1. See Exchange Act Release No. 56376 (Sept. 7, 2007).

<sup>118</sup> Wachovia Letter.

<sup>119</sup> Associated Securities Letter.

<sup>107</sup> A summary of these comments addressing Amendment No. 1 was published in the **Federal Register** along with the Commission’s notice of Amendment No. 2. See *supra* notes 4 and 6.

<sup>108</sup> Letters from Patricia Struck, President, North American Securities Administrators Association (September 20, 2005) and Rosemary J. Shockman, President, Public Investors Arbitration Bar Association (Sept. 9, 2005).

<sup>109</sup> See, e.g., Letters from W. Thomas Conner and Eric A. Arnold, Sutherland Asbill & Brennan on behalf of The Committee of Annuity Insurers (Sept. 19, 2005) (“CAI Letter I”); John S. Simmers, CEO, ING Advisors (Sept. 19, 2005) (“ING Letter I”); ACLI Letter II; NAVA Letter II.

<sup>110</sup> Letters from Denise M. Evans, General Counsel, Associated Securities Corp. (Sept. 19, 2005) (“Associated Securities Letter”); John L. Dixon, President, Pacific Select Distributors (Sept. 16, 2005) (“Pacific Select Letter”); and Julie Gerbert, Vice President, United Planners’ Financial Services of America (Sept. 19, 2005) (“United Planners Letter”).

<sup>111</sup> ACLI Letter II; Pacific Select Letter; and United Planners Letter.

<sup>112</sup> CAI Letter I; NMIS Letter.

<sup>113</sup> ING Letter I.

<sup>114</sup> ACLI Letter II.

<sup>100</sup> CAI Letter III.

<sup>101</sup> Letter from Eric A. Arnold and Clifford E. Kirsch, Sutherland Asbill and Brennan LLP on behalf of Committee of Annuity Insurers (May 24, 2007) (“CAI Letter IV”); Letters Type G and H.

<sup>102</sup> See *supra* note 21.

<sup>103</sup> See CAI Letter IV.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> See Letter from James S. Wrona, Associate Vice President, FINRA (Aug. 10, 2007).



that were in subparagraph (c)(1)(D) of Amendment No. 2 to paragraph (b) in Amendments Nos. 3 and 4. By doing this, NASD added these determinations to those factors a registered representative must consider and retained them as considerations for principal review.

i. Comments on Proposed Rule 2821(c)(1)(A) as Amended by Amendment No. 2—Principal Review and Approval

The rule, as amended by Amendment No. 2, would have required principals to consider the extent to which the customer would benefit from the unique features of a deferred variable annuity. A number of commenters remarked that their comments on proposed Rule 2821(b)(1)(B) are equally applicable to this provision and that “would” should be changed to “could” and that the modifier “unique” should be deleted.<sup>120</sup> In response to comments, NASD changed “unique” to “various.” As amended by Amendment No. 3, the rule would require registered principals to have a reasonable basis to believe that the customer has been informed, in general terms, of the various features of deferred variable annuities.<sup>121</sup>

ii. Comments on Proposed Rule 2821(c)(1)(C) as Amended by Amendment No. 2—Principal Review and Approval

The rule, as amended by Amendment No. 2, would have required principals to consider the extent to which the amount of money invested would result in an undue concentration in a deferred variable annuity or deferred variable annuities in the context of the customer’s overall investment portfolio. Two commenters stated the term “undue concentration” is imprecise and capable of multiple interpretations.<sup>122</sup> Some commenters also viewed the proposed requirement to consider the customer’s liquidity needs as subsuming the apparent intent of this provision.<sup>123</sup> In Amendment No. 3, NASD deleted this provision.

iii. Comments on Proposed Rule 2821(c)(1)(D)(ii) as Amended by Amendment No. 2—Principal Review and Approval

The rule, as modified by Amendment No. 2 would have required registered principals to consider the extent to which the customer would benefit from any potential product enhancements and improvements in the case of an exchange of a deferred variable annuity. One commenter stated that “would” should be changed to “could” because whether a customer benefits is determined years after the contract is purchased and depends on market performance.<sup>124</sup> In Amendment No. 3, NASD deleted this specific paragraph, but, provided in paragraph (b) (“Recommendation Requirements”) that principals must consider, in the case of an exchange, whether the customer would benefit from any potential product enhancements and improvements in their review.<sup>125</sup>

iv. Comments on Proposed Rule 2821(c)(1)(D)(iii) as Amended by Amendment No. 2—Principal Review and Approval

