

## Deferred Variable Annuities

### SEC Approves New NASD Rule 2821 Governing Deferred Variable Annuity Transactions

Effective Date: May 5, 2008

#### Executive Summary

On September 7, 2007, the SEC approved new NASD Rule 2821 regarding broker-dealers' compliance and supervisory responsibilities for deferred variable annuities.<sup>1</sup> The rule text is set forth in Attachment A and is effective May 5, 2008.

Questions regarding this *Notice* may be directed to James S. Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; or Lawrence N. Kosciulek, Director, Investment Companies Regulation, at (240) 386-4535.

#### Discussion

Deferred variable annuities are hybrid investments containing both securities and insurance features.<sup>2</sup> They offer choices among a number of complex contract options, which can cause confusion for both the individuals who sell them and customers who buy them. FINRA developed Rule 2821 to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities.

November 2007

#### Notice Type

- New Rule

#### Suggested Routing

- Compliance
- Continuing Education
- Internal Audit
- Legal
- Operations
- Registered Representatives
- Senior Management
- Systems
- Trading
- Training
- Variable Contracts

#### Key Topics

- Deferred Variable Annuities
- Disclosure
- Principal Review
- Sales Practices
- Suitability
- Supervision
- Training

#### Referenced Rules & Notices

- NASD Rule 2310
- NASD Rule 2330
- NASD Rule 2820
- NASD Rule 2821
- NASD Rule 3010
- NASD Rule 3012
- NTM 99-35
- NTM 01-23
- NTM 03-71
- NTM 05-50
- NYSE Information Memo 05-54
- SEC Rule 15c3-1
- SEC Rule 15c3-3

## The Rule's Application

Rule 2821 applies to the purchase or exchange (not sale or surrender) of a deferred variable annuity and the initial subaccount allocations.<sup>3</sup> Rule 2821 does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. Other FINRA rules, however, are applicable to such transactions. For instance, FINRA's general suitability rule (NASD Rule 2310) continues to apply to any recommendations to reallocate subaccounts or to sell a deferred variable annuity.<sup>4</sup> Rule 2821 applies to the use of deferred variable annuities to fund IRAs, but not to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans,<sup>5</sup> unless a member firm makes a recommendation to an individual plan participant, in which case the rule would apply to that recommendation.<sup>6</sup>

## The Rule's Main Requirements

Rule 2821 has four main requirements, which are discussed below. An outline of the general division of responsibility among registered representatives, registered principals and firms is included with this *Notice* (Attachment B). Firms and their associated persons should carefully review the actual rule language, however, to understand the breadth of the obligations that the rule imposes.

### Registered Representative Requirements for Recommended Transactions

Under the "Recommendation Requirements" section of the rule,<sup>7</sup> a registered representative must have a reasonable basis to believe that the customer has been informed, in general terms, of the material features of a deferred variable annuity, such as potential surrender period and surrender charge, potential tax penalty, mortality and expense fees, charges for and features of enhanced riders, insurance and investment components and market risk.<sup>8</sup> Although the rule requires only generic disclosure, registered representatives and principals may not ignore product-specific features. For example, a firm and its brokers cannot adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question.<sup>9</sup>

This section of the rule also requires that the registered representative have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization or a death or living benefit.<sup>10</sup> The rule does not require that a registered representative determine that the customer would benefit from *all* of these features or that the customer, in hindsight, actually took advantage of one or more of them.

Further, this section states that a registered representative must have a reasonable basis to believe that “the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable....”<sup>11</sup> Thus, the suitability determination must include careful consideration of the product in its entirety and its component parts, including initial subaccount allocations.

