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VIA ELECTRONIC MAIL AND OVERNIGHT MAIL

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Re: Proposed Model Suitability Regulation and Amendment to NAIC
Unfair Trade Practices Act

Dear Ms. Johnson and Ms. Mead:

On January 6, 2001, the National Association of Insurance Commissioners ("NAIC") published for comment from interested persons a draft of a proposed "Life Insurance and Annuities Suitability Model Regulation" ("Model Suitability Regulation").¹ This letter of comment is respectfully submitted by the Marketing Practices Committee of the National Association for Variable Annuities ("NAVA").² NAVA has over 350 member companies representing diverse participants in the annuity and variable life insurance policy industry, including insurance companies, broker-dealers, banks, law firms, and other industry service providers.

¹ The Model Suitability Regulation is on the NAIC's Website, "www.naic.org."

² NAVA is a not-for-profit organization dedicated to increasing public knowledge and acceptance of annuity and variable life products to retirement-focused Americans; to providing educational and information resources to its members and the public; to protecting consumers by encouraging adherence to the highest ethical standards by insurers, distributors, and all other participants in the diverse industry; and to protecting and advancing the interests of its members.

Our members play a critical role in helping Americans invest and save for their retirement. NAVA shares with its members a common goal of maintaining the highest standards of ethical sales conduct. We support the efforts of federal and state regulators in their efforts to foster high standards of sales conduct. We are pleased to offer below our comments on the proposed Model Suitability Regulation.

This letter begins with a summary of our recommendations. Following the summary, Section I provides an overview of the existing federal regulatory framework governing variable contracts and the investor protections this framework provides. Section II discusses the specific suitability rules (and related interpretive guidance) of two securities industry self-regulatory organizations, the National Association of Securities Dealers, Inc. ("NASD")³ and the New York Stock Exchange ("NYSE").⁴ Section III discusses the suitability requirements imposed under the federal securities laws as administered by the Securities and Exchange Commission ("SEC"). Section IV discusses how the SROs, the SEC, and private litigants enforce the various suitability rules.

Based on this assessment of the extensive existing federal regulatory framework governing suitability, Section V concludes that variable contracts, since they are already governed under this regulatory framework, are appropriately excluded from the Model Suitability Regulation as proposed in the latest draft thereof. Section VI concludes with a discussion of additional recommendations relating to the Model Suitability Regulation as it would apply to fixed annuity contracts.

Summary of Recommendations

- ***The proposed Model Suitability Regulation provides an exemption for "Registered Contracts," defined as variable annuity contracts or variable life insurance policies subject to the prospectus delivery requirements of the Securities Act of 1933. Because of the extensive and effective regulatory structure currently governing the issuance and distribution of Registered Contracts, including existing regulation of the suitability of sales of such contracts, we strongly support the proposed exemption.***
- ***Section 3.G of the Model Suitability Regulation enumerates categories of information included in the definition of "relevant information" that should be considered in making a suitable recommendation. We recommend that the***

³ The NASD carries out a number of regulatory activities through its wholly-owned subsidiary, NASD Regulation, Inc. For convenience, this letter refers to both organizations collectively as the "NASD."

⁴ A discussion of the suitability rules of other SROs, such as the American Stock Exchange, is beyond the scope of this comment letter.

definition of "relevant information" be revised to clarify that certain of these categories of information may not be relevant to some suitability determinations.

- *Section 3.I of the Model Suitability Regulation defines a "suitable recommendation" as one that, among other things, "is based upon relevant information" and "meets the purchaser's insurable needs or financial objectives" (emphasis added). We believe this is an unworkable standard, since it could result in the insurer and producer being viewed as "guarantors" of the suitability of an insurance contract. We recommend that the proposed definition of "suitable recommendation" included in the Model Suitability Regulation be revised to define a suitable recommendation as a "recommendation for the purchase of a life insurance or annuity product not exempted from this regulation, which (i) is based upon relevant information furnished after reasonable inquiry of a potential purchaser, such as the purchaser's insurance and investment objectives and financial situation and needs, and (ii) is reasonably believed by the producer and the insurer to meet the purchaser's insurable needs or financial objectives." This definition more closely reflects accepted suitability doctrine that requires a reasonable effort to obtain relevant information and a reasonable belief that the recommendation is suitable for the customer.*
- Section 5.A of the Model Suitability Regulation requires an insurer to establish, maintain and enforce policies and procedures reasonably designed to ensure that its producers make suitable recommendations. Broker-dealers selling annuities may sell the products of a number of different insurance companies. Section 5.A could result in a broker-dealer that sells the annuities of 10 different insurers, having to require its representatives to learn and follow 10 different companies' guidelines. We believe that this type of situation begs a different approach to developing and implementing suitability guidelines. *NAVA strongly recommends that Section 5.C, which currently permits an insurer to delegate certain of its duties, be revised further as follows: "An insurer may contract with a third party, such as an insurance agency or brokerage firm, (i) to establish, maintain and enforce, as required by Section 5.A, policies and procedures reasonably designed to ensure that the insurer's producers make suitable recommendations, and (ii) to deliver information and perform the functions described in Subsection B(1) and (2)."*

We believe that some insurers may reasonably conclude that their distributors are the most effective parties to establish appropriate suitability guidelines based on unique factors such as their customer bases, producers, physical locations, products, etc. Rather than requiring a broker-dealer and its producers to study, implement, and adhere to multiple suitability guidelines, we believe the proposed Model Suitability Regulation would be much more effective and better achieve its regulatory goals if it permitted the producer to adhere to one set of consistent guidelines, that is, the

guidelines established by his or her employer. If, for example, an insurer entered into an arrangement with a broker-dealer under which the broker-dealer's registered representatives followed the broker-dealer's established suitability procedures or guidelines, the insurer would, of course, monitor compliance with the guidelines as otherwise required under the Model Suitability Regulation.

