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January 24, 2008

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-9303

Re: FINRA Proposed Rule Change to Delay Effective Date of Certain Rule Changes Approved in SR-NASD-2004-183
(File No. SR-FINRA-2007-040)

Dear Ms. Morris:

Vanguard[1] supports FINRA's proposal to extend the effective date of certain provisions of Rule 2821 so that FINRA can address necessary changes to the principal review requirements of the Rule. Vanguard supports the public policy objectives of Rule 2821 but strongly believes that those objectives are not applicable in all cases. We greatly appreciate FINRA proposing an extension of time to fully consider the unintended and harmful consequences that might ensue if the Rule becomes effective in its current state.[2]

This comment letter explains Vanguard's view that the principal review requirements of the Rule should not apply to firms that do not make recommendations to customers regarding variable annuities. We describe Vanguard's deferred variable annuity business, the policies behind the principal review requirements of Rule 2821 and the unintended and harmful consequences we foresee if these requirements are applied to firms that do not make recommendations. Imposing the principal review requirements of Rule 2821 on firms that do not

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[1] The Vanguard Group, Inc. ("Vanguard") offers a wide array of mutual funds and other financial products and services to individual and institutional investors. Vanguard Marketing Corporation ("VMC"), a wholly owned subsidiary of Vanguard, is a registered broker-dealer and member of FINRA. VMC is the distributor of the Vanguard family of funds and is also the distributor of the Vanguard Variable Annuity. Unless the context otherwise requires, all references to "Vanguard" refer to Vanguard and VMC.

[2] Vanguard also supports a change to the seven day timing mechanism for principal review. Currently, the principal review must be completed "no later than seven business days after the customer signs the application." Linking principal review to the date a customer signs an application, as opposed to the date a firm receives an application, will likely prove unreliable and unworkable. Vanguard also supports amending the Rule to permit checks to be deposited in a suspense account pending completion of the principal review requirements of the Rule.

make recommendations does not further the purposes of the Rule and Vanguard, therefore, urges FINRA to exempt these firms from the principal review requirements.

Background. Currently, Rule 2821(c) states that "a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity" before a customer's application is transmitted to the issuing insurance company. The principal may approve a transaction if he or she "has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of [the] Rule." The Rule states that in reviewing each transaction, a principal shall *"treat[] all transactions as if they have been recommended."* (emphasis added) In Notice 07-53, FINRA announced approval of Rule 2821 effective May 5, 2008 and set forth FINRA's position with respect to several issues associated with the new rule. In particular, FINRA stated that *a principal must review all transactions "for suitability, irrespective of whether the orders were recommended" even at "a broker-dealer that does not have a sales force and does not make recommendations to customers."* (emphasis added) We are most concerned with this position and the application of the principal review requirements to firms that never make any recommendations to clients purchasing deferred variable annuities.

Vanguard's Sales of Variable Annuities. Vanguard Marketing Corporation ("VMC"), a wholly owned subsidiary of The Vanguard Group, Inc., serves as the exclusive distributor of a deferred variable annuity pursuant to the Vanguard Variable Annuity program. The Vanguard Variable Annuity is issued by Monumental Life Insurance Company[3] (a member of the AEGON Insurance Group) and invests exclusively in Vanguard mutual funds. VMC does not collect a sales charge or load or pay commissioned sales agents for distribution of the Vanguard Variable Annuity. There are no surrender charges associated with this product and the investment management, mortality and expense and administrative charges for this product are well below industry averages.[4] At this time, Vanguard does not offer any other deferred variable annuity product.

VMC's registered representatives do not solicit purchases of the Vanguard Variable Annuity nor do they provide recommendations to clients or potential clients with respect to the purchase or exchange of any deferred variable annuity product. Instead, they respond to incoming phone calls from clients and potential clients interested in Vanguard's annuity products. VMC's registered representatives are trained to ask and answer questions related to annuity products and to provide information to interested persons who are taking the initiative to purchase the product. VMC's registered representatives do not recommend any transactions, nor are they permitted to do so under VMC's policies and procedures. The decision to purchase or exchange a deferred variable annuity is one made solely by the investor. VMC's registered representatives do not receive commissions or other compensation based on the fact that an investor with whom they spoke purchased a deferred variable annuity.

