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January 14, 2020

Ms. Vanessa Countryman
Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Request for a Hearing on the Application for Order of Approval Pursuant to Section 26(c) of the Investment Company Act – Allianz Life Insurance Company of North America, et al. (File No. 812-14722)

Dear Ms. Countryman:

We represent Franklin Advisers, Inc., Franklin Mutual Advisers, LLC and Templeton Global Advisors Limited (together, the "Advisers") with respect to their opposition to the Application filed by Allianz Life Insurance Company of North America, et al. ("Allianz") on December 7, 2016, amended on May 31, 2017, and amended further on August 4, 2017, May 31, 2019 and August 13, 2019, SEC file no. 812-14722 (as amended, the "Application"). The Advisers serve as investment advisers to certain series of Franklin Templeton Variable Insurance Products Trust ("FTVIPT"), a variable insurance trust registered under the Investment Company Act of 1940, as amended (the "Investment Company Act") that consists of 18 series with over $20 billion in assets. Allianz requests an order approving the substitution of certain securities pursuant to Section 26(c) of the Investment Company Act and an order pursuant to Section 17(b) exempting Allianz from Section 17(a) to the extent necessary to permit it to engage in certain affiliated transactions otherwise prohibited by Section 17(a) of the Investment Company Act.

In our letters to the Staff of the Division of Investment Management, dated May 10, 2017, June 8, 2017, August 22, 2017 and September 12, 2019, we stated that the substitutions proposed by the Application would be inconsistent with the protection of investors.[1] The Application, if

[1] https://www.sec.gov/comments/812-14722/812-14722.htm. *See also* Anonymous Letter dated December 30, 2019 and sent to Chairman Clayton and others (a copy of which is included) ("Interestingly, if an insurance company suggested to an investor that they move their money to another fund, that would be investment advice

granted by the Securities and Exchange Commission (the "Commission"), would permit the substitution of 13 underlying funds of 36 different Allianz variable annuity and variable life contracts, each registered under the Securities Act of 1933 (the "Securities Act"), with 10 funds managed by either Allianz Investment Management LLC ("AIM") or Pacific Investment Management Company LLC, each an affiliate of Allianz (the "Proposed Substitutions"). Having registered these 36 variable contracts and chosen the proprietary and third party mutual funds to serve as investment vehicles for them, Allianz now seeks the Commission's assistance to unilaterally modify the choices contractowners agreed to over a period exceeding 25 years. The 13 funds to be replaced represent approximately $3.94 billion of total assets and include five series of the FTVIPT (each a "FTVIPT Fund" and together, the "FTVIPT Funds") with a total of approximately $1.91 billion in Allianz assets, as of December 31, 2018.

We believe that the Proposed Substitutions would involuntarily and materially alter the contracts that the investors originally purchased. The Proposed Substitutions would override the investment decisions contractowners made (in many instances, years ago) as to which variable contracts to purchase and which mutual fund(s) to implement their contract and, further, could affect the benefits, rights and privileges of the variable contracts the contractowners chose. As discussed below, the Commission should not facilitate such unilateral contract amendments where there is no analysis of the effect on the contractowner's investment decisions.

Instead of granting the Proposed Substitutions, the Commission should encourage Allianz to follow the customary method by which new funds are marketed to variable contractowners – offering the funds as an additional investment option for contractowners to choose. This would give contractowners the freedom to choose for themselves whether to modify the investment choices that they previously bargained for based on their individual circumstances.

Accordingly, on behalf of the Advisers and for the reasons discussed below, we hereby request a hearing on the Application. We believe that a hearing is needed for the Commission and all interested parties to consider evidence of the impact of the Proposed Substitutions on the investors that purchased the 36 different Allianz contracts, particularly those contracts using the FTVIPT Funds, and to determine whether the Proposed Substitutions are consistent with the protection of investors.

I. REASONS FOR GRANTING THE HEARING REQUEST

Section 26(c) of the Investment Company Act allows the Commission to approve a substitution of an underlying fund only if the "**evidence** establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title" (emphasis added). The Application makes no attempt to address the differing degrees of impact the Proposed Substitutions could have on any of the 36 contracts or even on the types of contracts. The variable contracts contain different guaranteed death benefits and living benefits that contractowners purchased, but the Application does not contain any evidence of the effect of each

subject to the Investment Advisers Act and would be held to a fiduciary standard. Instead, by forcibly moving the investor's money, they are somehow held to a lesser standard. This is not right. . . . Allianz and most substitution applications have not made a compelling case as to why the substitution is in the interest of investors ...").

Proposed Substitution on each benefit. The Application also asserts that the replacement funds are basically the same as the funds that they are replacing, but provides very little analysis to support this conclusion. Because the Proposed Substitutions would override the choices of thousands of contractowners, we believe that a hearing is needed to determine whether the Proposed Substitutions are consistent with the protection of investors.

We further believe that a hearing is necessary to consider the potential harm that the Proposed Substitutions could have on the remaining shareholders in the FTVIPT Funds. For example, the significant loss of assets in the FTVIPT Funds may result in fee and/or expense increases as certain of the FTVIPT Funds might lose the benefit of certain breakpoints in their investment advisory fees and fixed costs would be spread across a smaller base. These increases would also affect owners of variable contracts issued by other insurance companies that use the FTVIPT Funds as underlying fund investment options. Notwithstanding the statement in the notice of application (the "Notice") suggesting that the Commission is obligated only to ensure that contractowners are protected,[2] we believe that the Commission should ensure that the interests of *all* shareholders, including those remaining in funds affected by the Proposed Substitutions, should be considered when determining whether an order would be consistent with the protection of investors.

Congress amended Section 26(c) (formerly, Section 26(b)) of the Investment Company Act) in 1970 to require Commission approval of fund substitutions in insurance products. For at least 20 years following the adoption of the 1970 amendments, the Commission largely approved fund substitutions involving emergencies or unforeseen circumstances, such as the sudden closure of a fund offered as an investment option.[3] Over the last few decades, however, the underlying rationale for substitutions has changed dramatically, with the main impetus being the insurance company's desire to reduce expenses when contract benefits proved more expensive than predicted. Contrary to the assertion in the Notice, the Advisers do not argue that substitutions should be permitted only in rare or unforeseen circumstances. Instead, the Advisers believe that the sweeping nature of the Proposed Substitutions requires the Commission to perform a thorough and independent analysis of the impact on investors. Substitutions that take away investor choice on the basis of benefitting the annuity provider (in this case, by reducing the number of funds that the annuity provider is overseeing and in improving contract administration), should be subject to increased scrutiny of actual evidence of benefits to the contractowners. Where evidence of

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2 Notice of Application, Investment Company Act Release No. 33721 (Dec. 20, 2019).

