

July 19, 2007

**BY E-MAIL**

Ms. Nancy Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-0609

Re: **File Number 4-538**  
Rule 12b-1 Under the Investment Company Act of 1940

Dear Ms. Morris:

This comment letter is submitted on behalf of the Committee of Annuity Insurers (the "Committee").<sup>1</sup> The Committee is pleased to have the opportunity to offer its comments as the Securities and Exchange Commission (the "Commission") considers approaches to address issues presented by fees paid pursuant to Rule 12b-1 under the Investment Company Act of 1940, as amended (the "Investment Company Act"). The Rule allows fees to be deducted from mutual fund assets to pay distribution and shareholder service expenses.

The Committee supports the Commission's efforts to re-evaluate Rule 12b-1 in light of its evolving uses. The recent Roundtable on Rule 12b-1 hosted by the Commission<sup>2</sup> examined the role of Rule 12b-1 fees primarily in the context of mutual funds that sell their shares to the general public (either directly or through certain intermediaries). Of particular interest to the Committee, Rule 12b-1 is also relevant to mutual funds that sell their shares to insurance company separate accounts to support variable annuity (and life insurance) contracts ("insurance products funds"). Rule 12b-1 permits mutual funds, including insurance products funds, to bear expenses for distribution and shareholder services. Rule 12b-1 plans for insurance products funds typically provide for the payment of fees to an insurance company or an affiliated broker-dealer for administrative services or shareholder (*i.e.*, contract owner) services or for distribution services and activities.

The Commission has invited comments on Rule 12b-1, specifically how the Rule may be modified to address the changing uses of the Rule and, in the alternative, whether the rule should be repealed.<sup>3</sup> In addition, in a recent speech Mr. Andrew J. Donohue, the Director of the

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<sup>1</sup> The Committee of Annuity Insurers is a coalition of life insurance companies that issue fixed and variable annuities. The Committee was formed in 1981 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent over half of the annuity business in the United States. The member companies of the Committee are listed at the end of this letter.

<sup>2</sup> Roundtable on Rule 12b-1 (June 19, 2007) (the "Roundtable").

<sup>3</sup> SEC Press Release 2007 – 112 (June 12, 2007).

Commission's Division of Investment Management, stated that the annuity industry is "very much a part of the 12b-1 picture," and "strongly" encouraged the industry to submit its comments, "to ensure that ... the specific issues and nuances relevant to the variable products industry are fully considered."<sup>4</sup> Rule 12b-1 is indeed critical to the variable annuity industry and the Committee is appreciative of this opportunity to offer its views, from the perspective of issuers of variable annuities, on certain of the broad issues addressed at the Roundtable as they may affect issuers of, and investors in, variable annuities.

### **Background: The Structure of Variable Annuities**

The Roundtable focused largely on Rule 12b-1 in the context of sales of mutual fund shares to the general public directly, or through intermediaries such as so-called mutual fund "supermarkets" and qualified retirement plans. Insurance companies issuing variable annuities function in a manner similar to those intermediaries and provide many of the same or similar important services to investors. However, there are certain structural and operational differences between the use of mutual funds in variable annuities, and the distribution of mutual fund shares through those other channels, that impact how any changes in Rule 12b-1 would affect issuers of, and investors in, variable annuities. Accordingly, some background information may be helpful.

A variable annuity is a written contract between the insurance company that issues the variable annuity and the owner who purchases the contract.<sup>5</sup> The contract sets forth the rights and duties of the respective parties. Under state contract law, one party to a contract generally cannot unilaterally modify the contract terms.

Today, most variable annuities are issued through a two-tiered structure. The top tier consists of a separate account of the issuing insurance company, which is a segregated investment account established under state insurance law that holds variable annuity assets and liabilities separate and apart from the assets and liabilities of the insurance company's general account. Absent an exemption from the registration requirements of the Securities Act of 1933, variable annuity contracts are registered as securities under that Act. Similarly, absent an exemption from the Investment Company Act, the separate accounts are registered under the Investment Company Act. Such separate accounts generally are registered as unit investment trusts and are divided into subaccounts (analogous to separate series or portfolios of a management investment company).

