THE Committee
OF
Annuity Insurers
www.annuity-insurers.org

May 8, 2023

Via E-Mail
Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: File No. S7-04-23
Safeguarding Advisory Client Assets

Dear Ms. Countryman:

We are submitting this letter on behalf of the Committee of Annuity Insurers (the "Committee"),[1] in response to the U.S. Securities and Exchange Commission's (the "SEC") proposed new Rule 223-1 (the "Proposed Rule"), titled "Safeguarding Client Assets," under the Investment Advisers Act of 1940, as amended (the "Advisers Act").[2] The Committee appreciates the opportunity to comment on the Proposed Rule.

The Committee believes that many aspects of the Proposed Rule are problematic and, if adopted, will result in significant disruption and upheaval to the custodial market and the investment advisory industry without providing any meaningful investor protection benefit. The Committee focuses most of its comments on those aspects of the Proposed Rule that will have the greatest impact on the insurance industry, and more specifically, on issuers of registered variable annuity contracts ("VA Contracts"), registered index-linked annuities ("RILAs") and fixed annuities ("Fixed Contracts," and together with VA Contracts and RILAs, "Contracts"), and registered investment advisers ("Program Advisers") that recommend or purchase Contracts and/or provide advice to Contract owners ("Contract Owners") through asset allocation or other investment advisory programs (collectively, "Programs").[3] However, given the problematic nature of the Proposed Rule's efforts to include discretionary authority as a form of custody, the Committee is compelled to provide comments on this element of the rule (which does not have an exclusive impact on the insurance industry).

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[1] The Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's 32 member companies represent approximately 80% of the annuity business in the United States. The Committee was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of insurance, securities, banking, and tax policies regarding annuities. For over three decades, the Committee has played a prominent role in shaping government and regulatory policies with respect to annuities at both the federal and state levels, working with and advocating before the SEC, CFTC, FINRA, IRS, Treasury Department, and Department of Labor, as well as the NAIC and relevant and Congressional committees. A list of the Committee's member companies is available on the Committee's website at www.annuity-insurers.org/about-the-committee/.

[2] Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023), 88 Fed. Reg. 14672 (Mar. 9, 2023). The SEC's release on the proposed rulemaking is posted at https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf ("Proposing Release").

[3] The Committee uses the term "VA Programs" throughout this letter to refer to investment advisory programs through which registered investment advisers recommend or purchase VA Contracts and/or provide advice to VA Contract owners through asset allocation or other investment advisory programs.

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I. The Current Approach under the Custody Rule with respect to Contracts Should be Preserved, but Brought up to Date to Reflect Intervening Developments since the Issuance of the American Skandia Letter

The Proposed Rule, similar to the current custody rule (the "Custody Rule"),[4] defines the term "qualified custodian" to include a bank or savings association, registered broker-dealer, registered futures commission merchant, and certain types of foreign financial institutions.[5] Insurance companies are not included in the "qualified custodian" definition under either the Custody Rule or the Proposed Rule. In response to the Proposing Release's question regarding whether "insurance companies [should] be included in the definition of qualified custodian under certain circumstances, such as in the variable annuity context?"[6] the Committee strongly believes the answer is "no." Instead, the Committee believes the current approach under the Custody Rule with respect to Contracts should be preserved, but brought up to date to reflect intervening developments since the SEC staff issued relevant guidance under the Custody Rule.

In connection with VA Programs in which an investment adviser is deemed to have custody of client funds or securities as a result of being able to deduct advisory fees directly from a client's VA Contract value ("Fee Deduction Custody"), for many years the insurance industry has operated pursuant to 2005 no-action relief granted by the SEC staff to American Skandia Life Assurance Corporation (the "American Skandia Letter").[7] The American Skandia Letter permits an insurance company to serve in lieu of a qualified custodian when a Program Adviser is deemed to have custody of client funds and securities as a result of having Fee Deduction Custody.[8]

For the reasons set forth below, the Committee respectfully requests that in the adopting release for any final rulemaking related to the Proposed Rule, the SEC explicitly confirm that the current approach under the Custody Rule with respect to VA Contracts as reflected in the American Skandia Letter is preserved.[9] Further, the Committee respectfully requests that the SEC expand the scope of the American Skandia Letter guidance to cover other situations in which a Program Adviser is deemed to have custody – such as Related Person Custody or Discretionary Authority Custody[10] (if the Proposed Rule is adopted as proposed).

A. The SEC Should Explicitly Confirm that the Current Approach under the Custody Rule with Respect to VA Contracts is Preserved

The American Skandia Letter concerned a platform established by American Skandia, an insurance company, for unaffiliated investment advisers. The platform enabled these advisers to deduct their advisory fees directly from their clients' VA Contract value by periodically directing American Skandia to redeem a contract holder's accumulation units of one or more subaccounts of a separate account organized as a unit investment trust under the Investment Company Act of 1940, as amended (the "Company Act"), equal in value to the advisory fees for the relevant time period. Investment advisers participating in the platform were deemed to have custody of client

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[4] *See* Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended.

[5] *See* Proposed Rule 223-1(d)(10).

[6] 88 Fed. Reg. at 14687.