The rule, as modified in Amendment No. 2, would have required principals, in the case of an exchange of a deferred variable annuity, to consider the extent to which the customer’s account has had another deferred variable annuity exchange within the preceding thirty-six months. One commenter, while supporting this provision, believed that the registered principal should also review the total sales production of variable annuities of associated persons to detect unsuitable sales and other potential abuses.<sup>126</sup> A number of commenters stated that it would be difficult to comply with this requirement.<sup>127</sup> In their view, principals may have a difficult time obtaining this information, especially if the exchange occurred at another broker-dealer.<sup>128</sup> These commenters also stated that customers may not want to share this kind of information, citing privacy concerns or policy concerns with the other broker-dealers.<sup>129</sup>

One commenter stated that the proposed rule should specify whether principals have to collect information on exchanges that occurred at the reviewing firm only or also on

exchanges that occurred at other broker-dealers.<sup>130</sup> Two commenters argued that the proposed rule should clarify whether a registered principal is only obligated to consider prior exchange information if it is available to him or her at the time of his or her review.<sup>131</sup>

One commenter stated that the provision would impose substantial administrative and supervisory costs on broker-dealers, which would have to implement cumbersome and expensive additional surveillance tools.<sup>132</sup> Another commenter stated the proposed rule should clarify the level of inquiry and documentation necessary to comply with this provision.<sup>133</sup> In Amendment No. 3, NASD eliminated this specific provision, but provided in paragraph (b) (“Recommendation Requirements”) that principals must consider, in the case of exchange, the extent to which the customer account has had another deferred variable annuity exchange within the preceding thirty-six months.<sup>134</sup> NASD has stated that it will announce the effective date of the proposed rule change in a *Notice to Members* to be published no later than 60 days following Commission approval and that the effective date will be 120 days following publication of the Notice to Members announcing Commission approval. NASD has indicated that it may address the type of implementation issues commenters raised with respect to determining whether a customer’s account has had a deferred variable annuity exchange within the preceding 36 months in connection with that *Notice to Members*.

d. Comments on Proposed Rule 2821(c)(2)—Principal Review and Approval

The proposed rule would require the registered principal who reviewed and approved, rejected, or authorized the transaction to document and sign the determinations that he or she is required to make pursuant to subparagraph (c) of the proposed rule.

As proposed in Amendment No. 2, the principal who approves a transaction would have been required to sign the registered representative’s suitability determination. One commenter stated that this provision should be eliminated because “it would establish an unprecedented standard of requiring principals to fully endorse all of the considerations leading to the

<sup>120</sup> See, e.g., ACLI Letter IV; FSI Letter II; NAVA Letter III; SIA Letter II. See also *supra* notes 68 and 69.

<sup>121</sup> See Proposed Rule 2821(b)(1)(A)(i).

<sup>122</sup> See, e.g., NAVA Letter III; ACLI Letter IV. Two other commenters noted that NASD should provide more guidance on what would amount to an “undue concentration” because deferred variable annuities often take significant portions of a customer’s assets. See FSI Letter II; Sorrento Letter.

<sup>123</sup> See, e.g., ACLI Letter IV; CAI Letter II; NAVA Letter III.

<sup>124</sup> See NAVA Letter III.

<sup>125</sup> See Proposed Rule 2821(c) and Proposed Rule 2821(b)(1)(B)(ii).

<sup>126</sup> See NASAA Letter II.

<sup>127</sup> See, e.g., CAI Letter II; Contemporary Financial Letter; FSI Letter II; Mutual Service Letter II; Sorrento Letter; T. Rowe Price Letter II.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> See CAI Letter II.

<sup>131</sup> See Contemporary Financial Letter; Mutual Service Letter II.

<sup>132</sup> See NSCP Letter.

<sup>133</sup> See CAI Letter II.

<sup>134</sup> See Proposed Rule 2821(c) and Proposed Rule 2821(b)(1)(B)(iii).



salespersons' recommendations."<sup>135</sup> In this commenter's view, the principal's role should be to affirm the fact that the salesperson elicited information for completion of the suitability documents.<sup>136</sup> In Amendment No. 3, NASD eliminated the requirement that registered principals sign the registered representative's suitability determinations.

