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May 7, 2004

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

Re: File No. S7-11-04; Mandatory Redemption Fees for Redeemable Fund Securities; Release No. IC-26375A

Commissioners:

We represent the AIG American General domestic life insurance companies (together, the "Insurance Companies"[1]), and are submitting this letter on their behalf and on behalf of their various separate accounts (the "Separate Accounts"). The Separate Accounts are issuers of variable annuity contracts and variable life insurance policies ("variable products") and are registered with the Securities and Exchange Commission (the "Commission") as unit investment trusts pursuant to the Investment Company Act of 1940, as amended (the 1940 Act").

The Insurance Companies commend the Commission and their staff on their efforts to protect long-term investors whose interests are harmed by the frequent trading and market timing activities of some investors. The Insurance Companies are pleased to have this opportunity to comment on the Commission's proposed new Rule 22c-2 under the 1940 Act.[2] The proposed rule would require mutual funds to impose a two-percent fee on the redemption of shares purchased within the previous five business days. As proposed, the redemption fee would apply

[1] The Insurance Companies consist of: American General Life Insurance Company, The United States Life Insurance Company in the City of New York, AIG Life Insurance Company, and American International Life Assurance Company of New York.

[2] *Mandatory Redemption Fees for Redeemable Fund Securities; Proposed Rule*, Investment Company Act Release No. 26375A (Mar. 5, 2004), 69 Fed. Reg. 11762 (Mar. 11, 2004) (to be codified at 17 C.F.R. Part 270) ("Proposing Release").

to retail mutual funds as well as the funds in which the Insurance Companies invest in connection with issuing variable products ("Underlying Funds").

This letter responds in particular to the Commission's request for comment on the legal and administrative issues that insurance companies and funds would face as a result of the proposed rule,[3] the effectiveness of redemption fees, and other more effective ways to deter and prevent harmful frequent trading and market timing activities.

The Insurance Companies strongly oppose the application of proposed Rule 22c-2 to insurance companies, separate accounts and their underlying funds because of the resulting complex and onerous systems and administrative burdens. The Insurance Companies respectfully urge the Commission not to adopt Rule 22c-2, but rather to expand the use of other methods of curbing abusive market timing, as discussed below.

Systems and Administrative Issues

Pursuant to the proposed rule, the Underlying Funds would direct insurance companies, as intermediaries, to act according to each fund's chosen method from the three alternative methods under the proposed rule. Since each of the Insurance Companies' current 51 variable products has numerous and generally unrelated or unaffiliated Underlying Funds, the Insurance Companies would be required to support all three of the methods for each of the 51 current and any future variable products. This would result in the following onerous administrative burdens:

1) The administrative cost estimates discussed below would at least triple;
2) The ongoing administrative costs would at least triple; and
3) The time frames for implementation discussed below would increase to at least two to three years.

In the two-tiered structure of variable products, a separate account of the insurance company, typically registered as a unit investment trust under the 1940 Act, serves as a top tier. The separate account is generally divided into subaccounts, and the contract owner allocates premium payments among the subaccounts and can transfer contract value[4] among the subaccounts. Each subaccount, on an aggregate basis for all variable products, invests and redeems in a specified underlying fund (the bottom tier). The nature of this two-tiered structure means that extensive reprogramming of insurance company administrative systems would be required in order to have the particular variable product contract owners be responsible for payment of the Underlying Funds' redemption fees.

[3] Proposing Release, 69 Fed. Reg. at 11767.
[4] Contract value as used in this letter means the value under a contract or policy attributable to the particular owner or owners.

Under proposed Rule 22c-2(b), the funds would choose from among three optional methods of assuring the correct redemption fee is charged. The first two of these optional methods involve tracking and transmitting individual account information to mutual funds in a manner sufficient to enable the funds to impose the redemption fees, and the third requires collection of the redemption fees and transmittal of the fees to the funds by the insurance companies.

The costs associated with the first two methods would be substantially higher than the third method, as the Insurance Companies would need to work with numerous Underlying Funds independently (with their diverse communication methods) to develop a means for them to transmit, on a daily basis, the amount to be deducted from each subaccount and variable product owner's contract value.