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<sup>4</sup> Andrew J. Donohue, *Remarks Before the NAVA Compliance and Regulatory Affairs Conference*, June 25, 2007, available at <http://www.sec.gov/news/speech/2007/spch062507ald.htm>.

<sup>5</sup> For ease of reference, this comment letter refers to insurance companies as issuers of variable annuity contracts although, under the federal securities laws, insurance company separate accounts are the primary issuers of variable annuity contracts, with the insurer as a separate entity co-issuing the contract. See Stephen E. Roth, Susan S. Krawczyk, and David S. Goldstein, *Reorganizing Insurance Company Separate Accounts Under Federal Securities Laws*, 46 *Business Lawyer* 546 (Feb. 1991).

The bottom tier of the two-tiered structure typically consists of a number of mutual funds. Each subaccount corresponds to, and is invested exclusively in, a particular series, or portfolio, of one of the funds. Today's variable annuities generally offer dozens of subaccount or portfolio choices, and give the contract owner the opportunity to select from portfolios offered by a dozen or more different mutual fund complexes.<sup>6</sup> Under this structure, variable annuity owners allocate premium payments among the subaccounts offered within the contract, and may transfer contract value among those subaccounts in accordance with the terms of the contract.

We urge the Commission to consider that implementation of any changes to Rule 12b-1 will be complicated by the contractual nature of variable annuities, the two-tiered structure of one investment company investing in another, and the dual federal and state regulation of variable annuities.

### **The Committee's Comments**

With that in mind, the Committee respectfully submits the following comments.

#### **I. General Benefits to Variable Annuity Contract Owners From Rule 12b-1**

One of the fundamental issues presented at the Roundtable was whether the SEC should completely rescind Rule 12b-1. Consistent with the views expressed by a majority of Roundtable panelists, the Committee is strongly in favor of retaining Rule 12b-1. Certainly the fundamental principle of Rule 12b-1 – that distribution and service fees can be deducted from fund assets (subject to appropriate procedural safeguards) – should be retained.

Rule 12b-1 fees support important distribution-related services to variable annuity contract owners. As is the case with "retail" mutual funds, Rule 12b-1 plans in insurance products funds provide an important source of revenue to support activities such as promoting the funds to prospective contract owners, printing fund prospectuses and sales literature for use with prospective contract owners, and *agent training and education related to the funds*. Similarly, just as is the case with retail mutual funds, Rule 12b-1 plans in insurance products funds support the activities of both broker-dealers and insurance companies in providing on-going shareholder services to owners of variable annuity contracts (and the related administrative services).

Roundtable participants pointed out that an investment in a mutual fund should not be viewed as a one-time 'event' (where the salesperson is compensated solely by a one-time commission). Rather, they argued that the distribution of mutual fund shares (and Rule 12b-1 Plans) should be considered in the context of an on-going relationship between the investor and a financial professional, involving services and advice over time (such as periodic portfolio reviews, modifications for changes in circumstances, advice with respect to withdrawing funds in

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<sup>6</sup> One or more of those mutual fund complexes may be managed by an affiliate of the insurance company, but most products offer a large number of portfolios that are part of unaffiliated mutual fund complexes.

retirement, etc.) and that on-going 12b-1 fees are an entirely appropriate method of providing compensation for such services. The Committee believes that this is even more true with respect to variable annuities. As noted above, in the typical structure, each variable annuity subaccount invests in a different mutual fund portfolio, and since variable annuities are even more specifically designed for a long-term professional relationship, they involve all of the same on-going services. The use of fees paid under Rule 12b-1 plans to provide financial support for this relationship and these services in the context of variable annuities is proper and appropriate.<sup>7</sup>

Roundtable participants discussed the many services that particular financial intermediaries (*i.e.*, fund 'supermarkets' and retirement plan administrators) provide on an on-going basis to current investors, including (1) transaction execution and settlement, (2) payment of dividends and distribution, (3) prospectus delivery, (4) maintenance of branch offices and call centers, (5) maintenance of websites, and (6) recordkeeping and other administrative functions. The participants pointed out that these are valuable services to current investors, and that Rule 12b-1 fees are a proper and appropriate source of compensation for these services.

