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Mr. Paul F. Roye
Director
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: **Mandatory Redemption Fees on Insurance-Dedicated Mutual Funds**

S7-11-04

Dear Mr. Roye:

As you know, at a recent open meeting of the Securities and Exchange Commission (the "Commission"), Chairman Donaldson noted that on February 25, 2004, the Commission will consider proposing a rule to require mutual funds to impose a mandatory redemption fee on market timers.[1] Chairman Donaldson also noted that the Commission would be considering any pertinent recommendations from the NASD's Omnibus Account Task Force.[2] As you know, the Task Force was convened at the Commission's request to consider how a mandatory redemption fee could be imposed on trades processed through omnibus accounts, since funds typically do not have information that identifies customers who acquire and dispose of fund shares through such accounts at intermediaries such as broker-dealers.

The Omnibus Account Task Force's report (the "Omnibus Account Report" or "Report") noted in a footnote that members of the NASD's Independent Dealer/Insurance Affiliate and Variable Insurance Products Committees had been consulted to identify challenges unique to the insurance industry. Members of these two committees noted that significant systems modifications would be required to detect frequent trading by variable contract holders, that some insurance contracts offer an unlimited right to transfer among funds, and that there may be legal issues associated with imposing fees in these circumstances. The Report did not, however,

[1] *See* Opening Statement at SEC Open Meeting, by Chairman William H. Donaldson, Washington, DC, available at http://www.sec.gov/news/speech.shtml#chair (visited February 9, 2004).
[2] *See* REPORT OF THE OMNIBUS ACCOUNT TASK FORCE (January 2004), available at http://www.nasd.com/pdf_text/omnibus_report.pdf (visited February 9, 2004).

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elaborate upon or seemingly factor these variable insurance product issues into its subsequent discussions and recommendations.

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") to provide additional information about the administrative and legal challenges mentioned in the Omnibus Account Report.[3] We hope that this information will assist the Commission staff in developing a comprehensive rule proposal and in identifying and seeking public comment on the specific issues that a mandatory redemption fee proposal would raise for insurance-dedicated mutual funds and insurance companies issuing variable annuities.

Two-tiered Structure of Variable Contracts

As you know, there are significant differences between mutual funds and variable annuities. Unlike mutual fund shares, a variable annuity is a written contract between two parties: the insurance company that issues the contract and the owner who purchases the contract. That contract gives each party certain rights, and in general neither party can unilaterally change the terms of the contract or take away a right of the other party. Importantly, variable annuity contracts generally give the owner certain rights with respect to the pricing of purchases, redemptions, and transfers between investment options (generally called "subaccounts"). Those rights are based on and consistent with the Investment Company Act of 1940 (the "1940 Act") and rules thereunder, including Rule 22c-1.[4] These contracts also specify, and limit, the charges that can be assessed in connection with the contracts.

Virtually all variable annuities today are issued through a two-tier investment company structure. The top tier is a separate account of the issuing insurance company that is registered under the 1940 Act as a unit investment trust. The separate account is generally divided into subaccounts, and the owner allocates premium payments among the subaccounts and can transfer contract value among the subaccounts. Each subaccount typically invests in shares of a particular registered mutual fund portfolio (the bottom tier).

State insurance laws generally require that variable annuity contracts contain detailed pricing formulae. For example, Section 6.D.(1) of the National Association of Insurance Commissioner's *Model Variable Annuity Regulation* (the "Model Regulation") requires variable annuity contracts to stipulate the "investment increment factors" to be used in computing the dollar amount of variable benefits or other contractual payments or values thereunder. To

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[3] The Committee of Annuity Insurers is a coalition of life insurance companies that issue fixed and variable annuities. The Committee was formed in 1981 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent approximately half of the annuity business in the United States.

[4] The Commission has proposed amendments to Rule 22c-1. *See* Release Nos. 33-8343; IC-26287 (December 11, 2003). The Committee submitted a comment letter on the proposal on February 6, 2004.

comply with the Model Regulation, variable annuity contracts typically contain detailed provisions specifying how transaction requests are priced. For example, variable annuity contracts generally provide that "accumulation units" are used to account for all amounts allocated to or withdrawn from a subaccount as a result of purchase payments, withdrawals, transfers, or fees and charges. The insurance company determines the number of accumulation units of a subaccount purchased or canceled by dividing the amount allocated to (or the amount withdrawn from) the subaccount, by the dollar value of one accumulation unit (known as accumulation unit value, or "AUV") of the subaccount as of the end of the business day during which the notice for the transaction is received at the insurance company.