For each of the Insurance Companies' seven administrative systems, the first two methods would require the building of unique infrastructures to accept the transmissions and translate the data into each system's transactions, along with the ability to review each variable product and its allocation rules to properly process the redemption fees. For just one of the seven administrative systems, the development costs to administer either one of the first options are estimated to exceed $1,000,000 and require one to two years to implement. The other six systems could be developed during the same time period, but will likely involve even higher expenses associated with using outside vendors.

The third method would require the Insurance Companies to impose the redemption fees and remit the proceeds to the Underlying Funds. For administrative systems that have the capability to immediately track holding periods of the separate account interests of each contract owner, the third method is less burdensome, as it does not require the separate collection, integration and transmittal of individual contract owner trading activity information to the fund each business day.

However, not all administrative systems operate on this kind of real-time, integrated basis. Many administrative systems are only able to track aggregate redemptions and purchases by the separate accounts, and separately and subsequently calculate and track individual contract owner interests. In order to identify the holding periods using these unintegrated systems, it would be necessary to separately sort through the transactions, possibly manually, to identify the contract owners and the holding periods of their various separate account interests. Significant systems modifications, testing and installation would still need to be accomplished by the Insurance Companies for this third method, at an estimated cost of at least $100,000 for each of the seven administrative systems with a development and testing time of 9-12 months, along with the likely need to employ outside vendors.

Accumulation units[5] are used to account for amounts allocated to or withdrawn from a subaccount. The insurance company determines the number of accumulation units of a subaccount purchased or canceled by dividing the amount allocated to or withdrawn from the subaccount by the dollar value of one accumulation unit. This calculation is made as of the end of the business day on which notice of the transaction is received. Canceling accumulation units presents an assortment of administrative problems.

Placing so much responsibility on intermediaries such as insurance companies could cause increased expense and risk for the funds that would rely on the intermediaries for compliance.[6] As described above, the two-tiered structure of insurance companies and the funds would make it difficult to accurately assess redemption fees, a concern expressed by many other commenters.[7] The funds, as a matter of due diligence, may need to have procedures to help ensure the accuracy of the redemption fees.

Regardless of the method used, transmittal of detailed transactional reports on a weekly basis would nevertheless be required under section (c) of the proposed rule. Providing this information is administratively impractical and would constitute a significant additional burden producing little benefit. For example, for each of the Underlying Funds included in a variable product, the Insurance Companies would need to build a table that ties each fund to a given fund manager, and work with each manager to establish a means of securely transmitting this sensitive data (some of which is subject to privacy constraints). The initial development of a table would take several months, and then an additional month for each fund. Depending on whether and to what extent any consistency exists between and among the funds, this project could take several years to complete, at a significant expense.

The Insurance Companies strongly oppose the application of proposed Rule 22c-2 to insurance companies and their underlying funds because of the resulting complex and onerous systems and administrative burdens.

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[5] Interests in a separate account or subaccount are accounted for during both the accumulation phase and the payout phase by use of units. Units used during the accumulation phase are called "Accumulation Units." According to the Commission's manual used for conducting inspections of separate account operations, accumulation unit value is usually calculated by a formula that produces the same result as the following formulas: Current Unit Value = (Prior Unit Value) * (Net Investment Factor). Net Investment Factor = 1 + (Net Investment Return). Net Investment Return = (Gross Investment Return) - (Aggregate Percentage of Charges taken as a percentage of separate account assets on each valuation date). Gross Investment Return = (Change in dollar value of underlying Fund Share since last valuation) / (Value of Fund Share as of last valuation).

[6] *See* Comments of Sheldon R. Stein, General Counsel for Ariel Capital Management, LLC and Ariel Mutual Funds (Apr. 13, 2004). All comments cited are on the proposed mandatory redemption fee, file number S7-11-04, unless otherwise noted.

[7] Comments by 60 individuals or entities on a stipulated prototype form referred to by the Commission as "Letter Type A."

Unintended Consequences

Another potential administrative system dilemma is adoption of the "FIFO" method under which shares held the longest time are treated as redeemed first and shares held the shortest time are treated as redeemed last. Systems that employ the "LIFO" method of last in, first out, would have to be changed. Such a time-consuming and expensive change is senseless because neither the FIFO nor the LIFO method are determinative with regards to market timing. The FIFO method may not take into account more recent transactions that may constitute market timing because the method does not look to the most recent purchase.

