September 17, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-03-13
Money Market Fund Reform; Amendments to Form PF
Release No. 33-9408, IA-3616, IC-30551 (the "Proposing Release")

Dear Ms. Murphy:

We are submitting this letter on behalf of our client, the Committee of Annuity Insurers (the “Committee”),\(^1\) in response to the proposed rule, *Money Market Fund Reform; Amendments to Form PF*, issued by the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) on June 5th, 2013 (the "Proposals").\(^2\) We appreciate the opportunity to submit these comments.

The Committee recognizes and appreciates that the SEC included special provisions in the Proposals to accommodate variable insurance contracts, by including exemptions from Section 27(i) of the Investment Company Act of 1940 (the “1940 Act”) in both the floating NAV alternative and the fees & gates alternative\(^3\) (the “Alternatives”), and the Committee strongly supports and endorses these proposed exemptions. However, for the reasons discussed below the Committee has several general comments and recommendations regarding the Proposals’ impact

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\(^1\) The Committee of Annuity Insurers is a coalition of 28 life insurance companies that issue fixed and variable annuities. The Committee was formed in 1982 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent more than 80% of the annuity business in the United States. A list of the Committee’s member companies supporting this letter is attached as Appendix A.

\(^2\) The Proposals were published in 78 Fed. Reg. 36834 (June 19th, 2013).

\(^3\) See proposed rules 2a-7(c)(3)(iii)(B) (FNAV) and 2a-7(c)(2)(iv) (Fees & Gates). Section 27(i) of the 1940 Act requires that variable insurance contracts be redeemable securities. We assume that the phrase “variable insurance contracts” in these exemptions includes both variable annuity contracts and variable life insurance policies; we respectfully request that the SEC confirm this in any adopting release.
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on and treatment of variable annuities (often referred to as “VAs”). In addition to and separate from those general comments, with respect to each of the two Alternatives, certain additional accommodations are necessary and appropriate for variable annuities, and these accommodations are consistent with and do not undermine the purposes and goals of the Proposals.

Although this letter focuses on variable annuities, the points made herein also apply with equal force to variable life insurance contracts unless otherwise noted.4

I. Background: Variable Annuities Are Not Money Market Funds

Although variable annuity contracts usually include a money market fund as an underlying investment option, variable annuities are not money market funds. There are a number of very important differences that, the Committee believes, the SEC must take into account.

Almost all variable annuities are organized in two-tier structures. The top tier is a separate account of the insurance company that is registered as a unit investment trust under the 1940 Act, absent an exclusion or exemption.5 The separate account typically is divided into subaccounts, and each subaccount invests exclusively in a specified underlying mutual fund portfolio (the bottom tier), registered as an open-end management investment company under the 1940 Act. The contract owner or participant under a group allocated contract6 allocates the premiums and cash value among the subaccounts, and therefore indirectly among the underlying mutual fund portfolios.7

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4 The term “variable insurance contracts” when used herein refers to both variable annuity and variable life insurance contracts.

5 The registration is on Form N-4, which generally also registers the annuity contract (or interests in the separate account) as securities under the Securities Act of 1933 (the “1933 Act”).

6 For simplicity, “contract owner” is sometimes used herein to refer to the person who makes the investment decision regarding the allocation of premiums and cash value among the subaccounts; this is the owner of an individual annuity contract or, in most cases, a participant in a group (allocated) contract. Similarly, under a group unallocated contract, the participant typically directs the contract owner to allocate such participant’s premiums and cash values among the underlying mutual fund portfolios; however, in some instances, it is the employer/contract owner who makes the investment allocation decisions. Under all unallocated contracts, participant level accounts are not maintained by the insurance company, but rather by a record keeper or plan administrator pursuant to the plan - - not pursuant to the contract. This letter applies to both individual and group allocated and unallocated contracts.

7 There are some variable annuity separate accounts that utilize a single tier structure and are registered as management investment companies under the 1940 Act (absent an exclusion or exemption). The proposed rules allow for this, by providing the exemptions from Section 27(i) noted above, with respect subaccounts that either are a money market fund (i.e., a management company) or that invest all of their assets in a money market fund (i.e., a unit investment trust). Although this letter focuses on the two-tier structure, the discussion and positions recommended herein apply at least equally to management separate accounts; in some ways, the problems discussed herein can be even more acute for variable annuities where the separate account is structured as a management investment company.
Variable annuity contracts can be issued to retail investors or in connection with IRAs, and these are registered under both the 1933 Act and the 1940 Act. Variable annuity contracts also are issued in connection with certain types of qualified plans, and if so are exempt from registration under both the 1933 Act and 1940 Act. Variable annuity contracts can also be sold in private placements that are exempt from securities registration. This letter applies to all of these categories of variable annuity contracts.