- *The NAIC has proposed to add a new Section P to the Unfair Trade Practices Act ("UTPA"). Section P would designate the "failure to make suitable recommendations" as an unfair trade practice for purposes of the UTPA. "Failure to make suitable recommendations" is defined as "[r]ecommending the sale of a life insurance policy or annuity product without considering appropriate relevant information about the purchaser's insurable needs and financial objectives." We recommend strongly that this proposed provision not be added to the UTPA, since it is inconsistent with the Model Suitability Regulation, lacking in any guidance for application, and likely to cause ungrounded private litigation.*

We are extremely concerned that in jurisdictions where the doctrine of implied rights is accepted, the proposed provision would provide a basis for a private right of action that could lead to "strike" suits against insurance companies. There is an existing and well-established legal framework under state law available to litigants to claim a particular recommendation was unsuitable. We believe that adding a completely new and untested legal basis for recovery, where the proposed statutory provision defines suitability differently than in the Model Suitability Regulation and is devoid of interpretive guidance (including the absence of any of the exemptions in the Model Suitability Regulation), is imprudent and potentially harmful to the solvency of insurance companies that become enmeshed in frivolous private litigation. We believe these are critical concerns and recommend that the proposed statutory amendment not be added to the UTPA.

I. Existing Regulatory Framework Governing Registered Contracts

A comprehensive regulatory framework governs variable annuity contracts and variable life insurance policies subject to the prospectus delivery requirements of the Securities Act of 1933 ("Securities Act") (such contracts and policies referred to hereinafter as "Registered Contracts," the term used in the Model Suitability Regulation). This regulatory framework is perhaps more extensive than for any other financial product sold in the United States. At the state level, Registered Contracts (like other insurance contracts) are subject to comprehensive regulation under state insurance laws. State laws govern the organization and licensing of insurance companies, and state insurance departments regularly examine insurance company operations. Registered Contracts and amendments thereto generally must be filed with and approved by each state in which the contracts are sold. Insurance agents must be licensed in each state in which they operate.

Only licensed insurance agents, who must pass qualifying examinations, may sell Registered Contracts.

In addition to being governed under this state regulatory framework, Registered Contracts are regulated as securities pursuant to a comprehensive regulatory framework under the federal securities laws. The primary federal securities laws that regulate Registered Contracts and the separate accounts through which they are issued are the Securities Act, the Securities Exchange Act of 1934 ("Exchange Act"), and the Investment Company Act of 1940 ("Investment Company Act"). The SEC administers these acts.

- A. The Securities Act requires life insurance companies to provide investors with comprehensive prospectuses required to describe all material features of Registered Contracts. The prospectus provides a purchaser with information upon which he or she can make an independent suitability determination.**

Registered Contracts are securities and must be registered on registration statements filed with the SEC before they can be offered to the public. The registration statements contain statutory prospectuses that must be provided to contract owners. In fact, since most contracts involve a "two-tier" investment structure where premiums are invested in insurance company separate accounts that in turn invest in underlying mutual funds, investors generally receive *one* prospectus describing the contract and *another* prospectus describing each of the underlying funds to which money is allocated. The SEC staff reviews and comments on registration statements, and a registration statement usually must be amended in response to staff comments before it will be declared effective. A "post-effective amendment" updating a contract's registration statement generally must be filed at least annually.

The Securities Act imposes liability (including strict liability for issuers of securities) on any person who offers or sells a security by means of a prospectus that includes a material misstatement or omission. The SEC prosecutes violations in enforcement actions brought in administrative proceedings or in courts of law. Purchasers also can bring private actions in courts of law.

- B. The Securities Exchange Act of 1934 requires broker-dealers selling Registered Contracts to register with the SEC and the NASD and imposes a pervasive regulatory structure on these broker-dealers.**

The Exchange Act requires Registered Contracts to be distributed through broker-dealers registered with the SEC. Broker-dealers and individual producers, or "registered representatives," are subject to extensive operational and financial rules that cover,

among other things, minimum net capital requirements, reporting, recordkeeping, supervision, advertising, and sales activities.

In addition to the broker-dealer regulatory framework established by the Exchange Act, registered broker-dealers and their registered representatives also must be members of the NASD. The NASD is a self-regulatory organization overseen by the SEC. Broker-dealers registered with the NASD must comply with an extensive series of rules. Among other things, examinations are required, fingerprints must be provided by all associated persons, and numerous supervisory, suitability, advertising, and recordkeeping and reporting rules apply.

C. The Investment Company Act of 1940 imposes a comprehensive federal corporate regulatory framework on separate accounts through which Registered Contracts are issued, prohibiting self-dealing and other practices that may not be in investors' best interests.

The Investment Company Act regulates how registered investment companies (including insurance company separate accounts issuing Registered Contracts) are operated, imposing an extensive federal regulatory structure on separate accounts and underlying funds. For example, the Act governs how variable annuities and shares of underlying funds are issued and redeemed. There are also corporate governance requirements and prohibitions against self-dealing.

Each separate account regulated under the Investment Company Act must file a report on its operations annually with the SEC. In addition, an annual and semi-annual report containing information about the underlying mutual funds that serve as investment options for the variable annuities must be sent to contract owners. In some cases, these reports also will contain information on the variable annuities themselves and on the separate accounts issuing them.

The SEC inspects variable annuity separate account operations regularly. The SEC also inspects various locations, such as broker-dealer offices, from which variable annuities are sold. Recommendations are made and any deficiencies noted. If the situation is serious enough, it is referred to the SEC's enforcement division.

