# Ron A. Rhoades, B.S., J.D., CFP®

2450 N. Citrus Hills Blvd.
Hernando, FL 34442-5348
Phone: 352.746.4460
Toll-Free: 1.866.746.4460


July 3, 2006

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE, Washington, DC 20549-1090

Re: File No. SR-NASD-2004-183

Comments regarding Proposed NASD Rule 2821, "Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities"

Dear Ms. Morris:

I wish to thank the Commission for the opportunity to submit comments on this proposed rule. I serve as the Director of Research and Chief Compliance Officer of a registered investment adviser firm. I also serve as an estate planning and tax attorney in private practice, particularly for high net worth retirees. I write to express comments in support of the proposed NASD Rule 2821, but also to suggest that higher standards should apply in deferred variable annuity[1] sales, particularly by NASD firms and their representatives who provide services as to activities which are properly subject to the Investment Advisers Act of 1940. Specifically, I recommend:

(1) **The sale of a deferred variable annuity by an NASD firm should be accompanied with a short, written disclosure of <u>all</u> of the costs associated with such variable annuity and its sub-accounts, including the often-omitted transaction costs relating to trading within the funds (or sub-accounts).**

[1] A variable annuity, in general, is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). The proposed rule focuses exclusively on transactions in deferred variable annuities, whether nonqualified or in qualified (i.e., traditional IRA) accounts.

(2) **The sale of a deferred variable annuity should be undertaken with either: (a) appropriate tax advice provided by the selling firm; or (b) a clear, concise and prominent statement that the purchaser obtain tax advice from his or her tax advisor prior to purchasing the product.**

(3) **Sales of deferred variable annuities to senior citizens should be strongly discouraged, and written consumer disclosures should state that in the vast majority of instances such sales would be regarded as "unsuitable" under the federal securities laws.**

(4) **An NASD member firm and its registered representative, if also functioning in the capacity as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"), possesses a fiduciary duty to the customer. This fiduciary duty, which imposes far broader and stricter requirements, would often be breached through the sale of the vast majority of variable annuity products, due to high "total fees and costs" associated with such investment products and due to significant adverse tax consequences associated with nonqualified deferred variable annuities.**

<u>A. Background.</u> The proposed rule, as amended and republished in the most recent SEC release[2], has four main provisions:

(1) requirements governing recommendations, including a more specific suitability obligation, specifically tailored to deferred variable annuity transactions;

(2) principal review and approval obligations;

(3) a specific requirement for members to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule; and

(4) a targeted training requirement for members' associated persons, including their registered principals.

---

[2] SEC (Release No. 34-54023 (June 21, 2006), available at http://www.sec.gov/rules/sro/nasd/2006/34-54023.pdf.

The text of the NASD's proposed rule 2821, as amended by the second amendment thereto, states in pertinent part:

> 2821. Members' Responsibilities Regarding Deferred Variable Annuities
>
> (b) Recommendation Requirements
>
> (1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that: (A) the customer has been informed of the material features of a deferred variable annuity, such as the potential surrender period and surrender charge; potential tax penalty if the customer sells or redeems the deferred variable annuity before he or she reaches the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of a deferred variable annuity; and market risk; (B) the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit); and (C) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by paragraph (b)(2) of this Rule. These determinations shall be documented and signed by the associated person recommending the transaction.
>
> (2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing investment and life insurance holdings, liquidity needs, liquid net worth, risk tolerance, tax status and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.
>
> (c) Principal Review and Approval.
>
> (1) No later than two business days following the date when a member or person associated with a member transmits a customer's application for a deferred variable annuity to the issuing insurance company for processing and irrespective of whether the transaction has been recommended, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider (A) the extent to which the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit); (B) the extent to which the customer's age or liquidity needs make the investment inappropriate; (C) the extent to which the amount of money invested would result in an undue concentration in a deferred variable annuity or deferred variable annuities in the context of the customer's overall investment portfolio; and (D) if the transaction involves an exchange of a deferred variable annuity, the extent to which (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose death or existing benefits, or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees and charges for riders and similar product enhancements), (ii) the customer would benefit from any potential product enhancements and improvements, and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months. These considerations shall be documented and signed by the registered principal who reviewed and approved the transaction ...
>
> (d) Supervisory Procedures. In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012, 3013 and 3110, a member must establish and maintain specific written supervisory procedures reasonably

> designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen the transaction and require a registered principal to consider those items enumerated in paragraph (c) of this Rule, as well as whether the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges.
>
> (e) Training. Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in paragraph (b)(1)(A) of this Rule.

