ACLI
Financial Security for Life

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Via electronic submission (IM-Rules@sec.gov)

Sarah G. ten Siethoff
Acting Director, Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Investment Company Cross Trading
Staff Statement March 11, 2021

Dear Ms. ten Siethoff:

Thank you for the opportunity to provide comments to the Securities and Exchange Commission ("the Commission") on the Staff Statement issued on March 11, 2021 regarding cross trading and Rules 2a-5 and 17a-7 under the Investment Company Act of 1940 ("the Act").

The American Council of Life Insurers ("ACLI") is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 95 percent of industry assets in the United States.

Executive Summary

Many ACLI members sponsor mutual funds that are made available as investment options in variable life and variable annuity products.[1] The adoption of Rule 2a-5 under the Act (the "Valuation Rule") impacts how ACLI members sponsoring mutual funds value fund assets and how such assets are traded. In particular, ACLI members are concerned about the potential unintended consequences of summarily disqualifying certain important securities, such as corporate bonds and other fixed income securities, under the Valuation Rule. As we will discuss below, ACLI members and affiliated mutual funds are significant investors in the securities disproportionately impacted by these changes.

[1] According to ACLI compilation of data from the National Association of Insurance Commissioners, as of year-end 2019, ACLI members held $2.8 trillion in separate account assets, including approximately $244 billion in corporate bonds. See American Council of Life Insurers 2020 Life Insurers Fact Book ("2020 ACLI Fact Book") at 11 (and table 2.2 at 15, *citing* ACLI tabulations of National Association of Insurance Commissioners ("NAIC") data.) (https://www.acli.com/-/media/ACLI/Files/Fact-Books-Public/2020LifeInsurersFactBook.ashx?la=en)). Separate accounts support life insurance company liabilities associated with variable life insurance, variable annuities and pension products.

In addition, ACLI members are still digesting both the direct and potential indirect ramifications of the Valuation Rule.[2] Our members note that the definition adopted in the Valuation Rule is not limited in applicability to cross trading; rather, the Commission intends that the new definition of "readily available market quotations" will "apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7."[3]

Sweeping Impact of Valuation Rule

Prior to the adoption of the Valuation Rule, the term "readily available" was not defined in the Act or the Rules promulgated under the Act. The Valuation Rule establishes the following definition to be used in determining whether a market quotation is "readily available" for purposes of Section 2(a)(41) of the Act:

> "[A] market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable."[4]

This definition follows the definition of a "level 1" input in the fair value hierarchy outlined in U.S. GAAP.[5] Under the Commission's definition, a security will be "considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs."[6] In "all other circumstances," including where securities are valued using "level 2" inputs in the U.S. GAAP fair value hierarchy, fair value would have to be used.[7]

The Commission noted that, "[s]ecurities valued using level 2 inputs include securities that are not traded on an active market, and/or are valued using inputs other than quoted prices for the specific security (such as credit spreads)" and that the use of level 2 inputs is, "not consistent with the concept of readily available market quotations under the Act."[8]

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[2] ACLI members appreciate what we believe to the be the intent of the Staff Statement – to better understand cross trading and the practical impact of the Valuation Rule. We expect that other commenters with a broad view of the marketplace will provide valuable insight to the Commission. This letter is more narrowly focused on the potential impact of cross-trading limitations associated with the Valuation Rule on ACLI member companies as significant long-term investors.

[3] 86 FR 748, at 773 (January 6, 2021).

[4] 17 CFR § 270.2a-5(c).

[5] Accounting Standards Codification ("ASC") 820-10-35-40.

[6] 86 FR 748, at 771.

[7] 86 FR at 771.

[8] 86 FR at 772.

This broad statement summarily dismisses many reliable, safe, long-term and transparently-priced securities, such as asset-backed securities[9], corporate bonds[10], (non-U.S. Treasury) government bonds[11] and municipal bonds[12]. These fixed income securities have long been used and are critical to long-term, conservative investors such as ACLI members and many of their customers.

Life insurers are significant investors in the fixed income securities market; 48% of the industry's total assets were held in bonds at year-end 2019[13]. The life insurance industry is also the largest institutional holder of corporate bonds, holding more than 22% of all U.S. corporate bonds. In 2019, life insurers invested a total of $2.6 trillion in corporate debt issues.[14]

As the Commission notes in the Valuation Rule release, both level 1 and level 2 inputs have long been accepted by the Commission as reliable for fair valuation methodology. As the Commission knows, under US GAAP, level 1 inputs are defined as "quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date."[15]

Level 2 inputs are different, but no less reliable, transparent and safe when determining "readily available." Level 2 inputs are observable to market participants, either directly or indirectly,[16] and are generally based on market data obtained from sources independent from the reporting entity. This can include quoted prices for similar assets and liabilities in active markets or quoted prices for identical or similar assets and liabilities in markets that are not active. Level 2 may consist of

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[9] These securities include, for example, mortgage-backed securities and they are generally priced by independent pricing services and brokers. The pricing provider applies dealer quotes and other available trade information, prepayment speeds, yield curves and credit spreads to the valuation. These inputs are observable market inputs.

[10] Corporate bonds are generally priced by independent pricing services and the spreads are commonly sourced from broker/dealers, trade prices and the new issue market. These inputs are observable market inputs.

[11] Securities from agencies such as the Federal Home Loan Bank and the Federal Home Loan Mortgage Corporation are generally valued using the spread above the risk-free yield curve. These inputs are observable market inputs.

[12] Securities issued by U.S. state and municipality entities or agencies and are generally priced by independent pricing services. The pricing services typically use spreads obtained from broker-dealers, trade prices and the new issue market. These inputs are observable market inputs.