D. Regulation of Broker-Dealers Distributing Registered Contracts

In order to sell Registered Contracts, a distribution firm must be registered with the SEC as a broker-dealer and be admitted as a member of the NASD. Individuals selling contracts are not required to be registered as broker-dealers, but must be "associated with" a registered broker-dealer and registered with the NASD as a representative or principal of an NASD member. To register with the NASD, an individual must satisfy applicable examination requirements and file registration forms.

Once the individual is associated with a registered broker-dealer, the broker-dealer is required to supervise the activities of the individual for compliance with the laws and regulations, including NASD rules, applicable to broker-dealers.

SEC registration subjects a broker-dealer to an extensive framework of rules, including net capital requirements, bonding requirements, membership requirements with respect to the Securities Investor Protection Corporation, and recordkeeping rules. NASD membership subjects the broker-dealer to a framework of rules governing membership, conduct, and other market activities, including continuing education requirements for producers, or "registered representatives."

A critical component of both the SEC and NASD regulatory framework is the additional statutory and regulatory requirements for broker-dealers to establish comprehensive supervision procedures. Section 15(b) of the Exchange Act grants the SEC the power to sanction a broker-dealer and its associated persons for "fail[ing] reasonably to supervise" another person. Section 15 also provides, however, that a person cannot be deemed to have failed to supervise another person if established procedures are in place reasonably expected to prevent and detect violations.

With respect to the NASD, NASD Rule 3010 requires registered broker-dealers to establish a rigorous system of supervision built upon offices of supervisory jurisdiction (OSJs), that bring a structured framework to the management of field sales conduct. Registered principals within each OSJ perform such functions as: maintenance and enforcement of written supervisory procedures and compliance manuals; periodic examination of customer accounts; branch office inspections; review and endorsement of customer transactions and the correspondence of registered representatives; conducting mandatory compliance meetings; overseeing compliance with continuing education requirements; approval of the opening of all new accounts; and review and approval of all advertising and sales materials.

II. NASD and NYSE Suitability Rules

A. NASD Suitability Rule

One of most important doctrines under the federal securities laws that has endured since the enactment of the statutes is the suitability doctrine. Broadly defined, the suitability doctrine is a duty on the part of the broker to recommend to a customer only those securities reasonably believed to be suitable to the investment objectives and peculiar needs of that particular customer.⁵ A suitable recommendation requires the matching of two elements: (i) the investment objectives, peculiar needs, and other

⁵ See, e.g., Lewis D. Lowenfels and Alan R. Bromberg, *Suitability in Securities Transaction*, 54 BUS. LAW. 1557 (1999).

investments of the particular customer with (ii) the characteristics of the security that is being recommended.⁶

The two primary self-regulatory organizations of the securities industry, the NASD and the NYSE, have adopted rules embodying the suitability doctrine. The NASD's suitability doctrine is embodied primarily in NASD Rule 2310, entitled "Recommendations to Customers (Suitability)," and in three collections of "Interpretive Material," IM-2310-1, IM 2310-2, and IM-2310-3.

Rule 2310 provides:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer,⁷ other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Unlike the suitability requirements imposed under the federal securities laws, which have been based primarily on the antifraud provisions of the securities acts, the NASD's suitability rule is grounded in broad ethical principles. These ethical principles must govern all activities of NASD members and their registered representatives, as required by Rule NASD Rule 2110: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." With regards to suitability, IM-2310-3 states that:

⁶ *Id.*

⁷ Rule 2310(c) defines a "non-institutional customer" as a customer that does not qualify as an "institutional account" under Rule 3110(c)(4). Rule 3110(c)(4), in turn, includes as institutional accounts banks, insurance companies, registered investment companies, investment advisers registered under the Investment Advisers Act of 1940 or with a state securities commission, and investors with total assets of at least \$50 million.

"The Association's suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Members' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Members are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer."

In summary, Rule 2310 requires broker-dealers to recommend a security only when the broker-dealer reasonably believes that that the security is suitable for the customer, and places upon the broker-dealer an affirmative duty of inquiry. In addition to the information required by Rule 2310(b), Rule 3110 requires the broker-dealer to maintain customer account information that will differ depending on whether the account is institutional or non-institutional, or discretionary or non-discretionary. Recognizing that the duty of inquiry may vary depending on the particular customer and recommended security, some broker-dealers as a matter of good business practice have different and detailed account information requirements for different types of accounts, including retirement accounts, margin accounts, and commodities and futures accounts.⁸

The NASD has on a number of occasions issued interpretive guidance relating to its suitability rule. IM-2310-2 enumerates certain practices that have been found by NASD disciplinary panels to violate the suitability rule. IM-2310-2(e) notes that as new financial products are introduced, members must make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to educate the customer about these features. IM-2310-2(e) recognizes the responsibility of the producer to match the unique characteristics of a particular security with the characteristics of a particular customer, a responsibility the producer is uniquely situated to carry out.

The NASD has issued several significant interpretations of its suitability rule as it applies to the sale of variable contracts. In 1996, the NASD provided a list of factors that could be considered under suitability rules.⁹ More recently, the NASD has issued comprehensive detailed guidance related specifically to variable annuity contracts and variable life insurance policies. This guidance is discussed below.

⁸ Lewis D. Lowenfels and Alan R. Bromberg, *Suitability in Securities Transaction*, 54 BUS. LAW. 1557, 1564 (1999).

⁹ Notice to Members 96-86 (December 1996).

B. NASD's Variable Annuity Marketing Guidelines

In May 1999, the NASD issued marketing guidelines for variable annuities. The guidelines were published in Notice to Members 99-35 (May 1999). The guidelines identify areas of concern that the NASD expects to be addressed in the supervisory procedures of NASD member firms that sell variable annuities. Highlights of the guidelines are summarized below.

