MEMORANDUM

TO: File No. S7-26-22

FROM: Quinn Kane, Senior Counsel, Division of Investment Management

RE: Meeting with representatives of the American Council of Life Insurers and the Committee of Annuity Insurers

DATE: June 6, 2023

On June 6, 2023 staff from the U.S. Securities and Exchange Commission (the "SEC") met with representatives of the American Council of Life Insurers ("ALCI") and the Committee of Annuity Insurers ("CAI").

Participants included SEC staff from the Division of Investment Management: Sarah ten Siethoff (Deputy Director), Brian Johnson (Assistant Director), Michelle Beck (Senior Financial Analyst), Holly Miller (Senior Financial Analyst), Angela Mokodean (Branch Chief), Y. Rachel Kuo (Senior Counsel), Mykaila DeLesDernier, Quinn Kane (Senior Counsel), and Thoreau Bartmann (Co-Chief Counsel); and the Division of Economic and Risk Analysis: James McLoughlin (Financial Economist), and Dasha Safonova (Financial Economist).

Representatives of ALCI included the following:

- Patrick Reeder
- James Szostek
- Jennifer McAdam

Representatives of CAI included the following:

- Stephen Roth
- Ronald Coenen Jr.

The participants discussed the Commission's proposal titled *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting* [Release Nos. 33-11130; IC-34746].

Joint Comment Letter of
the American Council of Life Insurers (ACLI)
and the Committee of Annuity Insurers (CAI)
on the SEC Swing Pricing-Hard Close Proposal

June 6, 2023

Overall Position of the ACLI and CAI

– The SEC should abandon the swing pricing-hard close proposal (the Proposal) entirely.

– As a general matter, the Proposal reflects unsound public policy and raises concerns under the Administrative Procedure Act.

– For variable products and retirement plans, the hard close Proposal is unworkable, would result in significant investor harm, and is irreconcilable with the operation of variable contracts and retirement plans.

– *In no event can insurance companies or their two-tier separate accounts (registered or unregistered), nor retirement plans or their recordkeepers, be subject to a hard close requirement that would result in the loss of same day pricing for fund orders transmitted after a mutual fund's pricing time (4 pm Eastern Time).*

Key Facts: Variable Contracts and Separate Accounts

- Variable products are legally enforceable contracts between insurance companies and contract owners.
- They must be supported by a separate account of the issuing insurer. The separate account must be insulated from the general account and maintain equal assets and liabilities.
- The vast majority of separate accounts have a two-tier structure with designated underlying mutual funds.
- Two-tier separate accounts are generally divided into subaccounts, with each being a single variable investment option and corresponding to a single underlying fund.
- Variable contracts guarantee pass through of separate account investment experience, achieved through unitization of the separate account tied to underlying fund NAVs.
- This unitization of separate accounts makes variable products “NAV-dependent” contracts.

Key Facts: Variable Contracts and Separate Accounts

Four-Step Daily Order of Operations for Separate Accounts

Step 1
Dissemination of the underlying funds' NAVs for that business day
(e.g. 4:30 pm)

Step 2
Strike unit values (AUVs) using the funds' NAVs and the contractual net investment factor formula
(e.g. 5 pm)

Step 3
Calculate contract values and process unit transactions for that business day based on the AUVs
(e.g. 5-8 pm)

Step 4
Submit an order to each underlying fund based on the net unit transaction activity for each subaccount
(e.g. 8:30 pm)

Due to the NAV-dependent nature of variable products, and as reflected in longstanding SEC precedent, insurers necessarily transmit fund orders (Step 4) after 4 pm.

This leads to two fundamental problems with the Proposal: (1) bad swing factors and (2) daily separate account breakage.

Problems with the Proposal for Variable Contracts

Fundamental Problem #1: Bad Swing Factors

Contract owners who transact "today" will bear the costs generated by contract owners who transacted "yesterday."

- In the context of variable products, the Proposal will not achieve the policy objective for swing pricing, *i.e.*, "to pass on costs stemming from shareholder purchase or redemption activity to shareholders engaged in that activity."

- The Proposal will produce illogical and inequitable results as the degree and direction of flows change from day to day, inevitably resulting in harm to contract owners.

- The Proposal will *<u>not</u>* eliminate first-mover advantage, as contract owners will be incentivized to be the first one out of the separate account in times of stress.

Example of Bad Swing Factors

<u>Day 1 (Illustrating Separate Account Order of Operations)</u>

- <u>Until 4 pm</u>: **Insurance Company X** receives orders under the variable contract.
- <u>4:30 pm</u>: **Underlying Fund A** publishes its Day 1 NAV.
- <u>5 pm</u>: Insurance Company X strikes the Day 1 AUV for **Subaccount A**. Orders for Subaccount A received prior to 4 pm will receive the contractually entitled Day 1 AUV, which will be calculated based on the Day 1 NAV.
- <u>Until 8 pm</u>: Insurance Company X processes the Day 1 unit transactions for Subaccount A. **Assume 1% net unit outflows.**
- <u>8:30 pm</u>: Insurance Company X transmits a redemption order to Underlying Fund A.

<u>Day 2 (How Does the Day 1 Unit Flow Impact the Day 2 Swing Factor?)</u>

- <u>Prior to 4 pm</u>: Underlying Fund A receives no orders other than the redemption order transmitted by Insurance Company X after close on Day 1.
- <u>4 pm</u>: Underlying Fund A begins to calculate its Day 2 NAV.
    - The swing factor will be based entirely on the 1% net unit outflows from Day 1.
    - The swing factor will not reflect any Subaccount A activity occurring on Day 2.
- <u>4:30 pm</u>: Underlying Fund A publishes its NAV for Day 2.
- <u>5 pm</u>: Insurance Company X strikes the Day 2 AUV for Subaccount A, using the Day 2 NAV. Orders received by Insurance Company X prior to 4 pm on Day 2 will receive the Day 2 AUV.

