Sutherland
Asbill &
Brennan LLP
ATTORNEYS AT LAW

1275 Pennsylvania Avenue, NW
Washington, DC 20004-2415
202.383.0100
fax 202.637.3593
www.sablaw.com

May 9, 2005

BY E-MAIL

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

Re: Additional Comments to Final Rule Regarding
Mutual Fund Redemption Fees (File No. S7-11-04)

Dear Mr. Katz:

This letter is submitted on behalf of the Committee of Annuity Insurers (the "Committee").[1] The Committee is pleased to have the opportunity to offer its comments in response to the request of the Securities and Exchange Commission (the "Commission") in Release No. IC-26782 (March 11, 2005) (the "Adopting Release") for additional comments on newly-adopted Rule 22c-2 (the "Rule") under the Investment Company Act of 1940, as amended (the "Investment Company Act").[2] The Rule permits open-end management investment companies, including series thereof (referred to as "funds"), to impose redemption fees in order to discourage 'market timing' and/or to recoup expenses incurred due to frequent trading activity.

The Committee supports the Commission's efforts to protect long-term investors in mutual funds ("funds") and variable annuities from abuses stemming from short-term or frequent trading activities. In addition, the Committee is very appreciative that in the Adopting Release, the Commission recognized that significant refinements may be necessary "to address the special circumstances of insurance company separate accounts." These comments are intended to assist the Commission in that important effort. As described below, the Committee believes that as applied to variable annuities, the Rule, as currently worded, may lead to the assessment of redemption fees on transactions within variable annuities that do not pose any risk of abusive trading or have any potential to harm other investors. Furthermore, the Committee also believes that the Rule as currently adopted creates significant administrative complexities and legal issues

[1] 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 approximately half of the annuity business in the United States.

[2] The Rule was initially proposed by the Commission in 2004. See Mandatory Redemption Fees for Redeemable Fund Securities, Release No. IC-26375A (Mar. 5, 2004) [69 FR 11762 (Mar. 11, 2004)] (hereinafter, the "Proposing Release").

WO 386415.4

for insurance companies issuing variable annuities.[3] The Committee appreciates this opportunity to provide its comments and recommendations to assist the Commission in refining the operation of the Rule through amendments with respect to variable annuities in areas that reflect the structural realities of variable annuities, yet maintain the spirit and purpose of the Rule.

I. Structure of Variable Annuities

As the Commission is aware, a variable annuity is a written contract between the insurance company that issues the variable annuity and the owner who purchases the contract.[4] Today, in most cases, 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 Investment Company Act, the separate account is required to register under the Investment Company Act. Generally, separate accounts are registered as unit investment trusts and are divided into subaccounts. The bottom tier of this two-tiered structure typically consists of a number of series mutual funds, and each subaccount corresponds to, and is invested exclusively in, a particular series, or portfolio, of one of the funds. In this manner, 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.[5]

For tax reasons,[6] the funds that are available through registered insurance company separate accounts can not be available directly to the public. Accordingly, mutual fund complexes have created separate funds, apart from their 'retail' funds, that are only available to insurance

---

[3] This comment letter does not address certain aspects of the proposed amendments that would apply to variable life insurance policies as well as variable annuity contracts. However, the issues and concerns, and recommendations, discussed herein apply equally to variable life insurance policies. Moreover, many of these same considerations apply in the context of participant-directed employee benefit or retirement programs. The fact that this comment letter focuses on variable annuities is in no way meant to imply that the matters addressed herein are not equally applicable in such other contexts.

[4] 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).

[5] 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.

[6] *See* Section 817(h) of the Internal Revenue Code.

company separate accounts (and certain qualified retirement plans); these specially dedicated funds are referred to as "insurance product funds."

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. Each subaccount, in turn, invests in the corresponding portfolio. However, the insurance company is the actual owner of fund shares, and the insurance company does not hold them in trust for the contract owners.[7]

Operationally, variable annuity owners do not actually engage in transactions in shares of the underlying portfolios; rather, contract owner transactions (and other elements of variable insurance products, such as periodic deductions of charges, payment of death benefits, etc.) take place in the form of purchases in or redemptions from the subaccounts. To account for amounts allocated to or withdrawn from a subaccount as a result of purchase payments, withdrawals and transfers, and other items, values in each subaccount generally are measured in terms of "accumulation units." Each subaccount has its own accumulation unit value, which is distinctly different from the net asset value per share of the underlying portfolio. On a daily basis, the insurance company aggregates all orders received from contract owners with respect to a particular subaccount, and transmits net purchase or redemption orders to the fund in which the subaccount is invested.

