May 7, 2004

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

RE: File No. S7-11-04

Dear Mr. Katz:

On March 2, 2004, the Securities and Exchange Commission (the "Commission") proposed a new rule designed to require short-term shareholders to reimburse mutual funds for costs incurred when they use a fund to implement short-term trading strategies, such as market timing. The proposal would add new rule 22c-2 under the Investment Company Act of 1940 to require mutual funds to impose a two percent redemption fee on the redemption of shares purchased within the previous five days.[1] The rule would also apply to short-term transfers among subaccounts within variable annuity contracts.[2]

This letter of comment on the proposed new rule is respectfully submitted by the National Association for Variable Annuities ("NAVA").[3]

Summary of proposed rule

Proposed rule 22c-2 would make it unlawful for a fund to redeem a redeemable security issued by the fund, within five business days after the security was purchased, unless it imposes a redemption fee of two percent of the amount redeemed. The proposed rule provides for four exceptions: (1) redemptions of $2,500 or less; (2) in the case of an unanticipated financial emergency; (3) redemptions from money market funds and funds that issue securities that are listed on a national securities exchange (exchange-traded funds or "ETFs"); and (4) any fund that adopts a fundamental policy to affirmatively

[1] Release No. IC-26375 (March 2, 2004) (the "proposing release"). Throughout this comment letter, proposing release page number references are to the proposing release as published by the Commission on its Web site.
[2] See proposing release at page 4.
[3] 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.

permit short term trading of its securities, if its prospectus clearly and prominently discloses that it permits short-term trading and that such short-term trading may result in additional costs.
Where fund shares are purchased through a financial intermediary, such as a broker-dealer, retirement plan administrator or an insurance company that sponsors a registered separate account organized as a unit investment trust, three alternative methods of assuring that the appropriate redemption fees are imposed are provided by the proposed rule.

Summary of NAVA's position

NAVA supports the Commission's ongoing efforts to protect fund investors and curtail abusive short-term trading or "market timing" activities within mutual funds that may result in increased costs and lower returns that are borne by long-term investors. These efforts to date include requiring investment companies to adopt and implement written compliance programs designed to prevent violation of the federal securities laws, and enhanced disclosure of policies and procedures with respect to frequent purchases and redemptions of fund shares and the use of fair value pricing.[4]

However, in regard to the present proposal to require a mandatory redemption fee, we are concerned that the costs that will be required to implement the proposed redemption fee may outweigh the protection such fees will provide.

The costs for funds and their financial intermediaries will be very significant. The proposing release estimates that the first year aggregate costs for system upgrades to evaluate transactional data to match purchases and redemptions and to store and process information will be $1,178,000,000 for funds and $1,145,800,000 for intermediaries. The ongoing operation and maintenance costs are estimated to be $30,876,000 per year for funds and $805,800,000 per year for intermediaries.[5] The costs for insurance companies offering variable insurance contracts may be higher than for other financial intermediaries because of their multiple systems and relative complexity. Much of this cost may ultimately be borne by investors.

There is also considerable uncertainty as to whether the proposed redemption fee will be effective in deterring market timing activities. In proposing the redemption fee, the Commission staff conceded that the rule is not designed to be the ultimate solution to the problems posed by market timers engaging in time zone arbitrage and that the best solution is the requirement that mutual funds fair value any securities whose daily market quotations are stale or unreliable.

The recently adopted rules mentioned above both reinforce the importance of fair value pricing to prevent harmful market timing. In particular, new rule 38a-1 requires funds

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[4] See Release Nos. 1A-2204 and IC-26299 (December 17, 2003) and Release Nos. 33-8408 and IC-26318 (April 16, 2004).
[5] See proposing release, page 35, fn 102.

(and insurance company separate accounts) to adopt policies and procedures to monitor for circumstances that may necessitate the use of fair value prices, establish criteria for determining when market quotations are no longer reliable for a particular portfolio security, provide a methodology by which the fund determines the current fair value of the portfolio security, and regularly review the appropriateness and accuracy of the method used. We believe funds and insurance companies offering variable insurance contracts are now utilizing fair value pricing methodologies more aggressively to eliminate stale prices, resulting in a reduction of abusive market timing activity.