Indeed, using the FIFO method, along with the five-day holding period, could have unintended adverse consequences when used by wealthy investors who make a series of large investments and avoid triggering the redemption fee. The redemption would be considered as coming from the FIFO investment and not from the more recent event held for under five business days. However, smaller investors not capable of making such a series of purchases to establish a base cushion of investment deemed to be the redeemed portion could be exposed to the fee although not acting in an abusive scheme of market timing.

The use of FIFO accounting may land unfairly upon owners who make exactly the same transfers (which could happen if, for instance, two or more owners were using the services of the same financial adviser who had sold the same form of variable product to each) but whose contract values are different and are allocated differently. Under FIFO accounting, any owner with pre-existing contract value in an investment option and who transfers to that option, followed by a transfer within five days out of that same investment option, may escape the proposed redemption fee. On the other hand any owner who had no pre-existing contract value balance in an investment option but who transferred in and out within five days would be subject to the redemption fee, whether LIFO or FIFO accounting is applied. It may be that FIFO accounting over time would discriminate in favor of owners with larger contract values, since such owners would have been handed a road map of how to avoid mandatory redemption fees and have the means (large contract values) to avoid the fees. As between the two owners, both have in theory acted to harm the fund and others invested in the fund, but one pays and the other does not.

The Proposing Release states that use of the LIFO method would include automatic purchase plans, dividend reinvestment plans, and the like which "do not bear the characteristics of market timing."[8] Even so, disregarding the most recent purchase when matching it with the most recent redemption may not capture instances of market timing. Any analysis of purchases and redemptions should examine interests whenever acquired, as market timing activities could go undetected under the use of either method.

[8] Proposing Release, 69 Fed. Reg. at 11765 n.32.

Ineffectiveness of a Redemption Fee

The arbitrary five-day holding period will only affect so-called time zone arbitrage common to funds that primarily invest in foreign securities, and then only in certain circumstances, and will not impact many other market timing activities, particularly those of wealthy investors capable of making a series of large investments and holding their positions beyond the five-day holding period. Imposition of the mandatory redemption fees contemplated under the proposed rule does not address market timing itself, and may serve as no deterrent to market timing activities. Indeed, under some circumstances the proposed redemption fee may serve no purpose whatsoever in deterring market timing, particularly when a contract owner believes that the financial benefit to the owner to market time and suffer the redemption fee is outweighed by the potential gain.

Moreover, it is not clear that a 2% redemption fee would have any inhibiting effect on much of the most damaging time-zone arbitrage that captures wide volatility that yields large percentage returns. In addition, as the Commission is aware, other mutual funds, including bond funds, have also been vulnerable to market timing activities. Bond funds generally have a longer time horizon for market timing opportunities. The arbitrary nature of the holding period would mean that market timing within a five-day period would be subject to a redemption fee while market timing within a six-day period would not. Market timing can and will likely persist under the proposed rule if adopted in its present form, or any form that stipulates holding periods and the method of determining them.

The effectiveness of redemption fees has been questioned by commenters as well as Commissioner Paul Atkins.[9] A number of commenters have criticized the proposed redemption fee for penalizing investors who do not participate in frequent trading activities.[10] Several commenters have questioned whether the actual costs to mutual funds due to short-term trading are great enough to justify a two percent redemption fee.[11] One commenter argued that the redemption fee will not affect small timers, who are exempt, and large timers, who can hold their position long enough to avoid the fee while hedging their mutual fund positions.[12] Also, this commenter suggested that in order to avoid fees, a mutual fund investor may, instead of selling the fund, swap to a third party using a derivative product and then sell shares back to the fund on

[9] Judith Burns & Mark Wigfield, *SEC Proposes Fee on Rapid Trades*, WALL ST. J., Feb. 26, 2004, at D7.

[10] *See, e.g.*, Comments of Warren W. Wall, W. Wall & Company, Inc. (Mar. 18, 2004); Comments of the State of Washington State Investment Board (Mar. 17, 2004); Comments of Steven D. Landis, Landis Financial & Investment Services (Mar. 16, 2004); Comments of Rooney Barker, M Financial Services, Inc. (Mar. 12, 2004).