In addition to the NASD's general suitability rule[3], the NASD has previously adopted a rule regarding communications with the public regarding variable product sales.[4] This rule requires clear identification

---

[3] Rule 2310, NASD's general suitability rule, requires that, when recommending that a customer purchase, sell or exchange a security, an associated person determine whether the recommendation is suitable for the customer. The text of Rule 2310 provides in pertinent part: "2310. Recommendations to Customers (Suitability):
(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, 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."

[4] 2210-2. Communications with the Public About Variable Life Insurance and Variable Annuities.
The standards governing communications with the public are set forth in Rule 2210. In addition to those standards, the following guidelines must be considered in preparing advertisements and sales literature about variable life insurance and variable annuities. The guidelines are applicable to advertisements and sales literature as defined in Rule 2210, as well as individualized communications such as personalized letters and computer generated illustrations, whether printed or made available on-screen.
(a) General Considerations
(1) Product Identification. In order to assure that investors understand exactly what security is being discussed, all communications must clearly describe the product as either a variable life insurance policy or a variable annuity, as applicable. Member firms may use proprietary names in addition to this description. In cases where the proprietary name includes a description of the type of security being offered, there is no requirement to include a generalized description. For example, if the material includes a name such as the "XYZ Variable Life Insurance Policy," it is not necessary to include a statement indicating that the security is a variable life insurance policy. Considering the significant differences between mutual funds and variable products, the presentation must not represent or imply that the product being offered or its underlying account is a mutual fund.
(2) Liquidity. Considering that variable life insurance and variable annuities frequently involve substantial charges and/or tax penalties for early withdrawals, there must be no representation or implication that these are short-term, liquid investments. Presentations regarding liquidity or ease of access to investment values must be balanced by clear language describing the negative impact of early redemptions. Examples of this negative impact may be the payment of contingent deferred sales loads and tax penalties, and the fact that the investor may receive less than the original invested amount. With respect to variable life insurance, discussions of loans and withdrawals must explain their impact on cash values and

of the product as a variable annuity, the requirement of clear language describing the negative impact of early redemptions (relating to liquidity of variable annuities, which can possess substantial surrender charges), and a prohibition against representations or implications that a guarantee applies to the investment return or principal value of the separate account.

It should also be noted that the NASD, in its Proposed Rule Change submission,[5] stated that "the [broker-dealer] firm and its associated persons could not adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question."[6] The NASD further alluded that "reasonable-basis suitability is akin to a due diligence requirement."[7]

In response to comments on the earlier proposed rule, the NASD deleted from paragraph (b) of the proposed rule and all references to long-term investment objectives in paragraph (c) ("Principal Review and Approval") and paragraph (d) ("Supervisory Procedures"). In addition, NASD stated that "in general, deferred variable annuities are appropriate only for customers with long-term investment objectives who intend to take advantage of tax deferred accumulation and annuitization."[8] Although NASD recognized that some deferred variable annuities have shorter holding periods and smaller surrender fees than traditional deferred variable annuities, it stated that a deferred variable annuity is suitable for an investor without a long-term investment objective only in rare cases. NASD also "strongly cautioned" firms to

---

death benefits.

(3) Claims About Guarantees. Insurance companies issuing variable life insurance and variable annuities provide a number of specific guarantees. For example, an insurance company may guarantee a minimum death benefit for a variable life insurance policy or the company may guarantee a schedule of payments to a variable annuity owner. Variable life insurance policies and variable annuities may also offer a fixed investment account which is guaranteed by the insurance company. The relative safety resulting from such a guarantee must not be overemphasized or exaggerated as it depends on the claims-paying ability of the issuing insurance company. There must be no representation or implication that a guarantee applies to the investment return or principal value of the separate account. Similarly, it must not be represented or implied that an insurance company's financial ratings apply to the separate account.

[5] Proposed Rule Change by National Association of Securities Dealers, File No. SR-2004-83, Amendment No. 2, submitted May 4, 2006, available at http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_016480.pdf.

[6] *Id.*, at page 20.

[7] *Id.*, at page 20, fn. 27.

[8] *Id.*, at page 21.

scrutinize any deferred variable annuity transaction involving customers without long-term investment objectives and to carefully document any analysis in favor of recommending such a transaction.