- ***Customer Information.*** Broker-dealers and their registered representatives should make reasonable efforts to obtain comprehensive customer information. Notice to Members 99-35 lists a number of specific information items that should be considered. A registered representative should discuss all relevant facts with the customer, including liquidity issues, fees, applicable premium taxes, and market risk. When a variable annuity transaction is recommended, the registered representative and a registered principal should review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying subaccounts recommended to the customer are suitable.
- ***Product Information.*** The guidelines indicate that registered representatives should have a thorough knowledge of each variable annuity that is recommended. To the extent practical, a current prospectus should be given to the customer when a variable annuity is recommended. Prospectus information about important factors should be discussed with the customer. Registered representatives may use only approved sales material.
- ***Liquidity and Earnings Accrual.*** The guidelines indicate that variable annuities typically should be recommended only to customers with long-term investment objectives. A registered representative should make sure that the customer understands applicable surrender charges and tax penalties. The broker-dealer should develop special procedures to screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a specific age, since depending on certain contract features some customers of advanced age may be unsuitable for a variable annuity investment.
- ***Income, Net Worth, and Contract Size Thresholds.*** The guidelines provide that broker-dealers should establish procedures to require a principal's review of variable annuity investments that exceed a stated percentage of the customer's net worth and any contract in which a customer is investing more than a stated dollar amount.

- ***Investment in Tax Qualified Accounts.*** The guidelines also address situations in which a registered representative recommends the purchase of a variable annuity for a tax-qualified retirement account (*e.g.*, 401(k) plan, IRA). The guidelines indicate first that the representative should disclose to the customer that tax deferral is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. Then, according to the guidelines, the representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.
- ***Variable Annuity Replacements.*** The guidelines suggest that broker-dealers should develop an exchange or replacement form. The form should, among other things, include an explanation of the benefits of replacing one contract for another variable contract, and should be signed by the customer, registered representative, and registered principal. The representative and principal should determine that replacing the existing contract is suitable. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges. The guidelines indicate that the broker-dealer should consider developing compliance systems, such as computer programs, that can monitor and identify registered representatives with high rates of exchange activity.

C. NASD's Variable Life Marketing Guidelines

In July 2000, the NASD published variable life insurance marketing guidelines. The guidelines were published in Notice to Members 00-44 (July 2000). The guidelines address the following specific areas of concern.

- ***Obtaining Customer Information.*** When recommending a variable life insurance policy, NASD members and their registered representatives should make reasonable efforts to obtain comprehensive customer information, such as the customer's age, annual income, net worth, liquid net worth, number of dependents, investment objective, sources of funds for investment, investment experience, existing investments and life insurance, time horizon, and risk tolerance. The registered representative should document the information in a customer account form.
- ***Reviewing Customer Information.*** In determining whether a customer wants and needs life insurance protection and can afford the premiums likely necessary to prevent lapse, members are urged to consider implementing certain specific procedures such as establishing internal percentage ratio guidelines, such as the ratio of scheduled or target premium to income or

household income, or percentage of scheduled or target premium to liquid net worth; providing a checklist of items for the principal to review; utilizing at the point of sale allocation percentage guidelines when underlying fund allocations are made; and establishing special supervision requirements for sales to older customers.

- ***Product Information.*** Like the variable annuity marketing guidelines, the variable life guidelines emphasize the importance of knowing the product, being able to clearly convey the information to customers, and providing customers with prospectuses when practical. The guidelines recommend that broker-dealers provide their representatives with examples, such as lifestyle case studies, to illustrate what the member considers to be potentially unsuitable recommendations and what type of activity would warrant additional supervisory review, and provide customers with member-approved product information brochures that explain the features and principal risks associated with variable life insurance.
- ***Variable Life Insurance Replacements.*** The guidelines caution members that variable life replacements can involve new fees, extended surrender charge periods, higher insurance risk ratings due to ill health, new suicide and incontestability periods, and unfavorable tax consequences. NASD members should adopt procedures for reviewing replacement recommendations, including using a replacement form, signed by the customer and the registered representative, for all transactions. Members should make the following determinations:
 - proposed replacement transactions are suitable;
 - registered representatives have complied with firm procedures and applicable state regulations regarding disclosure requirements; and
 - replacement questions on applications are answered, with appropriate follow-up when they are not.

The guidelines urge generating compliance reports tracking replacement activity by each registered representative, with replacement activity exceeding a certain percentage of the registered representative's total activity triggering further review. Upon reasonable request and to the extent practical, wholesale members should assist retail broker/dealers in monitoring the replacement activity of their customers. Members may decide to design a compliance system to flag unacknowledged replacement activity by utilizing background information such as surrenders, reduced face amounts, lapses, and modified surrenders.

- ***Life Insurance Financing.*** The guidelines urge NASD members to use caution in recommending life financing transactions. Importantly, Notice to Members 00-44 indicates that the NASD believes that the burden of demonstrating that financed transactions are in the customer's best interests would generally be more difficult than for a routine sale of variable life insurance. NASD members should provide forms to registered representatives to document a customer's informed consent to a life financing, signed by the customer, registered representative, and a registered principal. For internalized activity, members could create a system that matches new policies with disbursements from existing policies for a set time period and track that activity. Members should consider whether to vary review and report periods in order to prevent registered representatives from timing financed or replaced transactions to escape detection.
- ***Advertising And Sales Literature.*** The guidelines remind NASD members of the filing, review, and supervision requirements relating to variable life advertising and the requirement to file the format for hypothetical illustrations used as sales literature. Communications discussing the tax-deferral benefits of variable life insurance should not obscure or diminish the importance of the life insurance features of the product. The guidelines state that any variable life insurance communication that overemphasizes the investment aspects of the policy or potential performance of the subaccounts may be misleading.
- ***Members' Supervisory Systems And Procedures.*** Notice to Members 00-44 emphasizes that the NASD supervision rule requires members, regardless of their size or complexity, to adopt and implement a supervisory system that is tailored specifically to a member's business and that addresses the activities of all registered representatives and associated persons.