A. Unit Values for Money Market Subaccounts Are Not Stable

The value of an investment in a variable annuity contract is measured in “accumulation units” in each subaccount, similar to shares in a mutual fund. Each accumulation unit has an accumulation unit value, initially set arbitrarily (generally at $10.00) when the subaccount begins operations. Thereafter, the accumulation unit value (the “AUV”) changes daily to reflect the changes in the net asset value (the “NAV”) of the corresponding underlying mutual fund portfolio, any dividends declared by the portfolio, and certain separate account charges assessed under the annuity contract.

This applies the same way to all of the subaccounts, including subaccounts that invest in an underlying money market fund (a “money market subaccount”) as well as stock and bond subaccounts. A money market subaccount would generally begin operations with a $10.00 AUV, and invest in a money market fund with a stable NAV of $1.00. Thereafter, the subaccount’s AUV would change every business day, increasing to reflect the dividends declared by the money market fund, but offset negatively by the separate account charges. So whereas the underlying (bottom tier) money market fund maintains a stable NAV by, among other things, declaring daily dividends to reflect its earnings (increasing the number of fund shares credited to each account), there is nothing equivalent to dividends at the separate account (top tier) level. Instead, the fund’s dividends are reflected by an increase in the separate account’s AUV (in effect, “floating” the AUV).

As noted above, a money market subaccount’s AUV also reflects separate account charges, which are deducted daily in the calculation of the AUV. In recent years, with low interest rates, many variable annuity prospectuses have disclosed the possibility that the money market subaccount’s AUV could decline, even if the underlying money market fund maintains a stable $1.00 NAV, because the separate account charges could exceed the low yield of the money market fund.10

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8 See Section 3(a)(2) of the 1933 Act and Section 3(c)(11) of the 1940 Act. “Qualified” refers to tax-qualified plans such as Section 401(k) and governmental section 457 plans, and pension and profit-sharing plans.

9 See Section 4(2) of the 1933 Act and Regulation D thereunder, and Sections 3(c)(1) and 3(c)(7) of the 1940 Act. The comments and observations set forth herein generally apply to both registered and unregistered variable annuity contracts unless otherwise noted.

10 It is common for variable annuities to have a mortality and expense risk charge in the range of 1.25% (on an annual basis) or more, and an annual contract maintenance charge of $25 to $40. In addition, many variable
In short, an underlying money market fund’s stable $1.00 NAV is not “passed through” the variable annuity separate account to the contract owner or participant. Their investment in the money market subaccount is reflected in the subaccount’s AUV, which varies daily. Since a money market subaccount does not have a stable AUV, variable annuity contract owners do not invest in a money market subaccount for a stable value. Any money market reforms should not treat variable annuity contract owners the same as direct investors in a money market fund.

B. **Variable Annuities Are Contracts**

Variable annuities are not mutual funds. Investing in a money market fund through a variable annuity is very different from making a direct investment in shares of a money market fund. Variable annuity purchasers have a written contract with the insurance company, which gives the purchaser - the contract owner - certain rights (such as the right to withdraw some or all of the cash surrender value at any time) and severely restricts the insurer’s ability to change the terms of the contract (e.g., the insurer cannot impose fees or charges that are not provided for in the contract) without the consent of the other party to the contract (i.e., the contract owner). The contract or policy form, spelling out the rights and protections of the contract owner and the duties and obligations of the insurer, must be approved by the applicable state insurance department. Direct investors in money market funds do not have such a contract. The Commission has the authority to grant exemptions from provisions of the 1940 Act (and we commend the Commission for recognizing the need for, and proposing, exemptions from the redeemability requirement in Section 27(i) for variable insurance contracts); however, the Commission cannot authorize insurance companies to breach their contracts with variable annuity owners (doing so would also be in violation of state insurance laws and regulations). This is a critical difference between mutual fund investments and variable annuities.

C. **Variable Annuities Are Not Short-Term, Liquid Investments**

Variable annuities are inherently very different than money market funds. Variable annuities are designed for retirement and other long-term financial planning, and variable annuity prospectuses generally disclose this prominently. They provide for tax deferral on any earnings (known as inside build-up), but as noted above they also impose insurance charges, administrative charges, fees for optional benefits, etc. that are not imposed on stand-alone money market funds. Variable annuities are not designed or intended to be used as short-term investments, like money market funds can be.

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annuities offer enhanced death benefits, optional living benefits, and various other optional benefits, each of which can carry additional charges reflected in each subaccount’s AUV, including a money market subaccount’s AUV.