Many funds and insurance companies have also implemented new procedures and added additional market timing restrictions to their prospectuses and increased their scrutiny of suspicious trading practices to discover and remove market timers from their funds. In variable contract prospectuses, these restrictions include limiting the number of transfers into and out of a particular subaccount during a given time period, rejecting transfers that exceed a stated amount, requiring stated minimum amounts to remain in a subaccount following a transfer, and requiring that all transfer requests be made through the U.S. mail and contain the original signature of the contract owner.

In light of the above, we believe a mandatory redemption fee should be considered by the Commission only after it has determined that its effectiveness in deterring market timing outweighs the cost, and other currently employed measures, including fair value pricing, are not adequately controlling the problem.

If the Commission concludes that a redemption fee should be required at this time, we have several comments in regard to the applicability of the proposed rule to variable annuities and variable life insurance contracts that take into consideration the differences between mutual funds and variable insurance products. For contracts issued after the adoption of a redemption fee rule, our comments are intended to assist the Commission in refining the proposal in order to accommodate the unique structure and characteristics of variable insurance products.

For existing contracts, we discuss several legal issues that are raised by a mandatory redemption fee that are not addressed in the proposing release. We believe these issues need to be analyzed by the Commission and specifically addressed in any final rulemaking.

Variable insurance contracts issued subsequent to the adoption of the proposed rule

A redemption fee for contracts issued subsequent to the adoption of the rule should be applied under the following circumstances:

1. Administration of the redemption fees must be handled by the insurance company. As the Commission is aware, most variable annuity and variable life insurance contracts are issued through a two-tier investment company structure. The first or top tier consists of a separate account of the life insurance company

that, absent an exemption, is required to be registered as an investment company under the 1940 Act. The separate account is a segregated investment account established under state insurance law to hold variable annuity and variable life insurance assets and liabilities separate and apart from the insurer's general account liabilities and assets.

The separate account is typically divided into subaccounts, each of which invest solely in the shares of an affiliated or unaffiliated underlying fund organized as an open-end management investment company. This is the second or bottom tier of the two-tier structure. Variable insurance product owners can allocate their purchase payments and transfer contract value among the various subaccounts. Purchases, sales and transfers between subaccounts are communicated by the customers to the insurance company, which in turn transmits the appropriate instructions to the underlying funds to accomplish the transaction. Variable insurance contract owners, therefore, do not have direct contact with the underlying funds. The purchases, sales and transfers are accounted for in "accumulation units." When a contract owner sells shares in an underlying fund, no actual redemption of shares occurs. Rather, the insurance company cancels the appropriate number of accumulation units at the separate account level.

Insurance companies have systems to track subaccount transactions by contract owners but the underlying funds themselves do not. It would be extremely difficult, if not impossible, for the insurance companies to provide the underlying funds with all of the information they would require to identify contract owners engaging in short-term trading that would trigger the redemption fee. Changes to multiple systems would be required at great cost to the insurance companies. For the reasons discussed earlier, we do not believe the benefits of a redemption fee justify the imposition of such costs.

2. The insurance company, not the underlying fund, should determine the specific method that will be used to assess the redemption fee. For mutual fund shares held through financial intermediaries such as insurance companies, the proposing release provides three alternate methods for assuring that the appropriate redemption fees are imposed and leaves it up to the fund to select the method(s) to use.[6] Since, as explained above, the insurance company should be the entity administering the redemption fee, it should also be left to the insurance company, not the fund, to select the method to be employed. Moreover, variable insurance contracts typically offer 30-40 different underlying funds, many of which are unaffiliated with the insurance company.[7] If the decision as to the method to use is made by the funds, an insurance company could be required to implement multiple procedures for providing information to the funds and/or imposing the redemption fee directly.

[6] See proposing release at page 8.