#### 5. Comments on Proposed Rule 2821(d)—Supervisory Procedures

The rule, as modified by Amendment No. 2, would have required members to implement procedures and require principals to consider whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.

Two commenters argued that the phrase "particularly high rate" is vague and unworkable.<sup>137</sup> A number of commenters noted that the proposed rule implies that principals would have to implement a transaction-by-transaction review and stated that members should be able to rely on exception reports as an effective solution to unsuitable exchanges.<sup>138</sup> One commenter also requested clarification regarding what should happen if a registered representative does have a particular high rate of exchanges.<sup>139</sup> NASD modified this provision in Amendment No. 3, eliminating the reference to a "particularly high rate" of exchanges.

#### 6. Comments on Proposed Rule 2821(e)—Training

As provided in Amendment No. 2, members would be required to develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of the proposed rule and that they understand the material features of deferred variable annuities. Several commenters questioned the need for this specific requirement, as well as the standards applicable to the training.<sup>140</sup>

NASD declined to amend this provision in response to comments.

#### 7. NASD's Response to Comments

As discussed above, in response to the comments received on Amendment No. 1 NASD amended portions of the proposed rule and responded to comments. NASD also filed a response to the comments received on Amendment No. 2 with the Commission addressing concerns regarding the need for the proposed rule, the regulatory process that NASD undertook in developing the proposed rule, and the statutory requirements for SRO rulemaking.<sup>141</sup> In Amendment Nos. 3 and 4, NASD further responded to comments and modified the proposed rule.

#### IV. Discussion and Commission Findings

The Commission has reviewed carefully Proposed Rule 2821, the comments, and NASD's responses to the comments, and believes that NASD has responded appropriately to the concerns raised by the commenters. The Commission finds that Proposed Rule 2821, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association, and, in particular, with section 15A(b)(6) of the Act, which requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>142</sup>

Over approximately the past three years, the majority of informal actions brought against broker-dealers as a result of NASD examinations of variable annuity sales have involved the failure to establish or follow written supervisory procedures.<sup>143</sup> During this time period, NASD also brought numerous enforcement actions charging broker-dealers with failing to supervise sales of variable annuities.<sup>144</sup> In addition, NASD's examinations found a

substantial number of unsuitable recommendations and instances of failing to obtain customer account information.<sup>145</sup> It also brought numerous enforcement actions for making unsuitable recommendations.<sup>146</sup>

The proposed rule is designed to curb sales practice abuses in deferred variable annuities. Its recommendation requirements provide a specific framework for a broker-dealer's suitability analysis of these securities. By setting forth factors that a broker-dealer must specifically consider in recommending deferred variable annuities and requiring the registered representative to obtain certain information from his or her customers, the proposed rule should improve communications between registered representatives and customers regarding these securities. The supervisory review component should foster a thorough analytical review of every deferred variable annuity transaction in a timeframe that will limit the possibility of unsuitable recommendations and transactions. The proposed rule as a whole is geared to protecting investors by requiring firms to implement more robust compliance cultures, and to give clear consideration of the suitability of these complex products.

Commenters asserted that the proposed rule, because it is product specific, would result in significant burdens on competition. Pursuant to the Act's requirement, the Commission has considered the impact of Proposed Rule 2821 on efficiency, competition and capital formation,<sup>147</sup> as well as whether the rule would impose any burden on competition not necessary or appropriate in furtherance of the Act.<sup>148</sup> We note that other products, including options and penny stocks, are subject to product-specific regulations, due to their complexity or their history of sales practice abuses. NASD has demonstrated through its history of examinations, enforcement actions, and guidance to members that regulating variable annuities like other products has not been sufficient to curb sales practice abuses. Moreover, we note that the Act allows the Commission to approve a self-regulatory organization rule that imposes burdens on competition so long as those burdens are necessary or appropriate in furtherance of the purposes of the Act.<sup>149</sup> We believe that to the extent the

<sup>135</sup> See ACLI Letter IV.

<sup>136</sup> *Id.*

<sup>137</sup> See ACLI Letter IV; FSI Letter II.

<sup>138</sup> See ACLI Letter IV; CAI Letter II; FSI Letter II; NAVA Letter III.

<sup>139</sup> See CAI Letter II. The commenter questioned whether the principal has to reject the transaction or just give it closer scrutiny.

