MEMO# 21604

September 17, 2007

SEC Approves FINRA Rule Governing Sales Practices of Deferred Variable Annuities

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TO: VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 17-07 RE: SEC APPROVES FINRA RULE GOVERNING SALES PRACTICES OF DEFERRED VARIABLE ANNUITIES

The Securities and Exchange Commission has granted accelerated approval to a proposed rule change filed by FINRA to adopt Rule 2821, as amended, relating to sales practice standards and supervisory requirements for transactions in deferred variable annuities. [1]

The proposal has four primary components. First, it imposes a product specific suitability obligation on FINRA members for an investor's purchases or exchanges of a deferred variably annuity and for an investor's initial subaccount allocations. [2] The suitability analysis requires a member to have a reasonable basis to believe that the transaction is suitable, and sets forth the considerations and requirements necessary to achieve that determination. Such determination must be documented and signed by the recommending member.

Second, the proposal contains standards for principal review, requiring a principal to treat all transactions as if they have been recommended. This review must occur prior to transmitting the customer's application to the issuing insurance company but no later than seven business days after the customer signs the application. If a principal determines that a transaction is unsuitable and was not recommended, the principal may still authorize the transaction if the customer has been informed of the reason for the disapproval and the customer affirms that he or she wants to proceed. The proposal provides that the principal also must document and sign his or her suitability determination.

Third, the proposal requires members to develop and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in proposed Rule 2821. Finally, the proposal requires members to develop and implement training programs to educate members on the material features of deferred variable annuities and the requirements of the proposed Rule. The proposal states that FINRA will announce the effective date of proposed Rule 2821 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.

The Institute previously commented on the proposal, supporting the general goal of proposed Rule 2821 – to address problems relating to sales practices in the area of deferred variable annuities. [3] The Institute questioned, however, the approach of establishing a separate regulatory framework for one particular investment product and whether a separate rule was necessary to accomplish FINRA's goal. The Order finds that FINRA demonstrated that "regulating variable annuities like other products has not been sufficient to curb sales practices abuses" and "the complexity of deferred variable annuities warrant more targeted regulation." [4]

The Institute additionally questioned several specific aspects of the proposed principal suitability review requirements, including the timing of the review, the requirement to review transactions that are not recommended, and the necessity of determining a customer's "need" for the deferred variable annuity as compared with other products. These elements of the proposal have been addressed in the approved proposal.

To avoid violations of certain federal rules, the SEC also issued an exemptive order allowing FINRA members to hold customer funds for no more than seven business days while completing the required principal review under proposed Rule 2821 without becoming fully subject to Rule 15c3-3 of the Exchange Act and being required to maintain higher levels of net capital in accordance with Rule 15c3-1 of the Exchange Act.

Heather L. Traeger
Assistant Counsel

endnotes

[1] SEC Release No. 34-56375 (September 7, 2007) ("Order"). The Order can be found at http://www.sec.gov/rules/sro/nasd/2007/34-56375a.pdf. The rule text of the proposal can be found on FINRA's website at http://www.finra.org/RulesRegulation/RuleFilings/2004RuleFilings/P012781. Comments are due 21 days from publication of the Order in the Federal Register.

[2] To the extent the proposal does not apply to a particular transaction in deferred variable annuities, FINRA's general suitability rule, current Rule 2310, will apply (e.g., reallocations of subaccounts).

[3] See Letter from Ari Burstein, Associate Counsel, Institute, to Nancy M. Morris, Secretary, SEC, dated July 19, 2006, and Letter from Frances Stadler, Deputy Senior Counsel, Institute, to Jonathan G. Katz, Secretary, SEC, dated September 19, 2005.

[4] In response to comments, the Order also states that the Exchange Act of 1934 "does not require a cost/benefit analysis with respect to proposed self-regulatory organization rules that are filed with, and approved by, the Commission." Nonetheless, as a practical matter, the Order notes that FINRA considered the costs and benefits of the proposal as it was developed and modified.