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

Submission by E-mail

RE: Mandatory Redemption Fees for Redeemable Investment Company Securities; Release No. IC-26375; File No. S7-11-04.

Dear Mr. Katz:

The American Council of Life Insurers is a national trade association with 368 members representing 71 percent of all United States life insurance company assets. Many of our members manufacture variable contracts that are distributed through broker-dealers and other intermediaries. Life insurers also manage one-fifth of America's privately administered pension and retirement plan assets, many of which are funded by variable annuity contracts totaling $918 billion.

As significant participants in the securities marketplace, life insurers have a direct interest in effective solutions to market timing abuses in the mutual fund industry. Our members have carefully evaluated the SEC's proposed Rule 22c-2, and have developed suggestions to make the proposal more fully and equitably useful. We greatly appreciate the opportunity to add our views to the important dialog on these matters before the SEC.

Summary of the Proposal

Proposed Rule 22c-2 would require that open-end investment companies impose a fee of two percent of the proceeds on shares redeemed within five business days of purchase. The rule would not permit investment companies to impose a fee higher or lower than two percent. Investment companies must impose the two percent fee, unless transactions trigger one of four exceptions.

The rule would not preclude investment companies from instituting a holding period longer than five days. Investment companies would determine the amount of any fee according to a first in, first out "FIFO" method on transactions.

A *de minimis* provision in the proposal allows investment companies to waive the redemption fee if the amount of the shares redeemed is 2,500 dollars or less. The SEC also invited comment on an alternative that would require investment companies to waive redemption fees if the amount of the shares redeemed is $2,500 or less.

Proposed rule 22c-2 would give the investment company and financial intermediaries through which investors purchase and redeem shares three alternative methods of assuring that the appropriate redemption fees are imposed.[1] The proposal would allow a waiver of redemption fees in the case of an unanticipated financial emergency, upon written request of the shareholder.[2]

The proposed rule provides four exceptions to the mandatory redemption fee.

- The rule would not require investment companies to collect redemption fees on redemptions of $2,500 or less, and would provide for fee waivers in the case of financial emergencies.
- The rule would exclude money market funds from its scope.
- The rule would not apply to exchange-traded funds.
- The rule would not apply to any investment company that (i) adopts a fundamental policy to affirmatively permit short-term trading in all of its redeemable securities, and (ii) discloses in the prospectus that it permits short-term trading of its shares, and that such trading may result in additional costs for the investment company.

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[1] Under the first method, the intermediary must transmit to the investment company (or its transfer agent) at the time of the transaction the account number used by the intermediary to identify the transaction. Under the second method, the intermediary would enter into an agreement with the investment company requiring the intermediary to identify redemptions of account holders that would trigger the application of the redemption fee, and transmit holdings and transaction information to the investment company (or its transfer agent) to allow the investment company to assess the amount of the redemption fee. Under the third method, the investment company would enter into an agreement with a financial intermediary requiring the intermediary to impose the redemption fees and remit them to the investment company.

[2] Investment companies would be required to waive the fee on redemptions of $10,000 or less. Investment companies would also be permitted to waive the fee on redemptions greater than $10,000 under the emergency circumstances.

Summary of Position

- The life insurance industry supports sensible regulatory actions thwarting abusive market conduct and protecting investors against excessive market timing.

- Life insurers oppose a requirement that mutual funds underlying variable contract separate accounts impose *mandatory* redemption fees or that mandatory redemption fees be imposed at the omnibus account level in employer-sponsored retirement plans.

- Alternative solutions to market timing abuse, such as fair value pricing or limitations on excessive transactions, operate without discrimination across all product platforms, like variable contracts.

- We strongly urge the SEC to suspend adoption of Rule 22c-2 for a reasonable period of time until a study can be conducted evaluating the effectiveness of alternative mechanisms other than mandatory redemption fees in stemming market timing.

- Variable contract separate accounts can more effectively prevent abusive market timing without mandatory redemption fees in underlying funds through other mechanisms such as fair value pricing.

- The SEC should not adopt a rule that may discourage registrants' from using a wide, and continually evolving array of tools to stem abusive market timing.

- Mandatory redemption fees will impose significant, expensive burdens on competition between publicly available mutual funds and other financial products.