<sup>140</sup> One commenter stated there is no need for additional training requirements because NASD Rule 2310 requires registered representatives to understand the material features of the products they sell. See FSI Letter II; Letter Type C. Other

commenters believed this provision is duplicative of the Firm Element portion of NASD's continuing education requirements. See, e.g., 1st Global Letter II; FSI Letter II. One commenter believed the training requirements would interfere with members' efficient and effective allocation of training resources. See FSI Letter II. A number of commenters also suggested members' programs be held to the standard of being "reasonably designed to achieve compliance" with the proposed rule. See, e.g., Contemporary Financial Letter; ING Advisors Letter II; Mutual Service Letter II.

<sup>141</sup> See NASD Response Letter.

<sup>142</sup> 15 U.S.C. 78o-3(b)(6).

<sup>143</sup> See *infra* note 148.

<sup>144</sup> See *infra* note 150.

<sup>145</sup> See *infra* note 148.

<sup>146</sup> See *infra* note 150.

<sup>147</sup> 15 U.S.C. 78c(f).

<sup>148</sup> 15 U.S.C. 78o-3(b)(9).

<sup>149</sup> *Id.*

proposed rule imposes burdens on competition, these burdens are necessary or appropriate in furtherance of the purposes of the Act, and particularly the purpose of protecting investors.

Commenters also expressed the view that Proposed Rule 2821 may impose compliance costs on broker-dealers that exceed their costs of complying with rules applicable to other products. The complexity of deferred variable annuities warrant more targeted regulation. NASD has attempted over the past few years to address problematic and unsuitable sales through non-rulemaking means, but has not found that approach to be successful. We agree with NASD that Proposed Rule 2821 will lead firms to enhance their compliance and supervisory systems, which in turn will provide more comprehensive and targeted protection to investors.<sup>150</sup>

While NASD has issued a number of *Notices to Members and Regulatory and Compliance Alerts* regarding the suitability of deferred variable annuities,<sup>151</sup> it continues to encounter numerous questionable sales practices through its examinations,<sup>152</sup> as well as

through its investigations and informal discussions with its members.<sup>153</sup> Just within the last few years, NASD has brought a number of cases involving failures to supervise, suitability violations, and misrepresentation in connection with purchases and exchanges of deferred variable annuities.<sup>154</sup>

enforcement actions, discussed in note 150 below. *Id.* Nor do the findings include information from special examination initiatives. *Id.*

<sup>153</sup> See NASD Response Letter.

<sup>154</sup> See, e.g., *Phillip Nelson*, NASD Case No. 2006004829701 (April 3, 2007) (providing misleading communication to customer regarding a variable annuity); *Victoria C. Smotherman*, NASD Case No. 2006003897501 (March 21, 2007) (fraudulently inducing purchases of variable annuities); *Donna Vogt*, NASD Case No. EAF0400730002 (Feb. 21, 2007) (making unsuitable variable annuity recommendations); *Raymond James Financial Services, Inc.*, NASD Case No. EAF0400730001 (Jan. 31, 2007) (failing to properly supervise by permitting producing branch managers to supervise themselves and by not properly reviewing variable annuity sales and exchanges); *Peter F. Esposito*, NASD Case No. 2005002689601 (Dec. 8, 2006) (submitting falsified account information to his firm concerning the liquidation of a variable annuity); *Quick & Reilly, Inc.*, NASD Case No. E102003158301 (Dec. 1, 2006) (failing to supervise variable annuity sales); *Waddell & Reed, Inc.*, NASD Case No. E062004029603 (Nov. 24, 2006) (failing to supervise sales of variable annuities where unregistered persons were selling such products); *David L. McFadden*, NASD Case No. E2005000226001 (Nov. 15, 2006) (fraudulent and unsuitable sales of variable annuities, mutual funds, and exchange traded fund shares); *CCO Investment Services, Corp.*, NASD Case No. E112005014002 (Oct. 16, 2006) (failing to, among other things, supervise variable annuity sales); *Daniel Carlos Lacey*, NASD Case No. E062004000201 (Aug. 11, 2006) (making unsuitable recommendations regarding variable annuities exchanges); *Michael K. Maunsell*, NASD Case No. 2005001939501 (Aug. 2, 2006) (making unsuitable variable annuity recommendations); *Carole G. Ferraro*, NASD Case No. E0520030291 (July 21, 2006) (making unsuitable recommendations regarding variable annuities); *Jerry Swicegood*, NASD Case No. 2005002683001 (July 13, 2006) (falsifying documents related to variable annuity exchanges); *Eric J. Brown*, NASD Case No. E112003006903 (June 27, 2006) (making unsuitable recommendations and false statements regarding variable annuities); *Joseph Vitetta*, NASD Case No. E10200412250 (June 8, 2006) (making unsuitable recommendation regarding a variable annuity, among other violations); *AmSouth Investment Services, Inc.*, NASD Case No. E052004025802 (May 24, 2006) (failing to establish and maintain reasonable supervisory system in connection with sales of variable annuities and mutual funds); *Charles Snyder*, NASD Case No. E112004042001 (May 2, 2006) (making unsuitable variable annuity recommendations); *Frank P. Grasse*, No. EL120030533 (April 17, 2006) (falsifying customer information on variable annuity applications); *Tyler M. Kerrigan*, NASD Case No. E0520030355 (March 10, 2006) (recommending unsuitable variable annuity transactions); *Angelisa Savage-Bryant*, NASD Case No. E072004064201 (March 6, 2006) (misrepresentation in connection with a variable annuity exchange); *Brian Carr*, NASD Case No. E9B2003043802 (Feb. 22, 2006) (making unsuitable variable annuity recommendations); *John Babiarz*, NASD Case No. 2005002047301 (Feb. 10, 2006) (making unsuitable variable annuity recommendations); *Michael Lancaster*, NASD Case No. E8A20040995-01 (Nov. 30, 2005) (making

