NAVA
NATIONAL ASSOCIATION FOR VARIABLE ANNUITIES

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

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OFFICE OF THE SECRETARY

RE: File No. S7-27-03

Dear Mr. Katz:

On December 11, 2003, the Securities and Exchange Commission (the "Commission") proposed amendments to Rule 22c-1 under the Investment Company Act of 1940 (the "1940 Act") regarding the pricing of redeemable securities issued by registered investment companies ("funds").[1] This letter of comment on the proposed amendments is respectfully submitted by the National Association for Variable Annuities ("NAVA").[2]

The proposed amendments to Rule 22c-1 would require that all purchase and redemption orders be received by (i) the fund itself; (ii) the fund's designated transfer agent; or (iii) a clearing agency registered with the Commission, no later than the time the fund prices its securities (*e.g.*, 4:00 p.m., Eastern Time) in order to obtain the current day's price.[3] Several exceptions are also proposed, including an exception for "conduit" funds, which the proposing release notes invests all their assets in another fund and therefore must calculate their NAV on the basis of the other fund's NAV.[4]

NAVA and its members support the Commission's efforts to protect fund investors and to combat late trading abuses that have reportedly occurred at some mutual fund companies and brokerage firms. These abuses are indefensible, represent a betrayal of the trust of investors and deserve aggressive enforcement of existing federal securities laws.

We appreciate the opportunity to offer the following comments on the proposed amendments in so far as they would apply to insurance company separate accounts.

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[1] Release No. IC-26288 (December 11, 2003) (the "proposing release"). Throughout this comment letter, proposing release page number references are to the proposing release as issued by the Commission and as posted to its website.
[2] NAVA is a not-for-profit organization dedicated to the growth and understanding of annuity and variable life insurance products. NAVA represents all segments of the annuity and variable life industry with over 350 member organizations, including insurance companies, banks, investment management firms, distribution firms, and industry service providers.
[3] <u>See</u> proposing release at page 19.
[4] <u>See</u> proposing release at 7.

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Transactions Through Conduit Funds

As noted above, the proposed rule amendments provide for an exception that would permit orders to be transmitted to a fund after the 4:00 p.m. close and still receive the same day price treatment if the orders are received by a conduit fund. The exception states that "[a] fund may deem receipt of an order to have occurred immediately before the applicable pricing time if the fund, its designated transfer agent, or registered clearing agency receives the order from a registered investment company that invests in the fund in reliance on section 12(d)(1)(E) of the Act." The proposing release notes that this exception includes most insurance company separate accounts which invest the proceeds from the sale of interests in variable annuity and variable life insurance contracts in shares of the underlying mutual fund according to the directions of the investor in the insurance contract. This conduit fund exemption, however, is limited to entities that are registered with the Commission as investment companies.

NAVA generally supports this exception and believes it is consistent with the Commission's goal of eliminating late trading without undue burden. The majority of insurance company separate accounts funding variable contracts are registered with the Commission under the Investment Company Act of 1940 as Unit Investment Trusts and, as such will be able to avail themselves of the conduit fund exemption. Insurance companies currently have strict 4:00 p.m. trade cut-off policies and procedures in place.

Unregistered separate accounts funding variable insurance products are frequently used for private placement variable insurance contracts and for pension or profit sharing plans meeting the requirements of various provisions of the Internal Revenue Code. As with registered separate accounts, a great many of these separate accounts invest all of their assets in mutual funds and calculate their NAVs on the basis of the underlying fund's NAV. Because they are unregistered, they cannot take advantage of the conduit exemption.

Variable contracts require complex administrative systems. While an insurance company may have multiple computer systems in place to administer all of its variable contracts, it will have adopted standard procedures applicable to all variable contracts. NAVA and its members believe that the procedures that these life insurance companies have put into place are sufficient to protect fund investors and to combat late trading for both registered and unregistered separate accounts.

We believe that the underlying mutual funds, in order to assure themselves that the insurance companies have adopted proper protections to prevent late trading, may deem the insurance companies as administrators providing a material service to the fund and thus subject to the Commission's recently adopted "Compliance Programs of Investment Companies and Investment Advisers" rule ("Compliance Rule"). [5]

[5] Release No. IA-2204 (December 17, 2003).

Under the Compliance Rule, the underlying funds are required to adopt and implement written policies and procedures that provide for the oversight of compliance by any administrator. An administrator is "any person who provides significant administrative or business management services to an investment company."[6] As noted, this definition could be deemed to include insurance companies with respect to the services they perform that pertain to the operation of the fund, such as the processing of fund shares. Therefore, insurance companies offering unregistered separate accounts would then be indirectly subject to the Compliance Rule. Mutual Funds that could not satisfy themselves with the procedures adopted by the insurance companies or who felt that the relationship did not warrant the effort would not do business with the insurance company.

