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April 18, 2003

VIA HAND DELIVERY

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: **Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers**
File No. S7-03-03

Dear Mr. Katz:

This letter is submitted on behalf of the Committee of Annuity Insurers (the "Committee").[1] The Committee is pleased to have the opportunity to offer its comments in response to the request of the Securities and Exchange Commission (the "Commission") in Release Nos. IC-25925 and IA-2107 (February 5, 2003) (the "Proposing Release") for comments on new proposed Rule 38a-1 under the Investment Company Act of 1940 (the "1940 Act"). Rule 38a-1 would require all registered investment companies to establish, maintain and periodically review compliance procedures reasonably designed to prevent violations of federal securities and other specified laws.

In discussing the reasons for proposing Rule 38a-1 and the goals the rule is intended to attain, the Commission clearly was focused primarily on mutual funds (open-end management investment companies) and registered investment advisers.[2] Nonetheless, the proposed rule also

[1] The Committee of Annuity Insurers is a coalition of 31 life insurance companies that sell annuities. The member companies of the Committee represent over half of the annuity business in the United States. The Committee's comments advanced in this letter relate specifically to variable annuity contracts, although the comments in some cases may be equally pertinent to variable life insurance policies.

[2] For instance, the enforcement actions cited in the Proposing Release as examples demonstrating the "consequences of inadequate compliance programs" involved certain portfolio trading practices of mutual funds and/or registered investment advisers. *See* Proposing Release at note 14 and accompanying text. We note that to the extent Commission concerns with respect to these types of trading practices and supervision thereof provided impetus for the Commission's proposal, most insurance company separate accounts supporting variable annuity contracts are passive investment pools that buy and sell designated underlying mutual fund shares solely at the direction of variable annuity contractowners.

would require insurance company separate accounts registered as investment companies under the 1940 Act to adopt compliance procedures.[3]

Most variable annuity separate accounts are organized as "unit investment trusts" ("UITs") that do not have officers, directors or employees. Limited provision was made within proposed Rule 38a-1 for the passive nature of UITs by specifying that a UIT's principal underwriter or depositor would be responsible for certain oversight functions under the rule (whereas in the case of a mutual fund, the fund's board of directors would be responsible for the oversight functions).[4] We are submitting this comment letter on behalf of the Committee to identify for the Commission additional considerations the Committee believes are relevant to the implementation of the proposed rule with respect to insurance company variable annuity separate accounts (particularly UIT separate accounts).

Committee members believe the Commission's goals in proposing Rule 38a-1 are laudable and that requiring investment companies to adopt compliance procedures generally may further these goals. The comments in this letter reflect Committee members' consideration of how proposed Rule 38a-1 could most effectively and efficiently be implemented by individual Committee members and subsequently administered by the Commission and its staff. In analyzing how proposed Rule 38a-1 could be applied to separate accounts, Committee members were guided by the fact that unlike the operations of a typical mutual fund complex, variable annuity separate account operations often are conducted by multiple and diverse business units across an insurance company (or group of insurance companies) and regulated extensively under state insurance laws as well as under Commission and NASD regulations. Committee members concluded that in light of this diversity, Rule 38a-1 could be most effectively implemented by affording separate accounts broad flexibility to tailor compliance procedures to individual facts and circumstances without requiring specified minimum policies and procedures.

Accordingly, to ensure that variable annuity separate accounts, like mutual funds, can adopt and implement compliance procedures in the most efficient and productive manner possible, Committee members respectfully submit the following recommendations:

- *Rule 38a-1 should not specify minimum policies and procedures that insurance company separate accounts be required to incorporate into their compliance procedures.*

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[3] Insurance company separate accounts are separate investment accounts established by insurers to support variable annuity contracts and variable life insurance policies. *See* Stephen E. Roth, Susan S. Krawczyk and David S. Goldstein, *Reorganizing Insurance Company Separate Accounts Under Federal Securities Laws*, 46 BUS. L. 537, 542-43 (1991). Insurance company separate accounts generally are treated as investment companies subject to the regulatory provisions of the 1940 Act. Accordingly, among other things, separate accounts through which variable annuity contracts are issued generally are required to register as investment companies under the 1940 Act, although separate accounts that support only variable annuity contracts used in connection with certain tax-qualified retirement plans, or contracts offered in the private placement market, may not be required to register with the SEC in reliance on statutory exclusions from the 1940 Act.

