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Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
101 F. Street, N.E.
Washington, D.C. 20549-9303

April 10, 2006

Submission by E-mail

RE: Proposed Amendments to Rule 22c-2 under the Investment Company Act of 1940; Redemption Fees for Redeemable Investment Company Securities; Release No. IC-27255; File No. S7-06-06.

Dear Ms. Morris:

The American Council of Life Insurers is a national trade association with 377 members that help Americans accumulate, manage, and protect their assets for financial and retirement security by offering life insurance, annuities, long-term care, disability income insurance and pensions, including IRAs, 401(k), 403(b), and 457 plans. ACLI members account for 91 percent of the industry's total assets, 90 percent of life insurance premiums, and 95 percent of annuity considerations.

Many of our members issue variable life insurance and variable annuity contracts that would be subject to Rule 22c-2. 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 amendments to Rule 22c-2, and have developed suggestions to improve the initiative. We greatly appreciate the opportunity to add our views to the important dialog on these matters before the SEC.

Summary of the Proposal

Rule 22c-2 has a detailed administrative history worth summarizing. On March 11, 2005, the SEC adopted Rule 22c-2, allowing mutual funds to impose and retain a fee on redemptions within seven or more days of a purchase to offset the costs of short-term trading strategies, such

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as market timing. The redemption fee can total up to two percent of the amount redeemed. The SEC's March 11, 2005 release also invited supplemental comment on several issues.

The SEC's initial Rule 22c-2 proposal in 2004 would have *required* mutual funds to impose a redemption fee to thwart excessive trading. The final rule, however, authorizes mutual fund directors to establish a redemption fee if it is in the mutual fund's best interest, and provides flexibility to tailor the redemption fee to meet the needs of the fund.

In our comment letter, ACLI opposed mandated redemption fees, and advocated flexibility to use a variety of tools, including fair value pricing, exchange limits, or redemption fees to combat abusive market timing. ACLI noted that redemption fees would operate inequitably in two-tier financial products like variable contract separate accounts and pension plans.

Rule 22c-2 requires mutual funds to enter into written agreements with financial intermediaries to capture shareholder and transaction information on request, and to implement the mutual fund's instructions to thwart excessive trading by specific customers. The rule defines financial intermediaries to include administrators of participant-directed retirement plans, and unit investment trusts such as variable contracts separate accounts.

The March 11, 2005 release observed that modifications to the proposal "should reduce the costs of compliance to funds and intermediaries, [although] aggregate one-time costs for financial intermediaries to create systems to collect and transfer information to the funds may be significant." The SEC emphasized that the rule allows mutual funds to protect long-term investors against dilution caused by excessive trading and market timing in omnibus accounts.

According to the SEC, "[w]e also envision that the rule 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." The SEC explained that variable contract withdrawals are unlikely to be part of a market timing strategy.

In the 2005 Rule 22c-2 adoption release, the SEC sought feedback on whether fees should be waived on dividend reinvestments, and on non-discretionary transactions pursuant to prearranged instructions under employee benefit plans. The release also asks whether there should be a fee waiver on redemptions for unanticipated financial emergencies.[1] The rule became effective May 23, 2005, and imposed a compliance date of October 16, 2006.

On February 28, 2006, the SEC proposed supplemental amendments to Rule 22c-2 that are "designed to reduce the costs to mutual funds (and fund shareholders)." The SEC's February 28 release also notes the amendments clarify the rule's operation, and reduce the number of intermediaries with which the mutual fund must obtain information-sharing agreements. The amendments propose that if a mutual fund fails to obtain an information-sharing agreement with

[1] The release also invited comment on whether the SEC should establish uniform standards for holding periods and redemption fees under the rule. The SEC requested input on whether fees should be waived on redemptions up to $2,500 within seven days of purchase, and whether such a *de minimis* waiver should be uniformly mandated.

a particular financial intermediary, the mutual fund would be barred from accepting purchase requests from that intermediary, irrespective of whether the request is for the intermediary itself or on behalf of other persons.

Nothing in the February 2006 release addressed whether the rule would preclude the assessment of redemption fees on the redemption, pursuant to partial or full contract withdrawals, of shares issued by a UIT separate account.