B. The Sale of a Deferred Variable Annuity by an NASD Firm Should Be Accompanied with a Short, Written Disclosure of All of the Costs Associated with Such Variable Annuity and its Sub-accounts, Including the Often-Omitted Transaction Costs Relating to Trading Within the Funds (Or Sub-Accounts).

Having met with hundreds of individual investors during my career, I have never encountered an individual investor who has purchased a variable annuity who understands its fees and costs and the impact such fees and costs have upon the individual investor's ability to capture the long-range returns offered by the capital markets.[9] Moreover, the vast majority (perhaps 90% or more) of these investors are not aware of even the "disclosed" fees and costs of variable annuities.

Variable annuities can possess many layers of fees and costs. As an example, let's dissect one deferred variable annuity product sold by market-leader John Hancock, its Venture III product. The May 1, 2006 prospectus for this product indicates these costs assessed against sub-accounts:

[9] "Gross returns in the financial markets minus the costs of financial intermediation equal the net returns actually delivered to investors ... Applying the tyranny of compounding not only to the actual costs of fund operations but also to the even larger costs of, well, fund ownership, we find that each $1 invested at the outset by the average fund investor, before taxes and inflation, grew by only $2.39 over the full period, compared with the growth of $10.12 that came from simply owning the low-cost index fund. That is, investors received only 24 percent of the wealth that might easily have been accumulated simply by holding a low-cost, unmanaged stock market portfolio ... If our system of retirement savings were not the backbone of the wealth of the nation and our economic strength, perhaps this wealth-depleting arithmetic would not matter. But retirement savings are the backbone, and the arithmetic does matter." *The Relentless Rules of Humble Arithmetic*, Remarks by John C. Bogle, Founder and Former Chairman, The Vanguard Group, Financial Analysts Journal; November/December 2005. Mr. Bogle's remarks addressed the high costs of stock mutual funds. Variable annuities add another layer of costs. Mr. Bogle's remarks are available at http://www.vanguard.com/bogle_site/sp20060101.htm.

| | |
|---|---|
| Mortality and Expense Risks Fee: | 1.25% |
| Distribution Fee: | 0.25% |
| Daily Administration Fee (asset-based): | 0.15% |
| Sub-total: Mandatory annual separate account expenses: | 1.65% |
| Optional Annual Step Death Benefit Fee (deducted from separate accounts) | 0.20% |
| Optional Principal Plus for Life Fee (as a percentage of Adjusted Guaranteed Withdrawal Balance) | 0.40% (current fee[10]) |
| Sub-total insurance charges with optional "benefits: | 2.25% |

In addition, fees result from the funds held in the sub-accounts. The "disclosed fees" for stock mutual funds offered within the Venture III variable annuity (Series II) range from 0.80%[11] to 1.42% annually. I examine one of the lower-cost stock fund offerings for purposes of this continuing example. The "Core Equity Trust" possesses annual management fees of 0.79% per year, annual 12b-1 fees of 0.25% per year, and annual "other expenses" of 0.06% per year, for total "disclosed costs" of 1.10% per year (in addition to the insurance charges set forth above of 1.65% to 2.25%, depending upon options chosen). This "Legg Mason Funds Management, Inc. Core Equity Trust" fund seeks "long-term capital growth by investing, under normal market conditions, primarily in equity securities that, in the subadviser's opinion, offer the potential for capital growth. The subadviser seeks to purchase securities at large discounts to the subadviser's assessment of their intrinsic value." [12]

[10] The fee could be even higher. The prospectus states, in a footnote to the fee disclosure: "The current charge is 0.40%. We reserve the right to increase the charge to a maximum charge of 0.75% if the Guaranteed Withdrawal Balance is "Stepped-Up" to equal the Contract Value. The charge is deducted on an annual basis from the Contract Value."

[11] The fees for a money market fund are lower, at 0.77% of fund assets.

[12] Venture III May 1, 2006 Prospectus at page 14.

In addition to the "disclosed fees and costs" noted above, there are many "hidden" fees and costs associated with fund investing. A detailed explanation of these fees and costs can be found in my Working Paper, *Estimating The Total Costs of Stock Mutual Funds* (2006), available at www.JosephCapital.com. These "hidden" fees and costs are categorized as follows:

(1) brokerage commissions paid;
(2) transaction costs due to portfolio turnover; and
(3) opportunity costs due to cash holdings.