11 The tax deferral does not apply to annuity contracts owned by non-natural persons such as corporations. Hence, corporate treasurers do not use variable annuities as a cash management tool the way they use direct investment in money market funds.
In addition, VA contracts are rarely liquid investments. Withdrawals (redemptions) from VA contracts can have negative consequences for owners that are not present with direct investments in money market funds. These negative consequences can include:

- Surrender charges (up to 9%);\(^\text{12}\)
- Tax consequences (earnings are deemed withdrawn first, and taxed as ordinary income);
- A 10% tax penalty (prior to age 59 ½) for non-qualified contracts;
- Similar tax penalties, if not withdrawals restrictions, for qualified contracts (many VAs are used in 403(b) plans, 401(k) plans, IRAs, and other tax-qualified plans);
- Loss of death benefits;
- Significant reduction in or loss of living benefits (e.g., a withdrawal can reduce the amount of a guaranteed lifetime withdrawal benefit by a greater than dollar-for-dollar amount).

Another significant fact demonstrating that VA contracts are generally purchased as long-term investments, and not bought for short-term liquidity, is that more than twice as much in both VA sales and VA assets is in qualified plans as in non-qualified contracts,\(^\text{13}\) and qualified plans generally have their own limitations and prohibitions on, and penalties for, premature withdrawals.\(^\text{14}\)

Variable annuity contract owners can, of course, transfer their cash value out of a money market subaccount and into other subaccounts available under the contract, generally without the restrictions and consequences noted above. But the other subaccounts do not invest in underlying funds that maintain a stable NAV (and do not maintain a stable AUV themselves), so such transfers necessarily entail investing in mutual funds that are more risky and volatile than the money market fund and that do have a floating NAV, which is certainly not a solution for a VA contract owner concerned that the money market fund will “break the buck.”

There are, therefore, very significant disincentives for variable annuity contract owners to withdraw their cash values from money market subaccounts even if the underlying money market fund is in stress. For these reasons, variable annuities are clearly not used for, or suitable

\(^{12}\)See Rule 6c-8 under the 1940 Act.

\(^{13}\)In 2012, variable annuity sales to qualified plans were $97.1 billion, vs. $48.0 billion in non-qualified sales; in 2011, the VA sales figures were $104.8 billion in qualified and $50.7 billion non-qualified. In 2011, the VA assets in qualified plans were $1,012.5 billion, vs. $489.8 billion in non-qualified contracts. *IRI 2013 Fact Book*, Insured Retirement Institute (2013), pp. 53 – 54.

\(^{14}\)For example, elective contributions to 401(k) plans and 403(b) contracts generally may not be withdrawn prior to age 59 ½, severance from employment, death, disability, hardship, plan termination, or other limited circumstances. See Sections 401(k)(2)(B) and 403(b)(10) of the Internal Revenue Code. See also Rule 6c-7 under the 1940 Act (exempting separate accounts from Section 22(e) and other sections of the 1940 Act, permitting restrictions on redemptions from VAs sold in connection with the Texas Optional Retirement Program).
for, short-term investment and they are not liquid; underlying insurance products money market funds\(^{15}\) are not susceptible to a “run on the bank” by variable annuity contract owners.\(^{16}\)

It should be noted that these various variable annuity disincentives to “runs” – surrender charges, tax consequences and tax penalties, loss of insurance benefits and guarantees, etc. – apply at least equally, if not with greater force, to variable life insurance contracts.

II. The SEC Proposals and Variable Annuities

A. Generally: Variable Insurance Contracts Funds Should Be Exempt From Both Alternatives

The Proposals include two Alternatives, a Floating NAV Alternative and a Fees & Gates Alternative, and the SEC requests comments on both alternatives individually and on the possibility of combining them. For the reasons discussed above, the Committee does not believe that there is any need to apply either alternative in the context of money market funds only offered as investment options in variable insurance contracts. These funds did not have any liquidity problems during the recent financial crisis and none of them broke the buck. There was no “run” on variable annuities or variable life insurance contracts,\(^{17}\) and a run in variable insurance contracts is extremely unlikely, unlike a run on a bank or a money market fund.\(^{18}\) Just as insurance should not be regulated in the same way as banks, variable insurance contracts should not be regulated in the same way as money market funds. As discussed above, investing in a money market fund through a variable annuity is clearly not the same as a direct investment in a money market fund; owners of variable annuity contracts do not use them the same way that

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\(^{15}\) For tax reasons, mutual funds offered as investment options in non-qualified variable annuity contracts cannot be sold to the general public or to corporate institutional investors; they can only be sold to insurance company separate accounts and certain qualified retirement plans. See Section 817(h) of the Internal Revenue Code of 1986, as amended. Hence, all of the investors in these funds are subject to the expenses and other factors noted above that make them illiquid.