[7] *See* American Skandia Life Assurance Corp., SEC No-Action Letter (May 16, 2005), available at https://www.sec.gov/divisions/investment/noaction/asl051605.htm.

[8] *Id.*

[9] For the reasons described in further detail in Section V of this letter, the Committee requests that the SEC confirm that the American Skandia Letter guidance can be relied upon with respect to all Programs (including Programs involving Fixed Contracts and RILAs), and not just those involving VA Contracts.

[10] "Related Person Custody" and "Discretionary Authority Custody" are defined below.

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"funds and securities" as a result of their ability to deduct their advisory fees from their clients' VA Contract value, which would normally require the clients' funds and securities to be held by a "qualified custodian" under the Custody Rule. The relief granted by the American Skandia Letter allowed American Skandia, an insurance company, to serve *in lieu of* a qualified custodian with regard to the VA Contracts when an investment adviser utilizing the platform had Fee Deduction Custody.[11]

Over the last eighteen years, the insurance industry, including Committee members, have established programs and developed practices consistent with the relief granted by the SEC staff in the American Skandia Letter. The Committee believes that these programs and practices have met the goals of the Custody Rule's "qualified custodian" requirement – namely, the safeguarding of client assets and the protection of these assets from being lost, misused, stolen, or misappropriated. In fact, the Committee is not aware of any circumstances under which a Contract Owner's assets have been compromised as a result of an insurance company serving in lieu of a qualified custodian with regard to a VA Contract. Indeed, such a result is highly improbable, when considering the substantial protections, detailed below, that apply to a Contract Owner's VA Contract and the separate accounts of the insurance company through which the Contract Owner's purchase payment is invested.

Upon issuing a VA Contract, an insurance company generally is required under state insurance law to send the VA Contract to the Contract Owner. Thus, the Contract Owner, rather than the Program Adviser or insurance company, maintains custody of the VA Contract.[12] State insurance "free look rights" (which give the Contract Owner a limited period of time in which to return the VA Contract for a full refund) generally are triggered by delivery of the VA Contract to the Contract Owner.[13]

With respect to VA Contracts, a Contract Owner's purchase payment generally is invested in one or more investment options underlying a separate account of the insurance company that is registered under the Company Act. Contract Owners may apply the value of their payments to the various investment options available in the separate account according to their desired allocation. The investment options underlying VA Contracts typically consist of shares of open-end management investment companies that are themselves registered with the SEC under the Company Act. Pursuant to the VA Contracts, Contract Owners can change their investment allocations among the investment options (on a tax-free basis), subject to certain limitations. Unlike other types of securities, the assets underlying the VA Contracts, and any resulting appreciation, are legally owned by the issuing insurance company and not the Contract Owners.

Accordingly, unlike a typical investment adviser relationship in which funds or securities owned by clients are managed or advised on by investment advisers, the funds managed or advised on by Program Advisers are <u>not</u> legally owned by Contract Owners (but by the insurance company). The assets in the insurance company separate accounts, while legally owned by the insurance company under state insurance law, are legally segregated from the insurance company's other assets, and are insulated from the claims of the insurer's general creditors. Since the investment experience of the separate account assets determines the VA Contract benefits,

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[11] *See* the American Skandia Letter.

[12] In discussing a variable annuity asset allocation program substantially similar to the Programs described in this letter, the SEC staff has stated that "Under the Custody Rule, [VA Contract] Payment Arrangements would vest an investment adviser with custody of its clients' funds and securities. You are concerned that the Custody Rule would require an independent third-party custodian to maintain custody of ***the Contract Owner's funds and securities (i.e., the variable annuity contract)*** . . . ." (Emphasis added.) (*See* American Skandia Life Assurance Corp., SEC No-Action Letter (May 16, 2005). As noted, under state insurance law, Contract Owners generally must be provided the VA Contract upon issuance.

[13] *See*, *e.g.*, N.J. Admin. Code § 11:4-44.3(c); 28 Tex. Admin. Code § 3.9711; Iowa Admin. Code r. 191-15.9.

the SEC treats each separate account as a distinct investment company that (unless an exemption is available) must register as an investment company under the Company Act.[14] The insurance company is treated as the sponsor or "depositor" of the separate account investment company.[15] The insurance company is the legal owner of the underlying insurance fund shares held in the separate account (in uncertificated or "book entry" form). The performance of the insurance funds directly affects the cash value of the VA Contracts.

It has become increasingly common for Contract Owners to hire Program Advisers registered under the Advisers Act to provide professional asset allocation advice concerning the allocation of their purchase payments among the various investment options that are available within VA Contracts. The Program Advisers help Contract Owners effectively allocate the payments made under their VA Contracts and resulting cash values among the investment options in a manner that is consistent with Contract Owners' risk tolerance, investment objectives and time horizon.[16] VA Contracts frequently have dozens of underlying insurance funds, from a number of different mutual fund families, as investment options. The choice of investment options plays a key role in determining the cash value of VA Contracts, and thus the amount of payments that ultimately will be paid to investors under the VA Contracts.

