ACLI
Financial Security for Life

THE Committee OF Annuity Insurers
www.annuity-insurers.org

February 14, 2023

VIA ELECTRONIC SUBMISSION

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE, Washington, DC 20549-1090

Re: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N–PORT Reporting, File No. S7–26–22. Release Nos. 33–11130; IC–34746

Dear Ms. Countryman:

The American Council of Life Insurers (the "ACLI")[1] and the Committee of Annuity Insurers (the "CAI")[2] (together, "we," "our," or "us") are submitting this comment letter in response to the request for public comment by the Securities and Exchange Commission (the "SEC" or "Commission") on the proposed rulemaking titled "Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N–PORT Reporting" (the "Proposal").[3]

We urge the SEC to abandon the Proposal's swing pricing/hard close framework entirely. If adopted, hard close would impose substantial harms on American investors.[4] Of particular relevance to our members, the Proposal's hard close framework is irreconcilable with the operation of both variable contracts offering underlying mutual fund investment options and retirement plans that millions of Americans rely upon for financial security and retirement income. As we explain below, hard close conflicts with investor expectations and insurer contractual obligations, as well as legal and regulatory requirements applicable to our members and the proper, efficient functioning of the markets in which they operate. In no event can insurance companies, their registered and unregistered separate accounts that provide specified underlying mutual fund investment options, nor retirement plans or retirement plan recordkeepers providing variable contracts or mutual funds as plan investment options for plan participants, be subject to any hard close requirement that would result in the loss of same day pricing for orders transmitted after a mutual fund's pricing time.[5]

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[1] The ACLI is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. Ninety 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 well-being through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental, vision, and other supplemental benefits. ACLI's 280 member companies represent 94% of industry assets in the United States.

[2] The CAI is a coalition of life insurance companies formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of federal policy with respect to securities, regulatory, and tax issues affecting annuities. The Committee's current member companies represent approximately 80% of the annuity business in the United States. For over 40 years, the Committee has been actively involved in shaping and commenting upon many elements of the SEC regulatory framework as it applies to insurance contracts, such as variable annuities and variable life insurance policies ("variable contracts" or "variable products").

[3] 87 FR 77172.

[4] For simplicity, we use the term "investors" throughout to refer to policyholders, contract owners, and investors alike.

[5] For simplicity, this letter assumes that underlying funds would generally continue to strike their NAVs as of 4 p.m. ET. The issues raised in this letter would generally exist no matter the pricing time for an underlying fund.

After summarizing our comments, we first address our fundamental public policy concerns with the swing pricing/hard close framework set forth in the Proposal. We then focus on the severe and irreconcilable problems that the framework would specifically create for variable product investors, as well as for the insurance companies that issue variable contracts. We then comment on how the Proposal's hard close framework would raise similar extraordinary problems for retirement plans, retirement plan recordkeepers, and retirement plan savers.

I. SUMMARY OF COMMENTS

- **The Proposal's Swing Pricing/Hard Close Framework is not in the Public Interest and is Wrong for American Investors**

  This rulemaking does not meet the standards under the federal securities laws as being in the public interest, and the Commission has not demonstrated that the proposed swing pricing/hard close framework would "promote efficiency, competition and capital formation."[6] More generally, the swing pricing/hard close framework set forth in the Proposal reflects unsound public policy for American investors.

  The harms of the proposed framework would far outweigh any benefits. The Proposal would upend the fundamental underpinnings of mutual fund investing and the benefits of pooled investment vehicles that Congress understood when it enacted the Investment Company Act of 1940 (the "1940 Act") – a framework that, for many decades, has resulted in the beneficial expansion of market access for ordinary Americans. The SEC now seeks to upset the longstanding framework to address a narrow liquidity and dilution issue, but the SEC has not presented compelling evidence that a systemic dilution problem exists within the mutual fund or variable product sector today or that a significant dilution problem existed in March 2020. Further, the SEC has overlooked fundamental differences between European and U.S. markets, and those differences indicate that a European-based swing pricing/hard close model will not work in the U.S.

  With respect to the SEC's anticipated use of early cut-offs as part of the proposed framework, the widespread use of early cut-offs would be harmful to individual investors (who by and large participate in the market through intermediaries) and mutual fund investing. Same day pricing for investment decisions is a fundamental principle of investing in the U.S. Individual investors value and expect same day pricing, and hard close will make it significantly harder for them to receive same day pricing on their investment decisions. Investors will be confused and upset about the loss of traditional same day pricing for ordinary investment decisions. They will be treated as second-class citizens compared to institutional investors, as institutional investors would not be impacted by early cut-offs and would have unfair market advantages. The resulting inconvenience and distrust among individual investors would drive them away from mutual fund investing and stymie retirement savings. This result is fundamentally inconsistent with the SEC's mandate to protect investors and foster capital formation.