Similarly, in the variable annuity context,<sup>8</sup> insurance companies provide a large number of services on an on-going basis that relate to the underlying mutual fund portfolios that support the variable annuity contract, including (1) training and educating agents about the portfolios, including new portfolio choices and changes in existing portfolios, (2) delivering annually updated portfolio prospectuses to variable annuity contract owners, (3) delivering portfolio prospectus supplements to contract owners, (4) delivering the portfolios' annual and semi-annual shareholder reports to contract owners, (5) purchasing and redeeming fund shares to effectuate transactions made by contract owners (such as new premium payments, cash withdrawals, transfers between subaccounts, etc.), (6) redeeming fund shares to pay benefits under the contract (*e.g.*, death benefits, lifetime annuity payments, etc.), (7) maintaining branch offices and call centers that can provide information about the portfolios to contract owners, (8) maintaining websites that may contain information about the portfolios, (9) processing contract owners' instructions on how to vote fund shares attributable to their variable annuity contract, etc. These are valuable services to current investors (the existing variable annuity contract owners), and by providing these services the insurance companies that issue variable annuities relieve the insurance products funds of the expenses of providing these services. Accordingly, the Committee submits that it is entirely proper and appropriate that Rule 12b-1 Plans be used as a source of compensation for these valuable investor services.

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<sup>7</sup> Many shareholder services may be viewed as 'distribution' activities for Rule 12b-1 purposes insofar as they involve activities such as (1) recommending further investment in a portfolio, (2) recommending to a contract owner that he or she remain invested in a portfolio (*e.g.*, provide reassurance after a market drop), (3) recommending changes in asset allocation that involve investment in a new portfolio, or (4) delivering prospectuses for a prospective new portfolio. It is for this reason that such 'service fees' are generally authorized by a Rule 12b-1 plan. At the Roundtable Thomas Selman, Executive Vice President of the NASD, discussed the difficulty of distinguishing 'service' activities from 'distribution' activities.

<sup>8</sup> While this letter generally refers to variable annuities, the comments and recommendations made herein also apply to variable life insurance policies.

In summary, the Committee believes that Rule 12b-1 fees enable insurance companies to provide many important services to variable annuity contract owners in an efficient and cost-effective manner. Whether these are categorized as 'service' or 'distribution' activities, the services are a very valuable resource for investors relating to a long-term investment. Therefore, Rule 12b-1 should not be rescinded.

## II. 'Externalization' of Rule 12b-1 Fees

Some Roundtable participants discussed the possibility of 'externalizing' Rule 12b-1 fees. This would mean that instead of deducting the fees at the fund level (from the collective fund assets), the fee would be deducted separately from each individual investor's account. Proponents argued that many investors do not realize the amount they are paying in 12b-1 fees (or the services provided in return) and the impact of such fees on their investment return, and that externalizing the fees would make them more 'transparent' to investors. Opponents of externalization argued that the current system is very efficient, and that this efficiency would be lost if the fee were deducted at the individual account level. This, in turn, could result in increased costs to investors.

The Committee agrees with the opponents of externalization. Currently, the system can be viewed as a deduction of the fees at the 'wholesale' level, from the collective fund assets. Deducting the fees at the 'retail' level of individual accounts would, it seems, inevitably be more expensive.