Through administrative systems, insurance companies maintain records concerning Contract Owner purchases of VA Contracts. Such systems typically record, among other things, the timing and amount of purchase payments and withdrawals, Contract Owner allocations, cash values, and death benefit values and designate for each Contract Owner an "account" in the Contract Owner's name. Each transaction associated with a Contract is entered or fed through a systematic feed and updates a variety of supporting tables that record Contract values (such as cash value or death benefit value) and data at the Contract level. Contract data includes owner/annuitant name, social security number, date of birth, owner type and addresses.

VA Contract Owners (*i.e.*, Program Advisers' clients) may permit their Program Advisers to deduct their advisory fees directly from the separate account that supports the VA Contracts by periodically directing the insurance company to redeem units of the separate account equal in value to the advisory fees owed to the Program Advisers – as was the case with regard to the program discussed in the American Skandia Letter. In such arrangements, Contract Owners authorize (in writing) Program Advisers to submit redemption requests to the insurance company. While the logistics by which advisory fees are deducted from separate account assets varies across

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[14] *See Prudential Ins. Co. v. S.E.C.*, 326 F.2d 383 (3d Cir. 1964); 15 U.S.C. § 80a-2(a)(37) (2009) (defining separate account under the Company Act); *see also* 17 C.F.R. §§ 270.0-1(e), .6e-2(a), .6e-3T(a) (2009). *See generally* Tamar Frankel, *Variable Annuities, Variable Insurance and Separate Accounts*, 51 B.U.L. REV. 177 (1971).

[15] Separate accounts funding variable contracts can be structured in one of two ways. The separate account can invest directly in a portfolio of securities or other investments. This type of separate account, which was the predominant structure during the early years of variable contracts, is typically called a "managed account" and is classified as an open-end management company under the Company Act. Under the managed account structure, the active management of the investment portfolio occurs at the separate account level, like other open-end management companies (*e.g.*, mutual funds).

The second type of separate account structure involves two tiers. Instead of the separate account investing directly in securities or other investments, it is not actively managed, and simply invests in the securities of other specified investment companies whose portfolios, in turn, may be actively managed. This type of separate account is classified as a unit investment trust ("trust account") under the Company Act. The underlying investment is typically an open end investment company ("insurance fund").

Most VA Contracts in the market today are offered through this two-tier structure involving a trust account and insurance fund. Accordingly, this letter addresses separate accounts structured as trust accounts.

[16] Program Advisers also may provide advice concerning the allocation of Contract Owners' overall investment portfolio among VA Contracts and other securities or investment vehicles. In addition, they may manage an Account Owner's assets in the VA Contracts on a discretionary basis.

companies, upon receiving requests (typically quarterly) from Program Advisers to deduct their advisory fees, the insurance companies redeem the appropriate number of units of the separate account to pay such fees.

In addition, the insurance company typically sends Contract Owners quarterly account statements that identify the funds and securities in their accounts at the end of the period and all transactions in the account during that period, including payments of any advisory fees to Program Advisers. These statements permit Contract Owners to monitor the amount of payments to their Program Advisers and the allocation of their purchase payments and cash values in the separate account. Accordingly, these statements allow Contract Owners that have authorized fee deduction from their VA Contract values to determine if their Program Advisers have appropriately charged for their advisory services.

The separate account assets are more than adequately protected by provisions under: (1) state insurance law,[17] (2) the Company Act,[18] (3) the Securities Act of 1933, as amended (the "Securities Act"), (4) the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[19] and (5) the Sarbanes-Oxley Act ("Sarbanes-Oxley")[20] that, together, provide extensive protection to the assets of the separate account. Together, these statutes, and the regulations thereunder, provide a level of transparency, oversight, independent checks and balances, internal controls, and reporting that makes it unnecessary to disturb the status quo under the Custody Rule with respect to VA Contracts.

Given the unique structure underlying VA Contracts, the extensive regulation governing these securities, and the distinct nature of the advice offered by Program Advisers, the Committee believes that a Program Adviser is not in a position to misappropriate or misuse client assets that are provided to Contract Owners upon issuance of the contract. For these reasons, the Committee respectfully requests that in the adopting release for any final rulemaking related to the Proposed Rule, the SEC explicitly confirm that the current approach under the Custody Rule with respect to VA Contracts (as reflected in the American Skandia Letter) is preserved.

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[17] In addition to the separate account segregation requirements described above, the Committee notes that state insurance regulatory authorities are charged with overseeing insurance companies domiciled or operating in their states and regularly examine the operations and books and records of insurance company separate accounts to ensure they are in compliance with applicable state insurance laws. An insurance company issuing a contract is also required to file quarterly and annual reports regarding its financial condition, as well as annual reports on the financial condition of any separate accounts the company maintains in connection with VA Contracts.

[18] In addition to the separate account registration requirements under the Company Act discussed above, Item 23 of Form N-4 mandates that financial statements prepared in accordance with generally accepted accounting principles must be filed and audited. Moreover, independent auditors must provide their consent to include their audit opinion on audited financial statements in Form N-4 filings. And finally, pursuant to Rule 38a-1 under the Company Act, a separate account is required to adopt, implement and annually review written compliance policies and procedures reasonably designed to prevent violations of the federal securities laws, and must also designate a chief compliance officer to administer such policies and procedures.