3 *See e.g.*, Nationwide Life Ins. Co., Investment Company Act Release No. 17178 (Oct. 18, 1989) (order) (board of five funds managed by adviser unaffiliated with insurer voted to cease sale of shares and all operations of the funds due to their small size and high level of expenses; insurer substituted shares of five new funds); Bankers Nat'l Life Ins. Co., Investment Company Act Release No. 15827 (June 25, 1987) (order) (insurer substituted shares of a mortgage-backed securities fund that met the tax diversification requirements for those of a government securities fund that could not); Nationwide Life Ins. Co., Investment Company Act Release No. 13915 (May 1, 1984) (order) (owners voted to liquidate money market fund); Hartford Variable Annuity Life Ins. Co., Investment Company Act Release No. 13209 (May 2, 1983) (order) (three funds substituted for three virtually identical funds to avoid adverse tax treatment); Educators Life Ins. Co., Investment Company Act Release No. 10433 (Oct. 12, 1978) (order) (funds substituted in light of dissolution plan).

meaningful investor benefits is lacking, investors should be offered *more* choice, rather than a substitution that *takes away* investor choice.[4]

II. LEGAL ISSUES

a. Whether the Notice meets the standards required under the Administrative Procedures Act.

Under the Administrative Procedures Act (the "APA"), the Commission is required to undertake an independent "reasoned analysis" of the evidence presented in the Application to justify taking regulatory action.[5] A 2017 D.C. Circuit Court of Appeals decision makes clear that the Commission must make its own findings and determinations based on *evidence* when issuing an order.[6]

In the *Susquehanna* case, two options exchanges and two broker-dealers petitioned the court to review a Commission order approving proposed changes to Options Clearing Corporation ("OCC") rules. Among other arguments, the Petitioners asserted that that the order was defective because the Commission failed to make its own findings and determinations required in order to approve the rule proposal, including that the proposal was consistent with the Exchange Act.[7] Although the Commission's order stated that it had made its own specific findings and determinations, the court agreed with the Petitioners that the Commission had not. In the opinion written by Chief Judge Merrick Garland, the court found that the order "[reflected] little or no evidence of the basis for the OCC's own determinations—and few indications that the [Commission] even knew what that evidence was." The court found that the Commission's statements that it had "considered" or "found" certain factors was insufficient, and the court

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4 *See also* P. Roye, *"Understanding the Securities Products of Insurance Companies,"* New York, N.Y. (Jan. 10, 2002) *available at* https://www.sec.gov/news/speech/spch533.htm ("While in the past, these applications were mainly filed by insurance companies that were facing unforeseen circumstances caused by changes in the underlying fund, we are now seeing quite a few applications filed in connection with changes in the insurance company's strategic business plans. Accordingly, our analysis of these applications has evolved as well, in response to the new facts and circumstances reflected in these applications…[w]e look carefully at each application to determine the overall impact the substitution will have on contractowners."). Mr. Roye was the Director of the Division of Investment Management in 2002.

5 *See Susquehanna Int'l Grp., LLP v. Sec. & Exch. Comm'n*, No. 16-1061, 2017 WL 3389269 (D.C. Cir. Aug. 8, 2017) (hereinafter "*Susquehanna*"); *see also* KRISTIN E. HICKMAN & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 11.4 (5th ed. 2017) ("Since APA §706 requires courts to review all agency actions through application of the arbitrary and capricious test, all actions must satisfy the reasoned decision-making component of that test independent of the adequacy of the agency's evidentiary support for its findings."); *see also Illinois Commerce Comm'n v. ICC*, 848 F.2d 1246, 1258 (D.C. Cir. 1988) (noting that the agency could not delegate its own responsibility to independently investigate as required by the statute).

6 *Susquehanna.*

7 "The Exchange Act permits the SEC to approve OCC's proposed rule change only 'if it finds that' the proposal is consistent with the requirements of the Act. 15 U.S.C. § 78s(b)(2)(C)(i), (ii). That is possible only if the SEC 'determines that' the rule complies with specified requirements, 15 U.S.C. § 78q-1(b)(3)." *Susquehanna* at *10.

observed that "stating, not finding, is what the Commission did here."[8] The court emphasized that the Commission must actually make its own finding, noting:

> When a statute requires an agency to make a finding as a prerequisite to action, it must do so. Merely "[r]eferencing a requirement is not the same as complying with that requirement." . . . Nor may the agency delegate its responsibility to the regulated party. *See State of Idaho v. ICC*, 35 F.3d 585, 596 (D.C. Cir. 1994) (holding that the ICC failed to meet its responsibilities under [the National Environmental Policy Act] by "deferr[ing] not only to the judgments of other agencies, but also to that of Union Pacific, the licensee").[9]

The court held that by simply accepting the OCC's statements without making an independent review, the Commission had "effectively abdicated" its responsibility to undertake its own reasoned analysis, as the Exchange Act and the APA require. As a result, the Commission's conclusion was "unsupported by substantial evidence" and was thus "arbitrary and capricious."[10] The court remanded the order to the Commission.[11] In the same manner, the Notice re-states the assertions made in the Application and does not set forth a reasoned and independent analysis of the assertions in the Application. Because the Notice implicitly relies on Allianz's unsupported statements, the Commission would be effectively abdicating its responsibility under the APA if it granted the order.[12]

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8 *Susquehanna* at *8.

9 *Id.* (quoting *Gerber v. Norton*, 294 F.3d 173, 185-86 (D.C. Cir. 2002)).

10 Under the APA, a court must "hold unlawful and set aside agency action" that is "arbitrary [and] capricious" or "unsupported by substantial evidence." *See also NetCoalition v. SEC*, 615 F.3d 525, 539 (D.C. Cir. 2010) (emphasizing the need for the Commission to make an independent finding and support its finding with evidence, and noting that the court does "not defer to the agency's conclusory or unsupported suppositions").

11 Following the remand, the Commission determined that the OCC's information did not support a finding that the rule change was consistent with the Exchange Act. In reaching this determination, the Commission reiterated the *Susquehanna* court's holding that it must "critically evaluate the representations made and the conclusions drawn" by the OCC in determining whether the rule change was consistent with the Exchange Act. *See* Securities Exchange Act Release No. 85121 (Feb. 13, 2019).