For the year end Dec. 31, 2005, brokerage commissions paid by this fund were $560,178. The fund's Annual Report[13] states that the Dec. 31, 2005 fund's "total net assets" were $460,866,089. As a percentage of the fund's year-end total net assets, the brokerage commissions paid translate to a rate of 0.12% per annum.[14]

In 2005 the Portfolio Turnover for the Core Equity Fund, as stated in the "Statement of Additional Information" for the fund,[15] was stated as 65% per year. Since the fund appears to consist of mainly large-cap U.S. stocks, applying the methodology set forth in the Working Paper aforementioned, this would translate to *estimated* annual "transaction costs" (bid-ask spreads, market impact, and opportunity costs due to delayed or canceled trades) of 0.69% per annum.

The fund's Annual Report further indicates that the cash holdings of this fund as of the end of the year were minimal (this is unusual). Hence, no opportunity costs due to cash holdings are inferred.

---

[13] The fund's Annual Report can be found as part of the fund's filings with the SEC, using the EDGAR system. Or see http://www.sec.gov/Archives/edgar/data/756913/000092881606000276/a_jhtrust1.htm.

[14] A more accurate computation of the brokerage commissions would utilize the average total net fund holdings during the year, not the year-end amount.

[15] The fund's Statement of Additional Information can be found as part of the filing with the SEC, using the EDGAR system. Or see http://www.sec.gov/Archives/edgar/data/756913/000095013506002682/b59730jte485bpos.txt.

Hence, adding up the total *potential, estimated* costs of this variable annuity and this sub-account, we find the following:

| | |
|---|---|
| Insurance charges, with optional benefits riders: | 2.20% per year |
| "Disclosed" costs (per prospectus): | 1.10% per year |
| "Hidden" costs (estimated): | 0.81% per year |
| *Total annual estimated fees and costs of the variable annuity and its Core Equity Fund sub-account:* | **4.11% per year** |

It is doubtful that any reasonable investor would agree to incur such high annual fees and costs, if they were fully, clearly, and concisely disclosed.

The SEC's fees and costs disclosure regimen would be aided by fuller disclosure of all of the costs of investing, including the "hidden" costs of mutual fund investing. The NASD's Proposed Rule only requires that the registered representative insure that the individual investor "has been informed" of "mortality and expense fees; investment advisory fees; potential charges for and features of riders ...." No mention is made of any necessity to disclose the "hidden" costs of investing - brokerage fees, transaction costs, and opportunity costs due to cash holdings. To this end, the NASD's Proposed Rule, and the SEC's current disclosure regimen, does a disservice to investors, and misleads investors as to the total fees and costs which they may bear in connection with investments sold to them.

C. The Sale of a Deferred Variable Annuity Should Be Undertaken with Either: (A) Appropriate Tax Advice Provided by the Selling Firm; or (B) A Clear, Concise and Prominent Statement that the Purchaser Obtain Tax Advice from His or Her Tax Advisor Prior to Purchasing the Product.

I provide this excerpt from a book which I co-authored, titled *The Science of Investing: How To Use Academic Research to Increase Returns and Reduce Risks In Your Investment Portfolio* (2003), to summarize the enormous negative tax consequences with annuities.

> What Are The Negative Tax Problems Created With Annuities? Variable annuities are often touted for their ability to defer taxable income. Prior to the Tax Reform Act of 1997 and the development of tax-managed mutual stock mutual funds, tax deferral was indeed a benefit for many mutual fund investors. However, with the advent of lower tax rates for realized long-term capital gains and tax-managed stock mutual funds that minimize both realization of capital gains and dividends, the income tax benefit of nonqualified variable annuities has all but disappeared. (Remember - there are no income tax benefits for "qualified" variable annuities - those held in IRA accounts or 403(b) accounts - as these accounts already receive tax deferred treatment.) Let's compare two hypothetical investments, held for about 10 years, and earning an annual rate of return of 7.2%.

| | Nonqualified variable annuity | Tax-managed stock mutual fund |
|---|---|---|
| Amount invested: | $ 20,000 | $ 20,000 |
| Value after 10 years: | $ 40,000 | $ 40,000 |
| Increase in value: | $ 20,000 | $ 20,000 |
| Tax rate upon withdrawal: | 25% (Ordinary income tax rate) | 15% (Long term capital gains rate) |
| Income tax due: | $ 5,000 | $ 3,000 |
| Net after withdrawal: | $35,000 | $37,000 |

> Of course, several assumptions are made in the simple illustration above. We assume that the investor is in a 25% marginal income tax rate, that the lower 15% long term capital gains rate available under current tax law through 2008 is available, and that the receipt of $20,000 of ordinary income (from the annuity surrender) will not increase the investor's marginal federal

income tax rate. We also assume that the tax-managed mutual fund does not distribute any capital gains, dividends or interest during the holding period.