[19] Although not directly discussed above, it should be noted that anti-fraud provisions under both the Securities Act and the Exchange Act impose liability in connection with a separate account registration statement. Together, these provisions effectively require a registration statement to be free of any material misstatements or omissions.

[20] Sarbanes-Oxley imposes a number of audit and other requirements on separate accounts, since such accounts are considered "issuers" under Sarbanes-Oxley and "audit clients" under Regulation S-X. The audit requirements further assure the safety and soundness of assets maintained in an insurance company's separate account.

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B. The American Skandia Letter Should be Updated to Reflect Intervening Developments since the Issuance of the American Skandia Letter

The American Skandia Letter was issued in the context of a Program Adviser who had Fee Deduction Custody and was unaffiliated with the issuing insurance company. In the eighteen years since the American Skandia Letter was issued, the SEC has not provided explicit guidance as to whether the American Skandia Letter applies to other common circumstances under which a Program Adviser has custody. For instance, in 2009, the SEC amended the Custody Rule to provide that an adviser is deemed to have custody "if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services [the adviser] provide[s] to clients" ("Related Person Custody").[21] The American Skandia Letter necessarily could not have addressed Related Person Custody, which was added to the Custody Rule over four years after the letter's issuance.

As a threshold matter, in the context of VA Programs, the Committee does not believe that Related Person Custody should trigger the various requirements of the Custody Rule because VA Programs do not involve "client assets" held "directly or indirectly" by either a Program Adviser or, if applicable, its affiliated insurance company, in connection with the adviser's advisory services. This argument is addressed in more detail in Section IV of this letter. Notwithstanding this threshold matter, it remains unclear whether an investment adviser that is affiliated with an insurance company issuing a VA Contract can rely on the American Skandia Letter and custody the VA Contract with its affiliated insurance company in lieu of a qualified custodian.

The Committee notes that if the SEC declines to extend the American Skandia Letter guidance to situations in which a Program Adviser is deemed to have Related Person Custody, it would be necessary for the SEC to set forth how Program Advisers can simultaneously comply with the Proposed Rule and state insurance law (under which the assets invested by an Account Owner in a VA Contract must remain in the separate account issued by the insurance company). In this respect, Section 4F of the Model Variable Annuity Regulation requires that the insurance company itself maintain the assets in the separate accounts to support its contractual obligations.[22] Accordingly, under state law, insurance companies are not able to transfer the assets in their separate accounts supporting variable annuity contracts to a third party, such as a qualified custodian. As a result, it is not clear how Program Advisers with Related Person Custody can comply with the Proposed Rule in the absence of the SEC's extension of the American Skandia Letter guidance to cover Related Person Custody. It is also worth noting that (i) the insurance company's legal ownership of underlying funds is reflected on the books and records of the transfer agents for such funds, (ii) the insurance company maintains books and records concerning the separate account assets it legally owns and the benefits owed to Contract Owners under the provisions in the annuity contracts, and (iii) pursuant to state insurance law, the Contract is provided to the Contract Owner upon issuance.

By way of further example, the Proposed Rule would expand the definition of custody to encompass "any arrangement (including, but not limited to . . . discretionary authority*)* under which [an] adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction" ("Discretionary Authority Custody").[23] The Proposed Rule

[21] Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968 (Dec. 30, 2009), 75 Fed. Reg. 1455 (Jan. 11, 2010). The SEC's release on this rulemaking is posted at https://www.govinfo.gov/content/pkg/FR-2010-01-11/pdf/2010-18.pdf.

[22] Section 4F of the Model Variable Annuity Regulation adopted by the National Association of Insurance Commissioners provides: "The [insurance] company shall maintain in each such separate account assets with a value at least equal to the reserves and other contractual liabilities with respect to the account, except as may otherwise be approved by the commissioner." The Model Variable Annuity Regulation can be found at https://content.naic.org/sites/default/files/inline-files/MDL-250_0.pdf.

[23] *See* Proposed Rule 223-1(d)(3)(ii). In addition, like the Custody Rule today, an adviser with a general power of attorney also would have custody under the Proposed Rule. *Id*.

would define "discretionary authority" as the "authority to decide which assets to purchase and sell for the client."[24] This proposed expansion of the custody definition would sweep in Program Advisers who do not have Fee Deduction Custody or Related Person Custody (or custody because they have a general power of attorney), but have discretion to determine how to allocate cash values among the investment options in a VA Contract.

With regard to meeting the goals of the Proposed Rule (the safeguarding of client assets), the Committee has not identified any meaningful distinction between a Program Adviser who has Fee Deduction Custody – for which an unaffiliated insurance company is explicitly permitted to serve in lieu of a qualified custodian under the American Skandia Letter guidance – and a Program Adviser that has Related Person Custody or, if adopted as proposed, Discretionary Authority Custody. In all circumstances, the client asset – the VA Contract – is held by the client and the separate account assets underlying the VA Contract are legally owned by the insurance company and are subject to extensive requirements and restrictions under state insurance laws and the federal securities laws.