D. New York Stock Exchange Suitability Requirements

The New York Stock Exchange does not have a specific general suitability rule, but its "know your customer" rule requires NYSE members to use "due diligence to learn the essential facts relative to every customer [and] every order."¹⁰ The rule is regarded as protecting investors from being induced to purchase securities that involve inappropriate levels of risk.¹¹ The NYSE "leaves to the member organization's judgment the determination of which facts are 'essential' in the varying circumstances of each new account."¹² The NYSE suggests, however, that 37 separate pieces of information be

¹⁰ NYSE Rule 405.

¹¹ BROKER-DEALER LAW AND REGULATION (Aspen Publishers, Inc. 2000) at § 3.03, "The Suitability Doctrine."

¹² *Id.*, citing NYSE, Patterns of Supervision 41 (1982).

included in the new account form of a non-institutional customer "if deemed 'essential' for the particular account." These include, among other things, the customer's age, occupation, estimated income and net worth, marital status, number of dependents, citizenship, how the account was acquired, credit references, and investment objective.¹³

III. SEC Suitability Requirements

The SEC has developed a suitability doctrine applicable to broker-dealers based on Section 10(b) and Rule 10b-5, the antifraud provisions of the Exchange Act. A broker who makes an unsuitable recommendation may be liable under Rule 10b-5, although the specific elements that must be pleaded and proved in order to establish a suitability violation vary among the federal circuit courts that have addressed the question.¹⁴

Deception is a necessary element of any violation of Section 10(b) or Rule 10b-5.¹⁵ The deception in a suitability violation based on Rule 10b-5 may be supplied on the basis of either one of two theories: (1) that the broker misrepresented to his customer that the recommended security was suitable or failed to disclose to the customer that the recommendation was unsuitable; or (2) that the broker engaged in fraud by his conduct, because recommending an unsuitable security is inherently deceptive. Under the first (or "misstatement-omission") theory, the broker is liable because he made a misstatement of or omitted to state a material fact. Even if the broker makes no statement at all to the customer, his omission to disclose the unsuitability of a recommended security may bring about a liability if the broker has a duty to speak — a duty that arises from the relationship of trust and confidence between a broker and his or her customer.¹⁶

Under the second (or "fraudulent conduct") theory, the broker is liable because he recommended a clearly unsuitable security. Under this theory, unsuitability is comparable to churning (which is also considered to be an inherently deceptive practice). The difference is that churning deals with the quantity of the transactions executed for the customer while unsuitability deals with their quality.¹⁷

In general, to make out a suitability claim under Rule 10b-5, the following must be present. First, it is necessary for the defendant to make a recommendation of an unsuitable security or investment program (or to purchase a security for a discretionary

¹³ *Id.*

¹⁴ *Id.*, citing *Brown v. E. F. Hutton Group, Inc.*, 991 F.2d 1020, 1021 (2d Cir. 1993); *O'Connor v. R. F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir. 1978); *Village of Arlington Heights Police Pension Fund v. Poder*, 700 F. Supp. 405, 407 (N.D. Ill. 1988); *City of San Jose v. Paine, Webber, Jackson & Curtis, Inc.*, 1991 WL 352485 (N.D. Cal. June 6, 1991).

¹⁵ *Id.*, citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

¹⁶ *Id.*

¹⁷ *Id.*, citing *O'Connor v. R. F. Lafferty & Co., Inc.*, 965 F.2d 893, 898 (10th Cir. 1992).

account). Second, as in all Rule 10b-5 actions, the defendant must act with scienter; his conduct must be intentional or reckless. Third, if the plaintiff can show that the defendant made a material misstatement or omission as to the suitability of a security that he purchased, it is not necessary for the plaintiff also to show that the defendant controlled the account, but the plaintiff will have to prove — as he would in any Rule 10b-5 case based on a misstatement or omission — that he reasonably relied on the misstatement or omission and that it was a proximate cause of the plaintiff's losses. If, on the other hand, the plaintiff cannot point to any misstatement or omission but bases his unsuitability claim on the defendant's fraudulent conduct, control by the broker may be a necessary element of the plaintiff's case.¹⁸

IV. Enforcement and Private Litigation Relating to Suitability Rules

A. SEC Enforcement

The SEC is charged with monitoring and overseeing the application of the federal securities laws to variable contracts. Pursuant to inspection authority granted under the Exchange Act¹⁹ and the Investment Company Act,²⁰ the SEC conducts an active and comprehensive examination program. With regard to variable contracts, the SEC in early 1995 enhanced its activity in overseeing separate account operations and market conduct and sales practices through heightened inspection efforts and creation of a specialized inspection staff.²¹ Examinations are conducted by the SEC's Office of Compliance Inspections and Examinations ("OCIE"), and variable contract specialists located in the SEC's Washington, DC home office as well as five Regional Offices participate in the exams. Senior-level broker-dealer examiners specializing in variable contracts also participate. Areas of focus include suitability, replacements, life financings, and lapse rates. As with any SEC exam, violations of the federal securities laws can be referred to the SEC's enforcement division.²²

B. NASD Disciplinary Proceedings

The NASD also conducts an active examination program and sanctions its

¹⁸ *Id.*

¹⁹ See Section 17 of the Exchange Act.

²⁰ See Section 31(b) of the Investment Company Act.

²¹ See Kathleen Ujvari, "SEC Inspections," REGULATION AND DISTRIBUTION OF VARIABLE INSURANCE PRODUCTS at p. 14-3 (Aspen Law & Business 1999 and 2001 Supp., Clifford E. Kirsch, editor).

