

FRANK KEATING
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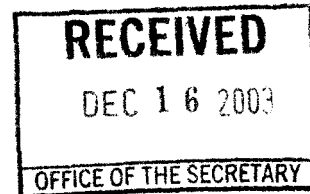
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ES104768

November 19, 2003

The Honorable Michael G. Oxley
Chairman, Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515



Dear Chairman Oxley:

As significant participants in the securities marketplace, life insurers have a direct interest in effective solutions to late trading and market timing abuses in the mutual fund industry. Our members have developed industry policy on solutions to these problems, which are addressed in H.R. 2420, as amended.

The American Council of Life Insurers is a national trade association with **399** members representing **72** percent of all United States life insurance companies. Many of our member companies manufacture and distribute variable annuities directly or through broker-dealers¹ and other intermediaries. Life insurers also manage one-fifth of America's privately administered pension and retirement plan assets, many of which are funded by variable annuity contracts totaling **\$918** billion.

We have carefully outlined our position on H.R. 2420 below, together with background on the life insurance industry. We greatly appreciate the opportunity to add our views to the important dialog on these matters before Congress and the SEC.

Summary of Position

- The life insurance industry supports strong regulatory and legislative actions thwarting mutual fund abuses and protecting investors. We endorse aggressive prosecution against individuals and firms that have fundamentally betrayed the trust of investors and retirement plan participants. Unbending SEC enforcement of the federal securities laws buttresses these important goals. Regulatory and legislative actions should be carefully crafted to avoid creating competitive imbalances in the marketplace.
- Mutual fund late trading abuses can be successfully prevented by strictly requiring transmission of purchase, redemption and reallocation instructions to mutual funds or pension plans, life

¹ Over 50% of the NASD's 664,798 registered representatives work for broker-dealers affiliated with life insurance companies.

insurers, and other intermediaries by the 4:00 p.m. close of the New York Stock Exchange. All instructions should be mechanically or electronically time-stamped for unequivocal verification. Mutual funds and intermediaries should establish clear procedures ensuring proper compliance, which should be subject to audit and inspection.

- Fair value pricing methodology provides the most effective means to thwart unfair dilution of net asset values caused by excessive market timing activity. Fair value pricing successfully eliminates time zone arbitrage attractive to market timers, and achieves the most accurate valuation of foreign securities in mutual fund portfolios. This methodology efficiently protects all direct mutual investors and indirect investors through two-tier vehicles such as variable annuities and pension plans. Market timing abuses in mutual funds can be cured through clear disclosure and consistent enforcement of mutual fund pricing and order practices.
- Specially focused redemption fees can also retard excessive market timing activity. This mechanism, however, does not work neutrally across all product platforms. For example, the tracking mechanics to correctly assign redemption fees in pension plans or employer groups may be formidable. While redemption fees in direct mutual fund investments operate easily, the same is not true in most two-tier structures such as pension plans.
- Focused SEC rulemaking provides the most effective means to address mutual fund abuses promptly.

Background on Two-tier Financial Products

Life insurers manufacture variable annuities and variable life insurance for distribution to individuals, and groups such as pension plans. These variable contracts are hybrid products with important insurance and securities characteristics. The SEC regulates the issuance and sale of individual variable contracts under the federal securities laws. The Department of Labor regulates variable contracts funding employee benefit plans. State insurance departments also regulate the insurance features of variable contracts.

Like mutual funds, life insurers' separate accounts funding variable contracts are registered under the Securities Act of 1933 and **the** Investment Company Act of 1940 because the account values fluctuate according to the investment experience of an underlying securities portfolio. The structure, operation, and distribution of variable life insurance and variable annuities are, however, different from publicly available mutual funds.

For example, variable contracts funded by life insurers generally operate under a two-tier structure. **At** the top tier, the separate account funds the variable contract based on an underlying menu of mutual funds at the bottom tier. Purchases, sales, and changes are transmitted from customers to the life insurance company, which in turn communicates the appropriate instructions to the underlying mutual funds.