Given the lack of distinction between these different forms of custody in the context of a VA Program, the Committee asks the SEC to update the guidance under the American Skandia Letter to reflect intervening developments since the issuance of the letter and explicitly extend such guidance to Related Person Custody and Discretionary Authority Custody (if the rule is adopted as proposed).

II. In the Alternative, the Proposed Rule Should be Amended to Provide an Exception Allowing Insurance Companies to Act in Lieu of a Qualified Custodian In Connection With Contracts

As an alternative to maintaining and expanding the no-action relief granted by the American Skandia Letter, the Committee requests that the SEC codify the American Skandia Letter guidance by adding an explicit exception to the Proposed Rule that allows Program Advisers to use an issuing insurance company in lieu of a qualified custodian in connection with Contracts. The Proposing Release acknowledges that "an insurance company serve[s] a particular role with respect to variable annuity contracts *similar to the role of a transfer agent with respect to mutual fund shares.*"[25] We note that the Proposed Rule would retain a long-standing exception, found in the current Custody Rule, for mutual fund transfer agents. More specifically, Paragraph (b)(1) of the Proposed Rule would provide that, "[w]ith respect to shares of an open-end company as defined in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1) ("mutual fund"), you may use the mutual fund's transfer agent in lieu of a qualified custodian . . . ."[26]

The similarity between an insurance company's role with respect to Contracts and a transfer agent's role with respect to mutual fund shares was the basis for the SEC staff's relief in the American Skandia Letter. A primary argument of American Skandia's request for relief was that an insurance company "acts like a mutual fund transfer agent with respect to the contract holders' variable annuity contracts and units of the separate accounts" and that, therefore, insurance companies "protect contract holders' funds and securities from misappropriation by . . . investment advisers . . . to the same extent as a mutual fund transfer agent."[27] The addition of an explicit exception for insurance companies in the Proposed Rule would be consistent with how the SEC treats mutual fund transfer agents.

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[24] *See* Proposed Rule 223-1(d)(4).

[25] 88 Fed. Reg. 14687 at FN 116 (emphasis added).

[26] *See* Proposed Rule 223-1(b)(1).

[27] *See* American Skandia Letter.

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The SEC staff's acknowledgment of the similarities between insurance companies and mutual fund transfer agents in the custody context necessitates consideration by the SEC as to why the two receive disparate treatment under the Proposed Rule – with insurance companies relying on limited no-action guidance from the staff and mutual fund transfer agents being granted a specific exception by the SEC in the Custody Rule. For these reasons, the Committee believes that it would be appropriate for the SEC to add an explicit exception, an example of which is provided below, for insurance companies in the Proposed Rule.

> (b) *Exceptions.*
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> …
>
> (*) *Insurance Policies or Contracts*. With respect to an insurance policy or contract issued by an "insurance company" as defined in section 2(a)(17) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(17)), you may use the issuing insurance company in lieu of a qualified custodian for purposes of complying with paragraph (a) of this section.

III. Application of the Proposed Rule's Written Agreement and Reasonable Assurances Requirements to Insurance Companies Would be Inconsistent with the American Skandia Letter and Create Significant Practical Difficulties

The Proposing Release asks whether insurance companies "would be able to agree to the contractual terms contained in the proposed written agreement requirement . . . [and/or] satisfy the reasonable assurance requirement . . . if an insurance company were holding client assets."[28] Below, the Committee addresses some of the practical difficulties of an insurance company complying with certain aspects of the written agreement and reasonable assurances requirements. However, as a threshold matter, based on a reading of the plain language of the Proposed Rule, the written agreement requirement and/or reasonable assurances requirement would not apply to an insurance company serving *in lieu of* a qualified custodian.

The Committee asks the SEC to affirm the Committee's understanding, based on the plain language of the Proposed Rule, that certain aspects of the Proposed Rule would not apply to insurance companies acting *in lieu of* a qualified custodian under the American Skandia Letter guidance. At least two aspects of the Proposed Rule, the "written agreement requirement" found in Section (a)(1)(i)[29] of the Proposed Rule and the "reasonable assurances requirement" found in Section (a)(1)(ii)[30] of the Proposed Rule, apply to custodial arrangements between an adviser and a "qualified custodian." Because the SEC staff concluded in the American Skandia Letter that VA Program assets do not need to be maintained with a qualified custodian (and, indeed, under state insurance law they may not be maintained with any person other than the issuing insurance company), but instead, can be held by the issuing insurance company, the Committee does not believe there is any support in the Proposed Rule text for applying the written agreement and reasonable assurances requirements to arrangements in which insurance companies act *in lieu of* a qualified custodian.

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[28] 88 Fed. Reg. 14687.

[29] Proposed Section (a)(1)(i) of the Proposed Rule would require, in part, "[a] qualified custodian [to] maintain possession or control of [the adviser's] client's assets pursuant to a written agreement between [the adviser] and the qualified custodian . . . ."

[30] Proposed Section (a)(1)(ii) of the Proposed Rule would require, in part, that an adviser "must obtain reasonable assurance in writing from the qualified custodian . . . ."