II. <u>Recommendations of the Committee</u>

In light of the two-tiered structure of variable annuities described above and the inherent differences between mutual funds and variable annuities, the Rule clearly should not apply to investors in variable insurance products in the same manner as it applies to investors in retail mutual funds. Applying the Rule in the same manner to both types of investments is not necessary to achieve the purposes of the Rule, and doing so would cause significant problems for issuers of variable annuities and would be contrary to the best interests of investors in variable annuities. The Commission should have the same interest in acting in the best interests of both direct investors in retail mutual funds and investors in variable annuities, which are also interests in registered investment companies.

Accordingly, the Committee respectfully makes the following suggestions and recommendations concerning the Rule as it would apply in the context of variable insurance products:

- With respect to variable insurance products, the Rule should be amended to limit the assessment of redemption fees solely to transfers between subaccounts, and to

---

[7] *See* Rule 26a-2(a) under the Investment Company Act.

provide that redemption fees cannot be assessed on other transactions within variable annuities that are not susceptible to being used for market timing purposes;

- In general, an amendment should be adopted to limit redemption fees to investor initiated transactions;
- The Rule should provide for uniform redemption fee elements and implementation methods, at least with respect to the applicability of redemption fees to variable insurance products;
- The Commission should more specifically and more broadly address conflicts arising between application of the Rule and the provisions of variable annuity contracts and state insurance law; and
- To reflect the significant administrative complexities and corresponding modifications that insurance companies will need to make to existing systems and procedures, or the development or purchase of new systems, to comply with the Rule, the Committee respectfully requests that the Rule's compliance date with respect to insurance product funds be extended.

A discussion of each of the aforementioned recommendations follows below.

A. Limitation of Redemption Fee to Transfers Between Subaccounts

The Committee recommends that the Commission adopt amendments to the Rule that would (1) limit the assessment of any redemption fee in connection with variable insurance products to transfers between subaccounts (also referred to as exchanges), and (2) prohibit the assessment of redemption fees on those variable insurance product transactions and operations that pose no danger of involving market timing. Currently, operation of the Rule would result in the assessment of redemption fees with respect to any transaction or operation within a variable annuity that resulted in a redemption of shares of a fund that has adopted a redemption fee, regardless of whether the transaction or operation is susceptible to market timing or other abusive trading practices.

As the Commission correctly observed in the Adopting Release, actual withdrawals from variable insurance products are not the types of transactions that are likely to be part of a rapid trading strategy. This is because actual withdrawals (full or partial) may involve consequences that could be significant, including the imposition of surrender charges and possible tax penalties. The Adopting Release states:

> We also envision that the [R]ule would not permit the assessment of redemption fees on the redemption, pursuant to partial or full contract withdrawals, of shares issued by an insurance company separate account organized as a unit investment trust that is registered under the [Investment Company Act]. These types of redemptions are unlikely to occur as part of a market timing or rapid trading strategy, and will permit contract holders to exercise a "free look" provision of their contracts without paying a redemption fee.[8]

We certainly agree that purchasers of variable annuities should not be penalized by underlying fund redemption fees merely because they exercise their *right,* mandated by state insurance law, to be able to return the contract after they have had an opportunity to read and consider it carefully (referred to as a "free look" right). Allowing insurance product funds to impose redemption fees in such circumstances would be inconsistent with those state insurance law requirements. Given the uncertain nature of the Commission's statement quoted above to the effect that it "envisions" that the Rule would not permit redemption fees on withdrawals from variable insurance products, we respectfully request that the Commission clarify this language by stating unequivocally that the Rule (even in its current form) does not permit the imposition of redemption fees on partial or full withdrawals from variable annuity (and life insurance) contracts.

In addition to withdrawals, however, there are numerous other transactions that take place in variable annuities that are clearly not susceptible to a rapid trading strategy, yet the Rule as currently in effect would allow *funds* to impose redemption fees on such innocent transactions. In addition to "free looks" and other withdrawals (including systematic withdrawals), these types of transactions include the following:[9]

- Periodic deduction of charges;
- Automatic rebalancing;
- Dollar cost averaging;
- Payment of death benefits;
- Annuity payouts;

---

8 Adopting Release, p. 29.

9 We applaud the Commission for correctly recognizing a number of these in the adopting release, such as contract withdrawals, deductions of periodic charges, systematic withdrawal plans, and periodic rebalancings.

- Full and partial exchanges conducted under Section 1035 of the Internal Revenue Code of 1986, as amended;
- Policy loans; and
- Exercise of guaranteed minimum withdrawal benefits.