In addition, it should be possible to make the fees more transparent without externalizing the deduction of the fee, and therefore the Committee urges the Commission to consider alternative methods of improving disclosure.

More importantly, externalizing the fee to the individual contract owner account level presents unique contractual and state insurance regulatory problems for variable products that are not present with respect to mutual funds. As noted above, a variable annuity is a legal contract between two parties – the purchaser (owner) of the contract, and the issuing insurance company. Among other things, in most cases the contract specifies, and therefore limits, the fees and charges that are permitted. Simply put, insurance companies that attempt to deduct 12b-1 fees from individual variable annuity contracts would be subject to claims for breach of contract. And there is the possibility of enforcement actions by state insurance regulators since the deductions could violate state insurance regulatory requirements (*e.g.*, deductions for 12b-1 fees were not included in the variable annuity policy forms filed with and approved by the state insurance departments). Commission amendments to Rule 12b-1 may (or may not) pre-empt state insurance requirements, but in any event the Commission cannot 'authorize' insurance companies to breach their legal contracts with their variable annuity contract owners or protect insurance companies from liability for doing so. Moreover, there is no justification for exposing the variable products industry to the certain expense of defending such claims, and to the uncertainty of litigation.

In addition, before proposing any change in the method of assessing fees to help support distribution and on-going shareholder services, the Commission should take into account the significant differences in the tax treatment of mutual funds and variable annuities, so there are no adverse tax consequences to owners of variable annuities.

### III. Improving Disclosure

A number of Roundtable participants advocated greater ‘transparency’ in 12b-1 fees. As noted above, some participants argued that mutual fund investors are not aware of nor do they understand the magnitude of 12b-1 fees, and do not appreciate the impact of such fees on their investment return. To address this issue, they recommended that the Commission focus its efforts on improving the transparency of such fees.

While it is far from clear just what ‘transparency’ means in this context, the Committee certainly supports good, clear disclosure of all material information to investors (here, purchasers of variable annuity contracts). However, careful consideration should be given to whether *additional* data regarding 12b-1 fees would really provide *better* disclosure, or whether the data would be useful to investors. The Committee urges the Commission to conduct consumer focus group studies and other types of analyses to determine whether additional data regarding 12b-1 fees would actually provide better disclosure or be meaningful in helping the public to make investment decisions.

We also recommend that any proposed additional 12b-1 disclosure be analyzed in the context of the Commission’s on-going efforts to simplify disclosure in general, as well as the Commission’s on-going consideration of the most effective means of delivering different types of disclosure (such as the “point-of-sale” proposal).

More particularly, careful consideration should be given to requiring additional data disclosure in the context of variable annuities. It is one thing to evaluate the pros and cons of additional 12b-1 data disclosure in the context of a prospectus for a single mutual fund portfolio, or in a particular mutual fund account statement. However, as noted above, many variable annuities currently offer 50 or more different portfolio choices from a dozen or more mutual fund complexes. Disclosing more data on so many underlying fund choices in a single variable annuity prospectus is more likely to be counter-productive than useful to investors. And many variable annuity owners spread their investment out over a number of the underlying fund portfolios available in the product, so adding disclosure to account statements regarding the 12b-1 fees paid for each of those portfolios could very well result in ‘data overload’ that obscures more important information, rather than providing useful information to investors.

The Committee urges the Commission to give careful consideration not just to the general idea of improving disclosure, but also to the practical impact of specific proposals in the context of variable annuities, as described above.


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The Committee appreciates the time and resources that the Commission and its staff have devoted to studying Rule 12b-1 so that any future proposal will reflect an understanding of its current uses and the impact changes will have on the industry and, more importantly, investors. The Committee looks forward to the opportunity to address more specific issues and nuances if and when the Commission issues an actual proposal. The Committee also appreciates your careful consideration of our comments and recommendations set forth herein.

Respectfully submitted,

**SUTHERLAND ASBILL & BRENNAN LLP**

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