Using this simple illustration we see that the investor with the tax-managed mutual fund receives a net amount of $2,000 more (despite our assumptions which favor the variable annuity). This translates to an annual average additional after-tax return of 1% over the 10-year period. Of course, the actual difference in returns is much greater - because the annuity investor likely incurred, on an ongoing basis, far greater investment costs due to annuity mortality, expense and administrative charges. These higher costs decrease the net investment returns for the variable annuity investor, thereby further decreasing the attractiveness of the nonqualified variable annuity relative to tax-managed mutual funds.

The Negative Tax Consequences of Leaving Nonqualified Variable Annuities On To Heirs. Think the example above of tax problems for our variable annuity holder during lifetime is bad. It gets worse if the annuity holder dies. Suppose our investor had died the day before the annuity and mutual fund were surrendered. Because a "stepped-up basis" exists for capital gain assets (such as stocks, stock mutual funds), but does not exist for variable annuities, the net to the heirs of the variable annuity (assuming they are in the same tax bracket, and do not possess any state or local income taxes) is still $35,000. The net to the heirs of the mutual fund is $40,000 (as all capital gains are eliminated). (In 2010 a limit is due to be imposed on the stepped-up basis, so that only $1.3 million of capital gain assets would be eligible for stepped-up basis treatment. Unless you have a significant estate, this change in the tax law would not affect our example above.) Another drawback of variable annuity payouts for many retirees and their families is the difference in the relative tax rates among family members. We've seen a lot of lower marginal tax rate retirees in Florida (where there is no state income tax) leave an annuity to children or other heirs who are in higher marginal rates for federal income tax purposes and who also pay state income taxes. In these instances tax deferral results in a deferral of ordinary income so it may be taxed at higher tax rates - and this is hardly ever a good thing.

Estate Planning and Variable Annuities. If you desire to delay distributions to an heir you may desire to leave an annuity to a trust created for that heir. However, an even higher rate of income taxation upon the deferred income can result. The highest federal income tax rate is achieved very early for (irrevocable) trusts - it takes less than $10,000 of income to get to the highest bracket. Although annuities are sometimes sold as probate avoidance devices, other devices work just as well for mutual funds and most other publicly traded investments. These include holding the investment asset or account as "joint tenants with rights of survivorship," "tenancy by the entireties," or in individual or joint names with a "pay-on-death" or "transfer-on-death" designation (available for nearly all brokerage firm accounts). A revocable living trust could also be considered.

> Furthermore, for those with "taxable" estates tax-deferred income (called "income in respect of a decedent") can be subject to both estate taxes and income taxes.

In my area of Florida I see variable annuities heavily marketed to senior citizens. As stated in my 1999 estate planning law firm newsletter to my law clients: "Nonqualified annuities designed to purchase and hold stock portfolios should be purchased by Florida retirees only rarely. I estimate that only 1 in 10 of my clients who possess these products have (or had) circumstances which dictated their purchase. For retirees these tax deferred annuities are actually tax inefficient and often hinder the accomplishment of various estate planning goals."

Despite the numerous tax disadvantages of deferred variable annuities under current tax law, advertisements and promotions abound touting their tax advantages. As a result, the vast majority of the senior citizen clients I see believe that the variable annuity they purchased from their broker or insurance agent possesses some magical tax benefit (when it in fact the variable annuity is clearly tax detrimental in the vast majority of cases). I believe there are two ways to counter this, which should be incorporated into the proposed rule:

The SEC can mandate that broker-dealer firms require that a principal of the firm ascertain the *tax suitability* of the investment as part of the principal's review. I note that the amended rule provides in pertinent part:

> "In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider (A) the extent to which the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit)."

Hence, I recommend that this portion of the rule should be further amended to read as follows:

> "In reviewing the purchase or exchange of a deferred variable annuity, the registered principal shall consider (A) the extent to which the customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit), and the extent to which the customer would possess tax detriments due to the conversion of potential long-term capital gain income (if taxed at more favorable tax rates for that customer) into ordinary income, and the extent to which the customer would possess tax detriments if the customer names a trust as beneficiary."