[11] *See, e.g.*, Comments of Sam C. Bills, Jr., Bills Asset Mangement (Apr. 27, 2004); Comments of Howard R. Hawley (Mar. 14, 2004); Comments of Gary J. Harloff, Ph.D., Harloff Inc. (Mar. 9, 2004); *see also* Comments of Steven D. Landis, Landis Financial & Investment Services (Mar. 16, 2004) (redemption fees should only be used to recoup actual costs incurred by funds because of abusive traders).

[12] Comments of Bin Zhou, Fair Value Research (Feb. 26, 2004).

day five to avoid a two percent fee; this swap could cost much less than the two percent fee.[13] Another commenter expressed the view that market timers would not be deterred if they can make a profit over and above the two percent redemption fee.[14]

Not only have redemption fees been widely criticized, evidence indicates that redemption fees are not as effective in reducing frequent trading and market timing activities as other methods. One earlier commenter[15] provided extensive information from a 2003 Hewitt study that suggests that holding requirements and purchase limits are more successful in reducing frequent trading than redemption fees. Holding requirements provide that money that is transferred into a fund must remain in that fund for a specified period of time. Purchase limits bar investors who transfer money out of a fund from investing in the same fund again for a specified period of time.

The study found that holding requirements curbed excessive trading by 98 percent and purchase limits by 88.3 percent. Use of a redemption fee stopped only 29.1 percent of frequent trading activities in the study. Holding periods and purchase limits are methods already in use by some insurance companies and have the support of the Washington State Investment Board.

Effective Alternatives

The Insurance Companies support the use of holding periods, purchase limits and fair value pricing. However, the Insurance Companies believe the most effective way to deter market timing and other abusive trading activities is for the Commission to adopt a uniform, set definition of market timing and other abusive trading activities and require funds and insurance companies to implement and enforce policies and procedures to deter and prevent such activities. Many others have urged the Commission to do just this.[16] While the Insurance Companies are staunchly opposed to the application of mandatory redemption fees to insurance companies and funds, they recognize that frequent trading and market timing activities are a concern in variable products. The Insurance Companies favor other less burdensome and complex alternatives to a mandatory redemption fee for all insurance companies and fund companies.

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[13] *Id.* at n.2.
[14] Comments of Warren W. Wall,W. Wall & Company, Inc. (Mar. 18, 2004).
[15] Comments of the State of Washington State Investment Board (Mar. 17, 2004).
[16] Comments of Eugene J. Asken (Mar. 31, 2004) (recommending clearly stated policies on purchase and redemption policies that are uniformly enforced); Comments of Steven D. Landis, Landis Financial & Investment Services (Mar. 16, 2004) (recommending clearly stated policies on purchase and redemption policies that are uniformly enforced); Comments 1st Global Capital Corp, File No. S7-26-03 (Feb. 6, 2004) ("[W]e believe that the Commission should set an industry standard definition of trading activity that is presumptively considered to be market timing."); Comments of Great-West Retirement Services, File No. S7-27-03 (Feb. 5, 2004) (encouraging the Commission to adopt a uniform definition of market timing); Comments of the New York State Deferred Compensation Plan, File No. S7-26-03 (Nov. 5, 2003) (stating that retirement plans' efforts to eliminate excessive trading have been "thwarted by the absence of a uniform definition of excess trading").

The Insurance Companies urge the Commission to expand the use of the alternative methods of reducing or eliminating market timing itself, instead of assessing a financial penalty for market timing that at the same time permits market timing. Some owners contemplating market timing may view the mandatory redemption fee as a penalty but not as a deterrent. The most common means by which market timing occurs is through the use of administrative features provided by the issuer of the variable product whereby the contract owner may make transfers by telephone or fax, or assign the owner's right to transfer to a financial adviser who understands how to time the market, while the owner may not. The Insurance Companies suggest that the prohibition of use of such methods to make transfers could be a barrier to market timing that cannot be overcome. For instance, an owner who transfers into and out of the same investment option more than twice in a given period could be required to make subsequent transfers from or to any investment option by prescribed methods that do not facilitate market timing. In the future, such an owner could be required to submit any order by 2:00 p.m. by facsimile. If that was not effective then the procedures could be readily amended to specify that transfer instructions must be only by written instruction delivered only via first class mail to the insurance company (so-called "snail mail"). This type of restriction on the method of effecting transfers could be in force against an owner for a specified period of time and does not appear to violate any rules against restricting the right of redemption, nor raise any state discrimination concerns.