Insurance Companies that offer registered separate accounts are also required, as the funds are, to adopt and implement written policies and procedures under the Compliance Rule. Reviewing procedures and practices for unregistered separate accounts could be made that much easier because one could examine the practices applicable to all separate accounts and ascertain any variations with respect to the unregistered separate accounts.

NAVA and its members urge the Commission to extend the conduit fund exception to unregistered separate accounts.

Alternative Approach

The proposing release seeks comment on an alternative approach that would permit fund intermediaries to submit orders to designated fund transfer agents or Fund/SERV after 4:00 p.m. if they have adopted protections designed to prevent late trading, such as:

- electronic or physical time-stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system;

- annual certification that the intermediary has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period; and

- submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit his report to the fund's chief executive officer.[7]

If the Commission determines not to broaden the conduit fund exceptions so as to include unregistered separate accounts funding variable contracts, we recommend that the Commission adopt the alternative approach to permit unregistered separate accounts to be administered in the same manner as the registered separate accounts. We believe that it is essential that fund purchases and redemptions in variable contracts issued by unregistered

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[6] See Release No. IA-2204 at fn. 26.
[7] See proposing release at 5.

separate accounts be treated in the same manner as orders from registered separate accounts and that orders received by the unregistered separate account prior to 4:00 p.m. be permitted to be submitted to the fund after 4:00 p.m.

Should the Commission fail to extend the conduit fund exception or adopt the alternative approach to unregistered separate accounts, NAVA and its members believe that harm to the contractholders and participants of these programs will result.

When a mutual fund modifies a policy or procedure it does so unilaterally after its board approves it. Insurance companies offering variable contracts enter into a contract with their contractowners. They cannot unilaterally or retroactively alter these contract rights, no matter how enlightened the change may be. To do so would expose the insurance company to lawsuits for breach of contract. In addition, several of our members have informed us that they have discussed these types of changes with various state insurance departments and have been told that any endorsement modifying existing contract rights will not be approved by the departments.

Under current procedures, in order for the insurance company to process its variable contract transactions on any given day, it must first obtain the net asset value (NAV) for each of the underlying funds offered by the variable contract. These values are generally established by the underlying funds at the close of the market at 4:00 p.m. Eastern Time. Upon receipt of the NAVs, the insurance company must then calculate multiple accumulation unit values (AUVs) based on each fund's NAV. Purchase and redemption orders in each fund are aggregated to arrive at the net amount of separate account units to be either issued or redeemed and corresponding fund shares to be purchased or sold. The following morning the resulting orders are placed with the fund, or its transfer agent.

In order to meet a hard 4:00 p.m. cut-off, insurance companies could attempt to impose an early cut-off at the separate account level. They would then prepare an estimated report of fund purchases and sales. There are a number of issues raised by this approach. Because insurance companies have such a significant number of AUVs[8] to calculate, some of our members have informed us that in order to prepare the estimated[9] fund order it would have to cut-off transactions of the separate account at 9:00 a.m., or earlier. The result will be that most contractowners will receive next day pricing for their investments, impacting their expectations and putting them at a disadvantage relative to other investors. It would also mean that the administrative burden on the insurance company would be significantly increased because the company would have to run its entire daily processes twice each day in order to provide adjusted entries based on actual fund numbers the next morning. We have been informed that for most of our members that is either not possible or would be unduly burdensome. Even if it were possible, under the

[8] Several NAVA members have reported having to calculate up to 19,000 AUVs each night (this is due to the number of products offered, the number of fund choices within the products, multiple classes of fund shares, and numerous unbundled options of differing charges).
[9] The fund purchase or redemption order could only be estimated because the insurance company needs the NAVs to calculate actual AUVs.

proposed rule, such estimated order would not meet the definition of "Order" as contained in the proposed amendment.

Another possible solution would be to have the separate account maintain uninvested cash overnight. We believe this poses serious issues. As noted above, the variable contract is a contract between the insurance company and the contractowner. Obviously, contracts vary significantly from company to company and even within a company. However, an informal survey of our members leads us to conclude that a good number of the unregistered variable contracts provide specific provisions for the purchase and calculation of separate account units, similar to that of registered variable contracts. Thus, contractowners of the unregistered variable contracts have come to expect, and indeed, many have the contractual right, to have the separate account purchase fund shares on the same day as the separate account units were purchased. As noted above, any abrogation of these contractual rights by the insurance company makes them vulnerable to lawsuits.

