May 9, 2005

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 11, 2005, the Securities and Exchange Commission (the "Commission") adopted new rule 22c-2 under the Investment Company Act of 1940 (the "Act") that allows registered open-end investment companies ("funds") to impose a redemption fee, not to exceed two percent of the amount redeemed, to be retained by the fund.[1]

Summary of the Rule

Under the rule, the board of directors of each fund must either approve a redemption fee or determine that imposition of a redemption fee is either not necessary or not appropriate. In addition, regardless of whether the board approves a redemption fee, each fund must enter into a written agreement with each financial intermediary of the fund, under which the intermediary agrees (i) to provide, at the fund's request, identity and transaction information about shareholders who hold shares through an account with the intermediary, and (ii) to execute instructions from the fund to restrict or prohibit further purchases or exchanges of shares by a shareholder who has been identified by the fund as having engaged in transactions that violate the fund's policies.

As noted, the redemption fee may not exceed two percent and would be imposed on shares redeemed within a time period set by the fund board that cannot be less than seven calendar days. Fund boards can set longer holding periods and the rule does not specify a maximum time period. The rule provides an exception for money market funds, funds that issue securities that are listed on a national securities exchange, and funds that affirmatively permit short-term trading, if the prospectus clearly and prominently discloses that such trading is permitted. The

[1] Release No. IC-26782 (March 11, 2005)(the "Release"). Throughout this comment letter, release page number references are to the Release as published by the Commission on its Web site.

Commission had originally proposed a mandatory two percent redemption fee on the redemption of shares purchased within the previous five business days.[2]

The Commission has also requested comment on a number of issues, including whether it should establish uniform standards for redemption fees charged under the rule.

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

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, we have serious concerns about the adverse effects the rule as presently adopted could have on variable insurance contracts and the competitive burden that would be placed on variable insurance products as compared to mutual funds.

I. Redemption fees on funds within variable insurance products will result in undue and unnecessary burdens

Implementation of redemption fees with respect to short-term transfers among subaccounts within variable insurance products is substantially more difficult and costly than implementation of such fees by retail mutual funds. Retail mutual funds can assess a redemption fee directly against shareholders of the fund. This is not the case with insurance company separate accounts.

As the Commission is aware, there are significant differences in structure between mutual funds and variable insurance products. 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 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. Under this structure, income, gains and losses, whether or not realized,

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[2] Release No, IC-26375 (March 2, 2004) (the "Proposing Release").
[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.
[4] See Release Nos. 1A-2204 and IC-26299 (December 17, 2003) and Release Nos. 33-8408 and IC-26318 (April 16, 2004).

from assets allocated to the separate account are credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

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. Purchases and sales, including those involved in transfers among subaccounts, are aggregated and netted at the separate account level on a daily basis and converted by the insurance company into an order to purchase or redeem the underlying mutual fund shares.

Because of this more complicated structure, the imposition of redemption fees by underlying funds will place significantly greater expenses and administrative burdens on variable insurance contract issuers relative to that imposed on publicly traded retail mutual funds, resulting in a vastly uneven playing field.

Moreover, insurance companies have implemented a variety of controls and procedures, 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. 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 of certain contract owners be made through the U.S. mail rather than via the Internet or by facsimile; and
- requiring that transfer requests contain the original signature of the contract owner.

The form amendments adopted by the Commission in April 2004 require variable insurance contract prospectuses to describe these restrictions and the insurer's policies and procedures for deterring frequent transfers with specificity.

In addition, funds and insurance companies offering variable insurance contracts have increased their utilization of fair value pricing methodologies to eliminate stale prices, resulting in a further reduction of abusive market timing activity. We look forward to the Commission's upcoming release addressing issues relating to fair valuation requirements which should help funds and insurance companies better implement fair value pricing strategies.

Given the unique structure of variable insurance contracts described above, our members believe that their trading restrictions and procedures are more effective in preventing market timing and abusive trading and less administratively burdensome and costly than the imposition of redemption fees by underlying funds within variable insurance products.

Separate accounts offered by insurance companies are also different from other types of financial intermediaries, such as broker-dealers and other entities that hold securities in nominee name. Most insurance company separate accounts are registered as Unit Investment Trusts. As such, they are considered registered investment companies and are required by Rule 38a-1 of the Act to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. These policies and procedures must address the use of fair value pricing of fund shares and compliance with the separate account's disclosed policies regarding market timing. The policies and procedures must be approved by the insurance company and reviewed at least annually. Finally, as registered investment companies, insurance company separate accounts and their market timing procedures are subject to regulation and examination by the Commission.