[4] *See* proposed Rule 38a-1(b).

- *Rule 38a-1 should permit insurance company separate account compliance procedures to incorporate by reference other compliance procedures from various business units of the insurance company.*

- *Only that portion of an insurance company's compliance procedures relating to variable annuity contracts should be subject to the requirements of Rule 38a-1.*

- *Rule 38a-1 should afford separate accounts flexibility to adopt oversight structures tailored to their individual facts and circumstances, including compliance procedures that (i) designate multiple compliance officers to administer and periodically evaluate and report on the procedures, or (ii) designate subordinate compliance officers who, while reporting to a single compliance officer, are primarily responsible for administering, evaluating and reporting on the procedures.*

* * *

Section I below summarizes the Commission's reasons for proposing Rule 38a-1. Section II describes how the proposed rule would apply to mutual funds and to insurance company separate accounts. Against this backdrop, Section III explains the Committee's specific recommendations.

I. Background of the Commission's Proposal

The Commission explained in the Proposing Release[5] that in its experience, investment companies with effective internal compliance programs administered by competent compliance personnel are much less likely to violate the federal securities laws. Accordingly, the Commission staff focuses its examination efforts on testing the effectiveness of controls and related compliance procedures and requests that management correct any weaknesses that the staff discovers. The Commission believes that this approach enables it to leverage its limited examination resources by directing additional resources to investment companies with weaker compliance controls and examining such companies more closely and more frequently.

The Commission explained in the Proposing Release that it believes its ability to protect investment company investors has in many respects come to rely upon the effectiveness of these compliance programs. The Commission believes these programs provide the first line of investor protection. Nonetheless, the Commission is concerned that while many investment companies have established effective programs staffed with competent and trained professionals, neither the federal securities laws nor its rules require investment companies to adopt and implement comprehensive compliance programs and not all investment companies have adopted and implemented adequate compliance programs. In the Proposing Release, the Commission

[5] The following discussion of the background of proposed Rule 38a-1 is drawn from Section I of the Proposing Release.

cited several enforcement actions that demonstrate the "consequences of inadequate compliance programs."

The Commission explained in the Proposing Release that in recognition of the importance of compliance programs to investors and to the administration of the Commission's examination authority under the 1940 Act, it is proposing Rule 38a-1 to require investment companies to adopt and implement policies and procedures designed to prevent violations of the federal securities (and certain other specified) laws; review these policies and procedures at least annually for their adequacy and the effectiveness of their implementation; and designate a chief compliance officer responsible for administering the policies and procedures. The Commission indicated that its goal in proposing Rule 38a-1 is to rely more on "self-policing" by the investment company industry and less on Commission examination teams.

From the insurance industry's perspective (many of whose members also offer retail mutual funds as well as insurance product-dedicated funds), the prototypical compliance system that appears to be contemplated by the Commission under proposed Rule 38a-1 would involve a mutual fund complex adopting one set of compliance procedures covering all fund operations within the complex. All compliance personnel would ultimately report to a single compliance officer, and the board or boards of directors of the mutual funds in the complex would oversee the compliance system.

II. How Would Proposed Rule 38a-1 Apply To Insurance Company Variable Annuity Separate Accounts?

Before providing specific Committee member comments as to how the application of proposed Rule 38a-1 to insurance company separate account operations will need to differ from the rule's application to the prototypical mutual fund complex, we discuss how the rule in its proposed form would appear to apply to mutual funds as compared to (and contrasted with) variable annuity separate accounts.

A. Application of proposed Rule 38a-1 to mutual funds

Proposed Rule 38a-1 would impose on mutual funds the requirements described below. The basic framework of proposed Rule 38a-1 as applicable to mutual funds calls for the "mutual fund" itself to adopt, maintain, and periodically review compliance procedures and maintain related records. In practice, since most funds are externally managed, employees of the investment adviser, third party administrator, or other third party service providers would perform these functions. On the other hand, the fund's Board of Directors would be responsible for overseeing the compliance procedures.