For example, an investor might have held a variable annuity for years, not engaging in any transactions (the typical "buy and hold") investor, and then pay an additional premium shortly[10] before the insurance company deducts a periodic charge; under the Rule as it currently exists, a fund could impose a redemption fee on the company's deduction of the periodic charge. Similarly, in many cases a variable annuity is purchased through regular and "automatic" premiums via payroll deduction or automatic drafts against bank accounts, and in such cases there would almost always be a premium payment shortly before a periodic deduction of charges. In addition, investors making regular, periodic investments should not be penalized because they make a one-time withdrawal for a mortgage down payment, or to pay college tuition, or for unusual medical bills, etc.

Moreover, it is important to be cognizant of the fact that the Rule applies, as it should, in situations where there are two separate transactions – a "purchase" into the investment company, followed by a "redemption" out of the investment company. In the context of variable annuities, this means a "purchase" into a particular subaccount, followed by a "redemption" out of that subaccount. As a practical matter, market timing (or other abusive short-term trading) can only be done when both the purchase and redemption are transfers. For example, an annuity contract owner could be making automatic monthly premium payments (*e.g.,* through automatic bank account drafts) and decide to make a transfer. Even if that is the only transfer that the contract owner makes for years, a fund could impose a redemption fee because the transfer takes place within the stated time period of the automatic premium.[11] Therefore, in the context of variable insurance products, the Rule must provide that redemption fees can only be imposed when both the purchase side (beginning the holding period) and the redemption side are owner initiated transfers. Otherwise, there could be many instances where innocent, long-term and non-timing investors in variable insurance products would be unfairly penalized by redemption fees.

---

[10] Actually, it would not have to be "shortly" before a periodic deduction for charges, because there is no limit on the length of time during which a fund could impose a redemption fee.

[11] If, for example, the holding period was 30 days, then a contract owner making regular monthly premium payments could never make a transfer without being penalized by a redemption fee, unless the Rule provides that a redemption fee can not be imposed unless both the purchase (beginning the holding period) and the redemption are investor initiated transfers.

The aforementioned transactions and operations do not involve, and are not susceptible to being used for, market timing or other abusive short-term trading purposes. These transactions and operations typically involve one-time events or are scheduled to occur on an automatic and systematic basis outside the discretion of the owner. In addition, they may be subject to annuity contract fees, expenses, tax penalties, and other consequences.

It might be difficult to clearly define all of the various transactions and operations in variable insurance products that are not susceptible to or appropriate for market timing or other rapid trading strategies, and that do not have the effect of diluting the interest of other investors. Fortunately, there is no need to do so, since transfers between subaccounts are really the only transactions in variable insurance products that can be abused by certain investors to the detriment of others.

Therefore, for the reasons stated above, the Committee strongly urges the Commission to amend the Rule to require – as a mandatory limitation - that with respect to variable insurance products, redemption fees can only be imposed on transfers between subaccounts and cannot be imposed in connection with other transactions and operations such as those identified above.[12] Allowing funds to impose redemption fees on those other transactions and operations, regardless of whether the transaction has anything to do with, or is even susceptible of being used with, market timing or rapid trading strategies is clearly contrary to the best interests, and protections, of innocent investors.

B. Limit to Investor Initiated Transactions

The Commission stated in the Adopting Release that it is considering whether the Rule should require that any redemption fee assessed by a fund be limited to circumstances in which the transaction giving rise to the assessment was initiated by the investor. For example, the Commission indicated that it received comments supporting an exemption for transactions executed pursuant to prearranged instructions, such as periodic contributions, periodic rebalancings, or other "involuntary transactions," and the Commission specifically noted that such transactions "appear to pose little or no short-term trading risk."[13] Although the Adopting

[12] This would be consistent with the current "market timing" disclosure requirements applicable to variable annuities. Those requirements are, among other things, to disclose whether the separate account or the insurance company has policies and procedures "with respect to frequent ***transfers*** of contract value among sub-accounts" (Form N-4, Item 7(e)(ii), emphasis added). There is no requirement, nor should there be, to disclose any such policies and procedures with respect to any other transactions or operations.

[13] See Adopting Release at n. 74. The Commission should make it clear, as the Adopting Release indicates, that "automatic" transactions, such as periodic rebalancing, automatic premium payments (via payroll deduction or bank account drafts), systematic withdrawals (including, for example, withdrawals pursuant to guaranteed minimum withdrawal benefit options), annuity payouts, etc. are not 'investor initiated.' Although the investor did, of course,

Release's discussion regarding an investor-initiated transaction limitation focused for the most part on transactions within retirement plans, such transactions and operations are similar to the variable annuity transactions and operations noted above that are automatic and do not pose any risk of market timing or other short-term trading abuse.