A paramount value of this alternative method of curbing market timing is its flexibility. First and foremost, the Commission's definition of market timing would provide essential guidance to the industry in addressing the current abuses. Any such definition can itself be modified as necessary if the Commission or the industry determines that the definition permits abusive practices. With regard to the mandated policies and procedures, insurance companies and the funds can adapt their policies and procedures to address evolving circumstances. Insurance companies and the funds would also have the ability to incorporate other means of combating abusive trading such as holding periods, purchase limits and fair value pricing, which research indicates are all more effective than redemption fees [17] and do not entail burdensome costs and extended implementation timeframes. Policies and procedures could be tailored rapidly to prevent and deter market timing; mandatory redemption fees, on the other hand, would be a restrictive and inflexible method of targeting market timing. The adaptations necessary under this alternative method can be implemented quickly and at relatively low monetary costs, with minimal administrative and systems burdens. This is in contrast to the imposition of a

[17] *See* Comments of the State of Washington State Investment Board (Mar. 17, 2004) (citing 2003 Hewitt study on effectiveness of holding periods and purchase limits); Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. Econ. & Org. 245, 272 ("Properly constructed fair-value pricing should completely eliminate dilution and should substantially reduce market timing activity and the associated costs to funds."). The Commission staff has stressed the importance of using fair value pricing to protect long-term investors from arbitrage activities of short-term investors. Letter of Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Apr. 30, 2001).

mandatory redemption fee. Furthermore, should the mandatory redemption fee prove ineffective in curbing market timing, there would be no change that could be easily implemented to achieve the Commission's and the insurance industry's goal of eliminating abusive trading.

Other Significant Concerns

The Insurance Companies have been advised that the proposed rule could raise significant issues based on constitutional, contractual, and state insurance law as to the ability of the Insurance Companies to impose redemption fees. Most in-force variable products allow contract owners to transfer contract value among investment options without any charge, or to make a certain number of transfers without a charge. As dually regulated products, these variable products are governed by state insurance laws that require variable products to specify maximum or guaranteed charges. State insurance laws also require these variable product forms to be approved by their respective state insurance departments prior to sale, and the insurance departments may well regard their collection as a unilateral amendment to the variable product to reflect an additional charge and not permit the change. Failure to administer the variable products in accordance with their terms may subject the Insurance Companies to state regulatory fines and sanctions (including state licenses to do business), even if the insurer is acting as an intermediary on behalf of the Underlying Funds. Because the Insurance Companies are subject to compliance with fifty-three different state and territorial jurisdictions the problem can reasonably be assumed to be compounded. This letter does not address these important issues, as the Insurance Companies believe that the Commission will analyze these issues inherent in dually regulated products. The Insurance Companies also believe that the systems and administrative issues described in this letter (the cost, time and inflexibility) are compelling without exhaustive discussion of these issues.

If the Commission, after considering the issues discussed in this letter, and other comments received, still intends to apply the redemption fee to variable products, the Insurance Companies trust that the Commission would, in any subsequent release:

1) provide insurance companies with additional legal support for the Commission's position;
2) work with state insurance departments to resolve state insurance law and regulatory issues;
3) provide grandfathering guidelines for existing variable products;
4) provide the public with notice of the Commission's position on these issues in an effort to minimize the burden of handling the resulting consumer complaints;
5) provide a clear exception for automatic withdrawal programs and systematic transfer programs, irrespective of issues relating to FIFO or LIFO; and
6) provide a lengthy transition period for the Insurance Companies to obtain necessary state approvals of variable product forms that provide for the collection of the

redemption fee, and to design and install the applications and system integration necessary to identify and collect the applicable redemption fees.

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We again express the appreciation of the Insurance Companies for the opportunity to present these comments regarding the Commission's proposal to require the imposition of a mandatory redemption fee. We would be pleased to discuss these or related matters with the members of the Commission or the Commission's staff, should you require additional information. Please contact Joan E. Boros at (202) 965-8150 or JEB@jordenusa.com.

Respectfully submitted,

Joan E. Boros

Joan E. Boros

cc: Steven Glover, Esq.
Laurie Jones, Esq.
Lawrence Blews, Esq.