If an “exchange” of one variable annuity for another is involved, the registered representative must have a reasonable basis to believe that “the transaction as a whole also is suitable for the particular customer” and must consider a number of additional factors.<sup>12</sup> Those factors include “whether (i) 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....; (ii) the customer would benefit from product enhancements and improvements; and (iii) the customer’s account has had another deferred variable annuity exchange within the preceding 36 months.”<sup>13</sup> Regarding the last factor, a registered representative must determine whether the customer has effected another exchange at the broker-dealer at which he or she is performing the review and must make reasonable efforts to ascertain whether the customer has effected an exchange at any other broker-dealer(s) within the preceding 36 months.<sup>14</sup>

The rule also requires a registered representative to make reasonable efforts to ascertain and consider various other types of customer-specific information when recommending that a customer purchase or exchange a deferred variable annuity. This information includes 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>15</sup> Although not explicitly addressed in the rule, deferred variable annuities generally are considered to be long-term investments and are therefore typically not suitable for investors who have short-term investment horizons.

Finally, a registered representative who recommends the purchase or exchange of a deferred variable annuity must document and sign the determinations discussed above. This signed document must provide reviewing principals with enough information to adequately assess whether the registered representative has complied with the requirements of Rule 2821.

### **Principal Review and Approval Obligations for All Transactions**

The rule's "Principal Review and Approval" section includes both timing and substantive components. With regard to timing, the rule requires review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after the customer signs the application...."<sup>16</sup> FINRA recognizes that (in view of the variety of features and provisions of deferred variable annuity contracts) principal review of these investments often can require more time than reviews of many other types of securities transactions. To ensure that broker-dealers have sufficient time for a rigorous and thorough review prior to transmittal, FINRA has provided interpretive relief and the SEC has provided an exemption (as described below) regarding a number of rules that otherwise might have, as a practical matter, shortened the period within which broker-dealers could review the transactions.

Broker-dealers often accept customer checks made payable to the issuing insurance company when customers sign applications for deferred variable annuities. The broker-dealers' receipt of the checks, however, could have triggered application of a number of other rules that might have required relatively quick principal reviews. NASD Rule 2330, for instance, generally prohibits improper use of customer funds, and NASD Rule 2820 specifically requires broker-dealers to "transmit promptly" the application and purchase payment for a variable annuity contract to the issuing insurance company. To alleviate the potential conflict between Rule 2821's review timing requirement and other FINRA rules, FINRA created an important exception: A broker-dealer may hold an application for a deferred variable annuity and a customer's non-negotiated check payable to an insurance company for up to seven business days without violating either Rule 2330 or Rule 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to Rule 2821.

An SEC exemption also was needed because "[m]any broker-dealers are subject to lower net capital requirements under [SEC] Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under [SEC] Rule 15c3-3 because they do not carry customer funds or securities."<sup>17</sup> Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it "promptly transmits" the checks to third parties.<sup>18</sup> The SEC has interpreted "promptly transmits" to mean that "such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities."<sup>19</sup>

In conjunction with its approval of Rule 2821, the SEC provided an exemption to the “promptly transmits” requirement under the following conditions:

- The transaction is subject to the principal review requirements of Rule 2821 and a registered principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with the rule;
- The broker-dealer promptly transmits the check no later than noon of the business day following the date a registered principal reviews and determines whether he or she approves of the purchase or exchange of the deferred variable annuity; and
- The broker-dealer maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company if approved or returned to the customer if rejected.

If all three of these conditions are met, a firm is “exempt from any additional requirements of [SEC] Rules 15c3-1 or 15c3-3 due solely to a failure to promptly transmit a check made payable to an insurance company for the purchase of a deferred variable annuity product by noon of the business day following the date the broker-dealer receives the check from the customer...”<sup>20</sup>

During the rulemaking process, some commenters asked whether principals must complete or simply begin their review prior to the transmittal of the application to the issuing insurance company. The principal review must be *completed* before transmittal of the application to the insurance company.

A coalition of 32 life insurance companies asked whether the timing of principal review under Rule 2821 would be impacted by a firm’s status as a “captive broker-dealer.” The coalition explained that a number of insurance companies share personnel with affiliated broker-dealers and have centralized units that may share personnel who are responsible for both the broker-dealer’s principal review of the variable annuity application and the insurance company’s issuance process. The coalition sought clarification that receipt of customer applications by broker-dealer personnel for principal review, even if those personnel share office space with and/or also work for the insurer, would not be considered “transmitted to the issuing insurance company for processing” under Rule 2821.