Accordingly, the Committee recommends that the Commission adopt amendments to the Rule that would limit the assessment of redemption fees solely to circumstances in which the specific transactions giving rise to the assessment (both the purchase side and subsequent withdrawal) were initiated by the investor,[14] and to provide – as a mandatory limitation – that redemption fees cannot be imposed on reinvested dividends or other distributions, or on shares purchased or redeemed pursuant to a prearranged contract, prearranged or standing instructions, or similar plans.[15]

In the context of variable annuities, transactions that are not investor initiated are easily identifiable, since they occur without a specific 'trade order' from the contract owner for the particular transaction.

---

initiate the automatic or systematic plan or program, the investor does not initiate each individual withdrawal transaction.

[14] The Committee would point out that an owner of a variable insurance product can acquire accumulation units in a subaccount in several ways. Obviously an owner can acquire accumulation units through a direct allocation of premium payments to the subaccount. In addition, an owner can acquire accumulation units by transferring contract value allocated to a different subaccount to such subaccount. Each of these transactions may be conducted via investor initiated transactions or by one of the automatic transactions described above. However, the Committee recommends that the Commission adopt amendments to the Rule that would limit the assessment of redemption fees solely to instances in which a contract owner acquired accumulation units through an investor initiated transaction, and subsequently redeemed the accumulation units through an investor initiated transaction. Such an amendment would maintain the spirit of the Rule while preventing it from being applied in circumstances that do not pose any risk of market timing or other short-term trading abuse.

[15] This would include portfolio rebalancing, systematic periodic withdrawals, etc., and provide the same type of protections to non-market timing investors in retail mutual funds as are recommended above in the context of variable annuity contract owners. This limitation should also apply to redemptions arising from transactions completely outside the control of contract owners, such as redemptions of shares of a fund underlying a variable insurance product due to a substitution or merger of such fund. Furthermore, at least with respect to variable insurance products, the Committee respectfully requests that the Commission make it clear that in the context of a fund of funds, a redemption fee can only be imposed on *investor* initiated transactions (*i.e.,* contract owner transactions), and that a bottom-level fund cannot impose redemption fees on transactions by the fund of funds. It is not clear whether the Rule as currently in effect achieves this result. Although the definition of "shareholder" in subsection (c)(4) does exclude a fund investing pursuant to section 12(d)(1)(G) of the Investment Company Act, we note that the term "shareholder" does not appear in subsection (a)(1) of the Rule (it is only used in subsection (a)(2)). Subsection (a)(1) is the 'redemption fee' provision, while subsection (a)(2) is the 'shareholder information' provision.

C. Uniformity of Fee Elements

1. Need for Uniformity

Under the Rule, a unit investment trust separate account[16] is deemed to be a "financial intermediary," and is thereby required to enter into a written agreement with the fund (or its principal underwriter) whereby the separate account agrees to (1) provide promptly upon request the Taxpayer Identification Number and specific transaction data for all variable annuity contract owners, and (2) execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by any owner who has been identified as having violated the fund's trading policy.[17]

As noted above, today a typical variable annuity contract offers a large (and growing) number of portfolio choices from a substantial number of different mutual fund complexes. Allowing different redemption fees with different elements in the same variable annuity would lead to significant disclosure problems for insurers, and, more importantly, is very likely to be bewilderingly confusing to purchasers of variable annuities. Without uniform standards, an investor in a given variable annuity product could be faced with a dizzying array of 8, 10, or 12 different redemption fees (imposed by different mutual fund groups) that could vary in amount, holding period, accounting methods, applicability, etc. Even a sophisticated, intelligent investor, who is not market timing, could easily get surprised with an unexpected redemption fee.

In addition, unless uniform standards and elements for redemption fees are adopted, insurance companies may be required to implement dozens of different redemption fees in a single variable annuity product, with different percentage amounts, holding periods, accounting methods, and exceptions and limitations. This would exponentially multiply the difficulties and expenses that insurers will face even in implementing a single redemption fee. As recognized by the Commission, insurance companies will have to make significant and costly changes to their existing administrative systems and procedures. Systems and procedures would need to be modified to monitor, identify and track transactions in subaccounts that would lead to the assessment of redemption fees. Without uniform standards, such systems and modifications would be required to account for any differences in the redemption fee policies of the various underlying funds in which the contract is invested.