Further, applying these two sections to arrangements in which an insurance company is acting in lieu of a qualified custodian presents practical difficulties with regard to the requirement in Section (a)(1)(i)(C) of the Proposed Rule that the "qualified custodian . . . obtain, and provide to [the adviser] a written internal control report" with certain specified terms.[31] The mechanics and operation of variable annuities make many parts of the internal control report requirement incapable of being implemented with respect to these securities. For example, the internal control report must include the accountant's opinion as to whether the qualified custodian's controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of the client assets held by that qualified custodian during the year.[32] In the VA Program context, it is unclear which controls of the insurance company would apply since the insurance company (*not* the Contract Owner) legally owns and controls the assets. In fact, it is not clear what the "assets" are over which controls are to be examined post-issuance of the annuity contract. What are the "assets" that must be safeguarded?

The Committee requests that the SEC, in connection with its discussion of the continued applicability (and expansion of) the American Skandia Letter, affirm that arrangements in which insurance companies act *in lieu of* a qualified custodian are not subject to requirements in the Proposed Rule (such as the written agreement and reasonable assurances requirements) that are specifically limited to custodial arrangements between advisers and "qualified custodians." If the SEC disagrees with the Committee's position, the Committee requests that the SEC explain how an insurance company could comply with the internal control requirement, given the unique nature of Programs and Contracts.

IV. VA Programs Do Not Involve "Client Assets" Held "Directly or Indirectly" By the Program Adviser or an Affiliated Insurance Company.

The Proposing Release asks whether "insurance companies maintain 'possession or control' of client assets."[33] The Committee does not believe that VA Programs involve "client assets" held "directly or indirectly" by either a Program Adviser or, if applicable, its affiliated insurance company, in connection with the adviser's advisory services. Application of the Proposed Rule is predicated on an investment adviser having "custody" of "client assets." The Proposed Rule defines "custody" as an adviser, or its related person, "holding, directly or indirectly, client assets, or having any authority to obtain possession of them . . . in connection with advisory services [the adviser] provide[s] to clients."[34] In the context of a VA Program, the SEC staff in the American Skandia Letter identified the "variable annuity contract" as the client asset potentially triggering the application of the Custody Rule:

> Under the Custody Rule, Direct Fee Payment Arrangements would vest an investment adviser with custody of its clients' funds and securities. You are concerned that the Custody Rule would require an independent third-party custodian to maintain custody of the contract holder's funds and securities (***i.e., the variable annuity contract)*** *. . .* (emphasis added)

As noted above, the VA Contract is delivered to the Contract Owner upon issuance of the contract. Thus, the contract is clearly not held by the adviser or its affiliated (or unaffiliated) insurance company. Application of the Custody Rule in the American Skandia Letter context was, instead,

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[31] *See* Proposed Rule 223-1(a)(1)(i)(C).

[32] *Id.*

[33] 88 Fed. Reg. 14687.

[34] *See* Proposed Rule 223-1(d)(3).

triggered by the Program Adviser's ability to deduct fees from the Contract Owner's VA Contract value.

The Committee acknowledges that a VA Program involving one or more investment advisers that are affiliated with the issuing insurance company would implicate Related Person Custody *if* the issuing, affiliated insurance company "holds, directly or indirectly, client assets." However, as explained above, the issuing insurance company does *not* hold "client assets" for purposes of the Proposed Rule. Upon receiving a premium payment from a Contract Owner, the insurance company immediately purchases shares of underlying insurance funds to support its contractual promises relating to the benefits under the Contract tied to contract value. Under insurance law, the insurance company (not the Contract Owner) legally owns the assets of its separate accounts, including shares of the insurance funds purchased by the insurance company. This legal ownership is reflected on the books and records of both the insurance company and the fund transfer agent. Since the insurance company legally owns the underlying insurance fund shares, those shares are not "client assets" for purposes of the Proposed Rule.[35] Finally, an adviser with Related Person Custody and/or Discretionary Authority Custody (if the rule is adopted as proposed), but not Fee Deduction Custody or some other form of custody that provides access to client assets, such as a general power of attorney, does not have the ability to obtain its fees (or anything else) out of the annuity contract.

Because Contract Owners own and hold their VA Contracts and the insurance company legally owns the assets of the separate account (*i.e.*, the shares of the insurance funds), aside from instances of Fee Deduction Custody or some other form of custody that provides access to client assets, such as a general power of attorney, there are no "client assets" held directly or indirectly by either a Program Adviser or an insurance company within the meaning of the Proposed Rule. Based on the plain language of the Proposed Rule itself, read in conjunction with the guidance in the American Skandia Letter, the *only* time "custody" is implicated in the context of a VA Program is when and if the adviser has Fee Deduction Custody or some other form of custody that provides access to client assets, such as a general power of attorney.