[7] According to the NAVA 2003 *Annuity Fact Book* (second edition, 2003), page 19, the average number of funds per variable annuity contract in 2002 was 34.

3. We agree with the proposing release that the redemption fee must be both mandatory and uniform. As discussed above, insurance companies have significant administrative systems in place to process subaccount purchases, sales and transfers. In addition, many companies have multiple products and systems, for both life and annuities. To permit redemption fees to be optional or variable in nature would make their administration extremely difficult.

4. There should be an exception for redemptions that take place within five days of fund activities that occur automatically. Many variable annuity contracts offer a number of asset management programs that are executed automatically by the insurance company, such as dollar cost averaging programs where funds are moved gradually from a money market portfolio into selected investment portfolios, and automatic asset rebalancing programs which automatically maintain the contract owner's desired diversification by periodically reallocating funds among the chosen subaccounts to reflect the originally designated investment mix. Asset rebalancing or reallocation is typically performed on a quarterly, semi-annual or annual basis. Automatic asset reallocations are also frequently required by particular variable annuity features such as guaranteed minimum income benefits (GMIB) and guaranteed minimum withdrawal benefits (GMWB). These transfers among subaccounts are non-discretionary and not part of a scheme to market time. Without an exception a contract owner could inadvertently trigger a redemption fee by making a withdrawal from a subaccount shortly after the transfer of funds into the subaccount as a result of one of these automatic programs.

   There should also be an exception for redemptions that occur automatically. Many variable annuity owners choose to receive payments from their contracts through a systematic withdrawal plan. These withdrawals are automatically made from the subaccounts invested in either monthly, quarterly, semi-annually, or annually. Variable life insurance contracts typically provide for monthly deductions that are allocated among the subaccounts to pay for administrative expenses and the cost of insurance. In both instances, the redemption from the subaccounts is the result of an automatic action by the insurance company rather than a discretionary action initiated by the contract owner, and thus are not characteristic of market timing and should not trigger a redemption fee.

   The proposing release states that the application of the FIFO method, under which the shares held for the longest time are treated as being redeemed first, should eliminate the need to include exceptions for these types of transactions which do not bear the characteristics of market timing transactions.[8] However, we believe that the opportunities for inadvertent application of the redemption fee as a result of automatic purchase or redemption programs may be greater with

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[8] See proposing release, page 29, fn 32.

variable insurance products because of their widespread use and we are not confident that the FIFO method will completely solve this problem.

5. There should also be an exception for redemptions that occur as a result of the purchaser's exercise of his or her right to cancel. State insurance laws require that all variable annuity and variable life insurance contracts contain a free look provision that entitles the purchaser to examine the contract for a specified period of time and cancel it and obtain a refund. In some instances, depending on the contract and state of issuance, the purchaser's premium payment is invested immediately into the underlying funds selected by the purchaser. If a purchaser elects to cancel the contract within five days after purchase, a redemption fee should not be imposed.

6. The periodic information provision in the proposed rule should not be applied in the case of variable insurance products. The proposing release provides that, regardless of the method selected to collect the redemption fee, the financial intermediary would be required, on at least a weekly basis, to provide to the fund the Taxpayer Identification Number ("TIN") of all shareholders that purchased or redeemed shares during the previous week, and the amount and dates of such purchases and redemptions. Providing this information weekly is not administratively practical for insurance company separate accounts and would impose great additional cost with little, if any, benefit. Moreover, as we have recommended, it is the insurance company which has the ability and responsibility to police market timing activities within its subaccounts. As registered investment companies, insurance company separate accounts and their market timing procedures are subject to regulation and examination by the Commission.

   In addition, providing this information is likewise not practical or cost efficient at the fund level. As discussed above, transfers among subaccounts within variable insurance products is a more complex process than purchases and redemptions of mutual fund shares. Even with the weekly information from the insurance company, the underlying funds in the variable subaccounts would have a very difficult time matching up transactions and determining whether a redemption fee is due.