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[3] In New York, the Vanguard Variable Annuity is issued by Transamerica Financial Life Insurance Company.

[4] The average cost for the Vanguard Variable Annuity is .57%. According to Morningstar, the industry average is roughly four times higher at 2.39%.

VMC also seeks to provide straightforward disclosure about the nature of the product so that clients have the information they need to determine for themselves whether a deferred variable annuity is appropriate for them. Such information is provided at www.vanguard.com, in brochures, in the prospectus and through discussion of information provided by VMC registered representatives. Vanguard believes it has developed supervisory procedures which are effectively tailored to this business model.

Vanguard is aware of other firms that have a similar business model for deferred variable annuities – wherein the member firm does not provide recommendations to clients or prospective clients, its registered representatives do not receive commissions, and the firm, instead, provides information to investors who then make their own decisions. VMC is able to offer a deferred variable annuity product at a cost that is significantly lower than the industry average, in part, because the investor is not charged for any costs associated with advising on specific recommendations. Vanguard believes this model and ones like it play an important role in the deferred variable annuities market by giving investors lower cost alternatives to other products and services.

The principal review requirements of 2821 are based on concerns that are not present at firms that do not make recommendations. Requiring principal review at firms that do not make recommendations does not further the purposes of the Rule. The primary justification for the principal review requirements of Rule 2821 has been to reduce the incentive for registered representatives to mischaracterize the nature of transactions with their customers to avoid compliance review of recommended transactions. Under VMC's business model, however, all transactions are non-recommended and there are no recommendations for registered representatives to "mischaracterize." All transactions are subject to the same compliance policies, procedures and oversight regime which are designed to ensure that all transactions are client initiated.

Rule 2821 was originally drafted to address two primary concerns with respect to the sales of deferred variable annuities. The first concern related to the "complexities" of deferred variable annuity products which, according to FINRA, "can cause confusion both for the persons associated with members who sell variable annuities and for customers who purchase them."[5] The second concern, and the one most applicable to the principal review requirements of the Rule, related to "questionable sales practices" that had been uncovered through FINRA examinations and investigations.[6]

More specifically, FINRA identified particular sales practices which were, to a great extent, the catalyst behind also requiring principal review of non-recommended transactions. For example, in addressing comments that had originally requested elimination of the principal review requirements for non-recommended transactions, FINRA stated:

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[5] SEC Release No. 34-52046A (July 19, 2005), 70 Fed. Reg. 42126 (July 21, 2005).

[6] Id.

> [FINRA] is aware of instances where associated persons have told their firms that deferred variable annuity transactions were not recommended in order to bypass their firms' compliance requirements for recommended or solicited sales. The … principal-review requirements for non-recommended transactions should reduce the incentive for persons to engage in such conduct.[7]

Later, as commenters continued to object to principal review of non-recommended transactions, FINRA amended the language of the Rule and agreed that "Rule 2821 should not prevent a fully informed customer from making his or her own investment decision."[8] While the principal review requirement for non-recommended transactions remained, FINRA amended the language of the Rule to specifically authorize a transaction if a principal determines it was not recommended and the customer affirms his or her desire to move forward after being informed of the reasons the transaction had not been approved by the principal. Again, the stated concerns behind the principal review of non-recommended transactions focused on the mischaracterization of transactions by registered representatives:

> Nonetheless, the new requirement that the principal independently determine that the transaction was not recommended adds another layer of protection. For example, this should discourage salespersons from attempting to bypass compliance requirements for recommended sales by simply checking the "not recommended" box on a form.[9]

Thus, the primary justification for requiring principal review of non-recommended transactions has been to reduce the incentive for registered representatives to mischaracterize the nature of transactions with their customers. Vanguard shares FINRA's concerns and believes it is critically important to protect investors from the types of abusive sales practices exposed through these investigations. This concern, however, is not present at firms that do not make recommendations. Rule 2821 should be tailored to address this particular issue and FINRA is in the best position to ensure that the Rule is well designed to protect investors from these harmful sales practices.