12 We attempted to gain some insight into the Staff's support for the Application by making a Freedom of Information Act ("FOIA") request for documents relating to the discussions between the Staff and Allianz. In response to our May 11, 2017 FOIA request (resubmitted on June 29, 2018) we received an email from the FOIA Office on August 28, 2018 with copies of certain correspondence containing the Staff's comments and Allianz's responses in connection with the filings of the first and second amendments and restatements of the Application. Because the correspondence did not include any evidence of the benefits to contractowners other than the two-year temporary waiver of Destination fund fees to match the Target fund fees, we continue to believe that a hearing is needed to determine whether the Proposed Substitutions would be consistent with the protection of investors.

b. Whether the Application meets the exemptive standards that Section 26(c) of the Investment Company Act requires.

Not only is the Notice deficient under the APA, the Application itself does not meet the standards for granting relief under Section 26(c).[13] Section 26(c) allows the Commission to approve a substitution of an underlying fund only if the "evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title". The Application does not contain any *actual evidence* that the Proposed Substitutions will be in the best interests of the affected contractowners. The Application lists three "benefits": a temporary two-year waiver of Destination fund fees to match Target fund fees, improved contract administration, and better fund oversight by Allianz due to fewer funds. With the exception of the temporary fee waivers, these benefits favor Allianz and not contractowners. In addition, given the long term nature of a variable contract, and how contractowners generally use these contracts when they reach retirement, it is difficult to ascribe much weight to the investor benefit resulting from the two-year matching fee waiver.[14]

The exemptive standard under Section 26(c) is different than the general exemptive standard in Section 6(c) of the Investment Company Act and other exemptive provisions of the federal securities laws. The distinction between Section 26(c) and Section 6(c) of the same statute is critical – Section 6(c) never uses the word "evidence." For that matter, the exemptive relief standards under the Investment Advisers Act of 1940, the Securities Exchange Act of 1934 (the "Exchange Act"), and the Securities Act do not include the "evidence establishes" language.[15] Where Congress includes a particular phrase in one section of a statute, but omits it in another, it is a general canon of construction that Congress acted intentionally and purposely in the disparate inclusion.[16] Congress specifically intended to require "evidence" or proof for Section 26(c)

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13 15 U.S.C. § 80a-26(c).

14 *See also* A. Donohue, *"Remarks Before the ALI-ABA Conference on Life Insurance Company Products,"* Washington, DC (Nov. 6, 2009), *available at* https://www.sec.gov/news/speech/2009/spch110609ajd.htm ("Investors look to variable products, and in particular, the living benefit riders that have become so central to the marketing of these products, to address particular financial objectives. Investors have legitimate expectations that they will get the benefit of the bargain that they struck with an insurer when buying a contract. This is perhaps more important for variable contracts than for other investment vehicles, **given the long-term nature of the investment,** and the significant surrender charges and tax penalties facing an investor whose expectations have been frustrated and who therefore looks to move on ....") (emphasis added). Mr. Donohue was the Director of the Division of Investment Management in 2009.

15 *See e.g.,* 15 U.S.C. § 80b-6a (Investment Advisers Act) ("The Commission . . . . may conditionally or unconditionally exempt any person or transaction . . . if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."); 15 U.S.C. § 78mm (Exchange Act) ("[T]he Commission . . . may conditionally or unconditionally exempt any person, security, or transaction, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."); 15 U.S.C. § 77z-3 (Securities Act) ("The Commission . . may conditionally or unconditionally exempt any person, security, or transaction . . . to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.").

16 The presumption of meaningful variation is a canon of construction that every word and clause must be given effect, and a variation in statutory wording throughout a statute denotes a change in meaning. *See Keene Corp. v.*

substitutions, given that Congress added Section 26(c) to the Investment Company Act to address concerns that investors were notified of substitutions after-the-fact.[17]

The Application states in a conclusory manner that "the terms and conditions of the proposed Substitutions are consistent with the principles and purposes of Section 26(c) and do not entail any of the abuses that Section 26(c) is designed to prevent." The Application provides no supporting evidence that the Proposed Substitutions are consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act.[18] Without such evidence, we do not believe that the Commission has a basis for granting relief under Section 26(c).

c. Whether the Application meets the Commission's own guidelines for filing exemptive applications.

The Application also fails to meet the Commission's current and long-standing evidentiary standards for exemptive applications. The Commission's Guidelines for Filing of Application for Exemption (the "Guidelines") require the following:

> Each applicant should state an adequate basis for the relief requested, including *detailed justification* for removal of any statutory protections, and *identify any positive benefits* expected for investors and any conditions imposed to protect investors. The Division will not support an application that requests relief not adequately justified. In such instances, the Division will request that the application be either withdrawn or significantly amended.[19]

The Guidelines note that, if the Division cannot support an application on this basis, the Division "will submit the application to the Commission with a recommendation that the application be set down for a hearing, unless it is withdrawn."[20]

United States, 508 U.S. 200, 208 (1993); *see also Bailey v. United States*, 516 U.S. 137, 146 (1995) (distinction in one provision between "used" and "intended to be used" creates implication that related provision's reliance on "use" alone refers to actual and not intended use); *see also* Office of the Legislative Counsel, U.S. House of Representatives, House Legislative Counsel's Manual on Drafting Style (1995) *available at* http://www.thecapitol.net/Research/images/HOLC.Manual.on.Drafting.Style.1995.pdf (Section 201 of the House Manual cites the "doctrine that variations within a law are designed to convey meaning" and Section 105 states that "[a] court presumes that different words have different meanings" and "that every word is there for a reason.").

[17] Pub. L. No. 91-547, 84 Stat. 1413 (Dec. 14, 1970); *see* House Committee on Interstate and Foreign Commerce, Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. 337 (1966).

[18] *NetCoalition v. SEC*, 615 F.3d 525, 541 (D.C. Cir. 2010) (holding that the Commission's order was arbitrary and capricious because of a "lack of support in the record for the [Commission's] conclusion" and noting that the Commission's conclusory statement "was a conclusion, not evidence.").

[19] Guidelines for Filing of Application for Exemption, Investment Company Act Release No. 14992 (Apr. 30, 1985) (emphasis added) (hereinafter "Guidelines"); *see* Investment Company Registration and Regulation Package, SEC Fast Answers (Feb. 19, 2013) *available at* https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html.

[20] Guidelines at n.3.

The Application does not provide a detailed justification for the Proposed Substitutions and fails to identify any positive and significant benefits expected for investors. The benefits asserted in the Application overwhelmingly run to Allianz – concentrated and streamlined operations, simplified administration of the variable contracts, increased ability to effectively oversee investment options available to contractowners – not to the contractowners themselves. While the Application states that the Proposed Substitutions are "designed to provide contractowners with the ability to continue their investment in similar Investment Options without interruption and at no additional cost," this could hardly be considered a benefit, particularly given the fact that the contractowners' investment choice is being taken away from them. It is simply not clear how the Commission could support the Application in accordance with its long-standing Guidelines.

d. Whether the Proposed Substitutions are consistent with the policy and provisions of the Investment Company Act.