unsuitable recommendations regarding variable annuity subaccounts); *Lawrence LaBine*, NASD Case No. C3A20040045 (Nov. 22, 2005) (unsuitable recommendations to five customers involving variable annuity subaccounts and mutual funds); *Mansell R. Spedding*, NASD Case No. E0220030907 (Sept. 21, 2005) (unsuitable subaccount allocation recommendation for variable annuity); *Rita N. Raymer*, NASD Case No. E0520030131 (Aug. 16, 2005) (unsuitable recommendations of variable annuities); *NY Life Sec., Inc.*, NASD Case No. E0520040104 (July 22, 2005) (failing to adequately supervise sales of variable annuities and mutual funds); *Paul Olsen*, NASD Case No. E3A20030539 (June 23, 2005) (negligently failing to tell customers about fees associated with variable annuity exchanges); *Bambi Holzer*, NASD Case No. E0220020787 (June 17, 2005) (negligently misrepresenting certain aspects of variable annuities); *Ilene L. Sonnenberg*, NASD Case No. C0520050024 (May 11, 2005) (recommending unsuitable variable annuity); *Raymond James & Assocs., Inc.*, NASD Case No. C0520050020 (May 10, 2005) (finding that registered representative made unsuitable recommendations and firm failed to maintain and enforce written supervisory procedures regarding sales of variable annuities); *Issetten Hanif*, NASD Case No. C9B20040086 (Apr. 6, 2005) (unsuitable recommendations regarding variable annuity and mutual fund exchanges); *Lawrence Labine*, NASD Case No. E02020513 (Nov. 19, 2004) (unsuitable variable annuity recommendation); *Edward Sadowski*, NASD Case No. C9B040102 (Nov. 17, 2004) (unsuitable variable annuity recommendation); *James B. Moorehead*, NASD Case No. C05040073 (Nov. 11, 2004) (failing to gather suitability information for variable annuity sales); *Juan Ly*, NASD Case No. C07040094 (Nov. 9, 2004) (unsuitable variable annuity switches and misrepresentations); *Jenny Chin*, NASD Case No. E04030619 (Oct. 29, 2004) (misrepresentation and omissions regarding variable annuities); *Glenn W. Ward*, NASD Case No. C05040075 (Oct. 14, 2004) (recommending unsuitable variable annuity); *Bernard E. Nugent*, NASD Case No. C11040031 (Sept. 1, 2004) (unsuitable recommendation involving the liquidation of mutual fund shares to purchase a variable annuity); *Samuel D. Hughes*, NASD Case No. C07040067 (Aug. 19, 2004) (unsuitable variable annuity switches, unauthorized sub-account allocations, and misrepresentations); *SunAmerica Sec., Inc.*, NASD Case No. C05040051 (July 12, 2004) (lacking adequate written supervisory procedures concerning review of variable annuity and variable universal life contracts); *Jamie Engelking*, NASD Case No. E3A020441 (July 2, 2004) (unsuitable variable annuity recommendation); *Pan-American Fin. Advisers*, NASD Case No. C05040034 (June 15, 2004) (failing to have adequate supervisory procedures for variable annuity sales); *Scott Weier*, NASD Case No. E04010714 (May 27, 2004) (unsuitable variable annuity recommendations); *Gregory Jurkiewicz*, NASD Case No. E3A030436 (May 4, 2004) (unsuitable variable annuity recommendation); *Michael H. Tew*, NASD Case No. C05040010 (Apr. 7, 2004) (unsuitable recommendations regarding variable annuities); *Steve Morgan*, NASD Case No. E3A020410 (Mar. 12, 2004) (unsuitable variable annuity recommendation); *Donald Lacavazzi*, NASD Case No. C11040009 (Feb. 24, 2004) (recommending unsuitable variable annuity switching); *Michael Blandchard*, NASD Case No. C11040005 (Feb. 16, 2004) (unsuitable variable annuity recommendations); *Prudential Inv. Mgmt. and Prudential Equity Group, Inc.*, NASD Case No. C05040008 (Jan. 29, 2004) (failing to supervise and maintain accurate records relating to variable annuity replacement sales); *Waddell & Reed, Inc.*, NASD Case No. CAF040002 (Jan. 14, 2004) (failing to ascertain suitability of recommended variable annuity exchanges and failure to supervise). NASD Enforcement actions are available at <http://>