---

[16] As we understand it, this includes both registered and unregistered separate accounts, such as accounts relying on the exemptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

[17] As noted above, variable annuity contract owners do not purchase or exchange fund shares - they are not fund shareholders. Rather, their transactions take place at the separate account level in the form of accumulation units.

Lack of uniformity is likely to lead insurance companies to eliminate a number of investment choices from variable insurance products, which is hardly in the best interests of investors in those products.

In light of these issues, the Committee recommends that the Rule be amended to adopt uniform standards, at least with respect to the applicability of redemption fees to variable insurance products. Specifically, the Committee recommends that the Commission amend the rule to provide for uniform standards with respect to the amount of the redemption fee and the holding period in the context of variable insurance products.[18] In addition, and as discussed in more detail below, the Committee recommends that the Commission amend the Rule to provide for uniform standards with respect to the fee assessment method, share accounting method, and de minimis exception.

Uniform standards would serve to reduce the considerable administrative complexities facing insurance companies issuing variable annuities under the Rule, as well as reduce the significant costs insurance companies will incur in modifying their administrative systems and procedures to ensure compliance with the Rule. More importantly, uniformity would ease disclosure issues and help limit, if not eliminate, investor confusion. In this regard, the Committee believes that uniformity itself is critical, and much more important than the specific elements of that uniformity.

2. Fee Assessment Method.

As discussed in the Proposing Release and Adopting Release, the Commission has proposed allowing funds and financial intermediaries to utilize three methods of assuring that appropriate redemption fees are imposed.

Under the first method, the intermediary would transmit to the fund (or its transfer agent), upon submission of each purchase and redemption order, the account numbers used by the intermediary to identify the investors. This method would require an insurance company to transmit to the fund on a daily basis with respect to each contract owner the account number and the dollar amount of the owner's purchase or redemption (or transfer) transaction. This information would enable the fund to match the current transaction with previous transactions by the same account and assess the redemption fee when it is applicable.[19]

---

18 In the context of applying the Rule to variable insurance products, the Committee recommends that the amount of a redemption fee be set at a uniform 2%. With respect to the holding period, the Committee cautions that a period that is longer than necessary to combat market timing (and other abusive short-term trading) undermines the fundamental concept of redeemability.

19 Consistent with the discussion in Section A above, if this method is utilized (either by choice or because it is mandated by the Rule), then for variable insurance products, information need only be supplied with respect to

Under the second method, the intermediary would transmit to the fund, as to redemption orders upon which the redemption fee would apply, transaction and holding information sufficient to permit the fund to assess the amount of the redemption fee. In effect, an insurance company would identify redemptions that trigger the application of the redemption fee and provide related information to the fund. This second method would require substantially less data transmission to the fund than the first method.

Under the third method, the financial intermediary, pursuant to an agreement with the fund, would be obligated to deduct the redemption fee as an administrative service on behalf of the fund and remit the proceeds to the fund.[20] This method would alleviate the burden on an insurance company of transmitting contract owner account and transactional information to the funds on a transaction-by-transaction basis. Although under this method an insurance company would administer the fee on behalf of the fund, it would still be entirely up to the fund (specifically, its board of directors) to decide whether to adopt a redemption fee, and what the elements of that fee would be (amount, holding period, exceptions, etc.) to the extent not mandated by rule.[21]

The Committee believes that the Commission should mandate a single method. The Committee also believes that it should be the third method. There does not appear to be a viable method for underlying funds to deduct the fee from an individual contract owner's account, which is where the deduction must take place. As a practical matter, only the issuing insurance company can deduct the fee from a specified contract; the fund can only deduct the fee from the insurer's omnibus account, which could result in the fee being spread among and borne by all investors in the applicable subaccount. Accordingly, the Committee believes that the Commission should mandate the third method.

---

investor initiated transactions that begin a holding period and transfers between subaccounts. Similarly, consistent with Section B above, under this method information would only need to be supplied with respect to investor initiated transactions. Amendments to the Rule or the attendant Commission release should make this clear.

[20] Many insurance companies currently have administrative service agreements with underlying funds, whereby the insurance company provides certain "shareholder" level services to contract owners on behalf of the fund.

[21] Even under this method, the insurance company does not have the power to decide whether or not a redemption fee should be imposed. However, in describing the third method, the Adopting Release uses language that mischaracterizes the intermediary's role. The Adopting Release states that the agreement with the fund would require the intermediary "to impose the redemption fee." (Adopting Release, text at n. 86). This language is absolutely inconsistent with the Commission's position that the application of Rule 22c-2 does not present conflicts with the terms of outstanding annuity contracts or state insurance law. In footnote 62 to the Adopting Release, the Commission states: "The redemption fee would be imposed by the *fund* rather than pursuant to a contract issued by the insurance company." (Emphasis in original, citing *Miller v. Nationwide Life Ins. Co.*, 391 F.3d 698 (5th Cir. 2004). It is imperative that the Commission clarify that even under the third assessment method, it is the fund, and not the insurance company, that imposes the redemption fee.