The life company processes customer orders directly and through intermediaries. Variable contract customers, therefore, do not have direct contact with the underlying mutual funds. In pension plans, participants transmit allocation instructions through a plan administrator to the life insurer, which conveys the information to the mutual funds underlying the plan's variable annuity contract.

addition, the Commission measures the benefits of proposed rules against possible anti-competitive effects, as required by the Exchange Act.³

Solutions to mutual fund late trading and market timing abuses should fulfill these important SEC and statutory goals to protect both competition and investors. The SEC should develop corrective rule modifications carefully to prevent any anticompetitive impact. This can be readily accomplished with a verified time stamp of all orders properly placed by the New York Stock Exchange close with mutual funds or intermediaries such as pension plans, life insurers, broker-dealers or other intermediaries. Similarly, fair value pricing imposes a product neutral impediment across all product platforms to market timing excesses.

Life Insurers' Position on H.R. 2420

We have carefully reviewed a manager's amendment to H.R. 2420 dated November 13, 2003, and offered by Representative Oxley. This amendment would add Title II to H.R. 2420, and is entitled *Prevention of Abusive Mutual Fund Practices*. Among other things, the amendment would address mutual fund late trading and market timing abuses by:

- Extending existing regulations governing trading by insiders in the underlying securities owned by mutual funds to apply to trading in fund shares;
- Prohibiting joint management by the same person(s) of mutual funds and hedge funds;
- Banning insiders from short-term trading of their own fund shares;
- Allowing, but not requiring, mutual funds to impose greater than two percent redemption fees to discourage short-term trading;
- Requiring the SEC to issue clearer rules encouraging fair value pricing to thwart excessive market-timing activity; and,
- Requiring investors to place orders up to, but not after, the 4 p.m. close of the New York Stock Exchange with mutual funds or intermediaries, such as pension plan administrators, life insurers issuing variable annuities, and broker-dealers.
 - o Under this approach, intermediaries could place trades with funds after the 4:00 p.m. close, although strict monitoring and an audit trail would be required.

The manager's amendment provides a balanced solution to mutual fund late trading and market timing abuses. Significantly, the amendment would not impose unfair burdens on individuals in pension plans or variable annuities. All investors in mutual funds would be treated equally and fairly irrespective of the financial product involved. Likewise, the amendment would not create an unwarranted competitive advantage for mutual funds over other financial products such as variable annuities or retirement plans. This solution avoids punishing other financial service institutions for problems that principally originated in the mutual fund industry.

The amendments' optional, but not required, authority for redemption fees to combat excessive market timing makes practical sense. **I**mportantly, this provision's optional feature recognizes that under

³ See testimony of Arthur Levitt, SEC Chairman, concerning appropriations for fiscal year 1998 before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the House Committee on Appropriations (Mar 14, 1997), which appears at <http://www.sec.gov/news/testimony/testarchive/1997/tsty0497.txt>

some circumstances some entities, such as state regulated variable annuity contracts or pension plan agreements, may not have the legal prerogative to assess mutual fund redemption fees to plan participants or contract owners.

The amendments' emphasis on fair value pricing methodologies represents a fair and effective tool to deter market timing abuses and to prevent stale pricing. Life insurers find fair value pricing to be a more equitable solution to excessive market timing in the contest of retirement plans and variable annuity contracts.

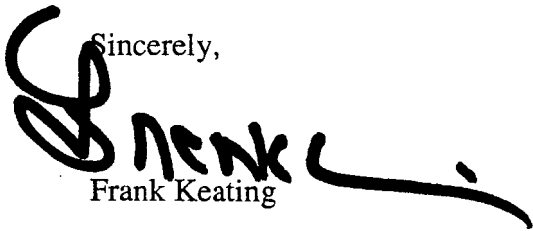
On balance, the manager's amendments to H.R. **2420** reflect a sound solution to abuses in the mutual fund marketplace. We support the bill's approach to provide guidance to the **SEC** in corrective rulemaking on a prompt, but reasonable timetable.

Conclusion

As a significant participant in the securities marketplace and the retirement market, the life insurance industry supports responsible remedies to mutual fund late trading and market timing abuses. The manager's amendment to H.R. **2420** provides a meaningful template for **SEC** rulemaking that will prevent abuse, protect investors, and preserve fair competition.

We respectfully request that our statement be entered into the record on this legislative action. If you have any questions, please contact Carl Wilkerson [202.624.2118], Kathryn Ricard [202.624.2152], or Angela Arnett [202.624.2112] of my staff. Thank you for your courteous attention to our views.

Sincerely,



Frank Keating

CC: Congressman Barney Frank
Congressman Richard Baker
Congressman Paul E. Kanjorski
William H. Donaldson
Paul F. Roye