The Proposed Substitutions are not consistent with the policy and provisions of the Investment Company Act as set out in Section 1(b) of the Act. Section 1(b) states that "the national public interest and the interests of investors are adversely affected ... (2) when investment companies are organized, operated and managed ... in the interests of directors, officers, investment advisers, depositors, or other affiliated persons thereof, ... rather than in the interest of all classes of such companies' security holders." The Proposed Substitutions would be in the interests of Allianz rather than contractowners.

Most exemptions granted under the Investment Company Act relieve registered funds from regulatory provisions where the safeguards associated with those provisions are not needed under the application's facts and circumstances, particularly when the requestor offers conditions to protect fund investors. Section 26(c), however, is different from all other Investment Company Act exemptions in that it permits the Commission to modify materially investor decisions after-the-fact. This type of exemption should only be granted where the investors affected would *demonstrably benefit* from after-the-fact modifications to their investments. There is no evidence in the Application that the contractowners will benefit from the Proposed Substitutions (other than a temporary fee waiver), and no record has been developed to indicate that the Proposed Substitutions are consistent with the policy and provisions of the Investment Company Act. The only certainty is that the Proposed Substitutions will deprive contractowners of the choices that they made.

Before Congress amended the Investment Company Act in 1970, substitutions were permitted merely upon notice to contractowners. In a 1966 Staff study, the Commission recommended that Congress, among other things, amend Section 26 to give contractowners a voice in fund substitutions:

> "Accordingly, the Commission recommends that section 26 be amended to require that proposed substitutions may not occur without Commission approval. Not only would there be Commission scrutiny, <u>but interested shareholders would also have an opportunity to state their views about the proposed substitution</u>. Before issuing an order approving the substitution, the

> Commission would be required to find that the substitution is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act."[21]

Without evidence of the potential effects of the Proposed Substitutions on contractowners' guarantees, it would be impossible for interested contractowners to form a reasoned basis upon which to state their views – thus frustrating the purpose of the amendment.

The Staff itself seems conflicted about substitutions. The Commission's Office of Investor Education and Advocacy issued an investor alert and bulletin regarding variable annuity buyout offers, which are essentially voluntary substitutions, noting that "[i]insurance companies may make buyout offers because it is in their best interest to do so…[and] do[es] not make a buyout offer solely based on a determination that it is in your best interest." [22] In a 2016 speech, David Grim, former Director of the Division of Investment Management, raised concerns about variable insurance contract buyout offers, noting:

> The staff believes these sorts of offers should remain under a spotlight given our ongoing concern that they may not be beneficial for all, or even most, contractowners. It is difficult to quantify the value of a living benefit, which changes over time with market movements and other variables. It is thus difficult to compare contracts in an exchange offer, or to assess any offer for a buyout of one's contract. Accordingly, let me reiterate my encouragement to you "to carefully monitor sales practices associated with these offers." [23]

In a buyout offer, contractowners receive consideration for accepting the insurance company's offer. In contrast, substitutions do not provide contractowners *any* consideration in exchange for giving up the funds they had selected, and should be of even *more* concern to the Commission. Given the lack of contractowner consent or financial compensation, the Commission should therefore view such transactions with heightened scrutiny.

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21 Securities and Exchange Commission, Public Policy Implications of Investment Company Growth (1966) at 337 (emphasis added).

22 Office of Investor Education and Advocacy, *Variable Annuities-Should you Accept a Buyout Offer?* (Jul. 14, 2016) *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_buyvarannuities.html.

23 D. Grim, "*Remarks to the ALI CLE 2016 Conference on Life Insurance Products,*" Washington, DC (Nov. 4, 2016) *available at* https://www.sec.govinews/speech/grim-remarks-ali-cle-2016-conference-life-insurance-products.html; D. Grim, "*Remarks to the ALI CLE 2015 Conference on Life Insurance Company Products,*" Washington, DC (Nov. 2, 2015) *available at* https://www.sec.govinews/speech/remarks-ali-cle-2015-conf-life-insurance-company-products-grim.html; *see also* N. Champ (former Director of the Division of Investment Management), "*Remarks to the ALI CLE 2014 Conference on Life Insurance Company Products,*" Washington, DC (Nov. 13, 2014), *available at* https://www.sec.gov/news/speech/2014-spch111314-nc ("[The Commission] is seeking to be proactive in identifying changes in the variable insurance product space, and to ascertain whether such changes raise investor protection concerns, whether they are consistent with existing disclosures and, more fundamentally, *whether they constitute a failure on the part of the issuer to honor the letter and the spirit of the bargain struck with investors*.") (emphasis added).

III. FACTUAL ISSUES

Under the Commission's rules governing hearing requests under the Investment Company Act, we believe that the Application presents "significant issues that have not been previously settled by the Commission" as well as important questions of policy and fact.[24] The Advisers firmly believe that a public hearing is needed to build a detailed record because of the lack of evidence in the Application and the issues it raises.

a. The Application does not assess the differing effects on the 36 variable contracts – or even the effect of the Proposed Substitutions in general – to determine whether the Proposed Substitutions are consistent with the protection of investors.

The Commission may only issue an exemptive order approving a substitution if the evidence establishes that the substitution is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act. In order to do so, the Commission must look carefully at each application to determine the overall impact the substitution will have on contractowners. Contractowners made two investment decisions when they invested – they chose a particular variable contract, and then they selected the underlying funds in which their contract would invest. A change in one or more underlying funds will have some effect on the performance and benefits of the contract, but the extent of that effect has not been presented. The performance of the underlying funds has more of an effect on a contract's guarantees during the accumulation phase of a variable annuity – before the contractowner starts receiving income – than during the income distribution phase. However, the Application does not provide any information on the percentage of the contracts that are in the accumulation phase versus the distribution phase. Without this information, the Commission lacks evidence on how the Proposed Substitutions would impact the different groups of contractowners, much less the evidence on which to base a finding that investors will be protected.

The Application acknowledges that 36 different Allianz variable annuity and variable life contracts will be affected. Because the contracts have different provisions and features, including guarantees, we believe that the Commission also must assess the differing degrees of impact on each of the 36 contracts – or at least the types of contracts affected – to determine whether the Proposed Substitutions are consistent with the protection of investors. The Application and Notice do not analyze the impact upon the different contracts, types of contracts, or even any particular contract, and thus the record to date consists solely of Allianz's unsupported assertions. As in *Susquehanna,* the standards of Section 26(c) do not permit the Commission to base its approval on the assertions of the regulated entity.