In the alternative, if the Commission ultimately decides to permit all three fee assessment methods, the Committee believes that in the context of variable insurance products, the insurance company should be the entity that determines which method is utilized. Permitting insurance products funds to specify the method used will result in insurance companies facing considerable complexities if the funds underlying the variable annuities select different methods. On the other hand, allowing the insurance companies to determine the method utilized would promote greater uniformity in the enforcement of redemption fees under the Rule.

3. Share Accounting Method.

The Committee also recommends that the Rule be amended to require that funds utilize a uniform share accounting method in determining the assessment of redemption fees. Adopting a uniform share accounting method would considerably reduce any administrative complexities, thereby promoting greater uniformity in the enforcement of redemption fees under the Rule, as well as reduce the related costs.[22]

4. De Minimis Waiver.

The Committee recommends that the Commission amend the Rule to provide for a de minimis waiver of the redemption fee with respect to smaller transactions. As the Commission noted in the Adopting Release, a de minimis waiver would help serve to prevent the assessment of redemption fees where they are not appropriate.

The Committee also recommends that the Rule be amended to provide that the de minimis waiver be made uniform and mandatory in the context of all funds, or in the alternative, at least with respect to variable insurance products. Making the de minimis waiver uniform and mandatory would simplify disclosure issues and reduce investor confusion regarding the waiver's applicability with respect to variable insurance products. Such an amendment would also serve to reduce the administrative complexities faced, and costs to modify administrative systems and procedures incurred, by insurance companies under the Rule.

In addition, the Committee recommends that the Rule be amended to provide for a de minimis waiver provision that is tied to a uniform redemption amount, rather than the amount of the redemption fee. A de minimis waiver tied to a uniform transaction amount would reduce the costs associated with insurance companies and other intermediaries being forced to accommodate funds assessing various levels of redemption fees (especially if the Rule is not amended to

---

[22] Determining the amount of any redemption fee by using the "first in, first out" ("FIFO") method of accounting has the advantage of helping to avoid the inadvertent (and unnecessary and harmful) imposition of a redemption fee on purely innocent transactions that have nothing to do with market timing ((*e.g*, periodic deductions of charges, automatic rebalancings, etc.).

provide for a uniform fee). In this regard, the Committee recommends that the transaction limit be set at $10,000. Such a limit would prevent the application of the Rule to smaller investors who redeem their fund shares shortly after purchase due to unanticipated personal financial circumstances, while still protecting funds and other investors from market timing and other trading abuses.

D. Contract Provisions and State Insurance Laws

Application of the Rule in the context of variable annuities also raises significant legal issues with respect to (a) the contractual terms of variable annuity policies, and (b) state insurance law.[23]

Owners of variable annuities enter into legally binding contracts with issuing insurance companies, and these contracts specify the rights and responsibilities of each of the parties, including maximum or guaranteed charges as well as contract owner ***rights*** to make transfers among subaccounts. Neither party to a legally binding contract can change that contract without the consent and agreement of the other party. If an insurance company executes instructions from the fund that restrict or prohibit further purchases or exchanges *among subaccounts* by a contract owner, as the Rule in effect requires, experience shows that contract owners will sue insurance companies for breach of contract.[24] Specifically, many contracts provide that owners have the right to make unlimited transfers, and often such contracts permit such transfers to be made without charge, or with a specific limit on any charge (a common provision is a limit of $25, and a restriction that even that fee can only be imposed after a certain number of free transfers in any year). As a result, insurance companies issuing variable annuities will be subject to substantial litigation risk by restricting transfers in existing contracts, in accordance with the Rule, despite the terms of the contract.

Similarly, variable annuity contracts specify, as terms of the contract, what fees and charges can be imposed by the insurance company. Again, contract owners have sued for imposing

---

[23] Retail fund shareholders do not have *contracts* with the fund, and state insurance law policy form approval and other requirements do not apply to retail funds.