   The apparent purpose of the TIN requirement is to provide funds with the ability to exercise adequate oversight over the fund intermediary's processes. In the case of insurance company separate accounts, funds already have this ability by virtue of new rule 38a-1. We believe that the underlying mutual funds, in order to assure themselves that the insurance companies have adopted proper protections to prevent abusive market timing, may deem the insurance companies as administrators providing a material service to the fund and thus subject to the compliance program requirements of the rule.

Under rule 38a-1, 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."[9] 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 transfers among subaccounts. 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.

7. There must be a sufficiently long transition period to enable insurance companies to make the changes to their systems and procedures that will be necessary in order for them to comply with the proposed rule. Our members have indicated that building the ability to identify and track contract owners who make short-term transfers among subaccounts and to impose the redemption fee will require extensive and costly system modifications. In addition, contract amendments adding a redemption fee will have to be filed with state insurance departments.

Existing variable insurance contracts

The new rule, as presently proposed, would also apply to existing variable annuity and variable life insurance contracts. This retroactive application raises a number of issues that the Commission should specifically address in any final rule that is adopted.

1. When a mutual fund modifies a policy or procedure, it may do so unilaterally after its board of directors has approved it. Following the board's approval, the modification is simply communicated to existing shareholders and implemented. In contrast to a mutual fund, the purchase of a variable insurance product creates a legally binding contract between the insurance company and the purchaser which set forth the rights and duties of the respective parties. Under state contract law, one party to a contract generally cannot unilaterally modify its terms.

   Mandatory redemption fees may raise significant legal issues under existing variable contracts. State insurance laws require that variable contracts specify maximum and guaranteed charges and pricing formulae. Contract provisions also detail limitations or charges applicable to transfers among subaccounts. In some cases, contract provisions guarantee owners the right to make unlimited transfers without charge. In other cases, provisions specify a maximum transfer charge or a minimum number of transfers that can be made without charge.

   These contract terms may arguably be viewed as limiting the ability of insurers to unilaterally impose a new transaction-based redemption fee, even if the insurer is

[9] See Release No. IA-2204 at fn. 26.

doing so on behalf of an underlying fund. Accordingly, many insurance companies have concluded that some of their contracts will not permit the imposition of the fee. In that case, to impose a redemption fee on transfers in such existing contracts would require, at the very least, the filing of amendments to the contracts with every state, with no guarantee of state approval of amendments that would abrogate existing contract rights. In fact, 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.

2. Even if state insurance departments are amenable to contract amendments, attempts to impose a redemption fee or otherwise modify or restrict transfer rights of inforce contracts could nonetheless subject insurance companies to litigation by contract owners whose rights have been curtailed. In one recent case considering this issue, a federal district court dismissed a breach of contract claim, reasoning that the underlying fund imposed the new redemption fee, not the insurance company.[10] Thus, the court found that the insurer did not breach its contractual obligations regarding transfer fees. However, this is a decision by a single trial level court and other courts may reach a contrary position.

   Regardless of how the proposed redemption fee is imposed or collected, we expect that contract owners will continue to bring similar litigation and file regulatory complaints claiming that new redemption fees amount to a breach of contract. The costs of defending these actions would be significant.

3. In addition to the risk of litigation, an insurer's failure to administer its contracts in accordance with approved terms, including provisions governing transfers and charges, may potentially form the basis for regulatory fines and sanctions, or disciplinary actions by a state insurance department that has approved the terms and conditions of variable insurance contracts.

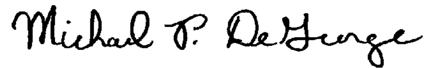
4. Based on these concerns, if the Commission determines to impose mandatory redemption fees on inforce variable insurance contracts, we strongly request that the Final Rule explicitly state that the Commission intends that the Rule will have retroactive effect on existing contracts.

5. As noted earlier, a sufficiently long transition period will be needed in order to accomplish the state filings of the contract amendments that will be required to add a redemption fee. In many states, this process can take in excess of 9-12 months.

[10] Miller v. Nationwide Life Insurance Company (2003 WL 22466236 (E.D. La.) (Oct. 29, 2003)

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