- **Policies and Procedures**. A mutual fund would be required to adopt and implement written policies and procedures "reasonably designed to prevent violations" of the federal securities laws, as well as other specified laws, by the fund, or by its

investment adviser, principal underwriter or administrator in connection with their provision of services to the fund.[6]

- Annual Review. The fund would be required to review, at least annually, the adequacy of the policies and procedures and the effectiveness of their implementation.

- Chief Compliance Officer. The mutual fund would be required to designate an individual as the fund's compliance officer. This individual would be responsible for administering the compliance policies and procedures and, at least annually, for providing the board a written report on the policies and procedures, any material changes to the policies and procedures since the last annual report, any material changes to the policies and procedures recommended as a result of the annual review conducted by the fund, and any material compliance matters requiring remedial action that occurred since the date of the last report.

- Fund Board Approval. The mutual fund's board of directors, including a majority of directors who are not interested persons of the fund, would be required to approve the policies and procedures of the fund, approve the compliance officer, and receive the annual report from the fund's compliance officer as described above.

- Recordkeeping. The mutual fund would be required to maintain certain records designed to demonstrate compliance with the rule.

B. Application of proposed Rule 38a-1 to variable annuity separate accounts

As noted in the beginning of this letter, notwithstanding the apparent focus of proposed Rule 38a-1 on mutual funds, the rule would apply to insurance company separate accounts registered as investment companies under the 1940 Act. With respect to separate accounts organized as management investment companies (commonly referred to as "managed accounts"), the rule likely would apply in much the same manner as to mutual funds, with employees of the managed account's investment adviser, principal underwriter and/or third party administrator conducting the compliance activities required under the rule (adopting, maintaining and periodically evaluating the compliance procedures) and the account's management committee (the equivalent of a mutual fund's board of directors) carrying out the requirements of the rule relating to board oversight responsibilities. With respect to UIT separate accounts, employees of the depositor, principal underwriter and/or third party administrator would conduct the activities required of the separate account under the rule, while the principal underwriter or

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[6] Proposed Rule 38a-1 would require investment companies to adopt procedures reasonably designed to prevent violations of the "Federal Securities Laws." For purposes of the rule, the term "Federal Securities Laws" is defined as the Securities Act of 1933, the Securities Exchange Act of 1934 (the "1934 Act"), the Sarbanes-Oxley Act of 2002, the 1940 Act, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act as it applies to investment companies, and any rules adopted thereunder by the Commission or the Department of the Treasury.

depositor itself would be required to approve the separate account's policies and procedures and chief compliance officer and receive annual reports from the compliance officer.[7]

Proposed Rule 38a-1 would impose the following general requirements on UIT separate accounts.

- **Policies and Procedures**. A UIT separate account would be required to adopt and implement written policies and procedures "reasonably designed to prevent violations" of the federal securities laws, as well as other specified laws, by the separate account, or by the principal underwriter or administrator of the separate account in connection with their provision of services to the separate account. (While proposed Rule 38a-1 generally requires compliance procedures to cover the activities of the investment adviser, principal underwriter and administrator, in the case of a UIT separate account there is no "investment adviser.")

- **Annual Review**. The separate account would be required to review, at least annually, the adequacy of the policies and procedures and the effectiveness of their implementation.

- **Chief Compliance Officer**. The separate account would be required to designate a chief compliance officer who would be responsible for administering the compliance policies and procedures and, at least annually, providing the separate account's principal underwriter or depositor a written report on the policies and procedures, any material changes to the policies and procedures since the last annual report, any material changes to the policies and procedures recommended as a result of the separate account's review of the policies and procedures, and any material compliance matters requiring remedial action that occurred since the date of the last report.

- **Principal Underwriter or Depositor Approval**. The separate account's principal underwriter or depositor would be required to approve the policies and procedures of the separate account, approve the compliance officer, and receive the annual report from the separate account's compliance officer as described above.

- **Recordkeeping**. The separate account would be required to maintain records demonstrating compliance with the rule.

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[7] For purposes of the 1940 Act, the "depositor" of a UIT separate account is the insurance company itself. The "principal underwriter" typically is an insurance company affiliate registered as a broker-dealer with the Commission and the NASD, although some insurance companies themselves are registered broker-dealers and may serve as the principal underwriter of the variable annuity contracts they issue.