[24] Numerous lawsuits alleging breach of contract have been filed by market timers *See, e.g , Prusky v. Reliastar,*2005 WL 226148 (E.D. Pa. 2005); *Prusky Aetna Life Ins. And Annuity Co.,* 2004 U.S. Dist. LEXIS 21597 (E.D. Pa. 2004); *American National Bank and Trust Co. of Chicago v. Allmerica Financial Life Ins. And Annuity Co.,* 2003 U.S. Dist. LEXIS 6706 (N.D. Ill. 2003); *Prusky v. Phoenix Life Ins. Co.,* 2003 U.S. Dist. LEXIS 4054 (2003); *First Lincoln Holdings v. Equitable Life Assurance Society of the United States,* 43 Fed. Appx. 462, 2002 U.S. App. LEXIS 18004 (2nd Cir. 2002); *American National Bank and Trust Co. of Chicago v. AXA Client Solutions, LLC,* 2001 WL 743399 (N.D. Ill. 2001); *Windsor Securities Inc. v. Hartford Life Ins. Co.* 986 F. 2nd 655 (3rd Cir. 1993). In addition, in a number of instances actual or threatened lawsuits have been settled without litigation, but at not insubstantial costs to insurance companies. There is no reason to believe that the Rule will preclude such lawsuits and claims in the future.

redemption fees,[25] and are likely to sue in the future if redemption fees are imposed where the annuity contract does not expressly provide for them. We expect such lawsuits to be against the insurance company, rather than against the underlying fund that imposes the redemption fee.[26]

We are, of course, aware that in footnote 62 to the Adopting Release, the Commission stated that:

> Nor do we believe, as several commentators suggested, that the application of [the Rule] will present an insuperable conflict with state insurance laws when a redemption fee is imposed on transactions by holders of existing variable annuity or variable life insurance contracts. The redemption fee would be imposed by the *fund* rather than pursuant to a contract issued by the insurance company.[27]

However, we respectfully point out that in making that statement, the Commission relied on a single court decision. Moreover, the Court of Appeals did not address the redemption fee issue; it affirmed the district court on other grounds. We respectfully submit that a single decision by one district court is hardly a sound basis for subjecting insurance companies to such significant litigation risks across the nation. Therefore, we respectfully request and recommend that the Commission do whatever it can to help alleviate the very serious problems, described above, that the Rule creates for issuers of variable annuities

Accordingly, in light of the very serious litigation risks that the Rule creates for issuers of variable insurance products, the Committee respectfully requests and recommends that the Commission clearly and affirmative state that, in its view, public policy in general, and specifically the policies and purposes of the federal securities laws, clearly support, if not compel, interpreting variable annuity contracts <u>and</u> state insurance laws (a) as permitting redemption fees in accordance with the Rule, and (b) as permitting restrictions and prohibitions on transfers by variable annuity contract owners. Such interpretations are, we submit, necessary for the protection of long-term investors in variable annuities.

The Committee agrees with the Commission that redemption fees assessed pursuant to the Rule should be deemed to be assessed by the underlying fund rather than the insurance company. On similar policy reasons, the Committee believes that if an insurance company restricts transfers within a contact owned by an owner identified by the fund as violating the fund's trading policies pursuant to instructions received by an underlying fund, such restrictions should be deemed as

---

[25] *See Miller v. Nationwide Life Ins. Co.,* 391 F.3d 698 (5th Cir. 2004).

[26] As noted above, owners of variable annuity contracts are ***not*** shareholders of the underlying funds, and do not have privity of contract with the funds. Accordingly, variable annuity contract owners may not have any ability to sue the underlying funds.

[27] Citing *Miller v. Nationwide Life Ins. Co.,* 391 F.3d 698 (5th Cir. 2004).

imposed by the fund and not by the insurance company.[28] In this regard, the Committee respectfully requests that the Commission explicitly set forth its position that under the Rule, any redemption fees and transfer or purchase restrictions would be imposed by the underlying fund, and any such fees or trading restrictions are merely administered by the insurance company on behalf of the fund. We believe that this should be made clear in amendments to the Rule itself as well as in any release by the Commission adopting amendments to the Rule.

Finally, we respectfully request that the Commission explicitly state its intention (indicated by footnote 62 of the Adopting Release) that the Rule, and interpretations thereof, should apply in the context of existing variable annuity contracts (*i.e.,* "in force" contracts).

E. Extension of Compliance Date For Insurance Products Funds

As discussed above, under the Rule, insurance companies will be required to enter into written agreements with funds (or their principal underwriters) to provide variable annuity owner and transaction data as well as execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by any owner who has been identified as having violated the fund's trading policy. Many insurance companies will be required to enter into dozens of such written agreements, as well as renegotiate and amend participation agreements and other contracts with underlying funds. Furthermore, as described above and noted by the Commission, insurance companies will be required to make significant and costly changes to their existing administrative systems and procedures, and/or develop or purchase new systems.