- Life insurers oppose a requirement that mutual funds impose redemption fees in connection with transactions from life company separate accounts, pension plans and other omnibus account structures. It would be extremely burdensome for plans to allocate redemption fees at the omnibus account level if the participants' transactions did not involve actual market timing activity, but nonetheless triggered a mandatory redemption fee.

- Proposed Rule 22c-2 does not appear to accommodate the differences between publicly available mutual funds and other structures, such as two-tier financial products or employer-sponsored retirement plans with open-architecture framework. Imposition of mandatory redemption fees in these arrangements is costly and burdensome to administer, and can lead to unfair application of redemption fees.

- Lack of uniformity in the proposed rule's requirements for imposing mandatory redemption fees will create nearly impossible administrative challenges in employer-sponsored retirement plans with open architecture.

- We respectfully suggest that the SEC work with the Department of Labor and the Department of Treasury to develop effective deterrents to market timing that can be adopted by plan sponsors.[3]

Background: The Operation of Two-tier Financial Products

Life insurers manufacture variable annuities and variable life insurance for distribution to individuals, and groups such as pension plans. These variable contracts are hybrid products with important insurance and securities characteristics. The SEC regulates the issuance and sale of individual variable contracts under the federal securities laws. The Department of Labor and the Department of the Treasury, through the Internal Revenue Service, promulgate rules and regulations governing retirement programs and the products used to fund them. State insurance departments also regulate the insurance features of variable contracts.

Like mutual funds, life insurers' separate accounts funding variable contracts are registered under the Securities Act of 1933 and the Investment Company Act of 1940 because the account values fluctuate according to the investment experience of an underlying securities portfolio. The structure, operation, and distribution of variable life insurance and variable annuities are, however, different from publicly available mutual funds.

For example, variable contracts funded by life insurers generally operate under a two-tier structure. At the top tier, the separate account funds the variable contract based on an underlying menu of mutual funds at the bottom tier. Purchases, sales, and exchanges are transmitted from customers to the life insurance company, which in turn communicates the appropriate instructions to the underlying mutual funds.

The life company processes customer orders directly and through intermediaries. Variable contract customers, therefore, do not have direct contact with the underlying mutual funds. In pension plans, participants transmit allocation instructions through a plan administrator to the life insurer, which conveys the information to the mutual funds underlying the plan's variable annuity contract.

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[3] An approach that establishes redemption restrictions applicable to all investment options within a pension plan would be easier for plan participants to understand. Also, record-keepers and service providers would be able to incorporate programming edits and filters to preclude transactions falling outside of redemption restrictions applicable to the plan as a whole.

It is important that solutions to market timing abuses work fairly with respect to pension plan participants, variable contract owners, and mutual fund investors, in spite of structural differences between these financial products. Authorizing inflexible solutions to market timing abuses that favor mutual funds would be an unfair response to systemic abuses that originated in the mutual fund industry.

Likewise, inflexible market timing solutions would give mutual funds an unequal marketplace advantage over competing financial products. The mutual fund industry should not be able to obtain leverage over competitors through market timing remedies.

Retail mutual funds can assess a redemption fee directly against their shareholders. In contrast, with variable contracts this charge must be assessed at the level of the insurer's separate account or the pension plan. Moreover, mandatory redemption fees in variable contracts or pension plans brings relatively cost-free revenue to mutual funds while erecting significant administrative and systems expenses to variable contracts and pension plans. Variable annuities, therefore, have similarities with, and differences from, publicly available mutual funds. Actions addressing mutual fund abuses should be carefully designed with those differences in mind.

Evaluation of the Proposed Amendments

We support investor protection that thwarts abusive market timing through a variety of carefully tailored mechanisms. We oppose Rule 22c-2 because it would inflexibly establish mandatory redemption fees as the primary solution to market timing abuse. Mandatory redemption fees may be infeasible in variable contract separate accounts funded by underlying mutual funds and in open architecture employer-sponsored plans at the omnibus account level. Imposition of mandatory redemption fees as proposed in Rule 22c-2 would unfairly increase the expense of these variable contracts relative to publicly traded mutual funds.

Market timing is an evolving market practice that can be ameliorated with a range of different solutions. A single solution cannot be fully effective in deterring abuse because market timers exploit discreet market conditions with different techniques. A remedy to time-zone arbitrage and stale pricing in thinly traded securities may have little impact on momentum timers. We strongly support, therefore, a range of remedies to arrest inappropriate market timing as the most equitable and effective systemic regulatory solution.