III. Specific Committee Recommendations

A. Rule 38a-1 should not specify minimum policies and procedures that a separate account be required to incorporate into its compliance procedures

The Commission asked for comment on whether Rule 38a-1 should specify certain minimum policies and procedures that would be required to be included in compliance procedures, and if so, what policies and procedures should be included. Committee members recommend that Rule 38a-1 not enumerate any minimum requirements with respect to specific policies and procedures that an insurance company separate account's compliance procedures be required to include. Committee members believe instead that the Commission should recognize the differences between mutual funds and managed and UIT separate accounts with a view toward providing separate accounts with latitude to craft compliance procedures that are "reasonably designed to prevent violation of the Federal Securities Laws" in the context of each individual separate account's fact and circumstances. This flexibility would enable a separate account to develop comprehensive compliance procedures covering multiple business units within the insurance company that administer various aspects of the variable annuity contracts supported by the separate account.

Mutual funds generally are organized as corporations or business trusts under state law. An external investment advisory firm typically organizes a mutual fund and is responsible for its day-to-day operations. The adviser generally provides the seed money, officers, employees, and office space, and usually selects the initial board of directors. In many cases, the investment adviser sponsors several funds that share administrative and distribution systems as part of a mutual fund "complex."[8]

As the Commission notes in the Proposing Release, investment companies and their advisers can vary widely in their operations. In our experience, though, mutual fund complexes typically have relatively similar operational structures with respect to which an investment advisory organization provides portfolio management and administrative, legal and accounting services; shareholder transactions and accounts are handled by a transfer agent; portfolio assets are held by a custodian; and fund shares are offered and sold by a principal underwriter. While it is common for funds to use external custodians and in some cases other third party service providers, a mutual fund's operations generally are subject to a single comprehensive regulatory structure established by the 1940 Act, comprehensive administration by a single investment adviser/administrator, and oversight by one board of directors or boards of directors that share common members.

The administration and regulation of variable annuity contracts and separate accounts differs significantly from mutual funds in certain important respects. For one thing, the issuance and ongoing administration of variable annuity contracts may be supported by business units throughout an insurance company or group of companies that are not dedicated solely, or in

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[8] *See Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24082 (Oct. 14, 1999).

some cases even predominately, to variable annuity contract administration.[9] To the contrary, because insurance companies have almost universally established separate account operations and begun offering variable annuity contracts as an adjunct to their fixed (or non-variable) annuity business, different aspects of variable annuity contract administration are, like fixed annuity and other insurance contracts, usually grouped according to insurance function and state insurance and tax law regulation rather than federal securities law regulation.

For example, an insurance company may support its entire sales force—responsible for the distribution of the company's variable annuity contracts, fixed annuity contracts, and life insurance business—by one business unit. This business unit may, among other things, field product-related questions relating to all of the company's life insurance and annuity contracts and handle all state insurance qualification and licensing issues as well as NASD and 1934 Act-related regulatory issues (with respect to broker-dealers and their registered representatives selling Commission-registered products).

The company's computer operations center, on the other hand, may handle all variable annuity contractowner application and ongoing transaction requests, as well as all other transactions by the company's fixed annuity and fixed and variable life insurance contractowners. The number of daily transactions in the latter category may far outnumber the number of daily variable annuity contract transactions. Finally, the company's legal and actuarial staff may be centered in yet another business unit.

As the above example demonstrates, because of the wide scope of an insurance company's various administrative and regulatory responsibilities, the company's business units may have a wider variety of compliance procedures than administrative or operational centers within a mutual fund complex. Moreover, in some instances insurance company business units may be more geographically dispersed.

For these reasons, the Committee recommends that Rule 38a-1 not require insurance company separate accounts to adopt any specific policies and procedures in connection with their compliance procedures mandated by the rule. Because separate accounts may vary so widely in their operations, the Committee believes strongly that Rule 38a-1 should provide the latitude and flexibility necessary for separate accounts to establish workable compliance procedures and effective oversight structures.

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[9] The development of the "ectoplasmic theory" early on in the regulation of variable annuity contracts permits application of 1940 Act regulatory requirements to an insurance company's variable annuity separate *accounts while avoiding* application to the insurer's general account operations. However, although an insurance company separate account retains a separate existence based in legal theory (as well as in accounting theory), from an operational standpoint that separate existence is largely a fiction.