Finally, as noted above, insurance companies will in many cases be required to prepare new policy forms and file the new forms (and contract amendments) with state insurance departments to reflect the ability to deduct redemption fees and restrict or prohibit transfers. In many states, new policy forms and amendments cannot be used until a considerable, and indefinite, period of time following filing (*e.g.,* until the state insurance department gives its approval) that is beyond the control of the insurance company.

To account for the considerable time it would take insurance companies to address these issues, the Committee respectfully requests that the compliance date for the Rule with respect to insurance products funds be extended to at least two years after adoption of amendments to the Rule. This extension would give issuers of variable annuities the necessary additional time to enter into written agreements with fund complexes, make required modifications to existing

---

[28] See footnote 21 above.

administrative systems and procedures and make any necessary filings with state insurance departments to ensure that they are in compliance with the Rule.[29]

F. **Board of Director's Considerations**

Finally, the Rule requires the Boards of Directors of all mutual funds, including insurance products funds, to make an affirmative decision as to whether to impose redemption fees. In the context of insurance products funds, we also note that the registration statement forms for variable insurance products require that the product's prospectus disclose whether the insurer has policies and procedures with respect to frequent transfers among subaccounts (*i.e.,* market timing policies and procedures). The Committee believes that it would be entirely appropriate for the Board of Directors of an insurance products fund to determine that it is not necessary or not appropriate for that fund to impose a redemption fee on the basis that the participating insurance companies have themselves adopted appropriate policies and procedures to protect investors from frequent trading.[30] We respectfully request that the Commission include a statement to that effect in a release adopting amendments to the Rule.

* * *

The Committee appreciates the time and resources that the Commission and its staff have devoted to rulemaking initiatives aimed at protecting investors from market timing and other trading abuses. The Committee also appreciates your careful consideration of our comments and recommendations set forth herein.

---

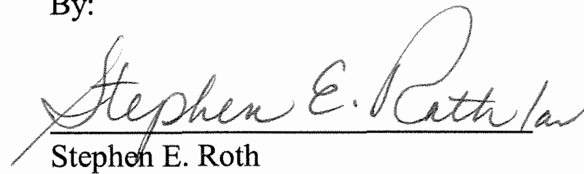
[29] We note, with appreciation, that the Adopting Release does indicate that the compliance date may be extended if the Rule is amended in response to comments. *See* Adopting Release, n. 91.

[30] Of course, such a determination would depend on an appropriate review and evaluation of the insurance companies' policies and procedures, and could be reversed or changed by the fund's board at any time.

Respectfully submitted,

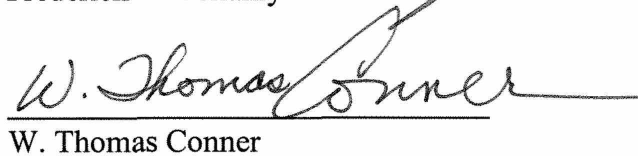
SUTHERLAND ASBILL & BRENNAN LLP

By:



Stephen E. Roth

Frederick R. Bellamy



W. Thomas Conner

FOR THE COMMITTEE OF ANNUITY INSURERS

cc: Committee of Annuity Insurers
Meyer Eisenberg, Esq., Acting Director, Division of Investment Management
Robert E. Plaze, Esq., Associate Director, Division of Investment Management
Susan Nash, Esq., Associate Director, Division of Investment Management
William C. Kotapish, Esq., Assistant Director, Division of Investment Management

SUTHERLAND ASBILL & BRENNAL LLP

2005
THE COMMITTEE OF ANNUITY INSURERS
MEMBER LIST

Allmerica Financial Company
Allstate Financial
American International Group, Inc.
AmerUs Annuity Group Co.
AXA Equitable Life Insurance Company
F & G Life Insurance
Fidelity Investments Life Insurance Company
Genworth Financial
Great American Life Insurance Co.
Guardian Insurance & Annuity Co., Inc.
Hartford Life Insurance Company
ING North America Insurance Corporation
Jackson National Life Insurance Company
John Hancock Life Insurance Company
Life Insurance Company of the Southwest
Lincoln Financial Group
Merrill Lynch Life Insurance Company
Metropolitan Life Insurance Company
Nationwide Life Insurance Companies
New York Life Insurance Company
Northwestern Mutual Life Insurance Company
Ohio National Financial Services
Pacific Life Insurance Company
The Phoenix Life Insurance Company
Protective Life Insurance Company
Prudential Insurance Company of America
Sun Life of Canada
Travelers Insurance Companies
USAA Life Insurance Company