Summary of Position

- The life insurance industry supports sensible regulatory actions thwarting improper market conduct and protecting investors against abusive market timing. Life insurers have instituted measures at the separate account level that have successfully minimized the incidence and opportunity for abusive market timing.

- ACLI has been an active participant in the dialog about balanced and fair solutions to abusive market timing.[2] The SEC has not fulfilled its responsibility to properly estimate or balance the economic impact of Rule 22c-2 and its proposed amendments on *all* marketplace participants.

- Rule 22c-2 is heavily skewed in favor of retail mutual funds' operation, structure and convenience. The rule and its proposed amendments disregard the unique structure and operation of variable life insurance and variable annuities, and impose significant unnecessary burdens with competitive impediments.[3]

- Redemption fees in mutual funds underlying variable contract separate accounts or redemption fees imposed at the omnibus account level in employer-sponsored retirement plans reflect only one approach to thwarting market timing. Several less burdensome alternatives can successfully achieve the rule's goals.

- Alternative market timing solutions for two-tier structures, such as fair value pricing or limitations on excessive transactions, operate successfully and more equitably for variable contracts and pension plans.

- The initiative's October 16, 2006 implementation deadline must be significantly extended to allow sufficient time to develop any systems required to monitor, report, and store records triggering the rule's standards. Minimally, the compliance date should be pushed back 18 months.

[2] *See* ACLI comment dated May 10, 2004 on Mandatory Redemption Fees for Redeemable Investment Company Securities; Release No. IC-26375; File No. S7-11-04; ACLI comment dated Feb. 6, 2004 on Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings; Release No. 33-8343; File No. S7-26-03; ACLI comment dated Feb. 8, 2004 on Amendments to Rules Governing Mutual Fund Pricing; Release No.IC-26288; File No. S7-27-03; ACLI comment on H.R. 2424 dated Nov. 19, 2003 in File No. S7-27-03.

[3] *See* Amend, *SEC Scrutinizes Redemption Language: Redefining Intermediary Could Save $378 Million*, Money Management Executive (Mar. 13, 2006)[The Rule 22c-1 amendments "would likely relieve a tremendous burden from the shoulders of the Nations's fund companies"].

- The SEC needs to directly address and respond to the impact of Rule 22c-2 on variable contracts and pension plans before the rule becomes operative.

Background: The Operation of Two-Tier Financial Products

Life insurers manufacture variable annuities and variable life insurance for distribution to individuals and to 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.[4] 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 individual 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 unit investment trust 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.

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 illicit market timing that favor mutual funds would be an unfair response to systemic problems that originated in the retail mutual fund industry. As a matter of perspective, nearly of all the SEC's market timing enforcement actions for abusive "sticky asset" arrangements involved retail mutual funds in large transactions with hedge funds and broker-dealer omnibus accounts[5].

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[4] *See* Seligman, Fundamentals of Securities Regulation (2000) at 245 [Analyzing the VALIC case, the author states that the Supreme Court "soon recognized that a variable annuity was neither solely an investment contract nor solely an insurance contract, and the insurance and investment elements could be segregated with sufficient precision so that the former might be regulated by the state insurance authorities and the latter by the Commission."].

[5] *See* In re Mutual Funds Investment Litigation (in re Janus Subtrack)*, 384 F. Supp. 2d 845 (D. Md. 2005)*; Polkes and Mustokoff, *District Court Weighs Novel Theories of Rule 10b-5 Liability in n Mutual Fund Market Timing*

The SEC's recently adopted amendments to Forms N-1A, N-3, N-4 and N-6 promote full disclosure about the position of each fund or variable contract on market timing.[6] Registrants must disclosure and the entity's policies and procedures with respect to excessive purchases and redemptions as well as risks to shareholders of frequent purchases and redemptions. Additionally, Rule 38a-1 significantly buttresses enterprise-wide implementation of applicable market timing tools.

Rule 22c-2 also requires 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 fairly about applicable market timing controls. Many insurance company separate accounts expanded disclosure in their 2004 and 2005 post-effective prospectus updates on this issue. While redemption fees may work with modest administrative burdens in retail mutual funds, fair value pricing provides a successful tool for variable contracts without triggering the significantly more complex administrative burdens that would occur due to structural differences from mutual funds.