To respond to the coalition’s request for clarification, it is necessary to emphasize that the main purpose of requiring pre-transmittal principal review is to have the principal review and determine whether to approve the application *prior to the issuance of the contract*. Ordinarily, FINRA would consider the application “transmitted” to the insurance company when the broker-dealer sends the application to the insurance company for processing, whether it is sent via electronic means, facsimile transmission,

regular or overnight mail, or courier. The dividing lines can become blurred, however, when a captive broker-dealer and insurance company share office space and/or employees who carry out both the principal review and the issuance process. In such situations, FINRA considers 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>21</sup>

In addition to addressing the timing of principal review, this section of the rule states that a principal shall treat “all transactions as if they have been recommended for purposes of this principal review” and shall only approve the transaction if he or she determines “that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule.”<sup>22</sup> A principal who determines that the transaction is unsuitable nonetheless may authorize the processing of the transaction if the principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the principal found it to be unsuitable, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. All of the determinations required by this part of the rule must be documented and signed by the principal.

FINRA emphasizes, however, that the rule does not *require* broker-dealers to effect trades that they determine are not suitable; rather, the rule *permits* them to do so under the narrow circumstances discussed above. Thus, the rule has no effect on existing principles of law or contractual terms that allow a broker-dealer to decline the acceptance of an order.

A few commenters asked whether principals have a more limited role under the rule if they are employed by a broker-dealer that does not have a sales force and does not make recommendations to customers.<sup>23</sup> The rule requires that a broker-dealer have procedures in place designed to ensure that principals receive appropriate information about both the customer and the product(s) so that they can fulfill their review obligations under the rule and that principals review *all* purchase and exchange orders for suitability, irrespective of whether the orders were recommended.

### **Firm Supervisory Procedures**

The rule specifically requires broker-dealers to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the rule.<sup>24</sup> This part of the rule includes the requirements that the broker-dealer implement surveillance procedures to determine if any “*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 this Rule, other applicable NASD rules, or the federal securities laws (‘inappropriate exchanges’) and have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges....”<sup>25</sup> The rule allows a firm to determine how to screen for and supervise such activity. Thus, a firm could perform this type of review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction.

### **Firm Training Program**

The fourth main requirement in the rule is a training component,<sup>26</sup> which requires that firms create training programs for registered representatives who sell, and for registered principals who review transactions in, deferred variable annuities. Among other factors, firms must include training on the material aspects of deferred variable annuities.

### **Use of Automated Supervisory Systems**

Rule 2821 does not preclude firms from using automated supervisory systems (or a mix of automated and manual supervisory systems) to facilitate compliance with the rule. Of course, firms that intend to rely on automated supervisory systems for compliance with Rule 2821 (or other rules) must remember that, at a minimum, a principal or principals would need to (1) approve the criteria that the automated supervisory system uses; (2) audit and update the automated supervisory system as necessary to ensure compliance with the rule; and (3) review exception reports that the automated supervisory system creates. As is always the case with the exercise of supervision under FINRA rules, the use of any automated supervisory system, aid or tool for the discharge of supervisory duties represents a direct exercise of supervision by the supervisor (a principal or principals under Rule 2821) and the supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule. Consequently, a principal or principals relying on such an automated supervisory system is responsible for any deficiency in the system’s criteria that would result in the system not being reasonably designed to comply with Rule 2821.

A broker-dealer need not designate only one principal to perform these tasks. Consistent with NASD Rules 3010 and 3012, a broker-dealer generally is free to allocate supervisory responsibilities among its qualified registered principals as appropriate (whether in the context of automated or manual supervisory reviews). Thus, a broker-dealer may, for example, designate several principals to be responsible for various parts of an automated supervisory system.