II. Uniform Standards

As described above, new rule 22c-2 contains only two standards: first, that a redemption fee may not exceed two percent and second, that a redemption fee can only be assessed on shares redeemed within a time period that is no less than seven calendar days. The Commission has requested comment on whether it should establish a set of uniform standards, and if so, what those standards should be.

As noted in the Release, commenters representing both fund complexes and intermediaries were of the opinion that wide variations in the rate, duration, exceptions and other features of redemption fees make it costly for intermediaries to assess the fees.[5] The absence of uniform standards for redemption fees will require intermediaries to accommodate numerous permutations of varying fees and increase their administrative costs. These costs, which will be substantial, will ultimately be borne by fund shareholders.

NAVA and its members feel strongly that if redemption fees are to be permitted on funds underlying variable insurance contracts, the Commission must establish uniform standards for the fees.

Variable insurance contracts typically offer 30-40 different underlying funds, many of which are unaffiliated with the insurance company.[6] In the absence of uniform standards, insurance companies issuing variable insurance contracts could be required to implement multiple

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[5] See Release at page 20.
[6] According to the NAVA 2004 *Annuity Fact Book* (third edition, 2004), page 26, the average number of funds per variable annuity contract in 2003 was 38.

redemption fees of varying amounts, with varying holding periods to trigger assessment of the fees, and multiple methods of calculating the fee. Current administrative systems are incapable of accommodating such variation and the costs to upgrade systems would likely be prohibitive.

The absence of uniform standards for redemption fees imposed by underlying funds also raises important disclosure issues. Variable insurance contract prospectuses are required to disclose detailed cost information, including any exchange fee charged on transfers from one subaccount to another and the range of total operating expenses charged by the portfolio companies or funds offered through the separate account. Forms N-4 and N-6 also require registrants to describe all deductions or charges from purchase payments and contractowner accounts as well as any limitations for the transfer of contract value between subaccounts. This disclosure would be lengthy and potentially confusing if multiple redemption fees with varying amounts, holding periods, exceptions and share accounting methods were included within a contract.

We recommend that the Commission establish the following standards for funds that choose to assess a redemption fee:

a. *Share accounting.* It is essential that there be a uniform share accounting method for the determination or calculation of the fee. We support the use of the FIFO ("first in, first out") method originally proposed by the Commission.

b. *De minimis waiver.* We agree that a *de minimis* waiver should be required for redemptions that result in a small fee, but we recommend that the threshold be raised to redemption fees of two hundred dollars or less. This would mean that a redemption of $10,000 would be exempt from a redemption fee in a fund with a two percent redemption fee.

c. *Amount of fee.* The amount of the redemption fee should be mandated. We agree with the rationale espoused in the Proposing Release that a uniform fee will "simplify the implementation of the rule and better enable intermediaries that hold fund shares in omnibus accounts to establish and maintain systems to collect these fees."[7] A fee of two percent appears reasonable to discourage abusive short-term trading and to compensate funds for the costs incurred as a result as a result of such trading.

   Length of holding period. There should be a maximum holding period for the assessment of a redemption fee. As presently adopted, funds can choose to impose a redemption fee on fund shares sold within an unlimited time period. We are aware that some retail mutual funds have recently set holding periods as long as six months and even one year for the assessment of a redemption fee. Such long holding periods are excessive and inconsistent with the potential harm to shareholders that the Commission is trying to prevent.

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[7] See Proposing Release at page 4.

In the Proposing Release, the Commission stated that its proposal was intended to supplement other measures taken by the Commission to address short-term trading, including abusive market timing.[8] In the Release adopting rule 22c-2, the Commission defined market timing as "(a) frequent buying and selling of shares of the same fund or (b) buying or selling fund shares in order to exploit inefficiencies in fund pricing."[9] This second form of market timing is also referred to by the Commission as "time zone arbitrage."