²² The SEC recently instituted an enforcement action against the president of a broker-dealer for fraudulent switching of his clients' variable annuity investments. The SEC alleged that the defendant, Raymond Parkins, induced his investment advisory clients to switch variable annuities by providing them with false and misleading justifications for the switches and by misrepresenting or omitting to inform them of the sales charges associated with the switches. *In re Raymond A. Parkins, Jr.*, Administrative Proceeding File No. 3-10300, Securities Exchange Act Release No. 43336 (September 25, 2000).

members for violations of its suitability rule.²³ These disciplinary proceedings are conducted initially by administrative panels of the SROs and, if appealed, are reviewed by the SEC. A in-depth discussion of SRO suitability disciplinary actions is beyond the scope of this comment letter.²⁴ Two recent NASD disciplinary proceedings, however, underscore the effectiveness of the NASD's suitability and other sales practice rules in sanctioning broker-dealers for unsuitable variable contract sales.

In 1997, the NASD fined Miguel Angel Cruz \$30,000, suspended him from using sales literature and advertisements for one year, and required him to file and obtain from the NASD Advertising Department a "no objection" letter concerning all of his advertisements and sales literature prior to use.²⁵ In addition, Cruz was required to pay \$6,544.12 in restitution to customers and requalify by exam as an investment company and variable contracts representative. The NASD's National Business Conduct Committee imposed the sanctions following appeal of a Chicago District Business Conduct Committee decision.

The sanctions were based on findings that, among other things, Cruz made unsuitable recommendations and misrepresentations of material facts to public customers in connection with sales of variable life insurance policies. In reaching its decision, the NASD's National Business Conduct Committee reviewed the stated investment objectives and goals of nine of Cruz's customers to determine independently whether the variable life policies sold to the customers were suitable. In the case of a customer that had indicated to Cruz that he had no interest in life insurance since he already owned life insurance, but was looking for an investment vehicle to save for retirement, the committee found the life policy to be unsuitable.²⁶

In a recent proceeding, the NASD censured and fined Pruco Securities Corporation, Inc., a broker-dealer subsidiary of The Prudential Insurance Company of America, \$20 million for violations of federal securities laws and NASD rules that occurred in connection with the offer and sale of variable life insurance policies.²⁷ The NASD found that sales of more than 200,000 Prudential variable life insurance policies from 1983 through 1995 violated NASD rules and federal securities laws. Specifically,

²³ Suitability violations by NASD members are decided by the NASD and the SEC under its suitability rule, Rule 2310, and the more general "fair dealing" rule, Rule 2110.

²⁴ The following are examples of NASD disciplinary proceedings involving allegations of unsuitable sales of variable contracts: Horace Richard Hillberry, NASD Case # CAF000004; Harold Martin Kotler, NASD Case # CAF990022; Harold Richard Eighme, NASD Case # CAF990021; Anthony Joseph Amaradio, NASD Case # C8A930047.

²⁵ District Business Conduct Committee For District No. 8 (CHI), Complainant, v. Miguel Angel Cruz, Respondent, Complaint No. C8A930048 (October 31, 1997).

²⁶ *Id.* (discussion of Cruz's customer William DeMaire).

²⁷ *Pruco Securities Corporation*, AWC No. CAF990010 (July 7, 1999).

the NASD found that Pruco and its representatives violated Rules 2110 and 2310 by making sales to customers for whom such sales were unsuitable, including persons who did not know they were purchasing insurance and persons who did not want to buy insurance.

C. Private Damage Actions for Unsuitability

Two types of unsuitability claims are recognized under Exchange Act Section 10(b) and Rule 10b-5. First is the unsuitability claim that is analyzed as a misrepresentation or failure to disclose a material fact.²⁸ The second is an unsuitability claim based on fraud by conduct that is closely analogous to a claim of churning.²⁹ Both types of claims require private plaintiffs to show scienter, or, at a minimum, recklessness, on the part of the producer.

Unsuitability claims can also be brought by customers against their brokers under state law.³⁰ State law unsuitability claims have involved different theories. One type of claim is brought under state securities fraud statutes; these claims require the same type of showing as fraud claims under Rule 10b-5. A second type of claim is brought based upon a breach of fiduciary duty owed by the broker to his or her customer. A third type of claim is based on the assertion that SRO suitability rules establish a standard of care owed by brokers to their customers and violations of these rules constitute negligence by the broker.³¹

In practice, the principal forum where private actions for damages based on unsuitability claims presently are heard is before the securities industry arbitration tribunals of the NASD, NYSE, and American Arbitration Association.³² These tribunals have a great deal of flexibility to decide cases since the arbitrators are free to adopt or reject in part or in whole any of the legal theories discussed above. For example, they can require or not require scienter. They can base a judgement on negligence or breach of fiduciary duty. Perhaps most significantly, they can go beyond any legal constraints and decide a case simply based on the equities.³³ In fact, commentators have recently observed that the increasing reliance by customers seeking damages on unsuitability claims to base their claims on SRO rules in arbitration "has eased meaningfully the

²⁸ See Lewis D. Lowenfels and Alan R. Bromberg, *Suitability in Securities Transaction*, 54 BUS. LAW. 1557, 1585 (1999), citing *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.* 132 F.3d 1017, 1021 (4th Cir. 1997); *Brown v. E. F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993).

²⁹ See *id.*, citing *O'Connor v. R. F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992).

³⁰ In this comment letter, we do not try to present a detailed discussion of the existing state law regulatory framework relating to suitability, but we note that the existence of such a framework is further reason why application of the Model Suitability Regulation to Registered Contracts is unnecessary.

³¹ See *id.* at 1592-93.

³² See *id.* at 1593.