Our members report that a variety of market timing controls insurers implemented in response to the SEC's disclosure amendments have proven effective in thwarting market timers. Life insurers have analyzed their insurance and annuity contracts, and have installed

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Litigation, 34 SECRLJ 1 (Spring 2006); Barbash and Seo. *The Post-Canary Fund Regulatory Deluge*, ALI-ABA Seminar on Broker-Dealer Regulation (Jan. 2005).
Roye, Integrity and Accountability: The New Imperatives for the Mutual Fund Industry*, (Mar. 22, 2004)* http://sec.gov/news/speech/spch032204pfr.htm*; Burns, Congress Urged to Overhaul Funds, Wall Street Journal (March 24, 2004) at D11; Burns, Congress Urged to Overhaul Funds, Wall Street Journal (Mar. 24, 2004) at D11; Martin Act Marionette, Wall Street Journal (Feb 12, 2004); Burns, Funds Watcher Blast Industry, Wall Street Journal (Mar. 23, 2004) at D7;* Shipman*, SEC's Atkins: Need Action from Fund Companies in Scandal, Wall Street Journal (Feb 25, 2004); State Investigation Reveals Mutual Fund Fraud*, Office of the New York State Attorney General, Press Release (Sept. 3, 2003); *Putnam is One of Those Tainted, and Plenty of Money is Staying Away*, Investor's Business Daily (April 29, 2004) at A06; *Tainted Firms' Damage Control Questioned; MFS, Putnam Downplay Missteps*, Investment News (Feb. 16, 2004) at 6; Morningstar, a company which provides independent information and analysis of mutual funds, recommended that investors "proceed with caution," "don't send new money" or "consider selling" mutual funds involved in recent "market timing." See *Fund Industry Investigation Update, available at* http://www.morningstar.com/fii/fundindustryinvestigation.html; Complaint, *State of New York v. Canary Capital Partners,* (N.Y. Sup. Ct. Sept. 3, 2003); *In re Alliance Capital Mgmt, L.P.*, No. 3-11359, 2003 SEC LEXIS 2997 (Dec. 18, 2003) *available at* http://sec.gov/litigation/admin/ia-2205.htm ; *SEC's Division of Enforcement Announces Agreement to Settle Fraud Charges Against Fleet's Columbia Mutual Fund Adviser and Distributor for Undisclosed Market Timing*, SEC, Press Release (Mar. 15, 2004); *In re Strong Capital Mgmt*., Inc., No. 3-11498, 2004 SEC LEXIS 1044, (May 20, 2004) *available at* http://sec.gov/litigtion/admin/34-49741.htm; *New York, Wisconsin Settle "Market Timing" Allegations with Strong Capital Management and Its Founder*, SEC, Press Release (May 20, 2004) *available at* http://www.oag.state.ny.us/press/2004/may/may20a_04.html; *n re Pilgrim Baxter & Assocs., LTD.*, No. 3-11524, 2004 SEC LEXIS 1267 (June 21, 2004) *available at* http://sec.gov/litigation/admin/ia-2251.htm;

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

contractually permitted measures. Controls implemented by life insurers 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 for underlying funds they sponsor when quotations for the underlying fund's portfolio securities 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 introducing fair value pricing methodology in underlying international funds, notwithstanding significant surrender charges in the variable annuity contract. Uniformly, our members report that instances of abusive market timing dropped significantly after the adoption of, and disclosure about, market timing controls by the life insurers. The SEC's existing requirements, therefore, have successfully achieved their goals regarding UIT separate accounts funding variable contracts and pension plans.

While specially focused redemption fees can retard excessive market timing activity, this mechanism does not work neutrally in two-tier 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 contracts.

The imposition of redemption fees at the omnibus account level in pension and annuity contracts would be difficult, if not impossible, to administer. Under 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 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 initiate allegedly "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.

Negative Impact of Proposed Rule 22c-2 Amendments 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.