In addition, the variable contracts contain different guaranteed death benefits and living benefits. The effect of each Proposed Substitution on each benefit varies greatly depending upon factors such as the performance of the fund, frequency of the election of the benefit, and the timing of the exercise of the benefits. Depending on the guarantee, higher fund returns can produce outcomes ranging from enhancing value, decreasing value, having an approximately equal chance of increasing or decreasing value, or having no effect on value. It is simply not possible to say,

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[24] 17 C.F.R. § 200.30-5.

based solely on the information in the Application, that the Proposed Substitutions would be in the best interests of *all* contractowners without assessing these factors.

The Application states: "What effect the proposed Substitutions may have on the value of the benefits offered by the contract guarantees would depend, among other things, on the relative future performance of the Target Funds and Destination Funds, which Section 26 Applicants cannot predict."[25] While the future performance of any current fund and replacement fund and their effect on guarantees cannot be predicted with certainty, the relative performance can be estimated based on the long-term historical differential performance of the two funds, and some of the FTVIPT Funds surpass the corresponding replacement funds in these estimates. A Monte Carlo analysis could predict the effects of the Proposed Substitutions on the contract guarantees under different market scenarios – an analysis that we believe insurance companies already perform as part of their financial risk analysis. We believe that such an analysis is necessary to determine whether the Proposed Substitutions benefit the contractowners.

The Notice asserts that if the Commission were to consider the effect of the Proposed Substitutions on changes in the value of contract guarantees, "the Commission would be tasking itself with calculating how substitutions would affect the value of variable insurance contract guarantees in the context of hundreds, if not thousands, of funds. Such calculations would be complex and rely on numerous assumptions and other factors, including estimates of the future performance of the funds involved over varying time frames, and the impact of future performance on the benefit base used to set the insurance guarantees." The Advisers do not believe it is the Commission's duty to calculate the evidence needed to support the Application. Instead, it is Allianz's duty to calculate and present evidence to the Commission on the potential effects of the Proposed Substitutions – which involve 13 funds underlying 36 Allianz variable annuity and variable life contracts.

Given the diversity of affected variable contracts, and the difference between the FTVIPT Funds and the proposed replacement funds, the Proposed Substitutions should not be granted *en masse* where the circumstances of any Proposed Substitution differ materially from another.

b. Many of the proposed replacement funds differ from the FTVIPT Funds.

The Application conclusively states that "the investment objective, principal investment strategies and principal risks of each Target Fund are similar or substantially similar to those of the corresponding Destination Fund." However, many of the replacement funds seem to have objectives and strategies that are not sufficiently similar to those of the existing funds, and in particular the FTVIPT Funds.

For example, Allianz proposes to replace the Franklin Income VIP Fund ("VIP Fund") with the AZL Fidelity Institutional Asset Management Multi-Strategy Fund ("AZL Fund"), a significantly different type of investment. Both funds seek a high level of current income as their investment goal, but the funds use markedly different investment strategies to achieve this goal. The VIP Fund, for example, invests in a diversified portfolio of debt and equity securities and may shift its investments from one asset class to another based on the investment manager's analysis

[25] The Application refers to a current fund as a "Target Fund" and to a replacement fund as a "Destination Fund".

of the best opportunities in a given market. The VIP Fund may invest up to 25% of its assets in foreign securities and may invest up to 100% of its total assets in debt securities rated below investment grade. By contrast, the AZL Fund seeks to achieve its investment objective by investing 60% of the fund's assets primarily in investment-grade fixed-income securities, and approximately 40% of the fund's assets in large cap common stocks. The two funds differ in fixed income style, equity style and asset allocation and are not substantially similar.[26]

Another Proposed Substitution would replace the Templeton Growth VIP Fund with the AZL MSCI Global Equity Index Fund, also a significantly different type of investment. The replacement fund employs an indexing strategy that is distinct from the Templeton Growth VIP Fund's actively-managed value strategy.[27] These changes in investment strategy and the differences in the performance mean that the replacement funds are not substantially similar to the current funds, and further supports the conclusion that the contractowner's original investment decisions would be unilaterally altered and taken away.

A third Proposed Substitution seeks to use the passively-investing AZL Russell 1000 Value Index Fund as a replacement for the Mutual Shares VIP Fund, which follows an unusual, actively-managed strategy of investing in undervalued securities, merger arbitrage investments and investments of distressed companies. This is a longer-term, generally contrarian strategy that is likely to provide significantly different results than an index, has historically tended to outperform in falling markets and in markets that favor value stocks, and has regularly generated equity returns with lower volatility than the Russell 1000 Value Index. The proposed replacement fund is a generic passive value index fund that does not offer such potential benefits.

These are just three examples where the Proposed Substitutions are not in fact "similar." We believe that if the contractowners are going to have their investment choices taken away from them, then at a minimum the Commission is obligated to perform a thorough and objective side-by-side analysis of each Proposed Substitution to ensure that these investors are protected.

c. The Proposed Substitutions produce benefits for Allianz but not for contractowners or remaining shareholders in the funds.

Allianz claims that the Proposed Substitutions will make their contracts more attractive to existing and prospective contractowners and more efficient to administer. In fact, these claims benefit Allianz, not the contractowners. The Application fails sufficiently to identify any significant benefits for investors, other than a temporary fee waiver. Given the long-term nature of these investments, a two-year waiver is hardly a meaningful benefit that could justify taking away the investment decisions of the contractowners.

The Proposed Substitutions would harm not only current contractowners but also the FTVIPT Funds and the remaining investors in the FTVIPT Funds. The loss of approximately

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26 As of December 31, 2018, the VIP Fund had a better performance track record than the AZL Fund across the five- and seven-year time periods, as well as in the calendar years of 2016, 2014, 2011 and 2010.

27 As of December 31, 2018, the Templeton Growth VIP Fund had a better performance track record than the AZL MSCI Global Equity Index Fund across the five- and seven-year time periods, as well as in the calendar years 2011 through 2016.

$1.91 billion in FTVIPT Fund assets resulting from the Proposed Substitutions, about 20% of total assets in the FTVIPT Funds (as of December 31, 2018), may result in fee increases as certain of the FTVIPT Funds might lose the benefit of certain advisory fee breakpoints and fixed costs would be spread across a smaller base. These fee increases would also affect owners of variable contracts issued by other insurance companies that use the FTVIPT Funds as underlying fund investment options.

Accordingly, the Commission cannot simply rely on conclusory representations in the Application and instead should consider evidence of how each Proposed Substitution: (i) would likely affect each type of contract and its material features; (ii) would compare to the fund that is being taken away from the contractowners; and (iii) would provide benefits to investors associated with the different variable contracts that would justify the removal of the contractowners' investment choice. Only then can the Commission make an informed "investor protection" finding on the Application as required under Section 26.