The Committee also notes that from a public policy perspective, because the VA Contract itself specifies the manner in which the amount owed by the insurance company is calculated, the customer protection issues associated with most types of securities are not present with VA Contracts. The fact that the insurance company's obligation is established by the terms of a contract fundamentally differentiates these securities from almost all other securities. As noted, advisers without Fee Deduction Custody or some other form of custody that provides access to client assets, such as a general power of attorney, have no authority to reach into the assets supporting the VA Contracts and the insurance company contractually must meet the terms of the contract regardless of any malfeasance by insurance company or investment adviser personnel. We also note that contract "units" do not have any value to anyone except the Contract Owner. For instance, the units cannot be sold, transferred, negotiated, misappropriated or otherwise converted for personal use by the insurance company, the investment adviser or any other person; they exist for the sole purpose of calculating the variable benefits owed to the Contract Owner under the contract. Moreover, as noted, the VA Contract is required under state insurance law to be delivered to the Contract Owner upon issuance.

Accordingly, the Committee requests that the SEC provide guidance in the adopting release for any final rulemaking on the Proposed Rule that, in connection with VA Programs, and aside from instances of Fee Deduction Custody or some other form of custody that provides access to client assets, such as a general power of attorney, there is no "client asset" held "directly or

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[35] We also note that although the units issued in connection with allocation of purchase payments to subaccounts technically may be "securities" for certain purposes of the federal securities laws, in practice they serve as an accounting mechanism to measure the contractual payments owed by the insurance company to its contract holders. This is evidenced by the fact that the insurance company may make payments to Contract Owners from both its separate account and its general account.

indirectly" by the Program Adviser or an affiliated insurance company that would trigger the application of the Proposed Rule.

V. For Reasons Similar to Those Articulated Above, the SEC Should Extend any Relief or Exceptions Provided in Connection with VA Programs to Programs involving all Types of Contracts

The Committee believes that its comments in this letter apply equally, if not with greater force, to Programs involving non-VA insurance products that are not contemplated by the American Skandia Letter, such as Fixed Contracts, RILAs, and fixed-indexed contracts, among others (the "Non-VA Contracts"). The insurance industry has evolved since the 2005 issuance of the American Skandia Letter – with the growing prevalence of fee-based non-VA Contracts for which investment advisers provide various types of investment advice.

The backbone of the Committee's comments in this letter are the substantial protections that apply with regard to a Contract Owner's VA Contract and the separate accounts of the insurance company through which the Contract Owner's purchase payment is invested. Non-VA Contracts enjoy similarly robust protections that achieve a similar end – the safeguarding of client assets and the protection of those assets from being lost, misused, stolen, or misappropriated. Unlike VA Contracts, which are funded by separate accounts registered as investment companies under the 1940 Act, Non-VA Contracts do not pass through the investment performance of an insulated insurance company separate account funding the Contracts to Contract Owners. Instead, the contract values, benefits, and guarantees provided by these contracts are paid out of assets held in the insurance company's general account or a non-unitized separate account.[36]

Under state insurance laws, the assets held in an insurance company's general account and/or a non-unitized separate account are legally owned by the insurance company, and not Contract Owners. Therefore, there is no "client asset" held directly or indirectly by either a Program Adviser or the issuing insurance company. Similar to VA Contracts, an insurance company generally is required under state insurance law to send the Non-VA Contract to the Contract Owner upon issuance. Thus, the Contract Owner, rather than the Program Adviser or insurance company, maintains custody of the Non-VA Contract.

Accordingly, the Committee requests that the SEC extend any relief or exceptions provided in connection with VA Programs to Programs involving Non-VA Contracts. This request is particularly important in light of the Proposed Rule's expansion of the scope of assets required to be maintained with a qualified custodian, beyond the "client funds and securities" contemplated in the current Custody Rule to include, "funds, securities, or other positions held in a client's account."[37] The language "other positions held in a client's account" may bring within the scope of the Proposed Rule Non-VA Contracts, such as Fixed Contracts, that have traditionally not been subject to the Custody Rule. Given the Proposed Rule's expansive scope, the Committee believes that it is appropriate for the SEC to promote a consistent approach under the Proposed Rule for all insurance products.

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[36] State insurance law generally requires an issuing insurance company to establish a separate account to fund the RILA. Given that there is no direct pass-through of separate account performance in the case of a RILA (as there is with a variable annuity), the separate account used to support the RILA is a "non-unitized separate account" – meaning that the separate account does not issue "units" of interest. The contract values, benefits and guarantees provided by RILAs are paid out of assets held in the insurance company's non-unitized separate account and the benefits due to a RILA Contract Holder are not directly related to the value of the assets held in the non-unitized separate account.

[37] *See* Proposed Rule 223-1(d)(1).

VI. The SEC Incorrectly Equates Discretionary Authority with the Ability to Remove Client Assets from an Account and Direct them to a Third Party of the Adviser's Choosing.