<sup>150</sup> See NASD Response Letter.

<sup>151</sup> See *Notice to Members* 96–86 and *Notice to Members* 99–35. In 2002, NASD issued a *Regulatory & Compliance Alert*, entitled “NASD Regulation Cautions Firms for Deficient Variable Annuity Communications,” that, among other things, discussed NASD’s discovery of unacceptable sales practices regarding variable annuities. In another *Regulatory & Compliance Alert* in 2002, entitled “Reminder—Suitability of Variable Annuity Sales,” NASD emphasized, in part, that an associated person must be knowledgeable about a variable annuity before he or she can determine whether a recommendation to purchase, sell or exchange the variable annuity is appropriate. NASD has also issued a number of *Investor Alerts* regarding variable annuities. In 2001, NASD issued an *Investor Alert* entitled “Should You Exchange Your Variable Annuity?” highlighting important issues that investors should consider before agreeing to exchange a variable annuity. In 2003, NASD issued an *Investor Alert* entitled “Variable Annuities: Beyond the Hard Sell,” which cautioned investors about certain inappropriate sales tactics and highlighted the unique features of these products.

<sup>152</sup> From July 2004 to April 2007, NASD completed a total of 807 routine examinations involving the review of variable annuities. See Letter from James S. Wrona, Associate Vice President, NASD (May 15, 2007) (“NASD Examination/Enforcement Update Letter”). These examinations resulted in 92 Letters of Caution, 45 Compliance Conferences, and 4 Acceptance, Waiver and Consent letters, in which a respondent accepts a finding of a violation, consents to the imposition of sanctions, and agrees to waive the right to a hearing. *Id.* While the majority of these actions involved the failure to establish or follow written supervisory procedures, a number of actions related to the failure to obtain and maintain customer account information, unsuitable recommendations, and the failure to comply with standards relating to communications with the public. *Id.* These findings do not include cause examinations, many of which result in formal action that is captured by

Some commenters expressed the view that NASD must wait before instituting rulemaking and show that a “demonstrable problem” exists.<sup>155</sup> While we believe NASD’s examinations and enforcement actions over the years clearly demonstrate an entrenched problem in the sales culture for these products, nothing in the Act requires NASD to make such a showing. Rather, the Act requires the Commission to determine that a proposed rule is consistent with the Act and consider whether the proposed rule would promote efficiency, competition and capital formation.<sup>156</sup> So long as its proposed rules meet the requirements of the Act, NASD can—and indeed should—be proactive in addressing problems in the sale of securities.

Some commenters also took the position that the proposed rule should be subject to a cost/benefit analysis.<sup>157</sup> The Act sets forth what the Commission must consider in determining whether to approve a proposed self-regulatory organization rule. It also sets forth requirements that the self-regulatory organizations must meet. The Act does not require a cost/benefit analysis with respect to proposed self-regulatory organization rules that are filed with, and approved by, the Commission.