\(^{16}\) In some cases, qualified variable annuities can invest in money market funds that are available to the general public. This letter generally applies to such contracts except as otherwise noted.

\(^{17}\) See generally “Insurance Markets: Impacts of and Regulatory Response to the 2007-2009 Financial Crisis,” U.S. Government Accountability Office (June 2013), GAO-13-583, finding that the impact of the financial crisis on insurers and policyholders was generally limited, with a few exceptions not relevant here.

\(^{18}\) See “In Washington, Every Problem Is A Bank,” The Wall Street Journal, August 28, 2013, p. A14 (arguing that most members of the Financial Stability Oversight Council (FSOC) do not understand the insurance business model or the nature of its regulation, noting that “the risk of customer runs [is] obviously central to bank regulation but less relevant for insurers. For example, while bank depositors can withdraw their money at any time, insurance policyholders typically cannot withdraw the face value of their policies in cash. Since few FSOC board members have insurance expertise, their confusion is not surprising. They want to regulate any financial institution that moves like it’s a bank.” Similarly, variable insurance contracts should not be regulated as if they are the same as money market funds.
investors use direct investments in money market funds. Nevertheless, prime\textsuperscript{19} money market funds are important to investors in variable annuity contracts for several reasons, including their use in dollar cost averaging programs and for temporary defensive purposes. Therefore, and notwithstanding the Proposal's efforts to accommodate variable insurance contracts,\textsuperscript{20} the Proposals should be limited so that they do not negatively affect variable insurance contracts. This can be done, for most but not all variable contracts, by exempting those money market funds that only sell their shares to insurance company separate accounts\textsuperscript{21} (referred to herein as "variable insurance contract money market funds"\textsuperscript{22}) from both Alternatives.

**B. Other General Comments**

As noted above, the Commission has proposed both a Floating NAV Alternative and a Fees & Gates Alternative, and requests comment on whether one or the other, or a combination of them both, should be adopted. As noted above, an exemption for variable insurance contract money market funds would not cover all variable annuities. Therefore, regardless of whether the Commission exempts variable insurance contract money market funds, the Committee has two additional general comments. First, and regardless of which Alternative is adopted, the Committee believes very strongly that the proposed exemptions from Section 27(i) of the 1940 Act should be adopted (with the clarification that the term "variable insurance contracts" in those exemptions includes both variable annuity and variable life insurance contracts).\textsuperscript{23}

Second, the Committee strongly opposes any form of the Fees & Gates Alternative. For the reasons discussed below, the Fees & Gates Alternative would present significantly more problems for issuers of variable annuities than does the Floating NAV Alternative. Gates in particular would present significant legal problems for variable annuity issuers (see discussion of the Fees & Gates Alternative below). Therefore, if forced to choose, the Committee would much prefer the Floating NAV Alternative over the Fees & Gates Alternative.

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In addition to and separate from the above general comments, the Committee has the following comments specific to each of the two Alternatives.

\textsuperscript{19} Government money market funds generally should be assumed not to be a viable alternative, because their lower yields could even more easily be less than the separate account charges, causing investors in them to lose money.

\textsuperscript{20} See note 3 above.

\textsuperscript{21} Some money market funds that sell their shares to insurance company separate accounts may also sell their shares directly to retirement plans or even to the general public. See footnotes 15 and 16, supra.

\textsuperscript{22} These funds may have also sold shares to sponsors or insurers to obtain seed money, which should not disqualify such funds from the recommended exemption.

\textsuperscript{23} See note 3 above.
C. Floating NAV Alternative

Generally, a floating NAV would not pose any significant legal, operational or administrative issues for variable annuity issuers. A floating NAV would be consistent with the operation of other underlying variable annuity subaccounts, which invest in underlying funds that have floating NAVs (i.e., NAVs that change daily). A floating NAV, in itself, is not inconsistent with the terms of VA contracts (but see discussion of the retail fund exception below).

1. Retail Fund Exception

Nevertheless, variable annuity money market subaccounts should have the option of investing in underlying insurance product prime money market funds that maintain a stable NAV and rely on the retail fund exception. Generally, for most VA contracts, the ultimate investors in the underlying mutual funds (the practical beneficial owners) are retail investors who are either (i) owners of individual annuity contracts, or (ii) participants under (allocated) group variable annuity contracts (where, in both cases, they have discretion to allocate their cash value to the various investment options offered in the contract or retirement plan). These individuals are the true beneficial owners and they control the investment decisions (i.e., whether to transfer out of money market subaccounts). Money market funds that are indirectly sold to these individuals – through variable insurance contract separate accounts and retirement plans – are fundamentally “retail” in nature, not institutional. Public policy supports looking through to these individual investment decision-makers in the context of the Proposals. A stable NAV at

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24 For unallocated group annuity contracts issued in connection with defined contribution plans, participants have no direct ownership rights under the annuity contract; however as noted in footnote 6, they generally do control their own investment allocation decisions. Accounts for each participant under an unallocated contract are not held at the insurance company; rather, such accounts (including all related transaction information) are established and maintained by a record keeper or plan administrator pursuant to the plan.