Day 2 orders for Subaccount A will get the Day 2 AUV, based on the Day 2 NAV.

However, the Day 2 NAV's swing factor will have been calculated entirely on the 1% net unit outflows from Day 1. Contract owners who transact on Day 2 will bear the costs generated by contract owners who transacted on Day 1.

Problems with the Proposal for Variable Products

Fundamental Problem #2: Daily Separate Account Breakage

Breakage will occur within every subaccount of every two-tier separate account on every business day.

- Breakage arises when a separate account (or any subaccount thereof) has an asset-liability mismatch.
  - Under the current framework, separate accounts avoid daily breakage because the underlying fund NAV applicable to Step 2 (striking AUV) and Step 4 (fund order) are the same.
  - Under hard close, due to the loss of same-day pricing, the NAV applicable to Step 2 and Step 4 will differ, creating separate account breakage as the underlying funds' NAVs change from day-to-day.
- The breakage risk would be extreme. Many insurers have several separate accounts, dozens of products, and hundreds/thousands of subaccounts and underlying funds.
- Daily breakage would place insurers in an impossible situation legally and financially, and would ultimately harm investors.

Example of Daily Separate Account Breakage

	Current Regulatory Framework	Proposed Hard Close Framework
Business Day 1		
Underlying Fund NAV	$10 per share	$10 per share
Subaccount AUV	$9 per unit	$9 per unit
Net Unit Flows for Subaccount	Net inflows – SA issues 1,000 units worth $9,000	Net inflows – SA issues 1,000 units worth $9,000
Order from Insurer to Underlying Fund (after 4 pm)	Purchase order for $9,000 in shares	Purchase order for $9,000 in shares
NAV for Order to Fund	***$10 per share***	***Unknown***
Business Day 2 (NAV per share increases 10% relative to Day 1)		
Underlying Fund NAV	$11 per share	$11 per share
Subaccount AUV	$9.90 per unit	$9.90 per unit
Total Value of Subaccount Units Issued on Day 1	$9,900	$9,900
Total Value of Fund Shares Ordered on Day 1	***$9,900***	***$9,000***
Subaccount Breakage Between Days 1 and 2	***$0 or 0%***	***($900) or (10%)***

No Practical Way to Avoid Fundamental Problems for Variable Contracts

– ***Insurance companies are constrained by existing contracts, investor disclosures, and applicable law.***
  - Variable contracts have been designed based on long-standing legal principles, including Rule 22c-1 as currently in effect.
  - Insurers have no right to unilaterally change outstanding contracts. Amending contracts would be practically impossible and the outcome would be uncertain.
  - Ability to invent novel pricing/processing procedures constrained by Rule 22c-1.
  - Undermining investor expectations would expose insurers to litigation risk.

– ***Early cut-offs would violate existing contracts and would solve nothing due to the NAV-dependent nature of variable products.***
  - Most insurers would not be contractually permitted to impose early cut-offs.
  - Early cut-offs would not address the root problem with the Proposal. Step 4 cannot occur before Step 1 in the daily order of separate account operations.
  - Even if an insurer cuts-off at 9:01 am, an insurer could not transmit an order reflecting unit activity for that day until after 4 pm.
  - Widespread early cut-offs would be harmful, impractical, costly, and anti-competitive.

Comments Specific to Retirement Plans

- The Proposal would require a complete restructuring of operations. The costs would be borne by the retirement plan system and participants.
- The Proposal raises problems for plans that are similar to variable products, with impacts to plan sponsors, providers, and participants.
- Highlighting three critical concerns:
  - ***Process****:* Retirement plan recordkeepers have procedures for processing transactions that are similar to variable products. A restructuring of those procedures would be extraordinarily burdensome.
  - ***Early Cut-Offs****:* An early cut-off cannot solve the barriers to submitting an order before funds have struck their NAVs. Without the current day's NAV, a plan recordkeeper cannot process many transactions involving multiple funds.
  - ***Breakage****:* If a recordkeeper is required to transmit fund orders before 4 pm, it could only do so based upon transaction estimates, using a hypothetical proxy for the funds' NAVs. This would give rise to breakage, due to differences in the proxy NAVs and actual NAVs. It is not obvious who would or could bear that breakage.
- A large portion of plan activity is not market driven. It is driven by plan terms as well as statutory requirements and deadlines. Pre-planned and systematic transactions would heavily influence swing factors.

Appendix – Example Contractual Provisions for AUV & Net Investment Factor Formula

- Accumulation Unit Values for each Subaccount are determined by multiplying the Accumulation Unit Value for the immediately preceding Business Day by the Net Investment Factor of the Subaccount for the current Business Day.
- The **Net Investment Factor** for each Subaccount is determined by **dividing A by B and multiplying by (1-C)** where:
  - **A** is (i) the net asset value per share of the [underlying fund] held by the Subaccount at the end of the current Business Day; plus (ii) any dividend or capital gains per share declared on behalf of such [underlying fund] that has an ex-dividend date as of the current Business Day;
  - **B** is the net asset value per share of the [underlying fund] held by the Subaccount for the immediately preceding Business Day; and
  - **C** is (i) the Separate Account Product Charges which are shown on the Contract Schedule for each day since the last Business Day. The daily charge is equal to the annual Separate Account Product Charges divided by 365; plus (ii) a charge factor, if any, for any taxes or any tax reserve established as a result of the operation of the Subaccount.