The Proposed Rule would explicitly include discretionary authority to manage client accounts within the definition of custody (referred to above as Discretionary Authority Custody). In justifying this result, the SEC states "[w]hen an adviser has discretion to trade client assets, it has an arrangement in which it may instruct the adviser's custodian to dispose the client's assets."[38] This is an inaccurate statement. Discretionary trading authority does *not*, *by itself*, entail the legal authority to "dispose of the client's assets," a phrase the Committee reads to include an ability to remove the client's assets from the account they are in and direct them to a third party of the adviser's choosing. Discretionary trading authority carries with it no authority beyond the ability to place buy, sell, and exchange orders with a broker, dealer, market maker, issuer, etc. It does *not* also carry the ability to "dispose" (i.e., remove) the client's assets from the account in which they are maintained.[39]

The SEC continues that "[a]n adviser's ability or authority to effect a change in beneficial ownership of a client's assets, including for purposes of trading, could place client assets at risk of loss that the rule is designed to address."[40] The Committee does not disagree with this conclusion but notes that such authority is considerably beyond mere trading discretion. A grant of trading authority does not also come with authority to change beneficial ownership of a client's assets. When it adopted amendments to the Custody Rule in 2003, the SEC wrote,

> **An adviser's authority to issue instructions to a broker-dealer or [other] custodian to effect or settle trades does not constitute 'custody.'** Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This 'delivery versus payment' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.[41]

The bolded language was *and remains* correct. Authority to place trades to buy and sell securities does not come with authority to change beneficial ownership of an account or to remove client funds or securities from the account in which they are maintained. All it entails is the ability to have cash exchanged for securities and vice versa. It is incorrect to suggest that such limited authority entails additional powers that have not been granted by the client.[42]

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[38] 88 Fed. Reg. 14677.

[39] The same holds true with respect to the SEC's assertions in the Proposing Release that "we also believe that discretionary authority presents the types of risks the rule is designed to address. The adviser, for instance, could use its discretionary authority over a client's assets to instruct an issuer's transfer agent or administrator (e.g., the administrator for a loan syndicate) to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls, thereby depriving the client of ownership." Trading authority does *not* entail authority to direct cash proceeds to an account the adviser owns; such authority is not included in the authority to buy and sell securities; any adviser with authority to direct cash proceeds of a sale to an account that the adviser owns and controls has such authority due to a grant of authority that is *beyond* discretionary trading authority.

[40] 88 Fed. Reg. 14677.

[41] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 at n.10 (Sept. 25, 2003) ("2003 Adopting Release") (emphasis added).

[42] The Committee agrees with the SEC that where an adviser is authorized to instruct an issuer or a transfer agent that recorded ownership of a client's privately offered security to redeem the client's interest *and* direct

The amended custody definition "would include any arrangement (including, but not limited to, a general power of attorney or discretionary authority) under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction."[43] The flaw with this approach is that the SEC equates two things that are quite different. The grant of a general power of attorney *necessarily carries with it* authority and permission to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction, whereas a grant of trading authority (by itself) does not. As the SEC implicitly recognized in 2003, an adviser's authority to issue instructions to a broker-dealer or other party to effect or settle trades does not provide the adviser with access to a client's assets. Such an adviser has no ability to reach those assets, move them out of the client's accounts, or change the beneficial owner of the assets. The Committee asks the SEC to clarify that, by itself, trading discretion does not cause an adviser to have custody; to have custody an adviser also must have authority to dispose of client assets or change beneficial ownership of a client's account upon the adviser's instruction.

The SEC states in the Proposing Release that "[w]e believe it is important to extend the protections of the rule by explicitly including 'discretionary authority' within the definition of custody."[44] The proposed discretionary authority definition is consistent with the definition in Form ADV and would be defined as "the authority to decide which assets to purchase and sell for the client."[45] One shortcoming of the SEC's approach is that the SEC equates discretionary authority with trading authority and the two are not the same. The SEC's proposed definition of discretion does not reference trading authority and in many advisory programs an adviser with discretion to decide what securities to buy and sell does *not* have trading authority. In this respect, there are various types of advisory programs in the market today in which one adviser has discretion to decide what securities to buy and sell and a different, unaffiliated adviser is responsible for, among other things, placing trades for clients.

The Committee requests the SEC to more precisely define discretion to clarify that mere responsibility for deciding what securities to buy or sell for a client's account, without more, does not result in such an adviser having custody of client assets. In this respect, the authority to decide what securities to buy or sell for a client's account, by itself, has no *per se* relationship to having authority to trade for a client's account (let alone holding or having access to client assets).[46]

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the proceeds to a particular account, such an adviser has custody. Similarly, the Committee agrees that an adviser with authority to change beneficial ownership of an account or to remove client funds or securities from the account in which they are maintained and transmit them to an account owned by a third party also has custody under the Proposed Rule; the Committee's point is that such authority is beyond the authority granted by discretionary trading authority.

[43] 88 Fed. Reg. 14680.

[44] *Id*.

[45] *See* Proposed Rule 223-1(d)(4).

[46] In other words, the SEC defined discretion in such a way that it is divorced from the concerns animating the Proposed Rule; security selection is sometimes a discreet activity that is divorced from trading authority and an adviser with the former does *not* necessarily have the latter.

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CONCLUSION

The Committee appreciates the opportunity to provide these comments on the Proposed Rule. Please do not hesitate to contact Clifford Kirsch (212.389.5052 or CliffordKirsch@eversheds-sutherland.com), Michael Koffler (212.389.5014 or michaelkoffler@eversheds-sutherland.com), or Issa Hanna (212.389.5034 or issahanna@eversheds-sutherland.com) with any questions or to discuss this comment letter.

Respectfully submitted,

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FOR THE COMMITTEE OF ANNUITY INSURERS