The SEC's recently adopted disclosure amendments to Forms N-1A, N-3, N-4 and N-6 provide a constructive, systemic approach to harmful market timing.[4] Registrants must provide disclosure about the risks to shareholders of frequent purchases and redemptions in investment company shares, and the investment company's policies and procedures with respect to excessive purchases and redemptions.

[4] *See*, Investment Company Act Rel. No. 26418 (April 26, 2004).

The amendments also require open-end management investment companies, other than money market funds, and insurance company managed separate accounts offering variable annuities to explain both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. The SEC's disclosure initiatives provide an efficient means to alert investors and will catalyze flexible, effective controls against abuse. Many insurance company separate accounts embellished disclosure in their 2004 post-effective updates.

Our members report that a variety of market timing controls insurers implemented in response to the SEC's disclosure amendments have already proven effective in thwarting market timers. Controls life insurers use include:

- Requiring certain contract owners to communicate purchase and redemption instructions through the U.S. postal service rather than through the internet or facsimile;
- Imposing restrictions on transfers out of certain underlying funds, such as international options, for a designated period of time;
- Implementing fair value pricing when underlying fund portfolio securities quotations are not readily available or timely;
- Limiting a contract owner's number of trades or exchanges during a calendar period;
- Charging redemption fees for excessive purchase and redemption turn-around at the separate account level or at the employer-sponsored plan participant account level; and,
- Retaining the ability to reject trades or exchanges that may be disruptive to the operation of an underlying mutual fund.

Our members indicate that uniform application of strong measures against excessive trading has promptly and successfully thwarted abusive market timers upon implementation. One company witnessed the withdrawal of several large contracts within 30 days of the introduction of fair value pricing methodology in underlying international funds, notwithstanding significant surrender charges in the variable annuity contract. Another company reported that abusive timing activity shrunk quickly in 2003 following the implementation of market timing controls other than redemption fees.

Significantly, some life insurers report that mandatory redemption fees have not been the most effective market timing solution. A March 2003 research report by Hewitt Associates LLC concluded that mandatory redemption fees proved to be the least effective of four mechanisms measured in preventing market timing in defined contribution plans.[5] The report summarized the results of a series of case studies in which Hewitt Associates examined the experiences of defined contribution plans that imposed four categories of restrictions on excessive trading.

[5] *See*, Hewitt Financial Services, *Preventing Excessive Trading in International Funds* (March 2003).

According to the Hewitt report, the most effective means to eliminate excessive trading was to require that purchases, transfers, and reallocations remain in the chosen underlying fund for a specified period of time.[6] Following this approach in order of success, the study identified purchase limits, trading limits, and redemption fees.[7]

Some companies have also observed that the mandatory two percent redemption fee alone will not stop harmful market timing because timers will simply view it as a cost of doing business. Other companies have also criticized the mandatory two percent fee as creating an unwitting safe harbor for market timers to conduct excessive trading.

Life insurers issuing variable contracts should be entitled to use a variety of mechanisms to thwart market timing, including redemption fees. The mandatory nature of the fees in Rule 22c-2, however, skews the ability of companies to implement other more effective means to discourage timing abuse.

Fair value pricing methodology provides another effective means to thwart unfair dilution of net asset values caused by excessive market timing activity. Fair value pricing successfully eliminates arbitrage attractive to market timers, and achieves accurate valuation of securities in mutual fund portfolios. We support the SEC's strong recommendation that mutual funds consistently use fair value pricing.

This methodology efficiently protects all direct mutual investors and indirect investors through two-tier vehicles such as variable annuities and pension plans. Market timing abuses can be successfully cured through clear disclosure and consistent enforcement of market timing practices. We encourage the SEC's development of specific interpretive guidance about the situations in which fair value pricing is warranted.

While specially focused redemption fees can retard excessive market timing activity, this mechanism does not work neutrally across all product platforms, and is extremely burdensome to administer in employer-sponsored plans. For example, the tracking mechanics to correctly assign redemption fees in pension plans or employer groups may be formidable. While redemption fees in direct mutual fund investments operate relatively easily, the same is not true in most two-tier structures such as pension plans and variable annuities.