As a practical matter, however, NASD considered the costs and benefits of the rule as the rule was developed and modified, and NASD’s members were actively involved in shaping the proposed rule. As NASD stated in its response to comments on Amendment No. 2 “[i]ndustry members are keenly aware of the potential costs and burdens that can result from rulemaking and, as is often the case, they raised and NASD considered such issues at multiple stages of the rulemaking process.”<sup>158</sup>

[www.nasd.com/RegulatoryEnforcement/MonthlyDisciplinaryActions/index.htm](http://www.nasd.com/RegulatoryEnforcement/MonthlyDisciplinaryActions/index.htm).

<sup>155</sup> See *supra* note 33 and accompanying text.

<sup>156</sup> 15 U.S.C. 78c(f).

<sup>157</sup> See *supra* notes 35–38 and accompanying text.

<sup>158</sup> As discussed in detail above, in its response to comments to Amendment No. 2, NASD noted the steps it went through as it developed the proposed rule prior to filing it with the Commission. It published the proposed rule in a Notice to Members and solicited comment. The proposal also went to five NASD standing committees (including two committees with subject matter expertise regarding variable annuities) for consultation and comment. NASD considered the public’s and the committees’ comments and modified the proposed rule in response. The NASD Regulation, Inc. Board of Directors then approved the proposed rule and the NASD Board of Governors had an opportunity to review it. These NASD boards include members of the broker-dealer and insurance industries. For detail on the composition of the boards, see NASD’s Response Letter.

#### *Accelerated Approval of Amendment Nos. 3 and 4*

As set forth below, the Commission finds good cause to approve Amendment Nos. 3 and 4 to the proposed rule, as amended, prior to the thirtieth day after the date of publication of the notice of Amendment Nos. 3 and 4 in the **Federal Register**. The revisions and clarifications in Amendment Nos. 3 and 4 were made in response to comments.

In Amendment No. 3, NASD modified the Recommendation Requirements in paragraph (b) of the proposed rule. Amendment No. 2 required members to have a reasonable basis to believe the customer has been informed of the material features of a deferred variable annuity. NASD revised the proposed rule to specify that a member must have a reasonable basis to believe that a customer has been informed “in general terms of the various features” of deferred variable annuities. NASD made this change in response to comments to clarify that the customer need only be informed about the features of deferred variable annuities in general terms, rather than be informed about the specific features of the deferred variable annuity the member might recommend.

In addition, in Amendment No. 3, NASD incorporated the factors that a firm must consider when exchanging deferred variable annuities in the recommendation requirements rather than in the principal review and approval requirements, while maintaining a requirement that principals consider these factors. NASD also eliminated two of the considerations relating to exchanges in response to comments: the extent to which the customer would benefit from the unique features of a deferred variable annuity and the extent to which the customer’s age or liquidity needs make the investment inappropriate.

Moreover, in Amendment No. 3, NASD revised the proposed rule in response to comments relating to the applicability of the proposed rule to non-recommended transactions. NASD clarified that while principals are to treat all transactions as recommended, a principal may authorize the processing of a transaction if it determines that the transaction was not recommended and that the customer affirms that he or she wants to proceed after being informed of the reason why the registered principal has not approved the transaction.

In Amendment No. 3, NASD also modified the supervisory procedures provisions of the rule in response to comments that the term “particularly high rates of effecting deferred variable

annuity exchanges” was vague. NASD revised the proposed rule to require implementation of surveillance procedures to review associated persons’ rates of effecting deferred variable annuity exchanges for consistency with the proposed rule, other NASD rules and the federal securities laws. NASD also clarified that members must have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges.

In addition, in Amendment No. 3, NASD revised the required timeframe for principal review, which it further revised in Amendment No. 4. As amended by Amendment No. 4, the principal must review the application prior to transmitting it to the issuing insurance company for processing, but no later than seven business days after the customer signs the application. This “prior to transmittal” standard was also incorporated in Amendment No. 1, and the Commission received a substantial number of comments on this standard. Although Amendment No. 1 did not explicitly limit the timeframe for principal review to no more than seven days, provisions of Exchange Act Rule 15c3–3 would have operated to limit the time in which broker-dealers could hold customer funds. In light of NASD’s requested exemption from Rule 15c3–3, the seven-day limit on principal review in Amendment No. 4 would replace that rule’s time limitation for transactions subject to that exemption with a more workable limit.