We believe that a 30-day holding period would be sufficient to dissuade market timing and other abusive short-term trading activities. Moreover, permitting funds to adopt longer holding periods could result in unreasonable restrictions on the redeemability of fund shares required by the Act. This redeemability is one of the key attractions of mutual funds. The Commission recognized this in the proposing release when it quoted from its testimony during the legislative hearings on the Act, "the most important single attribute which induces purchases of the securities of open-end companies by the public is the so-called 'redemption feature' of such securities – that is, the assurance that the shareholder may tender his shares to the company and receive at once, or in a very short time, the approximate cash asset value of such shares as of the time of tender."[10]

d. *Investor initiated transactions.* NAVA recommends that redemption fees charged by a fund be limited only to transactions initiated by investors. 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 rebalancing and automatic asset programs which automatically maintain the contract owner's desired diversification by periodically reallocating funds among the chosen subaccounts. Asset rebalancing or reallocation is typically performed on a quarterly, semi-annual or annual basis. 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.

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[8] See Proposing Release at page 3.
[9] See Release at page 4.
[10] See Proposing Release at page 27, fn 19.

The Release asks whether this exception is necessary if it provides for FIFO accounting for share holding periods. We believe it is. The opportunities for inadvertent application of a redemption fee as a result of automatic purchase or redemption programs may be greater with variable insurance products because of their widespread use and we are not confident that the FIFO method will completely solve this problem.

e. *Unanticipated financial emergency.* We do not support a redemption fee waiver in the case of an "unanticipated financial emergency," regardless of whether such waivers are mandatory or permissive. What may constitute an unanticipated financial emergency is too subjective and subject to abuse.

III. Variable Insurance Contracts

The Release states that the Commission "envision[s] 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…"[11] We support such an exception. As the Release states, such redemptions are unlikely to occur as part of a market timing or rapid trading strategy. Moreover, the absence of such an exception could violate variable insurance contract purchasers' "free look" rights under state law. 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 seven days after purchase, a redemption fee should not be imposed.

As discussed above, we feel that only transfers between subaccounts that are initiated by the variable insurance contract owner should be subject to a redemption fee.

Fund of Funds Arrangements. Variable annuity contract sometimes offer a fund of funds arrangement in which an underlying fund invests in shares of other underlying funds. These are used, for example, to offer targeted lifecycle funds that invest in other funds based on the investor's targeted retirement date. They are also used in lieu of the asset allocation programs discussed above. Instead of periodically reallocating a contractowner's subaccount units based upon his or her risk tolerance, a contractowner would select a fund of funds that meets his or her risk tolerance and a professional investment adviser manages the fund and makes allocations among the funds eligible for investment by the fund. Under such fund of funds arrangements, transfers between funds are directed by the professional investment adviser managing the fund, not individual contractowners. These transfers between funds do not involve market timing or other abusive short-term trading strategies and should not be subject to the imposition of redemption fees by the underlying funds.

[11] See Release at page 29.

Existing Variable Insurance Contracts

We continue to believe that redemption fees may raise significant legal issues for existing variable insurance contracts. 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.

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 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.

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. We are aware of 13 lawsuits that have been filed against insurance companies in the past by contract owners seeking to enforce transfer rights in variable insurance contracts.[12] Regardless of how a 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.

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[12] See *Windsor Securities, Inc. v. Hartford Life Ins. Co.*, 986 F.2d 655 (3rd Cir. 1993); *American National Bank & Trust Company of Chicago v. AXA Client Solutions, LLC*, 00-CV-6786 (N.D. IL, Oct. 30, 2000); *Prusky v. Prudential Insurance Company of America*, 44 Fed. Appx. 545 (3rd Cir. 2002); *Prusky v. Hartford Life Insurance Company*, 97-CV-00815 (E.D. PA, Feb. 3, 1997); *Prusky v. Hartford Life Insurance Company*, 01-CV-03417 (E.D. PA, July 6, 2001); *First Lincoln Holdings, Inc. v. The Equitable Life Assurance Society of the United States*, (S.D. NY 2001), aff'd 43 Fed. Appx. 462 (2nd Cir. 2002); *American National Bank & Trust Company of Chicago v. Allmerica Financial Life Insurance and Annuity Company*, 02-CV-5251 (N.D. IL, July 24, 2002); *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).

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.