³³ See *id.* at 1593-94.

customer's path to recovery and consequently has increased the customer's leverage to compel a significant settlement."³⁴

V. Registered Contracts Are Appropriately Exempted from the Model Suitability Regulation

The Model Suitability Regulation includes a proposed exemption for Registered Contracts. Based on the above assessment of the current extensive federal regulatory framework governing the issuance and distribution of Registered Contracts, including specific suitability rules, we conclude that the proposed exemption is appropriate and strongly support it.

As discussed in detail above, the combination of the Securities Act, Exchange Act, Investment Company Act, NASD and NYSE conduct rules, and state antifraud laws provide a comprehensive and proven regulatory framework governing every aspect of the issuance and distribution of Registered Contracts and the operations of the separate accounts through which they are issued. This framework includes established specific suitability rules that have governed the sale of securities for over 50 years. The SEC, NASD, NYSE, and private litigants enforce these suitability rules vigorously, and as a result an extensive body of administrative and judicial interpretations has been developed.

We believe strongly that imposing another layer of overlapping and potentially conflicting suitability rules on top of this existing regulatory framework, already proven effective for protecting investors, would create a burden for the industry that far outweighs any potential benefit. State insurance department examination staff would engage in reviewing suitability determinations that have already been reviewed by SEC and NASD examination staff. Insurers and distributors could be required to respond to suitability claims in 50 different state court systems, each of which may offer differing interpretations of their state's particular suitability rule.

We believe strongly that the imposition of such a duplicative and potentially conflicting system is inconsistent with two critically important regulatory goals recently espoused by Congress and the NAIC: functional regulation and uniformity in regulation across the 50 states.³⁵ The existing regulatory framework governing the suitability of sales of Registered Contracts achieves these goals, with identified and proven functional regulators and consistent federal regulation across the 50 states.

³⁴ *Id.* at 1558.

³⁵ See generally NAIC STATEMENT OF INTENT: THE FUTURE OF INSURANCE REGULATION.

VI. Additional Recommendations

We offer the following additional recommendations relating to the Model Suitability Regulation. Our recommendations are made specifically in the context of fixed annuities,³⁶ although they may also be relevant to consideration of how the Model Suitability Regulation would impact fixed life insurance.

A. Customer Information To Be Considered in Suitability Determinations

Section 3.I of the Model Suitability Regulation defines "suitable recommendation" to mean a "recommendation for the purchase of a life insurance or annuity product not exempted from this regulation, which is based upon *relevant information* obtained from a potential purchaser and that meets the purchaser's insurable needs or financial objectives" (emphasis added). Section 3.G indicates that "relevant information" includes, but is not limited to, occupation, marital status, age, number of dependents, sources of income, yearly income, the customer's need or primary objective for purchasing insurance, affordability of premiums to keep the policy in force, the customer's existing insurance, investments or savings, liquid net worth, tax status, need or desire for tax advantages or benefits provided by a product, investment experience of the customer, customer concern for preservation of principal, product time horizon, and the customer's awareness of liquidity limitations or surrender charges.

We believe that while the enumerated categories of information generally will be relevant to a determination of whether a contract is suitable, depending on the circumstances certain of the enumerated categories may not be relevant. For example, the "affordability of premiums to keep the policy in force" would not be relevant to a single premium immediate annuity. We recommend that the definition of "relevant information" be revised to provide that "relevant information may include, but is not limited to,"

B. Definition of "Suitable Recommendation"

As noted above, Section 3.I of the Model Suitability Regulation defines "suitable recommendation" as a "recommendation for the purchase of a life insurance or annuity product not exempted from this regulation, which is based upon relevant information obtained from a potential purchaser and that meets the purchaser's insurable needs or financial objectives." We believe that defining a suitable recommendation as only one that "*is based* on relevant information" and "*meets* the purchaser's insurable needs or financial objectives" (emphasis added) is inappropriate and unworkable. The standard

³⁶ As noted *supra* note 2, NAVA's mission is increasing public knowledge and acceptance of annuity and variable life products to retirement-focused Americans; to providing educational and information resources to its members and the public; to protecting consumers by encouraging adherence to the highest ethical standards by insurers, distributors, and all other participants in the diverse industry; and to protecting and advancing the interests of its members.

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establishes a results-based, rather than conduct-based, standard that could be second-guessed at any time, possibly years after a transaction, according to the subjective determination of whether the recommendation (i) was *in fact* based on all relevant information and (ii) did *in fact* achieve all of the goals of the customer. This standard could result in producers and insurers being viewed as "guarantors" that a product will meet the insurable needs and financial objectives of every contract purchaser.

This standard is inconsistent with the NASD's suitability rule, which requires that a producer make a reasonable effort to obtain necessary information, and, based on that information, recommend a security only if the producer *has reasonable grounds* for believing the recommendation is suitable for the customer. As one commentator has noted, the purpose of the suitability rule is not to make a broker-dealer an insurer of favorable investment performance.³⁷ Similarly, producers and insurers should not be insurers or guarantors that an insurance contract will meet every customer's investment or insurance needs. Rather, the relevant and accepted test is whether a reasonable basis exists for the recommendation.³⁸

We note that the NAIC's Variable Life Insurance Model Regulation, in Section 3.C, requires insurers to establish and maintain suitability standards to be used by the insurer. The standards must specify that "no recommendation shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of *reasonable grounds to believe that the purchase of the policy is not unsuitable for the applicant* on the basis of information furnished after reasonable inquiry . . ." (emphasis added). The official commentary to Section 3.C states that the section "imposes a duty on both the insurer and its agents to make a good faith, reasonable inquiry as to the facts and circumstances concerning a prospect's insurance and financial needs and to make no recommendation that a prospect purchase variable life insurance when such a purchase is not reasonably consistent with the information that is known or reasonably should be known to the insurer or agent." It also appears that the "reasonable basis" standard is a concept embodied in at least some of the state suitability rules discussed in the NAIC's white paper on suitability.³⁹

We recommend the following definition of "suitable recommendation": A "suitable recommendation" is a "recommendation for the purchase of a life insurance or annuity product not exempted from this regulation, which (i) is based upon relevant

³⁷ See National Association of Insurance Commissioners, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES (June 2000) (hereinafter referred to as the "NAIC White Paper") at 8, *citing* Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 Duke L.J. 445, 448.