Finally, a broker-dealer must ensure that it provides training for (1) the firm's relevant associated persons on how to correctly input information into the automated supervisory system and (2) the firm's principals responsible for reviewing and approving deferred variable annuity transactions on how to use and interpret the reports generated by the firm's automated supervisory systems in order to properly review and monitor deferred variable annuity transactions.<sup>27</sup>



## Endnotes

- 1 See SEC Order Approving FINRA's NASD Rule 2821 Regarding Members' Responsibilities for Deferred Variable Annuities (Approval Order), Securities Exchange Act Release No. 56375 (Sept. 7, 2007), 72 FR 52403 (Sept. 13, 2007) (SR-NASD-2004-183); SEC Corrective Order, Securities Exchange Act Release No. 56375A (Sept. 14, 2007), 72 FR 53612 (Sept. 19, 2007) (SR-NASD-2004-183) (correcting the rule's effective date). Created on July 30, 2007, the Financial Industry Regulatory Authority (FINRA) comprises the former National Association of Securities Dealers, Inc. (NASD) and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE). The FINRA rulebook consists of both NASD rules and certain NYSE rules until FINRA adopts a consolidated rulebook.
- 2 In general, a variable annuity is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint Report), available at [www.sec.gov/news/studies/secnasdvp.pdf](http://www.sec.gov/news/studies/secnasdvp.pdf); see also *NASD Notice to Members 99-35* (May 1999); *NYSE Information Memo 05-54* (Aug. 11, 2005).
- 3 Rule 2821(a)(1). The rule covers a stand-alone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another. For purposes of the 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 rule as a "purchase." The rule does not cover customer sales or surrenders of deferred variable annuities, including the sale or surrender of a deferred variable annuity in connection with an "exchange" of a deferred variable annuity for another product (such as a fixed annuity).
- 4 In a 2002 *Regulatory & Compliance Alert* entitled "Reminder—Suitability of Variable Annuity Sales," FINRA emphasized that Rule 2310 "applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor." *Regulatory & Compliance Alert* (Spring 2002) at 13. See also *NASD Notice to Members 05-50* (Aug. 2005) ("[R]ecommendations to ... surrender a ... variable annuity ... must be suitable, including where such ... surrender[s] are for the purpose of funding the purchase of an unregistered EIA."). As part of the suitability analysis under Rule 2310 regarding a recommendation to sell a deferred variable annuity, a registered representative must consider, *inter alia*, tax consequences, surrender charges and loss of benefits (such as death, living or other contractual benefits).
- 5 A deferred variable annuity purchased to fund an IRA (or other tax deferred account or vehicle) does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA (or other tax deferred account or vehicle) itself. Accordingly, where a customer is purchasing a deferred

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## Endnotes (cont'd)