IV. THE ADVISERS ARE INTERESTED PERSONS ENTITLED TO REQUEST A HEARING

The Advisers are interested persons within the meaning of Rule 30-5 and, accordingly, meet the other prerequisite for making a hearing request.[28] To be an interested person entitled to request a hearing on an application under the Investment Company Act, a requestor must state an ownership or other direct interest in the applicants at issue or demonstrate that it is likely to be harmed by the granting of the application.[29] If Allianz is permitted to replace FTVIPT Funds with proprietary funds, the Advisers will suffer a specific and material harm because they will lose significant advisory fee revenues. Therefore, the Advisers are likely to suffer demonstrable and material harm if the order is issued and the Advisers have identified concrete interests that would be impaired if the Commission issues the order.

Rule 0-5(c) under the Investment Company Act provides that the Commission will order a hearing when it appears that a hearing is "necessary or appropriate in the public interest or for the protection of investors, (1) upon the request of an interested person, or (2) upon its own motion."[30] The Advisers assert that they have raised material issues of fact and policy in this request that would warrant a hearing and that their request raises issues of public interest and investor protection relevant to the Application,[31] some of which the Commission has not previously considered.[32] Further, granting this hearing request would not interfere with the Commission's

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28 17 C.F.R. § 200.30-5.

29 *See* The Chase Manhattan Bank, N.A. and Chemical Bank, Investment Company Act Release No. 23186 (May 14, 1998) (order); Potomac Capital Investment Corp., Investment Company Act Release No. 17238 (Nov. 28, 1989) (order); Shearson Loeb Rhoades Inc., Investment Company Act Release Nos. 11834 and 11835 (June 26, 1981) (orders).

30 17 C.F.R. § 270.05(c) (2009).

31 *See, e.g.*, Pantepec International, Inc., Investment Company Act Release No. 17908 (Dec. 20, 1990).

32 *See* Vanguard Index Funds *et al.*, Investment Company Act Release No. 24789 (Dec. 12, 2000).

"orderly conduct of business," as a hearing would further develop the issues presented by the Application as well as clarify the appropriate standard for its review.[33]

CONCLUSION

The Application does not contain the evidence that would allow the Commission to determine whether the Proposed Substitutions are consistent with the protection of investors, as Section 26(c) and the APA require. The Application does not address how the Proposed Substitutions would affect each of the 36 contracts (or even the types of contracts), the potential effects of the Proposed Substitutions on contract benefits and guarantees, whether the Proposed Substitutions provide meaningful benefits that would justify the removal of investor choice; or financial impact on shareholders in the affected funds who will be left behind. The Commission is left to rely on assertions made in the Application instead of undertaking the independent "reasoned analysis" that the APA requires.

We do not see how the Commission can make a determination, based on the record that currently exists, that the Proposed Substitutions are suitable for, and in the best interest of, the affected contractowners without a hearing. If the Commission is going to pick winners and losers by granting an order that takes away a contractowner's investment decision, it should only do so with the greatest circumspection and upon a record more developed on the facts and supported by evidence and a legal analysis consistent with the provisions of the Investment Company Act. Absent such a record and analysis, the Commission should not grant the relief. Allianz remains free to make the new funds available as additional choices for investors, and investors retain their ability to decide what investments are best for their unique circumstances.

Thank you in advance for considering this hearing request. If you should have any questions or would like to discuss the contents of this request, please feel free to call me at 202 373-6725 or Monica L. Parry at 202 373-6179.

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33 Section 555(b) of the APA, 5 U.S.C. § 555(b), states in part, "[S]o far as the orderly conduct of public business permits, an interested person may appear before an agency or its responsible employees for the presentation, adjustment, or determination of an issue, request, or controversy in a proceeding, whether interlocutory, summary, or otherwise, or in connection with an agency function." As the language suggests, an "interested person" has a right to appear before an agency but its participation is qualified by the "orderly conduct of business." The Advisers are likely to be harmed if the Commission issues the order and have alleged issues of fact and policy relevant to the Application.

Please find enclosed proof of service upon Allianz in the form of an affidavit.

Very truly yours,

Thomas S. Harman

cc: The Hon. Jay Clayton, Chairman
The Hon. Robert J. Jackson, Jr., Commissioner
The Hon. Hester M. Peirce, Commissioner
The Hon. Elad L. Roisman, Commissioner
The Hon. Allison Herren Lee, Commissioner
Dalia Blass, Director, Division of Investment Management
Paul Cellupica, Deputy Director and Chief Counsel, Division of Investment Management
Rick A. Fleming, Office of the Investor Advocate
Alison Baur, Franklin Templeton Investments
Kevin Kirchoff, Franklin Templeton Investments
Erik T. Nelson, Senior Securities Counsel, Allianz Life Insurance Company of North America
Chip C. Lunde, Carlton Fields, LLP

To: Chairman Jay Clayton
Commissioner Hester Peirce
Commissioner Elad Roisman
Commissioner Robert Jackson
Commissioner Allison Lee
Rick Fleming. SEC Investor Advocate
Tracey L. McNeil, SEC Ombudsman
Lori Schock, Director, Office of Investor Education and Advocacy
Dalia Blass, Director, Division of Investment Management
c/o Venessa Countryman, SEC Secretary

Cc: Allianz Life Insurance Company

From: A Concerned American, Attorney, Compliance Professional and Investor

Re: Allianz Substitution; File No. 812-14722

Date: December 30, 2019

I am an attorney and compliance professional at a mid-sized broker-dealer and fund sponsor. I am submitting this letter anonymously because my employer does not want to sour relationships with its insurance company partners. I would like to raise concerns about the Allianz (and all) substitution applications. I do not believe this, or any, substitution application is in the best interest of investors.

I do not own an Allianz variable annuity and therefore do not have standing to request a hearing, but many of our clients do own them and take issue with these sorts of shenanigans.[1] I request that the Commission, Investor Advocate or SEC Ombudsman order a hearing on this matter on their own motion. I think once you understand the marketing of these products and the economics of a substitution transaction, you will be aghast.

A substitution is the replacement of one investment option offered through a variable annuity subaccount for another investment option. More plainly, the insurance company offered you, and you selected and invested in *Fund A* and then the insurance company now intends to move your money into *Fund Z* without your consent, often because it is in their financial interest to do so. The insurance company owes no duty of loyalty to the investor and is not a fiduciary. Instead, they can substitute as long as they gave any notice (no matter how buried) and they obtain regulatory approval. Section 26(c) of the Investment Company Act requires SEC approval of any such substitution. One concern when this provision was enacted was that investors could be stuck in an investment not of their choosing and that there could be costs associated with redeeming shares and selecting a new investment. In the variable annuity context, those charges include sales loads, tax consequences, and losing rich insurance benefits if an investor wished to redeem or move his or her investment.