Thus, the Commission finds good cause to approve Amendment Nos. 3 and 4 to the proposed rule, as amended, prior to the thirtieth day after the date of publication of the notice of Amendment Nos. 3 and 4 in the **Federal Register**.

#### **V. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 3 and 4, including whether the proposed rule is consistent with the Act.<sup>159</sup> Comments may be submitted by any of the following methods:

##### *Electronic Comments*

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD–2004–183 on the subject line.

<sup>159</sup> The Commission will consider the comments we previously received. Commenters may reiterate or cross-reference previously submitted comments.

### Paper Comments

• Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2004-183. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-183 and should be submitted on or before October 4, 2007.

### VI. Conclusion

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>160</sup> that the proposed rule, as amended (SR-NASD-2004-183), be, and it hereby is, approved.

By the Commission.

**Nancy M. Morris,**

Secretary.

[FR Doc. E7-18022 Filed 9-12-07; 8:45 am]

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-56373; File No. SR-FINRA-2007-005]

#### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change Relating to NASD Rule 11870 (Customer Account Transfer Contracts) and NYSE Rule 412 (Customer Account Transfer Contracts) To Make the Time Frames in the Rules for Validating or Taking Exception to an Instruction To Transfer a Customer's Securities Account Consistent With the Time Frames in the Automated Customer Account Transfer Service

September 7, 2007.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on August 8, 2007, Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared by FINRA. The Commission is publishing this notice to solicit comments from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend National Association of Securities Dealers, Inc. ("NASD") Rule 11870 ("Customer Account Transfer Contracts") and New York Stock Exchange ("NYSE") Rule 412 ("Customer Account Transfer Contracts") to make the time frames in the rules for validating or taking exception to an instruction to transfer a customer's securities account assets and for completing the transfer of the assets consistent with the time frames in the National Securities Clearing Corporation's ("NSCC") Automated Customer Account Transfer Service ("ACATS") transfer cycle. Below is the text of the proposed rule change. Proposed new language is *italicized*; proposed deletions are in [brackets].

#### 11000. UNIFORM PRACTICE CODE

#### 11870. Customer Account Transfer Contracts

(a) No Change.

(b) Transfer Procedures

(1) Upon receipt from the customer of an authorized broker-to-broker transfer

instruction form ("TIF") to receive such customer's securities account assets in whole or in specifically designated part, from the carrying member, the receiving member must immediately submit such instruction to the carrying member. The carrying member must, within [three] *one* business day[s] following receipt of such instruction, or receipt of a TIF received directly from the customer authorizing the transfer of assets in specifically designated part: (A) Validate the transfer instruction to the receiving member (with an attachment reflecting all positions and money balances to be transferred as shown on its books); or (B) take exception to the transfer instruction for reasons other than securities positions or money balance discrepancies and advise the receiving member of the exception taken. *The time frame(s) set forth in this paragraph will change, as determined from time-to-time in any publication, relating to the ACATS facility, by the National Securities Clearing Corporation (NSCC).*

(2) No Change.

(c) and (d) No Change.

(e) Completion of the Transfer

Within three business days following the validation of a transfer instruction, the carrying member must complete the transfer of the customer's security account assets to the receiving member. The receiving member and the carrying member must immediately establish fail-to-receive and fail-to-deliver contracts at then-current market values upon their respective books of account against the long/short positions that have not been delivered/received and the receiving/carrying member must debit/credit the related money amount. The customer's security account assets shall thereupon be deemed transferred. *The time frame(s) set forth in this paragraph will change, as determined from time-to-time in any publication, relating to the ACATS facility, by the NSCC.*

(f) through (n) No Change.

\* \* \* \* \*

#### Rule 412. Customer Account Transfer Contracts

(a) No Change.

(b)

(1) Upon receipt from the customer of an authorized broker-to-broker transfer instruction form ("TIF") to receive such customer's securities account assets in whole or in specifically designated part, the receiving organization will immediately submit such instruction to the carrying organization. The carrying organization must, within [three (3)] *one* business day[s] following receipt of such instruction, or receipt of a TIF

<sup>160</sup> 15 U.S.C. 78s(b)(2).

<sup>1</sup> 15 U.S.C. 78s(b)(1).