³⁸ NAIC White Paper, *supra* note 37, at pp. 8-9 (explaining that an analysis often applied by the courts in investment sales practice cases to determine suitability is whether a reasonable basis existed for a transaction).

³⁹ See NAIC White Paper, *supra* note 37, at pp. 11-14.

information furnished after reasonable inquiry of a potential purchaser, such as the purchaser's insurance and investment objectives and financial situation and needs, and (ii) is reasonably believed by the producer and the insurer to meet the purchaser's insurable needs or financial objectives."

C. Duties of Insurers

Section 5.A of the Model Suitability Regulation requires an insurer to establish, maintain and enforce policies and procedures reasonably designed to ensure that its producers make suitable recommendations. An insurer's policies and procedures are required to be appropriate to the methods of distribution and products sold.

While annuities have traditionally been sold by career agents of insurance companies, alternative distribution systems, including banks, broker-dealers, credit unions, and financial planners are largely responsible for the recent explosive growth of annuity sales.⁴⁰ With respect to variable annuities, industry sales for the first three quarters of 2000 were attributable to the following distribution channels: 28% independent NASD broker-dealers, 12% regional broker-dealers, 12% New York wirehouse broker-dealers, 12% bank/credit unions, 33% captive agency, and 3% direct response.⁴¹

Broker-dealers selling annuities may sell the products of a number of different insurance companies. For the sake of illustration, assume that a broker-dealer sells the annuities of 10 different insurers. Section 5.A of the Model Suitability Regulation would require each insurer to establish, maintain, and enforce suitability procedures that would have to be followed by the insurer's producers. A producer employed as a registered representative by the broker-dealer would be a "producer" of each insurer, which would mean that the producer would be required to review and follow 10 sets of suitability guidelines, in addition to his own firm's suitability guidelines. Each insurer's guidelines will likely be different to reflect different product features and sales practice concerns developed by the insurer over a number of years.

We believe that this type of situation begs a different approach to developing and implementing suitability guidelines. ***NAVA strongly recommends that Section 5.C. be revised to provide: "An insurer may contract with a third party, such as an insurance agency or brokerage firm, (i) to establish, maintain and enforce, as required by Section 5.A, policies and procedures reasonably designed to ensure that the insurer's producers make suitable recommendations, and (ii) to deliver information and perform the functions described in Subsection B(1) and (2).*** In effect, this flexibility permits an

⁴⁰ John T. Adney, Esq., Joseph F. McKeever, III, Esq., and Barbara N. Seymon-Hirsch, Esq., ANNUITIES ANSWER BOOK, Chapter 2, "How Annuities Are Sold," by Thomas F. Streiff (Panel Publishers 1998).

⁴¹ Rick Carey, "VA Sales Dip 8% in Third Quarter," National Underwriter, Life and Health/Financial Services Edition (December 4, 2000).

insurer to conclude that an unaffiliated distributor is the most effective party to establish appropriate suitability guidelines for its producers based on unique factors such as its customer base, producers, physical locations, products, etc. We believe adding this flexibility would enhance the effectiveness of the Model Suitability Regulation; rather than expecting a broker-dealer and its producers to study and implement multiple insurers' suitability guidelines, the producer could adhere to one set of consistent guidelines, the guidelines established by his or her employer. Of course, if an insurer contracted with a broker-dealer to develop suitability guidelines, the insurer would be required to monitor compliance with the guidelines as otherwise required under the Model Suitability Regulation.

D. Unfair Trade Practices Act

The NAIC has proposed to add a new Section P to the Unfair Trade Practices Act ("UTPA"). Section P would designate the "failure to make suitable recommendations" as an unfair trade practice for purposes of the UTPA. "Failure to make suitable recommendations" is defined as "[r]ecommending the sale of a life insurance policy or annuity product without considering appropriate relevant information about the purchaser's insurable needs and financial objectives." We recommend strongly that this proposed provision *not* be added to the UTPA, since it is inconsistent with the Model Suitability Regulation, lacking in any guidance for application, and likely to cause ungrounded private litigation.

We are extremely concerned that in jurisdictions where the doctrine of implied rights is accepted, the proposed provision would provide a basis for a private right of action that could lead to "strike" suits against insurance companies. As discussed above, there is an existing and well-established legal framework under state law available to litigants to claim a particular recommendation was unsuitable. ***We believe that adding a completely new and untested legal basis for recovery, where the proposed statutory provision defines suitability differently than in the Model Suitability Regulation and is devoid of interpretive guidance (including the absence of any of the exemptions in the Model Suitability Regulation), is imprudent and potentially harmful to the solvency of insurance companies that become enmeshed in frivolous private litigation. We believe these are critical concerns and recommend that the proposed statutory amendment not be added to the UTPA.***

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We thank you for the opportunity to respond to your request for comments.
Please direct any questions to the undersigned at (703) 707-8830 (extension 12), Joe Rath
at (614) 227-4896, or Ann Furman at (202) 965-8100.

Sincerely,

/s/ W. Thomas Conner

W. Thomas Conner
Vice President and General Counsel

CC: Mark J. Mackey
Mike DeGeorge
Judith Hasenauer