25 The Committee acknowledges that insurance companies, as the sponsors of their unit investment trust separate accounts, have the possibility of applying to the Commission for a substitution order under §26(c) of the Investment Company Act, which if granted could be viewed as treating the insurance company as an institutional investor (inconsistent with the retail fund exception). However, the proposing release acknowledges that the retail exception is not perfect, in that not providing for different treatment of intermediaries based on their characteristics “may not be consistent with the intent of the [retail] exception.” The release gives as an example the ability of the sponsor of a defined contribution plan sponsor to remove a money market fund from its offerings, resulting in the unilateral liquidation in one day of an amount that greatly exceeds the redemption limit, but notes that “this is a cost of our attempt to keep the retail exemption simple to implement.” Proposing release, pp. 91 – 94. The Committee suggests that the possibility of a substitution order is a similar situation.

In any event, it takes months to obtain a substitution order, and there is a public notice in the Federal Register several weeks before the order can be issued, so the fund would have plenty of notice. In addition, the SEC staff has the discretion (through delegated authority) to impose conditions on any such order, so the staff can ensure that there would be no ill effect on the fund’s liquidity or its stable NAV. And the very nature of the §26(c) substitution order process is of course wholly inconsistent with a “run on the bank” in times of stress.
the underlying fund level can have a strong appeal to these individuals, especially for popular
VA programs such as dollar cost averaging and automatic rebalancing. In addition, under the
Floating NAV Alternative, in practice it will be up to each money market fund to decide whether
it will be an institutional fund, with a floating NAV, or a retail fund, with a stable NAV. In this
regard, some money market funds are sold to fund both group annuities (and other types of
retirement products), and also to “direct” investors, who could be individuals who might rely on
the fund for check writing, or government officials and corporate treasurers who use the fund for
cash management and rely on a stable net asset value. So despite the fact that variable annuity
and retirement investors might tolerate a floating NAV, these other fund investors certainly
might not, leading the fund to opt to be a retail money market fund with a stable NAV.
Insurance companies should have the option of keeping their separate account’s money market
subaccount invested in their current fund, even if the fund elects to be a retail fund, rather than
being forced to seek a substitution order (under Section 26(c) of the 1940 Act) to move the
subaccount assets to a floating NAV fund. Certainly some variable annuity separate accounts are
invested in money market funds that sell their shares directly to the public, and these funds are
likely to elect retail fund status under the Floating NAV Alternative.26

For these reasons, money market funds that are sold to insurance company separate
accounts should be able to qualify for the retail fund exception from the Floating NAV
requirement; that seems to be the clear intent of the Proposal. However, the Committee believes
that two things are necessary to accomplish this: (1) a clarification in the definition of omnibus
account holder, and (2) an exception in the definition of retail money market fund.

(a). Clarify the Definition of Omnibus Account Holder

Money market funds that sell to insurance company separate accounts can only qualify
for the retail fund exemption if they can rely on the omnibus account provision. That provision
refers to brokers, dealers, banks, and other persons who hold securities issued in nominee name,
but does not mention insurance companies. Therefore, the Commission should clarify the
definition of omnibus account holder to include insurers, because it clearly was intended to
include insurance companies (or their registered separate accounts); the Proposal’s provision for
registered separate accounts in paragraph 2a-7(c)(3)(iii)(B) (FNAV) demonstrates this, since that
paragraph provides an exemption from Section 27(i) of the 1940 Act to permit insurers to impose
the $1,000,000 daily redemption limit (in the definition of retail money market fund) on their
contract owners who allocate contract value to a subaccount that invests in a money market
fund.27 However, insurers do not hold the underlying fund shares “in nominee name,” as the
definition of retail fund seems to require. Insurance companies are the actual owners of the
assets in their separate accounts, as required by state insurance laws, and the Commission has
recognized and facilitated this in paragraph (a) of Rule 26a-2 under the 1940 Act.

