NAVA®

April 12, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: File No. S7-06-04

Dear Mr. Katz:

On January 29, 2004, the Securities and Exchange Commission (the "Commission") proposed new rules and rule amendments to enhance the information broker-dealers provide to their customers in connection with transactions in certain types of securities.[1] The proposal would add new rules under the Securities Exchange Act of 1934 to require information at the point of sale and in transaction confirmations regarding costs and conflicts of interest. The required disclosures would be applied to transactions involving mutual funds, unit investment trust interests (including insurance securities) and municipal fund securities used for education savings.

This letter of comment on the proposed amendments is respectfully submitted by the National Association for Variable Annuities ("NAVA").[2]

NAVA supports the Commission's efforts to improve investor access to information regarding distribution costs and conflicts of interest in connection with the purchase of certain types of securities. However, we are very concerned about the specificity of information that would be required in regard to transactions involving variable insurance products. As we will explain below, we do not believe that the disclosures, as presently proposed, can be applied to variable insurance products in a manner that will result in meaningful assistance to investors considering the purchase of such a product.

Although the proposing release contains numerous requests for comment as to the appropriateness of the required disclosures to variable insurance products, the proposed rules

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[1] Release Nos. 33-8358 and 34-49148 (January 29, 2004) (the "proposing release"). Throughout this comment letter, proposing release page number references are to the proposing release as issued by the Commission.
[2] NAVA is a not-for-profit organization dedicated to the growth and understanding of annuity and variable life insurance products. NAVA represents all segments of the annuity and variable life industry with over 350 member organizations, including insurance companies, banks, investment management firms, distribution firms, and industry service providers.

appear to be tailored primarily for transactions involving mutual fund shares. However, there are significant differences between mutual funds and variable annuities and variable life insurance which make the proposed rules problematic for use with transactions involving variable products.

Two-tiered structure of variable insurance contracts

Most variable annuity and variable life insurance contracts are issued through a two-tier investment company structure. The authority for the variable insurance two-tier structure is derived from Section 12(d)(1)(E) of the Investment Company Act of 1940, which provides an exemption from the fund-of-fund limitations contained in Section 12(d)(1).

The first or top tier consists of a separate account of the life insurance company that, absent an exemption, is required to be registered as an investment company under the 1940 Act. The separate account is a segregated investment account established under state insurance law to hold variable annuity and variable life insurance assets and liabilities separate and apart from the insurer's general account liabilities and assets.

The separate account is typically divided into subaccounts, each of which invest solely in the shares of an affiliated or unaffiliated underlying fund organized as an open-end management investment company. This is the second or bottom tier of the two-tier structure. Variable insurance product owners can allocate their purchase payments and transfer contract value among the various subaccounts.

As a consequence of this structure, potential purchasers of variable annuity and variable life insurance contracts go through two levels of decision making; first, whether to purchase the contract, and second, what underlying funds to allocate their premiums to.

At the present time, when a person purchases a variable annuity or variable life insurance contract, the insurance company must provide a detailed variable product prospectus. Adding the detailed point of sale and confirmation disclosures proposed by the amendments will likely result in purchasers being overwhelmed by information.

Relative complexity of product

Variable insurance products are more complex as compared to mutual funds. Unlike a mutual fund, a variable insurance product is not pure investment, but also has an insurance component. The insurance component often consists of multiple benefit choices for the investor. Variable annuities, for example, offer a standard death benefit that guarantees that if the owner dies while still in the accumulation phase, his or her beneficiaries will receive the greater of the contract value or the premiums paid less any prior withdrawals. However, almost half of variable annuity contracts also offer enhanced death benefits, either as a standard feature, or as an option that can be selected by the purchaser.[3] These enhanced

[3] See NAVA *2003 Annuity Fact Book*, page 22 (second edition, 2003).

death benefits can take several forms (e.g., maximum anniversary value, annual roll-up, or the greater of the two). Various types of "living benefits" are also available in many contracts, such as guaranteed minimum income benefits, guaranteed minimum accumulation benefits, and guaranteed minimum withdrawal benefits. Variations may exist from contract to contract for these benefits as well.

Some contracts offer "bonuses" or credits on purchase payments. With this feature, the purchaser receives an immediate credit to his or her account equal to a percentage of the purchase payment. Variable annuities with bonus credits may have higher expenses than variable annuities without bonus credits.