Vanguard supports regulatory and industry efforts to enhance compliance and prevent associated persons from making false statements. However, the position set forth in Notice 07-53 requiring "suitability" reviews at firms that do not make recommendations does not further such an effort.[10] The concerns that the principal review of non-recommended transactions is

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7 Id. at 42129.

8 See Amendment No. 3 to SR-NASD-2004-183 at p. 12 (Nov. 15, 2006).

9 Id. at p. 13.

10 The "suitability" of a particular transaction, by definition, is a concept that only applies to recommendations. See FINRA Rule 2310, *Recommendations to Customers (Suitability)*. Imposing a "suitability"

designed to address are not present when: 1) all transactions are customer initiated; 2) there are no sales based commissions; and 3) there are no recommendations. Firms that operate in this limited manner typically have extensive training programs for their representatives as well as compliance policies and operating procedures to effectively implement these limitations. Nothing in the record suggests that the Rule is designed to address abuses at firms that operate in this limited manner. Rather, the review of non-recommended transactions was designed to address particular sales practice violations that were identified at firms where representatives make recommendations.

Imposing principal review on firms that do not make recommendations will have unintended and harmful consequences. We believe applying Rule 2821 to firms that do not make recommendations will have the unintended and harmful consequences of reducing investor choice, raising costs and adding to investor confusion. We appreciate FINRA's interest in considering these issues by delaying the effective date of the principal review provisions.

Ultimately, investors will be disadvantaged if firms like VMC have to comply with the principal review requirements of Rule 2821. Implementing a "suitability" model would require firms like VMC to create and maintain entirely new systems, practices and procedures. The cost and burden of implementing and maintaining a system pursuant to Rule 2821 is significantly higher for firms such as VMC than for firms whose existing or proposed business models already include recommended sales. Firms that make recommendations to customers have existing "suitability" obligations and requiring such firms to also review non-recommended transactions should not result in significant additional costs. Imposing "suitability" obligations on a firm like VMC, however, requires the creation of an entirely new operational structure. The cost of implementing and maintaining such a system would ultimately be borne by investors but provide no benefit to them. We believe that the principal review requirements, if applicable to VMC, would adversely affect the ability of VMC to offer a low cost variable annuity alternative. Because the questionable sales practices that led FINRA to adopt Rule 2821 do not exist at firms like VMC, these additional costs and burdens are unwarranted.

Requiring VMC and firms like it to perform "suitability" reviews will not only cost investors money, it will result in client confusion. Clients do not expect VMC to provide recommendations, and as a result, are very hesitant to provide the type of information needed to perform a suitability review.

Conclusion. Requiring firms that do not make recommendations to customers to comply with the principal review obligations of Rule 2821 will have significant "unintended and harmful consequences." Because the fundamental purpose of the review of non-recommended transactions is not applicable to such business models, Vanguard submits that further rule changes are appropriate to exempt from Rule 2821 firms that do not make recommendations to clients and do not receive sales based commissions with respect to deferred variable annuities.

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obligation on firms that never provide recommendations is a significant expansion of the substantive standards governing the conduct of such firms and was never the purpose of Rule 2821.

We appreciate the opportunity to comment on the proposal. Please do not hesitate to contact me or John Bisordi, Associate Counsel at (610)-669-2624, if you have any questions or require additional information.

Sincerely,

/s/ Heidi Stam

Heidi Stam
Managing Director and
General Counsel

cc: Andrew J. Donahue, Director, Division of Investment Management
Erik R. Sirri, Director, Division of Trading and Markets
Securities and Exchange Commission

Thomas M. Selman, Executive Vice President, Investment Companies/Corporate Financing Regulation
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