Unlike mutual funds, variable annuities are strictly enforceable contracts between insurers and contract owners that are subject to state insurance regulation. Some tentative solutions to excessive market timing, such as specially tailored redemption fees, may be contractually infeasible under existing variable annuity contracts.[8] For many existing

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[6] The report observed that a restricted transfer period of as little as seven days appeared to effectively eliminate excessive trading.
[7] The report indicates that the aging approach experienced a 98% difference in average daily net transfer activity before and after restrictions, while purchase limits experienced a 88.3% difference, trading limits witnessed a 63.1% difference, and redemption fees evidenced a 29.1% difference.
[8] For example, one of members reported that the Florida Insurance Department recently declined to allow a separate account to revise a variable contract to allow redemption fees aimed at market timing.

contracts, the expense risk charge guarantees that the life insurer will not increase fees during the life of the contract. Moreover, any amendments to variable contracts for added redemption fees would need approval of state insurance departments in which the contract was authorized for distribution.[9]

In contrast, a variety of other effective market timing deterrents can operate seamlessly under state insurance law. Fair value pricing, for example, presents a bar to opportunistic arbitrage activity without the impediments of state regulatory approval or contractual constraints. Incorporation of redemption fees in existing contracts, however, may be contractually infeasible because some contracts provide that fees cannot be increased after issuance.

Accordingly, we strongly oppose mandatory redemption fees as the solution to market timing abuse in mutual funds. Registrants should be able to implement a variety of tools to effectively thwart abusive market timing. Imposing across-the-board redemption fees may impair competition by erecting solutions favoring mutual funds that do not translate equitably to variable contracts funding two-tier structures such as individual variable annuity contracts and group pension arrangements funded by variable annuities.[10]

Negative Impact of Proposed Rule 22c-2 on Retirement Programs

Market timing is an issue of great concern to all investors including sponsors of, and participants in, employer sponsored retirement plans. The frequency and volume of market timing activity, however, is substantially lower in the employer sponsored retirement plan arena than in mutual funds generally. The vast majority of participants with individual accounts in defined contribution plans rarely accumulate account balances that rise to a level where abusive or excessive trading impacts the underlying fund held in a retirement plan.

Typically, individual participants do not control the timing of many transactions applicable to retirement plans. For example, contributions are submitted periodically by the plan sponsor or employer, which diminishes the precision needed by timers. Domestic relations orders and loan transactions are processed only after full documentation is provided, which can delay strike points essential to market timers.

Full account withdrawals require a triggering event, such as termination of employment, retirement, disability or death of the participant, before the order is processed. Some plans only permit exchanges or reallocations periodically, such as

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[9] While the SEC staff appeared to recognize this impediment in the proposal release, nothing was done to mitigate these significant state regulatory and contract law issues. *See* text accompanying footnote 50 in the release.

[10] Within the context of pension plans, certain redemption fee structures may force such programs to contradict other rules or requirements. For example, under the laws of various states, no surrender or termination charge can be assessed at the end of a contract's term [New York's Board of Deferred Compensation] and the full account value must be transferred.

monthly. Many typical plan transactions, therefore, lack the precise timing or control critical to market timing.

Many retirement and deferred compensation programs utilize an "open architecture" framework making options available to plan participants from multiple mutual funds. Increasingly, mutual funds have established redemption restrictions that are different from one mutual fund family to another, and from mutual fund to mutual fund within the same family.[11]

Most investments in employer-sponsored retirement plans use omnibus accounts. The imposition of mandatory redemption fees at the omnibus account level would be difficult, if not impossible, to administer. Under proposed Rule 22c-2, it is possible that a redemption fee could be applicable even though no individual participant actually engaged in a short-term trade transaction. In such an event, the allocation of redemption fees would be inappropriate and unfair.

There is a gap of logic in the assessment of a mandatory redemption fee under circumstances where there is no actual net trade, or when there is a net trade but no abusive transactions have been submitted. By way of example, in a retirement plan or an insurance company separate account, even if individual participants place "abusive" transactions, there may be no net trade at the omnibus or separate account level because purchases exceeded redemptions on that day. Similarly, it is possible that a redemption fee might appear to be applicable at the omnibus or separate account level, but no such fee is applicable based upon transactions placed by participants.