- variable annuity to fund an IRA (or other tax deferred account or vehicle), firms must ensure that features other than tax deferral make the purchase of the deferred variable annuity for the IRA (or other tax deferred account or vehicle) appropriate.
- 6 Another issue that arose during the rulemaking process is whether Rule 2821 would apply if a registered representative recommended a deferred variable annuity to an individual retirement plan participant and the annuity was the only funding vehicle for the employer's retirement plan. If the registered representative "recommends" the deferred variable annuity, then Rule 2821 would apply. However, not all communications about a deferred variable annuity would constitute a "recommendation" that triggers application of the rule. For instance, a firm's generic communication to plan participants indicating only that their employer has chosen a deferred variable annuity as the funding vehicle for its retirement plan generally would not constitute a "recommendation" triggering application of the rule. For a review of guidelines for determining whether a particular communication could be deemed a "recommendation," see *NASD Notice to Members 01-23* (Apr. 2001).
  - 7 Rule 2821(b).
  - 8 Rule 2821(b)(1)(A)(i). While the rule does not specify the exact type or form of disclosure that is required, a registered representative who merely delivers a prospectus to an investor ordinarily would not have a reasonable basis to believe that the customer has been instructed or educated—"informed"—about the material features of a deferred variable annuity for purposes of the rule.
  - 9 A broker's understanding of the features of an investment product is an important component of both reasonable-basis suitability (*i.e.*, the requirement that a broker determine, after appropriate due diligence, whether the product is suitable for at least *some* investors) and customer-specific suitability (*i.e.*, the requirement that the broker determine whether the product is suitable for the particular customer at issue). See *NASD Notice to Members 03-71* (Nov. 2003).
  - 10 In the past, it was apparent that some brokers and investors did not fully understand important aspects of these features. For instance, "although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds." *NASD Notice to Members 99-35* (May 1999). See also *NYSE Information Memo 05-54* (Aug. 11, 2005) ("A customer of advanced years might lack the actuarial expectations necessary for a deferred variable annuity to yield its benefit of income shelter versus costs, and his or her lower tax bracket might render such benefits marginal or negative.").
  - 11 Rule 2821(b)(1)(A)(iii).
  - 12 *Id.*
  - 13 Rule 2821(b)(1)(B).
  - 14 FINRA generally would view asking customers whether they had an exchange at another broker-dealer within 36 months to be a "reasonable effort" in this context.
  - 15 Rule 2821(b)(2).

## Endnotes (cont'd)

- 16 Rule 2821(c).
- 17 SEC Order Granting Exemption to Broker-Dealers from Requirements in Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks (Exemption Order), Securities Exchange Act Release No. 56376 (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007).
- 18 See Securities Exchange Act Release No. 31511 (Nov. 24, 1992) (stating that a firm shall not be deemed to receive funds if checks are payable to an entity other than itself—such as to another broker-dealer or escrow agent—and the firm promptly forwards such funds to the third party).
- 19 *Id.*, note 11, and 17 CFR §240.15c3-1(c)(9). The SEC has extended this definition to SEC Rule 15c3-3(k). See NYSE's SEC Rule Interpretations Handbook, at 15c3-3(k)(2)(ii)/015.
- 20 Exemption Order, *supra* note 17.
- 21 Several commenters have asked, in the case where a captive broker-dealer shares office space and/or employees with the insurance company, whether, in advance of the broker-dealer's principal approval of the transaction, the customer's funds could be deposited in an account at the insurance company and administration of the issuance processing could begin. The rule does not permit depositing the customer's funds in an account at the insurance company prior to completion of principal review. The rule, however, does not prohibit using the information required for principal review and approval in aid of the issuance process. For instance, the rule generally does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, *i.e.*, paper or electronic) that the insurer uses for the issuance process, provided that no further steps are taken in the issuance process.
- 22 Rule 2821(c).
- 23 One commenter asked whether Rule 2821 applies to an issuer's direct sale of a deferred variable annuity to a customer without any involvement of a broker-dealer or persons associated with a broker-dealer. FINRA's rules apply only to member broker-dealers and their associated persons. FINRA notes, however, that the determination of whether an entity should be registered as a broker-dealer rests with the SEC.
- 24 See Rule 2821(d).
- 25 *Id.* (emphasis added). FINRA notes that Rule 2821(d)(1) focuses on whether an *associated person* has effected an inappropriate number of exchanges, while Rule 2821(b)(1)(B)(iii) focuses on whether a particular *customer* has had another exchange within a 36-month period.
- 26 See Rule 2821(e).
- 27 The firm also would need to comply with applicable requirements of NASD Rule 3110 and SEC Rules 17a-3 and 17a-4 and interpretations thereof.

## ATTACHMENT A

New language is underlined.