We believe the Commission staff places too much reliance on *Miller v. Nationwide Ins. Co.*, 391 F.3d 698 (5th Cir. 2004). The Release cites *Miller* for the proposition that imposition of a redemption fee on existing contracts would not conflict with state insurance laws because the fee would be imposed by the fund rather than pursuant to a contract issued by the insurance company.[13] While the trial court did cite this fact as one of three reasons to grant the defendant's motion to dismiss, this was not part of the holding of the Fifth Circuit Court of Appeals. Rather, the Court of Appeals affirmed the dismissal on the grounds that the plaintiffs' claim under the Securities Act of 1933 was barred by the statute of limitations and their contract claim required dismissal because of the restrictions placed on state law claims under the Securities Litigation Uniform Standards Act ("SLUSA"). The Court of Appeals specifically stated:

> "[W]e express no opinion as to whether Miller did or did not have a viable claim under the Securities Act or whether he had a valid claim for state law breach of contract. We hold only that the statute of limitations ran as to any Securities Act claim and that SLUSA required dismissal of the state contract claim because plaintiff included with his state contract claim allegations of an untrue statement." 391 F.3d 698 at fn3.

Based on these concerns, we recommend that redemption fees imposed by funds offered within variable insurance contracts only apply to new contracts. If the Commission determines to permit the imposition of redemption fees on inforce variable insurance contracts, we strongly request that its rules explicitly state that the Commission intends that the rules will have retroactive effect to existing contracts and are intended to supercede all state laws and state insurance regulations.

IV. Financial Intermediaries

New rule 22c-2 also requires funds to enter into written agreements with each of their financial intermediaries under which the intermediary agrees to:

1. provide, promptly upon request by the fund, Taxpayer Identification Numbers of shareholders that purchased, redeemed, transferred or exchanged shares held through an account with the intermediary, and the amount and dates of such transactions; and

2. execute instructions from the fund to restrict or prohibit further purchases or exchanges of shares by a shareholder who has engaged in transactions that violate the fund's policies.

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[13] See Release at page 23, fn 62.

We are concerned that the rule does not place any limits on the frequency of funds' requests for shareholder identity and trading information. The Release estimates that 60 percent of funds will request shareholder information quarterly, or four times a year.[14] The Release further estimates that, under these assumptions, the aggregate cost burden of the information collection requirements on intermediaries will be $949,500,000 in the first year and a total of $1,730,613,600 over the first three years.[15] Even with the conservative assumptions concerning the frequency of information requests, these are significant costs. As noted in the Release, costs for some intermediaries will be even higher because of the number of funds with which they must communicate. This will likely be the case for issuers of variable insurance contracts that, as previously mentioned, typically offer 30 to 40 different fund choices. These costs will likely be passed on to fund shareholders in the form of higher fees.

The Release acknowledged that the originally proposed weekly quarterly reporting would have resulted in unnecessary burden and cost, but the rule contains no safeguards that funds will not, in fact, request shareholder information much more frequently than quarterly, thereby appreciably raising intermediaries' costs. Accordingly, we recommend that the rule specify how often a fund can make an information request and that it not be more frequently than quarterly.

The Proposing Release included three alternative methods for assuring the imposition of fees in accounts held through financial intermediaries. Under the first method, the intermediary could transmit the account number used to identify the transaction which could be matched with previous transactions by the same account to determine if a redemption fee is applicable. Under the second method, the fund and intermediary could have an agreement under which the intermediary identifies redemptions which would trigger a redemption fee and provides transaction and holdings information sufficient to permit the fund to assess the amount of the fee. Under the third method, the fund and intermediary could have an agreement under which the intermediary assesses the redemption fee and remits it to the fund.

The Commission has requested further comment on these options, including which entity should determine the option used. NAVA and its members continue to believe that, in the context of variable insurance contracts, administration of redemption fees must be handled by the insurance company. As discussed in Section I, the two-tier structure of variable insurance products makes transfers among subaccounts within variable insurance products a more complex process than purchases and redemptions of mutual fund shares.

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. There would also be great costs incurred by the underlying funds to create systems and processes that would essentially duplicate what the insurance company is doing to track

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[14] See Release at page 41.
[15] See Release at page 44.

transactions. The only workable methodology, in our opinion, is for the issuing insurance company to collect any redemption fee that may be due at the time of the transaction that triggers it.

It follows that the insurance company, not the underlying fund, should determine the specific method that will be used to assess the redemption fee. If the decision as to the method to use is made by the funds, an insurance company would be required to implement multiple procedures for providing information to the funds and/or imposing the redemption fee directly, which would be extremely costly.

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

Sincerely,

Michael P. DeGeorge

Michael P. DeGeorge
General Counsel