26 See footnote 16, supra.

27 In addition, footnote 280 of the Release explicitly includes insurance companies as a type of intermediary.
This is not a new issue for the Commission; the Commission addressed a nearly identical question in adopting a definition of “financial intermediary” in Rule 22c-2 under the 1940 Act. That rule was adopted to deal with market timing in mutual funds, and requires financial intermediaries to apply to their investors, (1) any trading restrictions imposed by the underlying mutual fund, and (b) any redemption fees adopted by the underlying mutual fund. The same analysis should apply to defining a retail fund in the context of omnibus accounts in the present situation.28 Rule 22c-2 defines “financial intermediary” to include:

“(i) A broker, dealer, bank, or any other entity that holds securities in nominee name;

(ii) an insurance company that sponsors a registered separate account organized as a unit investment trust, master-feeder funds, and certain fund of fund arrangements not specifically excepted from the rule; and

(iii) in the case of an employee benefit plan, the plan administrator or plan recordkeeper.”

Therefore the Adopting Release should clarify and confirm that VA insurers (on behalf of their separate accounts) are omnibus account holders, even though they are the legal owners of the underlying fund shares (assuming that the other applicable requirements are met). This can easily be accomplished simply by defining “omnibus account holder” to mean “a financial intermediary as defined in Rule 22c-2(c)(1).”30 This has the added advantage of including employee benefit (i.e., qualified retirement) plans.31

Alternatively, the Commission could define the term omnibus account holder by taking language from Rule 22c-2 and include in the proposed definition the phrase “or a unit investment trust or fund that invests in the money market fund in reliance on section 12(d)(1)(E) of the

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28 The Proposing Release refers to Rule 22c-2 in discussing the retail fund exception, noting that the rule provides an example of intermediaries assessing fund redemption fees and implementing fund policies such as account size limits, breakpoints, etc. Proposing Release at 90.


30 The Proposing Release repeatedly uses the term “intermediary” to refer to omnibus account holders. See, e.g., footnote 228 of the Proposing Release; note that pages 90-94 of the Proposing Release use the term “intermediary” (or intermediaries) 19 times interchangeably with omnibus account holder.

31 As noted above, for unallocated VA contracts held by employee benefit plans, the party that would maintain participant level account information would necessarily be the record keeper or plan administrator – not the insurance company. Since the participant accounts are held by the record keeper or plan administrator and not the insurer, the fund would need to look to the applicable indirect intermediary for the participant-level information in order for any redemption limits or other restrictions to be imposed.
(b). Exempt Variable Insurance Contracts from the Redemption Limit

The Floating NAV Alternative would define a retail money market fund in terms of a daily redemption limit of $1,000,000, but the proposing release requests comment on that and other possible tests (such as maximum account balance). Money market funds that sell directly to investors may be able to impose such limits, but as discussed above variable annuities are contracts, and such limits would be inconsistent with the terms of millions of outstanding contracts. Any of the approaches to defining a retail MMF (any redemption limit, maximum account balance, concentration test, etc.) would make it impossible for the fund to meet the condition that it have “policies and procedures reasonably designed to allow the conclusion that the omnibus account holder” will apply the $1,000,000 daily redemption limit (or other test) to the beneficial owner. To meet that condition, the money market fund would need to receive assurances or representations that the insurance company would impose the redemption limit (or other retail fund test) on individual contract owners, and insurers could not give such assurances or representations because such limits would be inconsistent with the terms of the outstanding variable annuity contracts. The effect of this would be that money market funds that sell to insurance company separate accounts could not qualify for the retail fund exception.33

Therefore, an exemption in the definition of retail fund is necessary for variable annuity (& variable life insurance) contracts, exempting such contracts from any redemption limit (or maximum account balance or other test). This could be accomplished by adding at the end of the proposed definition of omnibus account holder (paragraph 2a-7(c)(3)(ii) - FNAV) the following: “except that the $X,000,000 daily redemption limit shall not apply to owners of individual variable insurance contracts or to contract owners or plan participants under group variable insurance contracts.”

(c). Increase the Limit in the Definition of Retail Money Market Fund

If variable insurance contracts are not completely exempted from the redemption limit as recommended in subsection (b) above, then the Committee supports defining a retail money market fund in terms of a daily redemption limit (as proposed) as generally the best option. The alternatives noted in the Release (such as basing the definition on a maximum account balance or on shareholder concentration) would present significant and costly operational problems (including the difficulty of administering and implementing such tests; for example, unlike a mutual fund, an insurer would not have sufficient information about investment by another

32 Insurance company separate accounts in two-tier structures are unit investment trusts that rely on Section 12(d)(1)(E) of the 1940 Act.

33 Imposing a daily redemption limit on the aggregate of the insurance company’s transactions is simply not feasible.
The Committee also believes that a daily limit, as proposed, is preferable over a weekly (or other) limit, since it is easier to administer (e.g., a daily limit only requires measuring a single day’s transaction, whereas a weekly limit would require measuring all transactions over a rolling five business or seven calendar day period).