As an alternative to imposing a mandatory redemption fee in the retirement plan context, we request that the SEC consider another approach where the SEC, together with the Department of Labor and Treasury, would authorize pension record keepers to take individual action against participants engaging in market timing or other abusive transactions in reliance on instructions from a plan's underlying funds. Such an approach could include:

- allowing the record keeper to reject or reverse a transaction placed by an individual participant;
- limiting the ability of such individual participant to place transactions through the internet or a voice response system, so that transaction requests must be submitted in writing through the postal system;
- working with the plan sponsor to establish a requisite holding period applicable under the plan; or,
- working with the plan sponsor to establish limitations on trading frequency applicable under the plan.[12]

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[11] Collaboration between the SEC, the Department of Labor, and the Treasury Department to develop "safe harbor" redemption restrictions for retirement programs would be constructive and cost effective.

[12] Examples of actual limitations insurers have implemented are set forth in the bullet points on page 6 above.

ACLI recommends that the SEC exempt pension record keepers and pension plans that establish such alternative arrangements from the requirement of applying the mandatory redemption fee. We also respectfully encourage the SEC to consult with the Department of Labor and the Department of Treasury to develop other alternative arrangements that may be adopted by plan sponsors to curb market timing abuses within pension plans.

Balanced Marketplace Competition is Critical

In 1974, Congress amended the Securities Exchange Act by adding Section 23(a), which requires the SEC to consider the anti-competitive effects of rule changes, and to balance any impact against the regulatory benefit to be obtained.[13]

In a different context, former SEC Chairman Levitt emphasized the importance of reviewing the impact of rulemaking on competition when he stated:

> In response to the National Securities Markets Improvement Act of 1996 (NSMIA), the Commission has rededicated itself to considering how rules affect competition, efficiency, and capital formation as part of its public interest determination. Accordingly, the Commission intends to focus increased attention on these issues when it considers rulemaking initiatives. In addition, the Commission measures the benefits of proposed rules against possible anti-competitive effects, as required by the Exchange Act.[14]

Solutions to market timing abuses should fulfill these important SEC and statutory goals to protect both competition and investors. The SEC should develop corrective rule modifications carefully to prevent any anticompetitive impact. This can be readily accomplished with constructive market timing solutions that operate fairly across all product platforms.

The mandatory redemption fees in Rule 22c-2 would impose a significant competitive burden on many two-tier financial products like variable life insurance and variable annuities. Rule 22c-2 would give publicly available mutual funds an unwarranted advantage in the market place. This is unnecessary because market timing can be thwarted effectively with other mechanisms that do not create market place imbalances.

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[13] S. Rep. 94, 94th Cong., 1st Sess. (April 14, 1975) at 12.

[14] *See* testimony of Arthur Levitt, SEC Chairman, concerning appropriations for fiscal year 1998 before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the House Committee on Appropriations (Mar 14, 1997), which appears at http://www.sec.gov/news/testimony/testarchive/1997/tsty0497.txt

Conclusion

As a significant participant in the securities marketplace, the life insurance industry supports responsible remedies to market timing abuses. Disclosure about the risks of market timing, and the application of tools to thwart abusive practices are constructive approaches to this important regulatory issue. Mandatory redemption fees imposed by mutual funds underlying separate accounts should not be imposed in Rule 22c-2. This single solution to a complex issue can cause unnecessary dislocation in the financial marketplace.

It is necessary and appropriate to provide a balanced solution across all product platforms. The mandatory redemption fee proposal is not equitably balanced and may injure competition among financial products. Individual and group variable contracts can successfully thwart excessive purchases and redemptions with a variety of controls.

If the SEC does not jettison Rule 22c-2, we strongly recommend suspension of the proposal for a reasonable period of time to measure whether a range of market timing controls broader than mandatory redemption fees can successfully eliminate abusive practices. Our members' experiences indicate that other less operationally intrusive techniques can stem market timing abuse effectively across all product platforms without burdening competition. Another procedural alternative would be to apply Rule 22c-2 only to retail mutual funds.

If the SEC will postpone adoption of Rule 22c-2, ACLI will undertake to conduct or sponsor a study of life insurers' track record over a statistical measuring period to provide a baseline on which the SEC can make an independent assessment. Together with the SEC's own data distilled from its broad and targeted examinations of life insurers' separate account operations, these neutral sources of valuable information provide an important data base worth consulting before adopting a rule that could impose burdens that greatly exceed the limited benefits of mandatory redemption fees.

Thank you for your courteous attention to our views. Please contact us if you have any questions or need additional information.

Sincerely,

Carl B. Wilkerson