[6] When "the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in 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 § 77b(b).

- **Comments Related to Variable Contracts**

  - **The Proposal Fails to Consider or Evaluate the Costs to Variable Contract Investors as well as the Costs and Regulatory Problems that Sponsoring Insurance Companies Would Face**

Variable products are unique investments that provide American consumers with important insurance benefits. As of 2021, there were more than 28 million outstanding variable annuity contracts in-force,[7] and nearly 1.5 million new contracts were issued during that same calendar year.[8] The Proposal fails to consider the harms and costs to variable contract investors that would result from instituting a hard close. Nor has the SEC considered the magnitude of the risks and costs that, due to the contractual nature of variable products, likely would be borne by insurance companies that have issued and will issue variable products. For example, the Proposal does not acknowledge or evaluate the applicable state insurance regulatory requirements, as well as other federal regulatory requirements, that conflict with the Proposal, or the risks and costs that may be associated with those issues. The failure to identify and evaluate these issues, and to provide interested parties with a meaningful opportunity to comment on them, is fatal to the Proposal insofar as it impacts variable contracts, the investors who own them, and the life insurance companies that issue them.

  - **The Proposal Will Produce Bad Swing Factors for Underlying Funds, Passing on Fund Transaction Costs to the Wrong Variable Contract Investors**

If the SEC adopts the swing pricing/hard close framework as proposed, transaction costs stemming from contract purchase and redemption activity *will not* be passed onto the variable contract owners whose contracts generated those costs. Rather, due to the fact that variable contracts offering underlying fund investment options are inherently and immutably NAV-dependent products, and the way variable contract values are contractually determined, contract owners (including retirement plan participants) who transact "today" will bear the transaction costs generated by contract owners who transacted "yesterday." This flaw underscores why the Proposal should not apply to the variable contract sector.

  - **Hard Close Will Expose Separate Accounts to Significant Breakage Risk that Will Financially Harm Variable Contract Investors and Insurers and Will Trigger Uncertain Regulatory and Compliance Problems**

Variable contract separate accounts are not designed or intended to incur "breakage," but if the SEC adopts hard close as proposed, two-tier separate accounts investing in underlying mutual funds would be exposed to breakage risk every business day. Breakage arises when a variable contract separate account (or subaccount thereof) has an asset-liability mismatch, most notably when the potential liability (*i.e.*, the value of the outstanding units) exceeds assets (*i.e.*, the value of the underlying fund shares). Under the current framework, two-tier separate accounts avoid breakage because, every business day, the same NAV of the applicable underlying fund is used to both (i) strike unit values for the separate account and (ii) price the insurer's net purchase/redemption order to the underlying fund. The alignment

[7] In 2021, there were approximately 28,731,000 variable annuity contracts in-force (16,520,000 individual; 12,211,000 group). ACLI, Annuity Product Line Report, 2022 (forthcoming).

[8] There were approximately 1,480,000 variable annuity contracts issued in 2021 (761,000 individual; 719,000 group). ACLI, Annuity Product Line Report, 2022 (forthcoming).

of liabilities and assets is possible because the insurer receives same day pricing on its fund orders, even though those orders are transmitted after 4 p.m. However, if the Proposal is adopted, separate accounts will incur breakage because insurers will no longer receive same day pricing on their fund orders. *Breakage therefore would occur within every subaccount of every two-tier separate account on every single business day*. The financial harm to investors and insurance companies from this breakage would be massive, and it would expose insurance companies to significant and uncertain regulatory and compliance risks.

- **Bad Swing Factors and Separate Account Breakage Cannot be Avoided by Changing Contracts or Employing Early Cut-Offs**
    - **Insurance Companies are Constrained by Existing Contracts, Investor Disclosures, and Applicable Law**

Variable products are contractual agreements between insurance companies and their customers. Variable contracts give contract owners specified rights that are enforceable in a court of law. Insurers generally cannot unilaterally change the terms of the contract in a manner that would take away or limit a contract owner's rights. If the insurer were to do so, it would be in breach of contract and in violation of state insurance law.