However, the Committee believes that the daily redemption limit should be substantially higher than the proposed amount of $1,000,000. Any daily limit would frustrate the reasonable expectations (and contract rights) of many VA owners, but the higher the limit, the less negative impact there would be. The Committee recommends that the limit be $5,000,000.

(d). Grandfather Variable Insurance Contracts

If the Commission does not provide the complete exemption recommended in subsection (b) above in the definition of retail fund, then the Committee would urge that the Commission at least include a grandfather provision for outstanding variable insurance contracts because, as discussed above, new limits and restrictions cannot be unilaterally imposed on outstanding (in-force) contracts. Such a grandfather provision could be implemented by adding a clause at the end of paragraph 2a-7(c)(3)(ii), to the effect that the omnibus account holder need not apply the redemption limit (or other redemption restriction) to variable annuity (or variable life insurance) contracts that (a) were in force before [a specified date; see following paragraph], and (b) do not limit the contract owner’s right to make withdrawals in such a way as to permit the insurance company to impose the redemption or other limit or restriction.

Even for newly issued variable insurance contracts, insurers cannot simply add new limits or restrictions without the prior approval of applicable state insurance departments, which can take a significant amount of time. Therefore the date in clause (a) above should be at least two years after the rule adoption; this will be necessary to allow insurers sufficient time to obtain state insurance department approvals of new contracts or endorsements that would allow the insurer to impose redemption or other limits on newly issued contracts (or to permit the insurer or the fund to arrange for indirect intermediaries, i.e., plan recordkeepers or plan administrators, to impose such restrictions or limits). 34

D. Fees & Gates Alternative

The Committee strongly opposes any form of the Fees & Gates Alternative.

1. Redemption Gates

Any type of redemption gate would be very problematic for variable annuity issuers. First, of course, there is the problem that variable annuity owners have a contractual right to take withdrawals and to surrender their contracts, and generally to transfer their cash value out of any

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34 The proposed compliance date for the Floating NAV Alternative is two years after a final rule adoption.
subaccount, including the money market subaccount, on a daily basis without any gate or other delay. Outstanding variable annuity contracts allow daily redemptions with no provision for redemption gates, so imposing any gates would violate the terms of outstanding contracts, subjecting insurers to potential liability for breach of contract. It would also be a violation of state insurance laws and regulations, subjecting the insurer to regulatory actions by state insurance commissioners.

Second, variable annuity issuers provide a variety of programs that require periodic redemptions from money market funds. These programs include dollar cost averaging, automatic rebalancing, and automatic periodic withdrawals (these transfers between subaccounts are redemptions of units from one subaccount and a purchase of units in the other). Variable annuity payouts can require monthly redemptions from money market subaccounts. In addition, some variable annuities (and generally all variable life insurance policies) provide for monthly (or quarterly) deductions of certain charges, which may also require redemptions from money market funds. Variable annuity prospectuses describe all of these features of the annuity; they are material aspects of the security as it was sold to investors (along with the right to make withdrawals and surrenders). Therefore, imposing any type of redemption gate would present significant legal and operational problems for variable annuity issuers. For these reasons, without an appropriate exemption, money market funds that could impose redemption gates are simply not viable for variable annuity contracts.

2. Liquidity Fees

Liquidity fees pose the same problems. Outstanding variable annuity contracts generally would not permit the insurance company to impose such fees (and they are certainly not disclosed in the prospectuses used for the security offering). We understand the position that such fees, like redemption fees under Rule 22c-2 under the 1940 Act, could be viewed as being imposed by the fund and not the insurance company intermediary. But to our knowledge, that argument has not been ruled upon or accepted by a court or state insurance department, putting legal risk on any insurer that imposes liquidity fees on its contract owners. In addition, it seems very likely that at least some state insurance commissioners would determine that any

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35 It seems strange, to say the least, that an SEC rule proposal would cause issuers of securities to renge on the terms of the security offering, as described in the prospectus used for the sale.

36 See Release IC-26782 (March 11, 2005), 70 Fed. Reg. 13328, note 62 (adopting Rule 22c-2). If any form of liquidity fee is adopted, the Committee requests that the Commission confirm that, in its view, such fees would be imposed by the fund and not the insurer. Variable annuity contracts (and the prospectus) are very specific about what fees and charges can be imposed, and the insurer cannot add new fees to outstanding contracts.

37 This legal risk is magnified in situations where an affiliate of the insurer is the fund’s sponsor and investment adviser.
such liquidity fees violate not only the terms of the contracts, but also state insurance regulatory requirements as well.  