I note, however, that broker-dealer firms have historically avoided giving tax advice, and that most broker-dealer customer relationship contracts affirmatively disclaim the giving of tax advice as part of any investment recommendations made to the client. This is despite the huge impact of taxes upon an individual investor's net returns. Accordingly, given the reluctance of many broker-dealer firms to incorporate tax advice into investment advice, and the burden this might place upon broker-dealer firms to train both their principals and registered representatives in order to perform a tax suitability analyses, I alternatively recommend that each variable annuity sale be accompanied with the following disclosure, in 14-point (or larger) bold text:

> A nonqualified deferred variable annuity, while offering tax deferral of gains within the variable annuity contract, also creates, for many investors, substantial detrimental tax effects. These adverse tax consequences might include: (1) the conversion of long-term capital gain income into ordinary income upon withdrawal of gains from the annuity contract; (2) the loss of a stepped-up basis at time of death of the annuitant or owner of the annuity contract; (3) the potential imposition of higher marginal income tax rates if:
>
> > (a) gains are withdrawn during years in which required minimum distributions are required from traditional IRA accounts and other tax-qualified accounts; or

(b) if a beneficiary of the deferred variable annuity annuity is a trust; or

(c) if a beneficiary of the annuity is in a higher combined federal/state/local marginal income tax bracket than the variable annuity purchaser.

D. Sales of Deferred Variable Annuities to Senior Citizens Should Be Strongly Discouraged, and Written Consumer Disclosures Should State That in the Vast Majority of Instances Such Sales Would Be Regarded as "Unsuitable" under the Federal Securities Laws.

Despite the recent flurry of litigation against banks and brokerage firms for unsuitable sales of variable annuity products to senior citizens, and despite the recent forums and efforts by the SEC, NASAA, and consumer organizations, in my area of Florida variable annuities remain heavily promoted to the senior citizen population.

I have repeatedly warned retirees that if their broker, insurance agent, or other advisor suggests a variable annuity to them, they should “Run, don't walk. Get as far away as possible. There's very little chance that the variable annuity is right for you.” Despite the efforts I (and other members of my associated firms) have made to educate senior citizens regarding the many detrimental aspects of deferred variable annuities, I feel like at times like a child on a beach crying for help while trying to stem an onrushing tide coming through a broad channel with nothing but a small plastic shovel and bucket in hand.

I believe it is incumbent that any sale of a deferred variable annuity product to a person age 55 or older be accompanied with the following 14-point or larger written disclosure:

> Deferred variable annuities are not appropriate in the vast majority of instances for traditional IRA and Roth IRA accounts. Moreover, the tax deferral benefits of deferred variable annuities are rarely appropriate for most individuals who possess earned income given the availability of tax-qualified savings vehicles. Additionally, deferred variable annuities are very rarely suitable for purchase by any individual age 55 or over. Consult your legal and/or tax advisor for independent advice prior to the purchase of any variable annuity product.

E. An NASD Member Firm and its Registered Representative, If Also Functioning in the Capacity as an Investment Adviser under the Investment Advisers Act of 1940 ("Advisers Act"), Possesses a Fiduciary Duty to the Customer. This Fiduciary Duty, Which Imposes Far Broader and Stricter Requirements, Would Often Be Breached Through the Sale of the Vast Majority of Variable Annuity Products, Due to High "Total Fees and Costs" Associated with Such Investment Products and Due to Significant Adverse Tax Consequences Associated with Nonqualified Deferred Variable Annuities.

In my interviews of new clients to my firm, I almost always find that the client is unaware of the substantial distinctions between "product manufacturer's representatives" (i.e., registered representatives of a broker-dealer firm) and "purchaser's representatives" (i.e., representatives of a registered investment adviser firm). Many of the comments I receive from new clients include statements similar to these relative to the clients' relationships with their former stockbroker:

"I always thought that (my broker) represented my best interests."
"I had no idea that (this product) was so expensive."
"I trusted him."
"But she told me that this variable annuity was guaranteed."