Most investments in employer-sponsored retirement plans use omnibus accounts. 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 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.[7]

Functional Impediments in Rule 22c-2 and its Amendments for Variable Contracts

State Law Issues. 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 new specially tailored redemption fees, may be contractually infeasible under existing variable annuity contracts.[8] For many existing 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

[7] 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.
[8] For example, one of our 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.

redemption fees would need approval of state insurance departments in which the contract was authorized for distribution.[9]

In its 2004 and 2006 releases, the SEC appeared to disregard the impact of state insurance law standards and contract law. We take issue with this SEC position and the release's selective application of limited precedent. The March 2006 release states that the SEC staff does:

> [n]ot believe that redemption fees charged pursuant to rule 22c-2 should be interpreted to cause insurance companies to breach contracts with annuity holders. Redemption fees are not fees that the insurance companies are themselves imposing pursuant to the contract between the insurance company and its customer. Instead, the funds underlying the separate accounts will impose any redemption fees that are charged. *See Miller v. Nationwide Life Ins. Co.*[10]

We strongly disagree with the SEC's reliance on a single case in light of significant cases and law to the contrary. More seasoned variable contracts typically do not contain provisions directly allowing the insurers to control the trading of the contract holder, although they often contain provisions that allow the insurer to control the form in which trading requests may be made. Numerous court decisions demonstrate that insurers are vulnerable when imposing trade restrictions that are not consistent with contractual provisions and highlight the dangers of requiring insurers to impose any particular curb, such as redemption fees. Contract holders have been largely successful in lawsuits for breach of contract and fraud against life insurers attempting to limit contract holders' trading activities where not authorized by contractual terms.[11] Courts have been unsympathetic to insurance companies' installation of post-purchase remedies to curb abusive trading by their contract holders.[12] Even if redemption fees are theoretically viewed as fund level charges, they will often conflict with the explicit formula or description in the contracts about how separate account interests are valued.

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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] *See* Rel. No. IC-27255 at footnote 12, and accompanying text.

[11] *See, e.g.*, *Prusky v. Prudential Insurance Company of America*, No. 00-CV-2783 (D.C. Eastern Dist. PA) filed Nov. 29, 2000; First *Lincoln Holdings Inc. v. The Equitable Life Assurance Society of the United States*, 164 F. Supp. 2d 383 (S.D.N.Y. 2001); *Windsor Securities, Inc. v. Hartford Life Ins. Co*., No. 90-CV-3687 (E.D. Pa.), filed May 31, 1990, aff'd in part, rev'd in part, 986 F.2d 655 (3d Cir. 1993) ("Windsor I"); *Abramson v. Hartford Life Ins. Co*., Civil Action No. 94-0442 (Ct. Common Pleas, Montgomery Cty., Pa), filed March 1994 ("Windsor II"); *Prusky v. Hartford Life Ins. Co*., No. 97-CV-00815 (E.D. Pa.), filed Feb. 1997 ("Windsor III"); *Prusky v. Allstate Life Insurance Company,* 03-CV-0709 (E.D. PA, Feb. 4, 2003); *Prusky v. Phoenix Life Insurance Company,* 2003 U.S. Dist. LEXIS 4054 (E.D. PA, Mar. 4, 2003); *Miller v. Nationwide Life Insurance Company,* 391 F.3d 698 (5th Cir. 2004); *Prusky v. Reliastar Life Insurance Company,* 03-CV-06196 (E.D. PA, Nov. 12, 2003); *Prusky v. Aetna Life Insurance and Annuity Company,* 03-CV-06264 (E.D. PA, Nov. 14, 2003); and *Prusky v. John Hancock Variable Life Insurance Company,* 03-CV-06629 (E.D. PA, Dec. 9, 2003); *see also* Colter, *Insurers' Battles with Market Timers Often End in Court*, DowJones Newswire (Mar. 10, 2004)..

[12] *See* Windsor I, Windsor II and Windsor III, *supra*. In 2003, Allmerica Financial Life Insurance and Annuity Company encountered courts unresponsive to its endeavors to stem market timing activities. *American National Bank and Trust Company of Chicago and Emerald Investments United Partnership v. Allmerica Financial Life Insurance and Annuity Company*, No. 02 C5251 (D.C. Ill. 2003).

Even if state insurance departments are amenable to contract amendments, attempts to impose a redemption fee or otherwise modify or restrict transfer rights in existing contracts could expose life insurers to litigation by contract owners whose rights were constrained. Contract owners have filed more than 15 lawsuits against life insurers enforcing transfer rights in variable contracts.