1. Variable annuities are often marketed and sold on the basis that they offer funds from an array of well-known money managers. To then remove those money managers after an investor is locked-in (due to long surrender periods and valuable guarantees) is a bait-and-switch tactic that should <u>not</u> be permitted. <u>See</u> attached examples of marketing materials from various variable annuity websites (including Allianz).

[1] Many of our clients are upset when they are substituted, but have little recourse.

2. If a broker were to replace an investor's mutual fund with another fund (even a cheaper substantially similar fund), they would violate the securities law for engaging in unauthorized transactions. Why are you OK with insurance companies taking similar (often self-motivated) actions?
3. The securities laws require robust disclosure of conflicts of interest in nearly all contexts, except apparently when it comes to substitutions. Insurers should be required to include conflicts of interest disclosure at the time the investor purchases the contract before any substitution relief is granted.
4. Variable annuities are one of the most complex and complained about products and should be subject to heighted scrutiny, and <u>not</u> given the blind-eye. The SEC must make better efforts to hold substitutions to the scrutiny required by section 26© of the Investment Company Act. The SEC should give greater deference to the investment decision made by the investor and not a self-interested decision of the insurance company.
5. Many of the investment options made available in this substitution are already available under the contracts. If an investor wished to move his money, he or she could have. So, clearly moving money into these funds is not consistent with an investor's wishes.
6. Substitutions hurt the value of living benefits. Moving from actively managed funds to index funds reduces the variability of returns (both up and down). When you own a living benefit, you have downside protection so removing downside risk hurts the contract owner. Also, the diversification and more predictable outcome makes it less expensive for insurance companies to hedge (after all, it is easier to buy futures on an index than to hedge an actively managed portfolio). In fact, one SEC condition has long been that the replacement fund be no riskier (and errs on being less risky) than the replacement fund, which does not make sense when most contracts come with investment protections the investor is already paying for.
    a. The condition that the substitution does not reduce the value of any guarantee or benefit is not a meaningful condition. Actuaries and economist both could convincingly argue both sides as to whether a substitution reduces the value of a benefit. The new investment options do not reduce the value of benefits *per se*, but do reduce portfolio volatility (and downside risk) which is what the benefit protects against.
7. Interestingly, if an insurance company suggested to an investor that they move their money to another fund, that would be investment advice subject to the Investment Advisers Act and would be held to a fiduciary standard. Instead, by forcibly moving investor's money, they are somehow held to a lesser standard. This is not right.
8. Allianz and most substitution applications have not made a compelling case as to why the substitution is in the interest of investors. The use of third-party funds was used to draw in investors. To now claim that moving money in house makes the contract more attractive is ridiculous. Allianz has also not provided supported the position that the funds being replaced were unpopular or somehow hurting investors.
9. The following two substitutions should have been completed by a merger of funds (with approval of the fund board):
    - PIMCO Global Multi-Asset Managed Allocation Portfolio => PIMCO Balanced Allocation Portfolio
    - PIMCO Global Bond Opportunities Portfolio (Unhedged) => PIMCO Global Core Bond (Hedged) Portfolio

If Allianz/PIMCO believes the replacement funds are better option for investors than the replaced funds, then the two funds should have been merged together (with the replacement fund serving as the survivor fund) instead of using the substitution mechanism. Here, they are using a substitution to wok around a legitimate corporate action and avoiding having the fund's board (a fiduciary to the investors) pass on the transaction.

10. This same issue, replacing third-party fund with proprietary funds has led to a number of lawsuits in the ERISA space (including suits against Allianz). This shows a pattern of distasteful behavior by these entities trying to take advantage of captive investors. *See* https://www.investmentnews.com/article/20180102/FREE/180109996/allianz-agrees-to-settle-401-k-fee-lawsuit-for-12-million.

11. Even if you believe the substitution conditions are appropriate for a given situation, these conditions were developed to deal with a one-off substitution. It was never intended to deal with the situation where insurance companies replace many funds at once. The number of substitutions occurring at once (over the past 15 years) has been outrageous. The fact that the SEC follows the same rote conditions regardless of the number of fund substitutions does not seem appropriate.

Insurance Companies engage in substitutions to reduce administrative burden, reduce hedging costs, increase their own revenue, to remove unpopular investment options, and in response to fund liquidations. In my view, the SEC should only approve substitution orders when the fund I own is liquidating. Any self-motivate reasoning should not be permitted as it is a cost of doing business. For instance, many substitution orders replace funds offered by independent fund firms for those run by affiliates of the insurance company. One common reason for a substitution is administrative ease as it can be difficult to work with several fund shops. However, nobody forced the insurance company to offer independent funds in the first place. It was their choice and they often marketed their annuities on that basis. (See attached examples of marketing materials). They cannot now complain saying it is too expensive.

Also, on a related note, insurance companies are often permitted to replace liquidating funds with a money market fund based on several no-action letters. I believe this practice is not appropriate. In the 1980's and 1990's when these positions were formulated, money market funds provided more yield than they do today. Today (and for the past 12 years), any money market sub-account offered through a variable annuity is likely to lose money because the money market fund's yield is less that the contract's expenses. Defaulting investors to an investment that loses money cannot be in the investor's best interest.

Also, when considering the impact of substitutions on investors, I recommend you read the following letters submitted to the SEC by investors and those representing investors:

- Letter from Ed Snoke - https://www.sec.gov/comments/s7-19-19/s71919-6578066-201116.htm
- Letter from Andrea and Steven Calhoun - https://www.sec.gov/comments/812-14446/81214446-1485512-130580.pdf
- Letter from Raymond James - https://www.sec.gov/comments/812-14446/81214446-1485624-130601.pdf
- Letter from John Wahh - https://www.sec.gov/comments/812-14446/81214446-1557057-131501.pdf

Thank you.