While the NASD does not possess jurisdiction over registered investment advisers, *per se*, the NASD rule can be easily misconstrued by those who function both (or alternatively) as a representative of an investment advisory firm and as a representative of a broker-dealer firm. Hence, the proposed rule may very well mislead such representatives to conclude that variable annuity sales to a client are permitted under the stricter fiduciary standards of loyalty and due care applicable to investment advisers, when in point of fact they often would not be. As my March 8, 2005 comments[16] to the SEC regarding File No. S7-25-99; Proposed Rule: "Certain Broker-Dealers Deemed Not To Be Investment Advisers" pointed out:

> It is important to note a significant distinction between (non-fiduciary) fee-based brokerage accounts and (fiduciary) investment advisory accounts. Under the former the account agreements frequently contain the statement that no tax advice is given during the course of the brokerage relationship.[17] Registered investment advisers, by contrast, should not be able to waive the necessity to give tax advice, given its central importance to the net returns an investor receives.[18] As stated by Professor Macey, the "fiduciary duty of care requires that decisions on behalf of an entrustor be made after gathering relevant information, deliberating, and acting with 'wisdom and caution.' "[19] If the registered investment adviser lacks tax expertise necessary to integrate tax advice within the investment advisory process, the registered investment adviser should either acquire such expertise by education, provide such expertise through employment of agents, or require (in the terms of the advisory agreement with the client) that tax counsel be

[16] These comments can be found at http://www.sec.gov/rules/proposed/s72599/s72599josephcap.pdf.

[17] "Morgan Stanley does not provide tax or legal advice. Always consult with your own accountant or attorney concerning the tax or legal implications of your investment decisions." From Morgan Stanley brokerage account documentation, found in Annex II of comments of John H. Schaefer, President and Chief Operating Officer, Morgan Stanley, February 7, 2005.

[18] An example of the impact of poorly planned investment decisions can be seen from this excerpt from the SEC's Final Rule, *Disclosure of Mutual Fund After-Tax Returns*, 17 CFR Parts 230, 239, 270, and 274 [Release Nos. 33-7941; 34-43857; IC-24832; File No. S7-09-00]: "[T]axes are one of the most significant costs of investing in mutual funds through taxable accounts. In 1999, mutual funds distributed approximately $238 billion in capital gains and $159 billion in taxable dividends. Shareholders investing in stock and bond funds paid an estimated $39 billion in taxes in 1998 on distributions by their funds. Recent estimates suggest that more than two and one-half percentage points of the average stock fund's total return is lost each year to taxes. Moreover, it is estimated that, between 1994 and 1999, investors in diversified U.S. stock funds surrendered an average of 15 percent of their annual gains to taxes. Despite the tax dollars at stake, many investors lack a clear understanding of the impact of taxes on their mutual fund investments."

[19] Regulation of Financial Planners, White Paper Prepared for the Financial Planning Association (April 2002), at page 28.

engaged by the client as a condition of entering into the fiduciary relationship. The duty of due care, in the context of providing investment advisory services to individual investors, necessarily involves the application of tax minimization strategies. The investment adviser's duty to incorporate tax planning into the investment decision-making process is part of the fiduciary duty of due care, and likewise should not be capable of waiver.[20]

Hence, I suggest that the Proposed Rule be modified to add the following clause:

(f) **Additional Requirements For Those Serving As Investment Advisers.** This rule does not affect the higher continuing fiduciary duties of registered investment advisers and their representatives to ensure that a variable annuity recommended in connection with the implementation of a financial plan (or component thereof) be in the best interests of the customer, with due consideration given to both the total fees and costs associated with the investment product and the provision of investment advice, and with due

---

[20] In the opinion of the author, registered investment advisers who engage in the sale of most variable annuity products in nonqualified accounts undertake substantial professional risk, especially when selling such products to retirees. ***The fiduciary duty of due care requires a consideration of taxes and costs***, and alternative (and lower-cost) means of achieving risk reduction (afforded, to a very limited degree, by a variable annuity product's "death benefit" or "guarantee"). By contrast, insurance agents and stockbrokers do not appear to possess such stringent duties, and only possess a duty to consider the client's tax status under the lesser standard of "suitability." For more discussion on the inappropriateness of variable annuities, see the appendix to the author's August 30, 2004 comments to the SEC on this Proposed Rule, or obtain the report, *Why You Should Avoid Variable Annuities* (an excerpt from 2003 book, *The Science of Investing*, distributed as a public service by the Joseph Financial Group), available at www.JosephCapital.com.com, under "Publications.". Interestingly, neither the SEC nor the NASD requires a review of the tax implications of variable annuities as part of the suitability analysis. The following was summarized as the "suitability obligation" in a recent report:

> "In recommending the purchase of a deferred variable annuity, a registered representative would be required to determine that:
> • the customer has been informed of the unique features of the variable annuity;
> • the customer has a long-term investment objective; and
> • the deferred variable annuity as a whole, and its underlying sub accounts, are suitable for the customer, particularly with regard to risk and liquidity.
> The registered representative would be required to document these determinations."