Variable annuities are often offered in different classes. Most variable annuity contracts are "B-share" products which are sold with no initial sales load, but cancellation of the contract during its early years triggers a contingent deferred sales load or surrender fee. These charges typically range from 5-7% in the first year, and subsequently decline 1% per year to zero after 5-7 years. "L-share" variable annuities typically have shorter surrender charge periods, such as three or four years, but may have higher fees and charges. A small percentage of contracts are "A-share" products and have up-front sales charges instead of surrender fees. Like front load mutual funds, A-share variable annuities usually offer breakpoint pricing, which means the sales charges decrease depending on the cumulative amount of purchase payments that have been made. A-share contracts also typically have lower ongoing M&E fees than annuities with surrender fees. Finally, there are "C-share" contracts that have no front load or surrender fee.

Variable life insurance contracts are generally predicated on the contract owner making multiple premium payments in order to prevent a lapse of the policy. Variable life insurance contracts come in two basic forms, scheduled premium variable life insurance and flexible premium variable life insurance. Scheduled premium variable life insurance is similar to traditional whole-life fixed dollar insurance in that specified premiums must be paid when due to prevent lapse. With flexible premium variable life insurance contracts, the owner can determine the timing and amount of premium payments. However, if the cash or account value is insufficient to cover monthly mortality and other charges, the policy will lapse, and additional payments will be required to keep it in force.

As a result of "no action" letters from the SEC staff, insurance companies are not required to comply with present rule 10b-10's immediate and quarterly confirmation requirements so long as policyholders are provided with written statements annually and upon the occurrence of certain activities.[4]

Both variable annuities and variable life insurance contracts also offer numerous investment options. The choices may include stock funds, bond funds, balanced funds, money market funds, and specialty funds such as asset allocation, international and sector funds. The

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[4] See e.g., Nationwide Life Insurance Co. (Jan.11, 1987); Pruco Life Insurance (May 11, 1985); Provident-mutual Variable Life Insurance Co. (March 1, 1984); New England Mutual Life Insurance Co. (October 29, 1983).

various funds are often managed by different investment advisors, who may or may not be affiliated with the insurance company. The average number of funds per variable annuity contract in 2002 was thirty-four.[5]

The proposed confirmation and point of sale forms do not accommodate the complexity of these products and the large number of investment options. For example, would the required information regarding potential conflicts of interest be required for all of the thirty or more investment options or just those chosen by the purchaser? In addition, the confirmation is designed to be a one page form which cannot possibly handle all of the information that would be required if all of the investment options must be included. Moreover, we question how an insurer could provide all of the required information regarding potential conflicts of interest in a single page even if the information is limited to the particular underlying funds that are invested in by the purchaser if multiple funds are selected.

The point of sale form requires the broker-dealer to disclose relationships it has with funds or their affiliates. In the case of variable insurance products with multiple fund choices, this could necessitate disclosures regarding thirty or more funds, including funds that the purchaser is not presently investing in.

Further, as explained in more detail below, the large number of contract features available in variable products will make the comparison ranges required in the confirmations difficult to determine and potentially confusing to investors.

Purchaser's right to cancel ("free look")

State insurance laws require that all variable annuity and variable life insurance contracts contain a free look provision that entitles the purchaser to examine the contract for a specified period of time and cancel it and obtain a refund. This free look period may vary from ten to thirty days after receipt of the contract depending on the laws of the state where the contract is sold. This right to cancel makes the point of sale disclosure requirements superfluous for variable insurance products since during the free look period the purchaser would receive the more detailed, transaction specific information required in the confirmation before finalizing the decision to purchase the product.

Preparation of documents

With the purchase of a variable insurance contract, the selling broker-dealer would be responsible for preparing the point of sale documents. However, confirmations in the variable product area are prepared by the issuing insurance company on behalf of its selling firms. Under the proposed new rule, some of the information in the confirmation of a variable insurance product transaction will have to be supplied by the broker-dealer and other information will have to be supplied by the insurance company.

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[5] See NAVA *2003 Annuity Fact Book*, page 19 (second edition, 2003).

Distribution

Distributors of variable insurance products must register with the Securities and Exchange Commission as broker-dealers pursuant to Section 15(d) of the Securities Exchange Act of 1934. Many issuers of variable insurance contracts utilize multiple broker-dealers to sell their products. For example, some of our members have indicated that they have several hundred selling agreements with third party broker-dealers. We believe this would make it extremely difficult for an insurance company to ensure that any given registered representative is providing all of the information required by the proposing release at the point of sale.