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### 2821. Members' Responsibilities Regarding Deferred Variable Annuities

#### (a) General Considerations

##### (1) Application

This Rule applies to the purchase or exchange of a deferred variable annuity and the subaccount allocations. This Rule does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the Securities Exchange Act of 1934 or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

##### (2) Creation, Storage, and Transmission of Documents

For purposes of this Rule, documents may be created, stored, and transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

##### (3) Definitions

For purposes of this Rule, the term "registered principal" shall mean a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24), or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

#### (b) Recommendation Requirements

(1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with Rule 2310 and, in particular, that there is a reasonable basis to believe that

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

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by subparagraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by subparagraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning 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.

**(c) Principal Review and Approval**

Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after the customer signs the application, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. Subject to the exception in this paragraph, and treating all transactions as if they have been recommended for purposes of this principal review, a registered principal shall approve the transaction only if the registered principal has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule. Notwithstanding the foregoing, a registered principal may authorize the processing of the 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. The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and approved, rejected, or authorized the transaction.

**(d) Supervisory Procedures**

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012, 3013, and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

**(e) Training**

Members shall 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 this Rule and that they understand the material features of deferred variable annuities, including those described in subparagraph (b)(1)(A)(i) of this Rule.

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## ATTACHMENT B

### Division of Responsibilities Outline under Rule 2821 (Deferred Variable Annuities)

*This outline highlights the general division of responsibility among registered representatives, registered principals and firms under Rule 2821. Please be aware that, in the case of any misunderstanding, the rule language prevails. In addition, please note that your firm may have additional policies and procedures that registered representatives and principals must follow.*

#### Registered Representatives (RRs),

► **when recommending either a purchase or an exchange of a deferred variable annuity, must**

1. reasonably try to obtain and consider information about the customer, including
  - a. age
  - b. annual income
  - c. financial situation and needs
  - d. investment experience
  - e. investment objectives
  - f. intended use of the deferred variable annuity
  - g. investment time horizon
  - h. existing assets (e.g., investment and life insurance holdings)
  - i. liquidity needs
  - j. liquid net worth
  - k. risk tolerance
  - l. tax status
2. reasonably believe that the purchase or exchange is suitable, based on a variety of factors, including
  - a. the customer has been informed, in general terms, of the material features of deferred variable annuities, such as
    - potential surrender period and surrender charge
    - potential tax penalty components
    - mortality and expense fees
    - charges for and features of enhanced riders, if any
    - insurance and investment
    - market risk
  - b. the customer would benefit from one or more features of deferred variable annuities, such as
    - tax-deferred growth
    - annuitization
    - a death or living benefit
  - c. the particular deferred variable annuity as a whole, underlying subaccounts, and riders and similar product enhancements, if any, are suitable
3. document and sign his or her determinations, providing the principal assigned to review the transaction with enough information to assess compliance with the rule

► **when determining suitability for a recommended exchange of a deferred variable annuity, also must consider whether the customer**

1. would incur a surrender charge, be subject to a new surrender period, lose existing benefits or be subject to increased fees or charges
2. would benefit from product enhancements and improvements
3. has exchanged a deferred variable annuity within the last 36 months



### Registered Principals

1. must review each purchase and exchange and determine whether to approve the transaction before sending the customer's application to the insurer for processing, but no later than seven business days after the customer has signed the application
2. must treat all transactions as if they have been recommended for purposes of review
3. can approve the transaction only if he or she reasonably believes that it is suitable based on the factors that RRs must consider for recommended transactions
4. may authorize the processing of an unsuitable transaction if the principal determines both that
  - a. the transaction was not recommended and
  - b. the customer, after being told why the principal found it to be unsuitable, has stated that he or she wants to proceed with the purchase or exchange
5. must document and sign all determinations

### Broker-Dealer Firms,

#### ➤ with respect to supervisory procedures, must

1. have written supervisory procedures reasonably designed to achieve compliance with the rule
2. have surveillance procedures to identify which, if any, of their RRs have a rate of effecting exchanges that raises a question as to whether those exchanges comply with this or other rules
3. have procedures to address and correct exchanges that do not comply with this or other rules

#### ➤ with respect to training, must

1. create training programs on deferred variable annuities for RRs who sell, and for principals who review transactions in, these products