*Joint SEC/NASD Report on Examination Findings Regarding Broker-dealer Sales of Variable Insurance Products*, June 2004. The critical omission of the *determination of suitability from a tax perspective* is apparently missing from the duties imposed upon brokerage firms and insurance agents which engage in the selling of these products. In addition, the concept of suitability fails to require the product salesperson to look at the overall costs of the product relative to its benefits. An investment advisor, held to the higher fiduciary standard, must consider the tax impact of the product upon the investor, as well as costs of the product relative to its benefits. A fiduciary investment adviser is simply held to a higher standard of care, and such requires the acquisition and application of a higher degree of expertise in order to properly advise the individual investor client.

consideration given to both the tax benefits (if any) and the tax detriments associated with nonqualified deferred annuity investing.

By way of explanation, under English law (from which our system of jurisprudence was initially derived), it is reasonably well established that fiduciary status gives rise to five principal duties: (1) the no conflict rule preventing a fiduciary placing himself in a position where his own interests conflict or may conflict with those of his client or beneficiary; (2) the no profit rule which requires a fiduciary not to profit from his position at the expense of his client or beneficiary; (3) the undivided loyalty rule which requires undivided loyalty from a fiduciary to his client or beneficiary; (4) the duty of confidentiality which prohibits the fiduciary from using information obtained in confidence from his client or beneficiary other than for the benefit of that client or beneficiary; and (5) the duty of due care, to act with reasonable diligence and with requisite knowledge, experience and attention. From these five broad duties, and other sources, can be derived various standards of conduct.

Mere disclosure of fees, costs, and adverse tax consequences does not meet the requirement that the registered investment adviser act in the best interests of the client. Even written disclosures, however detailed - or simplified - or prominent - cannot overcome a client's lack of knowledge, given the wide gap of knowledge which exists between the fiduciary registered investment adviser and the client. Moreover, disclosures of conflicts of interest which may exist between the registered investment adviser and the client do not negate the duty of the registered investment adviser to act in the best interests of the client, and do not “cure” any lack of adherence to the five principal duties of fiduciaries (as previously outlined, above).

I am particularly disturbed by the ability of certain dually registered broker-dealer / registered investment adviser firms and their representatives to provide “trusted advice” as an investment adviser but to then shed their “trusted advisor” hat and turn into a product seller. This situation presents many possibilities for abuse. For example, a representative of a registered investment adviser should not be able to make a general recommendation to seek to lower taxes under a financial plan, then use that general recommendation while shedding the registered investment adviser hat (and donning the cap of the registered representative or product seller) to sell an expensive deferred variable annuity product (especially without a full and complete discussion of the often-present tax disadvantages of such products, and without a discussion of the many other - and better - ways to save taxes).

With due consideration given to total costs and adverse tax impact of deferred variable annuities, it will be the rare event, indeed, when a deferred variable annuity can be recommended to a client by a registered investment adviser.

**F. Conclusion.** While the NASD's Proposed Rule is a step forward toward greater safeguards for individual investors, the elimination in the most recent version of this Proposed Rule of all references to an examination of the customer's "long-term investment objectives" is quite disturbing. Moreover, from the standpoint of high costs and adverse tax consequences, it is the view of this adviser that most variable annuity products remain for many investors – particularly retirees – wholly inappropriate and unsuitable investments.

Additionally, it should be made clear that the recommendation of a variable annuity purchase, if arising out of any financial planning or other activity which is (or was) properly subject to the Advisers Act, is a recommendation that must withstand the much higher scrutiny required of fiduciary investment advisers when undertaking specific investment recommendations.

I would urge the SEC to require the NASD to incorporate the recommendations set forth above and to re-propose the rule prior to its adoption. While the current Proposed Rule is a step forward in the right direction, its vagueness, recent weakening, and its lack of imposition of stricter standards will continue to provide substantial opportunities for abuse of senior citizens and other investors through inappropriate deferred variable annuity sales.

Piecemeal measures are not sufficient to counter the extreme abuses this adviser has seen, and continues to see, in connection with the sale of deferred variable annuity products. The SEC should act swiftly, but deliberately, to counter the persistent onrushing tide of inappropriate variable annuity sales.

Thank you again for the opportunity to submit these comments.

Ron A. Rhoades, B.S., J.D., CFP®