Sample Marketing Materials

Figure 1:

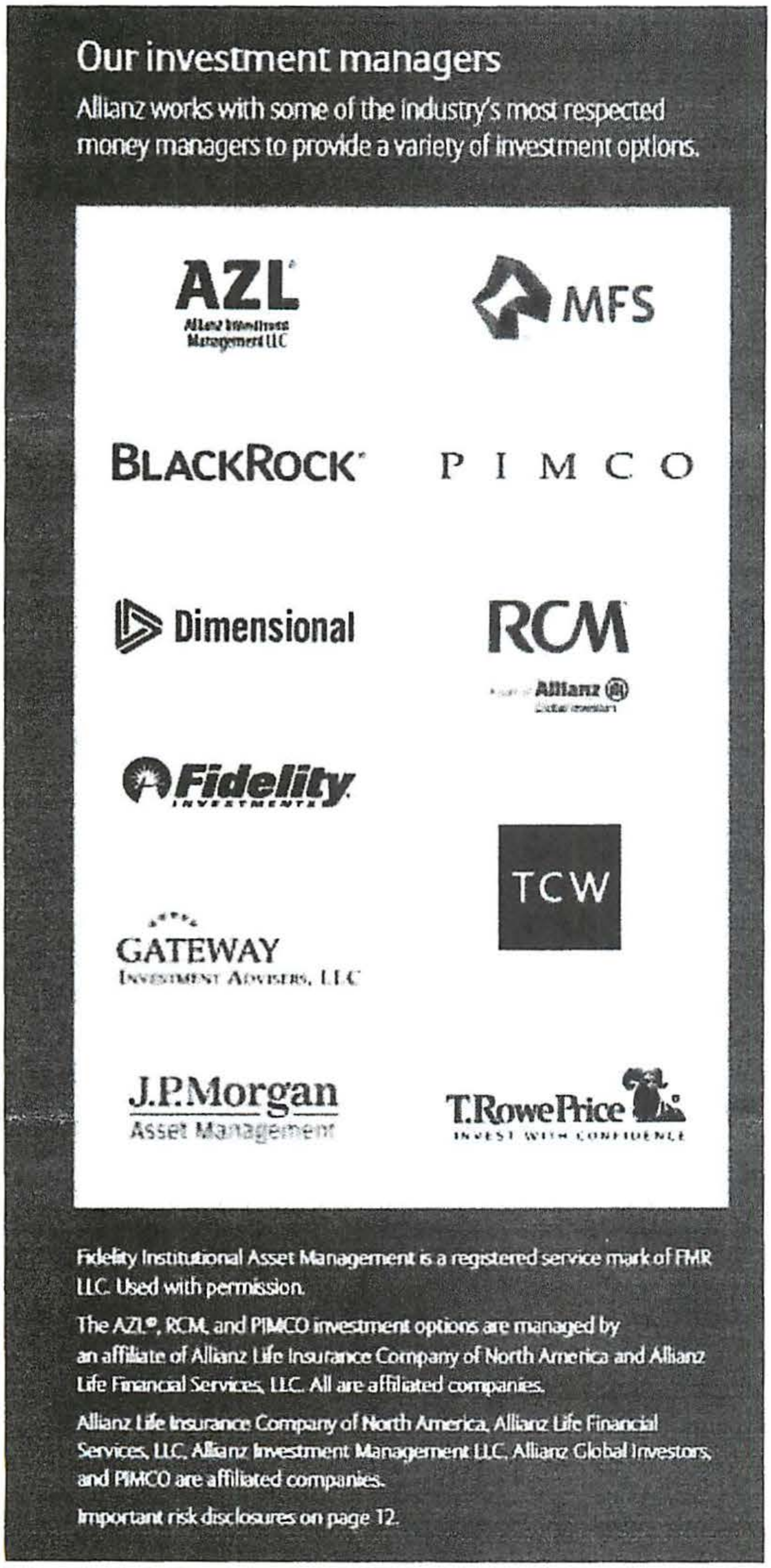

Figure 2:

A wealth of experience. Expertly applied.

Well-known, world-class asset managers.

The money managers represented within our wide array of investment options offer a wealth of experience in researching companies and managing portfolios. Their expertise can help you make the most of your investment.

New York Life MainStay Investments
MacKay Shields
Columbia Threadneedle Investments
Dreyfus — A BNY Mellon Company
PIMCO
MFS
Janus Henderson Investors
Neuberger Berman
VanEck
Cornerstone Capital Management
Fidelity Investments
Deutsche Asset Management
T. Rowe Price — Invest with Confidence
BlackRock
Winslow Capital
EPOCH
Eagle Asset Management
Invesco
Morgan Stanley Investment Management
American Funds — From Capital Group
Cushing Asset Management
Candriam Investors Group — A New York Life Company
ClearBridge Investments
Victory Funds

Figure 3:

Access to leading brand-name and boutique firms

Through Prudential's extensive research and relationships, Premier Investment gives you exposure to some of the largest and best-known asset management firms, as well as boutique specialty firms. The end result: you have access to a wide variety of leading-edge and innovative money management techniques to help grow your retirement assets.

AB

AQR

BlackRock

Cohen & Steers

ClearBridge Investments

Dana Investment Advisors

Columbia Threadneedle

Emerald

FQ FirstQuadrant

Franklin Templeton Investments

Asset Management

Jennison Associates

J.P.Morgan Asset Management

Hotchkis & Wiley

LM

Lazard

Lord Abbett

LMCG Investments

Loomis | Sayles

LSV Asset Management

MFS

Morgan Stanley Investment Management

Neuberger | Berman

Parametric

QMA

T.RowePrice

PGIM

RS Investments

UBS

Western Asset

William Blair

Wedge Capital Management

Wellington Management

Figure 4

Access well-known investment managers

Investment management is provided by some of the most well-respected and experienced investment managers in the world today.

AB	Fidelity Investments	JANUS	OppenheimerFunds
ALPS Red Rocks	First Trust	J.P.Morgan Asset Management	PIMCO
American Century Investments	Franklin Templeton Investments	Legg Mason Global Asset Management	Putnam Investments
American Funds	GAMCO	Loomis Sayles	SEI New ways. New answers.
BlackRock	Guggenheim	Lord Abbett	State Street Global Advisors
Delaware Investments	Hartford Funds	MFS	T. Rowe Price Invest with Confidence
DoubleLine	Invesco	Morgan Stanley Investment Management	Van Eck Global Since 1955
Eaton Vance Investment Managers	Ivy Investments	Neuberger Berman	7Twelve The Right Number

Note: The list above may not include all investment managers.

CERTIFICATE OF SERVICE

I, Thomas S. Harman, an attorney, hereby certify that on January 14, 2020, I caused a true and correct copy of the foregoing, **Request for a Hearing filed by Franklin Advisers, Inc., Franklin Mutual Advisers, LLC and Templeton Global Advisors Limited**, to be served via Federal Express on the following:

Erik T. Nelson
Senior Securities Counsel
Allianz Life Insurance Company of North America
Allianz Investment Management LLC
5701 Golden Hills Drive
Minneapolis, MN 55416-1297

Thomas S. Harman