State insurance laws require that variable contracts specify maximum and guaranteed charges and pricing formulae. Other contracts guarantee owners the right to make unlimited transfers without charge. Some insurance laws specify a maximum transfer charge or a minimum number of transfers that can be made without charge. These contract terms unequivocally limit the ability of insurers to unilaterally impose a new transaction-based redemption fee, even if the insurer is doing so on behalf of an underlying fund.

As a result of these judicial interpretations, many insurance companies conclude that certain contracts will not permit the imposition of the fee. Moreover, imposing a redemption fee on transfers within existing contracts would necessitate filing contract amendments in every state or territorial jurisdiction. It is unlikely that all jurisdictions would approve terms impairing existing contract rights. Several state insurance regulators have informed life insurers that any endorsement modifying existing contract rights will be disapproved. Consequently, life insures would face a mixed pattern of regulation that unnecessarily burdens uniform contract administration and design.

Unilateral imposition of redemption fees could unwittingly expose life insurers to litigation liability on the basis that variable contract expense risk charges represent an enforceable guarantee that the life insurer's charges will not increase during the life of the contract. The contention that redemption fees are fund level charges rather than separate account fees ignores the reality of ambitious litigants. Legal expenses incurred in defending vexatious litigation unfairly burden both the separate account and innocent contract holders that may indirectly suffer. Contrary to the SEC's statement in the 2006 release,[13] the amendments do not "reduce the costs of complying with the rule and clarify its application" for variable contracts. The SEC needs to carefully evaluate the rule's benefits against its consequences for the life insurance industry.[14]

This litigation exposure for life insurance contracts is different from post-purchase revisions to retail mutual funds: variable contracts are hybrid instruments with securities and insurance characteristics governed both by federal securities laws and state insurance laws. Mutual funds, however, do not face two levels of statutory standards. While many mutual funds may appropriately reserve the right to impose supplemental excessive timing constraints, state

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[13] Rel. No. IC-27255, 71 FR 44 at 11352 [text accompanying footnote 12]. While the footnote cites *Miller v. Nationwide* as authority for the proposition that redemption fees are not separate account charges but mutual fund charges, it ignores other significant cases with opposite holdings.

[14] "To use cost-benefit analysis in evaluating the merits of public actions requires translation of positive *and negative* effects to a common measure." *See* Moore, *Cost-Benefit Analysis: Issues in its Use in Regulation*, Congressional Research Service Report 95-760 (1995) at 3 [emphasis added]. The rule and its amendments provide no economic impact statement for life insurers and pension plans. It should be withheld until a balanced analysis occurs warranting the rule's impact on life insurers and pension plans. *See also* Hahn and Hird, *The Costs and Benefits of Regulation: Review and Synthesis*, 8 Yale Journal of Regulation 233 (1990).

insurance laws do not allow life insurers unilaterally to do so. The SEC's determination about the ease of unilaterally imposed redemption fees after inception of a variable contract in contravention of state law standards is wrong.

Infinite Logistical Complexities. Rule 22c-2 and its proposed amendments create profound tracking and compliance issues for UIT variable contract separate accounts. Many variable contracts have underlying funds from a wide variety of mutual fund complexes. The rule allows each mutual fund to establish different yardsticks for imposing redemption fees for abusive market timing. Each fund can charge different redemption fees up to the 2% maximum in Rule 22c-2. Although the tracking mechanics are relatively simple for each mutual fund in its own retail sales, it will be overwhelming for UIT separate accounts that face multiple different fees and measures of market timing. Even within the same mutual fund complex, redemption fee triggers can vary.

For life insurers managing separate accounts with many unrelated mutual funds, the nearly infinite range of different methodology and tracking would be extremely burdensome and costly. Our members estimate that the cost of building systems to properly manage, monitor and report transactions will be formidable, if possible at all. This consequence is unwarranted. On a cost-benefit analysis, the rule's approach fails as it pertains to variable contracts and employer-sponsored retirement plans funded by variable contracts.