B. Insurance company separate account compliance procedures should be permitted to incorporate by reference compliance procedures from different business units within the insurance company

Committee members believe that in certain situations it would not be practicable or meaningful to try to extract from the different compliance procedures employed by various business units just those procedures applicable to variable annuity contract administration. We note that the Commission specifically explained in the Proposing Release that the compliance procedures required by proposed Rule 38a-1 "should incorporate the policies and procedures [investment companies] have adopted pursuant to other requirements in the federal securities laws . . .," but that "these policies and procedures need not be contained in the same document."[10] We believe that the Commission's statement in this regard provides support for an insurance company separate account's Rule 38a-1 compliance procedures incorporating separate business units' compliance procedures, even in situations where the incorporated compliance procedures cover regulatory requirements (such as federal income tax regulations or state insurance law requirements) in *addition to* these required by the federal securities laws. Committee members recommend that the Commission expressly acknowledge in the adopting release for Rule 38a-1 (the "Adopting Release") or provide in the final rule itself that this practice would be permitted.

C. Only that portion of an insurance company's compliance procedures relating to variable annuity contracts should be deemed to be subject to Rule 38a-1

As discussed above, the Committee recommends that the Commission permit separate account compliance procedures to incorporate by reference compliance procedures from different business units across an insurance company. As also discussed above, the compliance procedures employed by the different business units of an insurance company will in many cases cover fixed and variable annuity and life insurance contracts and operations, as well as reflect requirements under state insurance laws, tax laws, Commission and NASD regulations, and other laws. For this reason, Committee members recommend that the Commission acknowledge in the Adopting Release or provide in the final rule itself that only the portion of an insurance company's compliance procedures relating to variable annuity contracts would be subject to Rule 38a-1.

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[10] *See* Proposing Release at note 26.

D. Rule 38a-1 should afford separate accounts flexibility to adopt oversight structures tailored to their individual facts and circumstances, including compliance procedures that (i) designate multiple compliance officers to administer and periodically evaluate and report on the procedures, or (ii) designate subordinate compliance officers who, while reporting to a single compliance officer, are primarily responsible for administering, evaluating and reporting on the procedures

As noted above, Committee members believe that in some circumstances insurance company separate account compliance procedures will need to incorporate by reference compliance procedures from various of the insurer's business units. For the reasons discussed, in some cases the scope of the compliance procedures of the different business units will be relatively broad due to the fact that the procedures must cover fixed and variable life insurance and annuity contracts and reflect tax, state insurance, federal securities, and other regulatory requirements. Because of the potentially broad scope of the individual procedures from different business units and the specialized expertise that will be necessary for compliance officers to administer the individual procedures on an ongoing basis, Committee members recommend that Rule 38a-1 permit separate account compliance procedures to be administered and periodically evaluated by multiple compliance officers where necessary and appropriate,[11] or, in the alternative, permit the procedures to be administered on an ongoing basis and periodically evaluated and reported on by multiple compliance officers, who in turn report to a single compliance officer.

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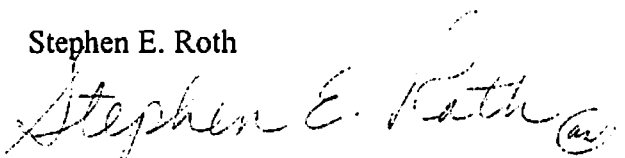
The Committee appreciates the time and resources that the Commission and its Staff have devoted to this initiative, as well as the opportunity to provide the Committee's views to the Commission. We also appreciate the Commission's careful consideration of the comments expressed herein.

Respectfully submitted,

Stephen E. Roth



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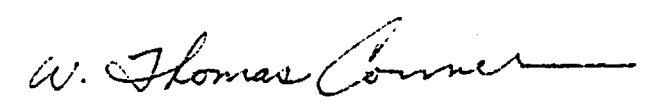

[11] *Cf.* USA PATRIOT Act and implementing rules thereunder; as noted in the Proposing Release at notes 44-45, the Act requires investment companies to establish anti-money laundering programs that designate an anti-money laundering compliance officer, while the implementing rules thereunder permit multiple persons to serve in this role.

cc: Committee of Annuity Insurers

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