Contracts also typically provide that the AUV of a subaccount will be calculated based on that business day's net asset value ("NAV") per share of the subaccount's underlying fund. The initial AUV for each subaccount is set by the insurance company. Subsequent AUVs for each subaccount are then determined by multiplying the AUV for the immediately preceding business day by the "net investment factor" of the subaccount for the current business day. The net investment factor for each subaccount is determined by dividing A by B and multiplying by (1-C), where:

A is

(i) the NAV per share of the underlying fund held by the subaccount at the end of the current business day; plus

(ii) any dividend or capital gains per share declared on behalf of such underlying fund that has an ex-dividend date as of the current business day;

B is the NAV per share of the underlying fund held by the subaccount for the immediately preceding business day; and

C is

(i) the asset-based separate account product charges for each day since the last business day; plus
(ii) a charge factor, if any, for any taxes or any tax reserve the insurance company has established as a result of the operation of the subaccount.

Possible Issues Relating To Mandatory Redemption Fees

There could be different methods for assessing a redemption fee on individual variable annuity contract owners. Each methodology, however, would be administratively complex and very well may raise significant legal issues.

One method would involve the insurance company deducting the redemption fee directly from a contract owner's account value by canceling accumulation units. From an administrative standpoint, we understand that adding the functionality necessary to identify and track contract owners who engage in short-term trades that would trigger assessment of the redemption fee, and then determining for subsequent transactions whether to assess the redemption fee, would require insurance companies to make extensive and costly systems changes. Perhaps more importantly, from a legal perspective, because variable annuity contracts are required by state insurance law to specify maximum or guaranteed charges, depending on the particular facts and circumstances existing contracts may need to be amended to permit an additional charge to be assessed. However, state insurance departments may not permit such an amendment.

Moreover, regardless of any position taken by state insurance regulators, there is no reason to believe that variable annuity contract owners would simply give up their rights under contractual provisions guaranteeing maximum charges, since as noted above, unlike mutual fund shareholders annuity contract owners have an actual, enforceable contract with the insurance company. In fact, we are aware that variable annuity contract owners who have had a short-term redemption fee imposed on their account have sued (or threatened to sue) insurance companies for breach of contract. A federal district court recently dismissed one such case on the grounds that the underlying fund, and not the insurance company, imposed the redemption fee. However, this case may not preclude other litigation on this point, and the associated litigation costs could be significant.

There could possibly be other methodologies for deducting a redemption fee in connection with variable annuity contracts, but these methodologies also would be costly and administratively complex and may raise similar legal issues. For example, an insurance company might be able to deduct a redemption fee by including the amount of the fee in the daily charge factor used in calculating the daily net investment factor used to calculate AUVs for each subaccount under the contract. Among other complexities, however, the company's data processing systems would be required to keep track of hundreds or thousands of additional AUVs (each of which may be required by Form N-4 to be disclosed in the registration statement for the contract). Another methodology could involve underlying funds deducting the fee. This approach, however, may require separate purchase and redemption orders to be submitted for each contract owner against whom a redemption fee is to be assessed, as well as the creation of a separate subaccount for each such contract owner.

Recommendations

Based on the complex administrative and legal issues that would face insurance companies and underlying funds if such funds were required to impose short-term redemption fees, we recommend that the Commission's rulemaking proposal make short-term redemption fees optional, rather than mandatory, for underlying insurance funds.[5] Similarly, we believe that insurance companies should not be required by any Commission rulemaking proposal to impose short-term redemption fees on contract owners.

* * *

The Committee appreciates the time and resources that the Commission and its staff have devoted to rulemaking initiatives aimed at protecting mutual fund and variable annuity investors from abusive market timing. We also appreciate your consideration of our comments and recommendations herein.

Respectfully Submitted,

Sutherland Asbill & Brennan LLP

By: Steve Roth

Stephen E. Roth

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FOR THE COMMITTEE OF ANNUITY INSURERS

cc: Robert E. Plaze, Associate Director, Division of Investment Management
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[5] We are recommending that short-term redemption fees be optional for insurance funds in case there may be circumstances where a fund and an insurance company determine that the benefits of a mandatory short-term redemption fee potentially outweigh the associated administrative costs. We note that some underlying insurance funds have recently adopted short-term redemption fees. The Commission could ask these funds to comment on the administrative and legal issues associated with such fees.