There may be circumstances under which some insurance companies believe that they do not have the contractual obligation to buy or sell fund shares on the same day as the contract transaction. NAVA and its members believe that were the fund shares to be purchased or sold the day after the accumulation units were purchased it would cause harm to the then current contractowners. (Of course, this assumes that the separate account can hold uninvested cash.)

> <u>Example</u>: An insurance company has an unregistered separate account that issues a variable contract. It received orders for the purchase or redemption of separate account units throughout the business day, until the 4:00 p.m. Eastern time cut-off. Sometime after 4:00 p.m., it receives the NAVs from the underlying funds and calculates its AUVs. The next day it places its orders with the funds and receives that night's price for its net purchases. Thus, the separate account transactions processed on day one resulted in a purchase order being placed with the fund the next day (day two).

Under the current procedures, the separate account receives the day one NAV. In this example, the separate account gets the NAV as of day two, and had uninvested cash reflected in the day one AUV. This uninvested cash over a period of time could present a significant impact on the performance of the separate account in increasing markets and may give withdrawing contractowners an advantage in declining markets. Because the NAV is required as the basis for determining the AUV, if contractowner transactions are to be processed on the day received, there will always be this mismatch unless the separate account is permitted to have its transactions submitted and processed after 4:00 p.m. for transactions in fund shares.

Rule 22c-1 was adopted to prevent the kind of dilution that is presented by this example. Even though the unregistered separate account is not subject to the Rule, we believe that the result of this course of action would not be acceptable as a general principle.

Our members have informed us that even if the provisions of the variable contract would permit them to calculate the AUV in the manner discussed in the example, other contract provisions may prevent them from having uninvested cash held in the separate account. We have also been informed that some insurance departments require the insurance company to file specific plans of operations or other documentation relative to the operation of the separate account. Should insurance companies materially change the manner in which the separate account deals with its investments, amended plans of operation would need to be filed with the insurance departments and there is no assurance that such plans would receive approval. The holding of uninvested cash overnight would represent such a material modification to the investment operations of the separate account.

Another alternative is for the insurance company to delay the purchase of the accumulation units until day two. For existing contractowners, such a delay will most likely violate their contract rights as discussed above. In addition, the unregistered separate accounts offer their products to persons and entities that would find either a day delay in the application of their funds to the separate account or the presence of uninvested cash held overnight in the separate account unacceptable. The Commission noted in the proposing release that:

> "We believe that the burden on most fund investors will be small because most are not sensitive to the time at which their purchases or redemption orders are priced. They make longer-term investments, often as part of an automatic purchase program, and treat the time and date of the purchase order as a random event controlled by their employer's payroll processing protocols, or the delivery of the mail."

We respectfully disagree with this belief, at least with respect to the majority of the unregistered separate accounts.

Cost/Benefit of the Proposal to Unregistered Separate Accounts

The Commission specifically requested comments as to whether the cost of compliance with the rule as proposed were justified by the benefits. We have been informed by our members that due to the numerous and varied systems, the costs for making the significant modifications that would be necessary for compliance[10] would be, if not prohibitive, then nearly so. Compliance with the rule for unregistered separate accounts would mean different procedures and different or significantly modified computer

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[10] This discussion of costs does not take into account any limitations imposed on the insurance company because of contract rights, which may make compliance with the rule moot.

systems than those used for the registered separate accounts. This would make compliance and auditing for compliance more difficult and costly. Such differences also create more opportunities for error.

When an investment manager of a mutual fund determines that it is no longer viable to offer a particular fund, it has the option of terminating the fund with little impact on shareholders. Insurance companies, as noted above, have a contract with their contractowners. They are obligated to continue the contract regardless of how costly compliance may be. To terminate the variable contracts would cause unexpected tax consequences to the contractowners, made more so by the types of products offered by the unregistered separate accounts.

We urge the Commission to modify the proposed rule to allow unregistered separate accounts to be operated in the same manner as registered separate accounts, either by expanding the conduit exception to include unregistered separate accounts or approving the alternative approach.

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Again, we appreciate the opportunity to comment. If we can answer any questions or be of further assistance, please contact me at (703) 707-8830, extension 20, or Judith Hasenauer at (954) 545-9633. Ms. Hasenauer chairs NAVA's Regulatory Affairs Committee.

Sincerely,

Michael P. DeGeorge
General Counsel