

SEC Approves FINRA Rule Governing Sales Practices of Deferred Variable Annuities

The Securities and Exchange Commission ("SEC" or "Commission") recently approved a new Rule 2821 (the "Rule"), proposed by the Financial Industry Regulatory Authority ("FINRA," formerly the National Association of Securities Dealers, Inc. "NASD") relating to broker-dealer sales practices with respect to purchases and exchanges of deferred variable annuities.¹ The Rule will create specific requirements governing broker-dealer transaction recommendations, which include a suitability obligation, principal review and approval criteria, and supervisory training requirements and procedures, all customized for certain deferred variable annuity transactions. The SEC approved the Rule on an accelerated basis.

Deferred variable annuities now join a very small group of securities products -- including naked options and oil and gas partnerships -- that have their own custom suitability requirements.

The Rule has been controversial since its initial proposal by the NASD back in December 2004. The Rule has been through several iterations and has come a long way from its original form.

To Which Transactions Does the Rule Apply and Are There Exempt Transactions?

The Rule applies to the original purchase or exchange of a deferred variable annuity and to

an applicant's original subaccount allocations. The Rule does not apply to reallocations of subaccounts made or to payments made after the initial purchase or exchange of a deferred variable annuity; however, the general suitability rule, Rule 2310, still applies to these transactions.²

The Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan. To be exempt, this plan must either be defined as a "qualified plan" under Section 3(a)(12)(C) of the Securities Exchange Act of 1934 ("1934 Act") or meet the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f). However, if recommendations are provided to an individual plan participant regarding a deferred variable annuity, the Rule will apply as to the individual plan participant.

Rule 2821 imposes responsibilities on registered principals even on transactions in which no recommendation is made. This includes the responsibility to determine if the transaction is suitable. A registered principal may authorize the processing of a non-recommended transaction if the registered principal determines 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 registered principal will still need to approve the transaction (as described below).

¹ SEC Release No. 34-56375 (Sept. 7, 2007). Text of the SEC order is at: <http://www.sec.gov/rules/sro/nasd/2007/34-56375.pdf>. Text of the Rule is at: http://www.finra.org/web/groups/rules_regulations/documents/rule_filing/p018737.pdf.

² Query whether the general suitability rule would apply if no recommendation were made by an associated person of a broker-dealer.

What are the Rule's Requirements?

The Rule has four primary components, summarized below.

Suitability obligation

- *Generally:* When recommending a purchase or exchange of a deferred variable annuity, a firm or associated person must have a reasonable basis to believe that the transaction is suitable in accordance with the already existing suitability Rule 2310 (discussed further below) and have a reasonable basis to believe that
 - the customer has been informed in general terms of the various features of the deferred variable annuity;
 - the customer would benefit from certain features of a deferred variable annuity; and
 - the annuity as a whole, the contract riders and product enhancements, and the underlying subaccounts to which premium payments are allocated are suitable for the particular customer.
- *Exchanges:* In the case of an exchange, the firm or associated person must consider whether the transaction as a whole would be suitable, including 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;
 - the customer would benefit from product enhancements and improvements; and
 - the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

The elements of the recommendation by the broker-dealer must be documented and signed by the associated salesperson making the recommendation.

- *Customer Information:* Before recommending the purchase or exchange of a deferred variable annuity, salespersons must make reasonable efforts to

obtain specific customer information. Such information includes age, annual income, financial situation and needs, investment experience and objectives, intended use of the variable annuity, investment time horizon, existing investment and life insurance holdings, liquidity needs, liquid net worth, risk tolerance, and tax status.

Review and Approval

Prior to transmitting a customer's deferred variable annuity application to the issuing insurance company for processing, but not later than seven business days after the customer signs the application, a registered principal must review and determine whether to approve the purchase or exchange of the annuity and document the suitability determination. The Rule provides that a registered principal shall only approve the purchase or sale upon a reasonable basis to believe that the transaction would be suitable based on the factors identified for the registered representative to review under the Rule. A principal must treat all transactions as if the transaction has been recommended.³ However, if a principal determines that a non-recommended transaction is unsuitable, the principal may still authorize the transaction so long as the customer has been informed of the reason why the transaction was not approved and the customer affirms that he or she wants to proceed.

Supervisory Procedures

In addition to existing supervisory and recordkeeping requirements, the broker-dealer must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the Rule. Also, a broker-dealer must have surveillance procedures to review for "inappropriate exchanges" and have policies and procedures to implement corrective measures.

FINRA has noted that 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.