The breadth of an insurance company's distribution system would also pose difficulties in its preparation of the confirmations. The insurance company would be responsible for ascertaining whether potentially hundreds of broker-dealer had a contractual relationship with an underlying fund complex, participated in revenue sharing or paid special compensation to its salespersons with respect to the funds within the complexes. It is also not uncommon for an insurance company to utilize twenty to thirty or more sub-advisers. As a result, the insurance company would also be responsible for ascertaining all direct and indirect relationships that may exist between the sub-advisers and the broker-dealers.

This problem for insurance companies is made even more difficult by the fact that a significant portion of many companies' distribution is unaffiliated. Variable insurance products are distributed through a variety of channels including captive insurance company agents, independent agents, stockbrokers, banks and direct response. Significant changes in variable annuity sales by distribution channel have occurred since 1995, with an increasing share being unaffiliated from the insurance company. For example, sales by the captive agency channel have decreased from 55% in 1995 to 35% in 2002, while independent agents have increased their share from 17% to 26%. Overall, 63% of all variable annuity sales in 2002 came through unaffiliated broker-dealers.[6]

Under the proposed new rule, an insurance company may be required to prepare selling firm-specific confirmations for dozens or even hundreds of selling firms and selling broker-dealers may have to rely on dozens of insurers to generate their confirmations.

Comparison range disclosure

Proposed rule 15c2-2 would require that the confirmations also provide median and 95th percentile range information for sales loads, asset-based sales charges and service fees, dealer concessions, revenue sharing, and portfolio brokerage commissions for transactions involving the same type of covered security. Given the relative complexity of variable insurance products, and the wide variety of benefits available among the products, it would be a challenging, if not impossible, task to determine what is an equivalent product for purposes of providing the comparison range. For example, some variable annuities are sold

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[6] See NAVA *2003 Annuity Fact Book*, page 36 (second edition, 2003).

on an "unbundled" basis which permits purchasers to select from a menu of optional product features. As described above, these optional features include bonuses, enhanced or stepped-up death benefits, guaranteed minimum income benefits, guaranteed minimum accumulation benefits, and guaranteed minimum withdrawal benefits, with a number of variations available within each type of feature. Each optional feature generally has a charge associated with it. Other contracts are sold bundled where the benefits and their costs are integrated into a single M&E charge.

As a result, we don't see how a meaningful comparison group of variable annuity or variable life insurance contracts can be constructed for purposes of making a comparison between "industry norms" and the fees and charges incurred with a particular transaction. Should the sales charges and service fees disclosed in a confirmation for the purchase of a variable annuity be compared with those incurred in purchases of all variable annuity contracts, regardless of features or options, or only those with similar or identical load structures and features? If all contracts are included, we question whether they would truly represent "comparable securities" as used in the Explanations and definitions page of the form. If the latter, how is the determination made as to what other contracts are similar enough to the contract being confirmed to be used to calculate industry norms? We believe the variations are simply too great. For example, both the Nationwide *Best of America* and the ING *Golden Select Premium Plus* variable annuity are "B" share products with no similar back-end loads. However, they offer markedly different features so their estimated asset-based sales charges and service fees vary greatly. The same problems exist with contracts with similar features but different sales loads.

Direct sales

Many variable insurance products are sold without any face-to face meeting between the customer and a registered representative. Under this circumstance, the proposed rules would require that the various point of sale disclosures be given orally.[7] Given the extensiveness of information that would be required in regard to transactions involving variable insurance products because of their more complex structure, this oral disclosure would likely be very lengthy and potentially very confusing to the investor. The number and variety of underlying funds and product features make oral disclosures completely unworkable.

Recommendation

It is our recommendation that the Commission propose rule and rule amendments specifically designed for variable insurance products. NAVA will make itself available to the staff to assist it in developing such a proposal should the staff so desire. As an alternative, we believe requiring more general narrative disclosures regarding distribution costs and conflicts of interest along the lines of the NASD's proposed amendments to Rule 2830 would work

[7] Proposing Release, page 39.

well for variable insurance products while providing consumers with the information needed to evaluate the purchase of a variable insurance product.[8]

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Again, we appreciate the opportunity to comment. If we can answer any questions or be of further assistance, please contact me at (703) 707-8830, extension 20, or Judith Hasenauer at (954) 545-9633. Ms. Hasenauer chairs NAVA's Regulatory Affairs Committee.

Sincerely,

Michael P. DeGeorge

Michael P. DeGeorge
General Counsel

[8] NASD Notice to Members 03-54 (September 2003).