Among many other provisions, variable contracts set forth how separate account unit values are to be calculated and how unit transactions are to be processed. Insurers could not deviate from these pricing and processing terms in their in-force contracts. Furthermore, if an insurer were to attempt to amend its in-force contracts, it would face an extremely challenging state insurance regulatory approval and customer consent process that would be impossible as a practical matter and would be rife with regulatory and litigation risk.

Apart from contractual constraints, insurance companies have for decades made representations to investors in variable contract prospectuses or other offering documents. If insurers were to change their pricing and processing procedures in an attempt to respond to the Proposal, the expectations of investors who relied on those past disclosures when deciding whether to buy their contracts would be unfairly undermined. It would be a breach of their trust. Moreover, disappointed investors could attempt to pursue private litigation for material misstatements in such disclosures.

- **Early Cut-Offs Are Not a Solution for Variable Contracts**

Because variable contracts offering underlying fund investment options are NAV-dependent products, early cut-offs would not address the root problems inherent in the proposed hard close framework. Specifically, early cut-offs would not alter the necessary order of operations for two-tier separate accounts, and therefore early cut-offs would not allow insurers to transmit orders prior to 4 p.m. or preserve their ability to receive same day pricing on their underlying fund orders. Thus, early cut-offs would not solve the bad swing factor or breakage problems caused by the Proposal. Given that early cut-offs would not solve those problems, there is no clear rationale for insurers to implement them. They would be taking on significant uncertain costs and risks and causing their customers to lose same day pricing for no justifiable reason. This is also true for retirement plans, plan participants, and plan service providers, whether they hold variable annuities or use other funding mediums.

- **Widespread Early-Cut Offs in the Variable Product Sector Would Be Harmful to Investors and the Market, as well as Extremely Impractical, Costly, and Anticompetitive**

Widespread early cut-offs in the variable product sector would be harmful to investors and extremely problematic for insurers. The serious investor harms that would affect the broader mutual fund and retirement plans sectors would also affect the variable product sector. Early cut-offs would very likely cause disproportionate harm and disruption to the variable product sector, with anti-competitive impacts on the variable products marketplace. Widespread early cut-offs for variable product transactions would also require a complete overhaul of trading systems with the resulting significant and substantial costs and burdens outweighing any benefits derived from the proposed swing pricing/hard close framework.

➢ **Comments Related to Retirement Plans**

This Proposal must be abandoned and withdrawn as it threatens the US retirement system, its operations and costs as well as the services that retirement savers and plan sponsors have demanded and enjoy.

Millions of Americans have trillions of dollars invested set aside for retirement through 401(k), 403(b), 457(b) plans as well as IRAs, SEPs, and SIMPLE IRAs, all of which is invested for the long-term to support financial security in retirement. These savers expect and receive same-day pricing on investment transactions. The existential concerns raised herein with regard to the hard close proposal with respect to insurance company variable contracts and separate accounts extend as well to retirement plans.

Life insurers offer insurance contracts and other investment products and services to qualified retirement plans and IRAs. ACLI and CAI member companies also are employer sponsors of retirement plans for their own employees. Three-fifths of small employers, those with 99 or fewer employees, rely on life insurer products and services for their employment-based retirement plans.

In the 20 years since the SEC last proposed and then abandoned a similar hard close proposal, Congress has enacted three significant and overwhelmingly bipartisan legislative packages dedicated to expanding and improving the private retirement system, one as recently as last December. The SEC's hard close proposal would set the system back by requiring a complete restructuring of plan operations, the cost of which will be borne by the retirement plan system and its participants, with no discernable benefit to balance out the harm.

For the reasons summarized above and explained in more detail below, the swing pricing/hard close framework set forth in the Proposal is unworkable, creates far more harm than benefit, and is irreconcilable with variable contracts and retirement plans. We urge the SEC to abandon hard close entirely. In no event can variable contract issuers and their separate accounts, 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 4 p.m. The SEC should not sacrifice the current regulatory framework—a longstanding and proven framework—for a regulatory framework that will be broken from day one.