Rule 22c-2 does not limit the frequency of mutual funds' request for shareholder identity and trading data. The March 2005 release indicated that intermediaries will face data calls quarterly in sixty percent of mutual funds. The release estimates that the aggregate expense of compliance for data collection will total about $1 million in the first year, and about $2 million over the following three years. With the potentially infinite variety in data methods and frequency among all mutual funds, the estimates are general estimates at best. Data collection vendors have indicated that the costs of developing and maintaining systems fulfilling the rule are challenging to estimate, as well as the unit costs for each institutional participant. With uncertain expenses and burdens, balancing the rule's benefit against its burden is formidable, if at all possible.

The SEC's releases emphasize that Rule 22c-2 has been crafted to reduce costs to *mutual funds* and to reduce the number of intermediaries with which mutual funds must negotiate information-sharing agreements. Those goals are noble and commendable in administrative rulemaking. The SEC, however, has wholly failed to consider the rule's greatly disproportionate burdens and costs on variable contracts and pension plans funded by separate accounts. In that regard, the rulemaking is deficient and presents troubling competitive hurdles for the life insurance industry that do not appear to have been given consideration. For life insurers, the SEC's cure is worse than the disease. What began as a market timing solution, has morphed into a excessive trading initiative that greatly favors retail mutual funds.[15] Our letter recommends below reasonable solutions that protect the interests of investors.

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[15] *See* Amend, *Redemption Rule Reaches Far and Wide: But the SEC Mandate Could Hold Hidden Treasures*, Money Management Executive (Feb. 13, 2006) ["Sales details provided through the (intermediary information) agreements might also offer funds a more accurate picture of their wholesaling force and how to compensate them.

The March 2006 release left the status of non-discretionary or automated transactions, such as asset allocation or rebalancing, uncertain under the rule, unresolved. Likewise, the release did not address the SEC's acknowledgment that Rule 22c-2 should 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. The release did not answer the SEC's question whether exceptions from redemption fees should be created for dividend reinvestments, *de minimis* activities, or hardship-related transactions. These uncompleted issues complicate compliance and increase burdens on life insurers. The rule needs to be delayed until its impact is more precise and balanced.

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.[16]

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.[17]

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 without favoring, for example, retail mutual funds over variable contract separate accounts.[18]

Since funds would be able to scrutinize net assets versus gross assets, they'll be able to determine which shareholders in a particular territory stay on the books or leave, an important new capability in an increasingly fee-driven business"].

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

[17] *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

[18] Recently, the past four Directors of the SEC's Division of Investment Management spoke at a forum sponsored by the American Enterprise Institute and the Brookings Institution, and observed that "the mutual fund industry is heavily over-regulated." *See* Hansard, *Ex-SEC Directors Bemoan Overregulation*, InvestmentNews.com (Feb. 28, 006). The former SEC directors observed that "regulatory overload will lead to less competition in the fund industry because the regulatory burdens are too expensive for new entrants." *Id* at 2. Significantly, a former director noted that imbalance in regulation in the investment management area also could lead to fewer intermediaries in the distribution of financial products. *Id*. Another director acknowledged that when the SEC adopted new regulations in

The 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.

The rule is unequivocally easier to administer for a mutual fund's own retail sales than for two-tier arrangements used in the life insurance industry for variable contracts and pension plans. The SEC's amendment narrowing the scope of intermediaries with whom mutual funds must execute information-sharing agreements was designed to reduce expenses and burdens on mutual funds. Moreover, the rule's information-sharing agreements will greatly benefit mutual funds in scrutinizing net versus gross assets to identify persisting shareholders that contribute to mutual funds' increasingly fee-based profits. [19] This added mutual fund benefit presents an odd contortion of the SEC's responsibility to consider and balance the competitive factors in rulemaking. Nothing in the rule or its amendments reduced burdens or expenses on life insurers. Our recommendations below address the rule's burdensome impact on variable contracts while also protecting against abusive market timing.