More importantly, perhaps, imposing liquidity fees and gates would be an immense administrative and operational burden for insurers. Variable annuity contracts are very complicated, much more complicated than money market funds. Many insurers utilize multiple administrative systems, some of which are ‘legacy’ systems that are used for contracts sold years ago. The cost and effort to implement liquidity fees would be prohibitive. Moreover, under the Proposals, insurers would need to be able to begin charging the fee on a day’s notice, when the fund hits the 15% weekly liquid asset level – unless the board decides not to impose the fee; and the insurer would not know the amount of the fee, because the board could impose a lesser fee. Nor would the insurer know how long the fee would be in effect or at what level (since the fund board could change the level). For these reasons, actually implementing the fee could be impossible, or prohibitively expensive, for insurers.

3. Exemptions From Fees & Gates

For these reasons, the Fees & Gates Alternative is simply not practical for issuers of variable contracts. The rule should provide that any fees & gates do not apply to owners of individual annuity contracts or to participants under group annuity contracts.

Alternatively (or in addition), if any form of the Fees & Gates alternative is adopted (and variable insurance contracts are not exempted), then the Committee strongly endorses exemptions from both fees & gates for certain types of transactions, at least in variable annuities. These transactions in variable annuities would not be reactions to market stress and generally should not present liquidity or other problems for underlying funds. Variable insurance contract transactions that should be exempt from fees and gates include:

1. Small beneficial owner redemptions (i.e., up to $100,000/day for each contract) and other transactions that fit within Partial Gates (such as a limited percentage of an owner’s account value, etc.). These are very unlikely to have an impact on underlying funds.

2. Requests submitted in advance, or “automatic” transactions (e.g., dollar cost averaging, automatic rebalancing, systematic partial withdrawals, and deduction of periodic charges). These transactions are certainly not reactions to market stress.

3. Death benefits and annuity payouts at maturity. These transactions also are certainly not reactions to market stress.

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38 For example, state insurance regulations have “nonforfeiture” requirements for variable annuities that have the effect of limiting the permissible charges imposed on contract owners. Including liquidity fees in these calculations could result in some contracts violating these requirements.
III. Conclusion and Summary

As discussed above, variable insurance contracts (both variable annuities and variable life insurance contracts) are not money market funds, they are not short-term, liquid investments, and they are not susceptible to a 'run on the bank.' They embody very significant disincentives to take withdrawals that do not apply to money market funds sold directly to investors. Therefore the Committee respectfully recommends and requests that the Commission modify the proposals as follows:

Generally:

- Exempt shares of variable insurance contract money market funds (as defined above\textsuperscript{39}) from both the Floating NAV and the Fees & Gates Alternatives.

- Adopt the proposed limited exemption[s] from Section 27(i) of the 1940 Act for variable insurance contracts (proposed rules 2a-7(c)(3)(iii)(B) (FNAV) and 2a-7(c)(2)(iv) (Fees & Gates)).

- Confirm that the phrase “variable insurance contracts” in proposed rules 2a-7(c)(3)(iii)(B) (FNAV) and 2a-7(c)(2)(iv) (Fees & Gates) includes both variable annuities and variable life insurance contracts.

- If one Alternative is adopted, it should be the Floating NAV Alternative (revised as recommended herein); the Fees & Gates Alternative should not be adopted.

If the Floating NAV Alternative is adopted:

- Clarify the definition of omnibus account holder to eliminate any doubt that it includes insurance companies on behalf of their separate accounts.

- In the definition of retail fund, exempt variable insurance contracts from the daily redemption limit (or other test or restriction).

  - If such an exemption is not provided, then substantially increase the daily redemption limit.

  - In addition, if such an exemption is not provided, then adopt a suitable grandfather provision for variable insurance contracts.

\textsuperscript{39} See text at footnotes 21 and 22, supra.
If the Fees & Gates Alternative is adopted:

- Exempt variable insurance contracts from any Fees & Gates.
  
  o If such an exemption is not provided, then adopt exemptions for small transactions, partial gates, requests submitted in advance (automatic transactions), and death benefits and annuity payouts.

  o In addition, if such an exemption is not provided, then confirm that any liquidity fee would be imposed by the underlying fund and not an insurance company intermediary, even if the insurance company administers the fee by deducting it from a contract owner withdrawal or transfer.

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The Committee appreciates the Commission’s careful consideration of these comments. If you have any questions or if there is any way we can assist you in this regard, please contact Stephen E. Roth at 202-383-0125 (steve.roth@sutherland.com) or Frederick R. Bellamy at 202-383-0126 (fred.bellamy@sutherland.com).

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