³ Interestingly, the requirement for a salesperson to make reasonable efforts to obtain customer information seemingly does not apply to a non-recommended transaction. Thus, it may be hard for a principal to approve a transaction for which the firm does not have customer information.

Training Program

The broker-dealer must implement a training program to ensure that associated persons who effect, and registered principals who review, transactions in deferred variable annuities comply with the requirements of the Rule and understand the material features of the product.

What is the Effective Date of the Rule?

The Commission approved the Rule on September 7, 2007. FINRA will announce the Rule's effective date in a Notice to Members to be published no later than 60 days following such approval, or by approximately November 6, 2007. The effective date will then be 180 days following publication of the Notice to Members.⁴

What is the Background and History of the Rule?

Variable annuities are already governed by the existing FINRA suitability rule, Rule 2310, which requires a selling broker-dealer recommending to a customer the purchase, sale, or exchange of any security to have reasonable grounds for believing that the recommendation is suitable for the customer. Suitability is based upon the facts, if any, disclosed by the customer as to his or her other security holdings and financial situation and needs.

The NASD filed the proposed Rule with the SEC on December 14, 2004. On July 19, 2005, the Commission released a notice regarding proposed Rule 2821 that sets forth these new practice standards and supervisory requirements for transactions involving the purchase or exchange of deferred variable annuities.⁵ NASD made numerous and significant revisions to the proposed Rule, scaling it back in several critical respects over the last several years for a total of four amended rule proposals, the most recent of which was filed with the SEC on March 5, 2007. NASD also filed

⁴ The SEC published a correction to the SEC order indicating that the effective date originally noted as 120 days was revised to 180 days, which is in accordance with NASD's normal practice.

⁵ Securities and Exchange Release No. 34-52046A, 70 Fed. Reg. 42126 (July 19, 2005).

an Extension for Time Period for Commission Action on August 8, 2007, with an expiration of October 1, 2007.

The recent Amendment No. 4 to the proposed Rule modified the proposal in two main ways. First, certain language in the "Recommendation Requirements" section was modified. The proposed Rule had originally stated that "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 determined* that the transaction is suitable in accordance with Rule 2310." The phrase "has determined" has been deleted and replaced with "has a reasonable basis to believe."

Second, NASD's Amendment No. 4 changed the timing of principal review. Amendment No. 2 proposed that a registered principal of the broker-dealer was to review and determine whether to approve the purchase or exchange of a deferred variable annuity no later than two days after the application is transmitted to the issuing insurance company. Amendment No. 3 proposed that a registered principal would have been required to review and approve a transaction no longer than two business days following the date an application is transmitted, or five business days after the application for a deferred variable annuity had been transmitted to the issuing insurance company.

Amendment No. 4 revised the principal approval provision to clarify that a broker-dealer holding a deferred variable annuity application and a non-negotiated check from a customer written to an insurance company for a period of seven days or less will not be in violation of NASD Rules 2330, which governs a broker-dealer's handling of customer securities and funds, and 2820, which has substantive requirements governing a broker-dealer's activities in connection with the sale of variable contracts.

Is a Broker-Dealer Fully Subject to Rules 15c3-3 and 15c3-1 of the 1934 Act?

In conjunction with the Rule, the SEC granted a conditional exemption to broker-dealers from Rules 15c3-1, the net capital rule, and 15c3-3 under the 1934 Act, which governs a broker-dealer's custody of customer securities. The exemptions permit a principal's review of a transaction subject to Rule 2821 for up to seven

business days without triggering more onerous net capital requirements under Rule 15c3-1 of the 1934 Act and without requiring the broker-dealer to establish and fund a customer reserve account under Rule 15c3-3.⁶

⁶ In order to comply with Rules 15c3-1 and 15c3-3, a broker-dealer must not be deemed to be carrying customer funds and must instead promptly transmit a check to the appropriate third parties. "Promptly transmit" has been interpreted to be "no later than noon of the next business day after receipt of such funds." A broker-dealer may be required to retain customer

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This update was authored by Jeffrey S. Puretz (+1 202 261 3358; jeffrey.puretz@dechert.com), Anthony H. Zacharski (+1 860 524 3937; anthony.zacharski@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and Alison C. Ryan (+1 949 442 6006; Alison.ryan@dechert.com).

checks for more than one business day when complying with Rule 2821.

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Allison R. Beakley
Boston
+1 617 728 7124
allison.beakley@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Steven S. Drachman
New York
+1 212 698 5627
steven.drachman@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell
Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz
Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Poretz
Washington, D.C.
+1 202 261 3358
jeffrey.poretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Washington, D.C.
+1 202 261 3386
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

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