Recommended Solutions

We recommend that the initiative be amended to exclude from Rule 22c-2 any mutual fund meeting the requirements of Revenue Ruling 81-225. This ruling governs the class of mutual funds underlying UIT separate accounts funding tax deferred insurance and annuity contracts. This approach ameliorates the rule's economic and competitive burdens on variable contracts, and is supportable for several reasons:

- Variable contracts have established a variety of procedures that have successfully minimized abusive market timing and prevent dilution of other contract owners' interests in the underlying funds, as discussed above;
- The vast majority of market timing involving "sticky asset" arrangements occurred in retail mutual funds, rather than in mutual funds underlying UIT separate accounts funding variable contracts or in pension plans;
- While variable contracts can be viewed as an "intermediary" in some contexts, they are different from other intermediaries, such as broker-dealers submitting omnibus orders on behalf of customers for retail mutual fund purchases, and do not share the same risks of unmanaged market timing.
    - Broker-dealers are not subject to the required disclosure and board determinations about market timing as registered UIT separate accounts are.
    - Similarly, broker-dealer intermediaries are not subject to Rule 38a-1 requiring special focus on compliance for market timing protections like registered separate accounts.

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the wake of recent mutual fund scandals, it didn't have much time to think about the collateral consequences of the regulations. *Id* at 2. In the same vein, we encourage the SEC to carefully consider the collateral consequences of Rule 22c-2, and to provide sufficient time to properly analyze the rule and it proposed amendments.

[19] *Id.*

    - Unlike hedge funds in retail mutual funds or broker-dealer omnibus accounts, individual or group variable contract holders lack the critical mass to impact significantly gross transactions in underlying mutual funds.
- Rule 22c-2 has a disproportionate impact on two-tier structures like UIT separate accounts that is not offset by demonstrated regulatory need; systemic problems in the life insurance industry have not been suggested or quantified by the SEC.
- Rule 22c-2 will unfairly increase life insurers' exposure to litigation over increased charges if redemption fees are required.

As an alternative to imposing a redemption fee in the retirement plan context, we request that the SEC, together with the Departments of Labor and Treasury, authorize pension record keepers to take individual action against participants engaging in market timing in reliance on instructions from a plan's underlying funds. This 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.[20]

ACLI recommends that the SEC exempt underlying mutual funds from the requirement of applying a redemption fee when pension plans and sponsors establish these types of market timing barriers. We respectfully encourage the SEC to consult with the Departments of Labor and Treasury to develop other alternative arrangements that may be adopted by plan sponsors to thwart market timing opportunities within pension plans.

Conclusion

Life insurers support reasonable remedies to abusive market timing in mutual funds. Integrity in the securities markets is a paramount goal. The SEC's solutions to market timing should be crafted to balance regulatory needs against the burdens of Rule 22c-2. It is profoundly ironic, however, that remedies to problems that originated and mushroomed in retail mutual funds will impose significant competitive burdens on life insurers and pension plans, while providing marketplace advantages to the mutual fund industry. This is unacceptable in administrative rulemaking.

The initiative acknowledged the unique status of variable contracts early in its development, but fully overlooked modifications that would fairly address the functional differences between the structure and operation of mutual funds and variable contract separate accounts. We strongly recommend two solutions that treat variable contracts and pension plans

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

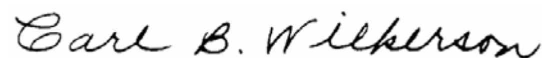
fairly and functionally in light of regulatory needs and investor protection. The rule can be properly designed to successfully thwart market timing without impairing competition.

Life insurers have installed a variety of functional controls that successfully minimized the opportunity for abusive transactions in variable contracts. Unlike mutual funds, variable contracts were not the source of significant market timing activity. Group variable contracts' omnibus orders to mutual funds are distinguishable from omnibus orders from broker-dealers for retail mutual funds: broker-dealers are not subject to board action about market timing protections, specialized disclosure, or Rule 38a-1. The opportunity for abusive market timing in broker-dealers' omnibus orders is significantly greater. Accordingly, Rule 22c-2 should be modified so that it avoids a damaging and unnecessary one-size-fits-all solution designed solely for retail mutual funds or broker-dealer omnibus accounts.

We commend the SEC for addressing abusive market timing in the mutual fund industry. Rule 22c-2 has the potential to enhance investor protection. More, however, needs to be done before the job is finished. Mutual funds underlying variable contracts and pension plans should be exempt from the requirements of Rule 22c-2 for the reasons explained above. In that way, Rule 22c-2's cure will be properly matched to market timing's historical illness.

Thank you for your attention to our views. If any questions develop, please contact me.

Sincerely,



Carl B. Wilkerson

cc: The Honorable Christopher Cox, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
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