[13] At year-end 2019, 48 percent of life insurer assets were held in bonds. Total bond holdings of both general and separate accounts amounted to $3.6 trillion, up $145 billion from 2018. Holdings of bonds in separate accounts increased 10.5 percent in 2019 to $436 billion. Bond holdings in general accounts increased to $3.2 trillion. See 2020 ACLI Fact Book at 14, *citing* ACLI tabulations of NAIC data. (https://www.acli.com/-/media/ACLI/Files/Fact-Books-Public/2020LifeInsurersFactBook.ashx?la=en)

[14] Corporate debt issues in 2019 represented the largest component of life insurer assets at 34 percent. Corporate debt issues totaled $2.6 trillion by year's end. These investments have generally increased steadily for many years and have grown at a 5 percent annual rate in the last decade. Life insurers are also significant investors in government bonds, investing $432 billion in U.S. government securities in 2019, and in mortgage-backed securities, investing $119 billion in mortgage-backed securities in 2019. See 2020 ACLI 2020 Fact Book at 14.

[15] Accounting Standards Codification ("ASC") 820-10-35-40.

[16] ASC 820-10-35-48.

inputs that are observable for a particular asset or liability such as interest rate and yield curves observable at commonly quoted intervals, implied volatilities, and credit spreads.[17]

ACLI members are not only long term investors; their products provide long term, reliable sources of income to their customers, including retirees. These customers could face increased costs and decreased benefits as a result of the Valuation Rule flatly eliminating the ability to cross-trade fixed income securities. For example, Asset-Liability Management ("ALM")[18] would need to factor in higher fixed income costs because the values of fixed income securities would likely increase if the ability to cross-trade is eliminated (*i.e.*, managers would need to go to the marketplace to effect fixed income trades resulting in higher execution and trade costs with no demonstrable higher benefit). Higher ALM modeling factors would result in higher product costs to policyholders and retirees, as well as potential decreases in benefits available under a policy or retirement product. Said another way, the inability of an underwriting insurance company to utilize fixed-income securities to facilitate customers' ALM could raise the customer's costs of such management. In addition, for variable insurance products where benefits are often tied to performance of investment accounts, higher trade costs result in lower performance and account values, which decreases benefits available to policyholders.

The Lack of Analysis of Sweeping Changes in Valuation Rule

Neither the Notice of Proposed Rulemaking[19] nor the Valuation Rule release[20] identify any specific current or historical, systemic issue with use of level 2 securities in any cross-trading activities. Yet the Valuation Rule dismisses their use entirely.

As the Commission notes in its release of the Valuation Rule, the Commission is "required to consider or determine whether an action is consistent with the public interest [. . .]" and "shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[21] While the ACLI and its members appreciate the extensive analysis that the Commission did in the release of the Valuation Rule, the basis for and the impact of completely removing Level 2 inputs from the definition of "readily available market quotations" does not appear to have been given sufficient consideration.

[17] ASC 820-10-35-48.
[18] Asset Liability Management ("ALM") is a tool that, for example, could show pension plan sponsors the potential consequences of different investment strategies. Effective ALM allows a plan sponsor to coordinate investments with plan liabilities in order to achieve desired financial goals.
[19] https://www.sec.gov/rules/proposed/2020/ic-33845.pdf
[20] https://www.sec.gov/rules/final/2020/ic-34128.pdf
[21] Section 2(c) reads, "Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S. Code § 80(a)(2)(c).

Consider, for example, the "promote [. . .] capital formation" prong. Level 2 securities – such as corporate and municipal bonds and Federal Home Loan Bank securities – are often the bedrock of capital formation.

Not only does removing a significant class of securities from the definition in Rule 2a-5 have a serious potential impact on activities such as cross trading, treating such securities differently than level 1 securities could also create a potential chilling effect.

Responses to Specific Questions[22]

1. Current cross trading practices.
    - As noted above, all Level 2 securities have been eliminated from consideration from cross trading. These securities are generally long-term in nature and include corporate bonds, municipal bonds and non-U.S. Treasury government agency securities.[23] As ACLI members work with their customers to engage in asset-liability management for long term liabilities, elimination of an entire class of safe, long term securities is potentially very limiting and, in the long run, more expensive to the customer.
2. Securities Eligible to Cross Trade: Pricing and liquidity.
    - As noted in the body of the letter and footnotes 9 – 12, the pricing of level 2 securities, should they be permitted to be utilized in cross trading, is highly transparent.
    - These level 2 assets, while not traded on exchanges, are generally highly liquid.
3. Controls.
    - ACLI expects that other commenters with a broad industry view will be in a better position to properly explain the robust controls that are in place for such trades and ACLI will not repeat those comments here.
4. Market Transparency
    - Transparency is already deeply embedded in the controls and pricing requirements of Rule 2a-5 and 17a-7. ACLI expects that other commenters with a broad industry view will be in a better position to properly explain the transparency that is in place for such trades and ACLI will not repeat those comments here.

Conclusion

ACLI Member companies are continuing to digest the impact of the Valuation Rule, including its impact on cross trading. We appreciate the specific questions that the Staff Statement raises.

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[22] As noted, above, this letter is limited in scope and ACLI will not provide answers to every question asked in the Staff Statement.
[23] For additional information about the scope of ACLI members' investments in these securities, please see infra, footnotes 12 and 13.

As the Commission considers the impact of Rule 17a-7 and the need for amendments, we would appreciate the opportunity to continue a discussion to make sure that the operations of our members, as long-term investors, are fully understood.

Very truly yours,

Patrick C. Reeder
Deputy General Counsel

Shelby Schoensee
Associate Counsel