II. THE PROPOSED FRAMEWORK IS WRONG FOR AMERICAN INVESTORS

The proposed swing pricing/hard close framework would constitute the greatest transformation in the relationship between U.S. investors, financial intermediaries, and investment companies since the enactment of the 1940 Act. However, unlike the enactment of the 1940 Act, this transformation would do more harm to investors than good. We acknowledge that the Proposal reflects the SEC's well-intentioned efforts to mitigate dilution risk, but our members do not believe that the current framework—which has been proven to work for almost a century and is consistent with the American investing public's expectations as to how pooled mutual funds operate—should be upended for a single anti-dilution tool (swing pricing) that would run counter to investor demands.[9]

Unjustified Demutualization of Funds – We have concerns that the SEC is attempting to demutualize open-end funds in a manner that deviates from the basic framework for pooled investment vehicles that Congress understood when it enacted the 1940 Act and that, for many decades, has resulted in the beneficial expansion of market access for ordinary Americans. Pooled investment vehicles offer investors several benefits, such as economies of scale, access to a wider array investment opportunities, and shared transaction costs. The SEC seeks to upset the framework for pooled investment vehicles by, without adequate justification, demutualizing transaction costs. In that sense, the SEC is attempting to require mutual funds to assume valuation and pricing characteristics similar to individual brokerage accounts and other individual investments. However, the sharing of transaction costs is a benefit of mutual fund investing that should be preserved, not discarded.

Too Focused on Extraordinary Short-Term Market Events – The proposed swing pricing/hard close framework is seemingly a solution in search of a problem, with significant consequences for American investors. The Commission seeks to justify the Proposal largely based on market volatility that occurred during a short period of time in March 2020 due to a once-in-a-generation public health crisis.[10] However, the SEC is so focused on extraordinary short-term market events that it has lost sight of the big picture. It contends that the March 2020 market events led to outlier redemption activity resulting in liquidity crunches, dilution, and herd behavior characteristic of a market panic. By mandating the use of swing pricing, the SEC seeks to restrain individual transaction activity in response to short-term market events, but the SEC has not made its case that the Proposal is good for Americans on a broader and continuous basis. To that end, the SEC has failed to demonstrate the risk of harm associated with outlier short-term market events warrants an upheaval of the U.S. market structure.

No Evidence Related to Insurance and No Consideration of Important Questions – It is particularly noteworthy that the SEC has not presented ***any*** market evidence specifically related to variable products. Considering the especially long-term nature of variable contract investors and the structure of variable contracts (*e.g.*, the existence of surrender charges as well as contractual limitations on frequent trading), we question whether there was outlier redemption

[9] In this letter, we raise fundamental concerns about the general merits and impacts of swing pricing, especially in the context of insurance. For a more specific discussion regarding the significant mechanical and other flaws associated with the swing pricing proposal, we refer to the comment letter of our colleagues at the Investment Company Institute ("ICI").

[10] It is concerning that the SEC justifies the Proposal based on dilution that is said to have occurred in March 2020, and yet acknowledges that it "[does] not have specific data about the dilution fund shareholders experienced in Mar. 2020." *See* 87 FR 77172, p. 178, fn. 40.

activity for insurance-dedicated mutual funds in March 2020. Before the SEC imposes an unworkable swing pricing/hard close framework on variable products, it must develop and present credible evidence that a problem exists in the markets in which our members operate.

Nor has the SEC considered or addressed a host of questions necessarily raised by applying the concept of swing pricing to the variable product sector. For example:

- Swing pricing is supposed to be driven by customer transaction activity, but in the variable product context, swing pricing would be heavily influenced by fee deductions, other systematic activity (*e.g.*, automatic withdrawals), and pre-planned activity (*e.g.*, employer plan contributions) unrelated to customers responding to market movements. Should swing pricing be so heavily influenced by automatic transactions and pre-planned transactions unrelated to ad hoc contract owner activity?

- Swing pricing would inevitably impact contract owners' and beneficiaries' insurance benefits. In many cases, they would receive lesser annuity payouts, death benefits, and guaranteed living benefits due to the realization of swing factors. Should swing pricing impact insurance guarantees?

- Variable annuity investors must take required minimum distributions (RMDs) under federal law. Should those investors be forced to bear the costs of swing factors caused by other market movers, and should minimum annual RMD requirements be impacted by swing pricing?

- Swing pricing will impact contracts that are not engaging in any trading activity. For instance, automatic reset features in guaranteed benefit riders will cause contract owners to realize the impacts of swing pricing without any corresponding mutual fund share purchase or redemption activity. Should swing pricing impact contracts that are not engaging in any trading activity?

- Would swing pricing disadvantage smaller underlying funds? Funds with relatively low net assets could be plagued by large swing factors that dissuade new investors. In that regard, would the Proposal cause smaller underlying funds to liquidate, stifle the creation of new funds, or dissuade insurers from onboarding smaller funds, especially non-proprietary funds?

- In the 2016 release adopting optional swing pricing, the SEC provided substantial guidance on how "GAAP NAV" versus "Swung NAV" would be used in mutual fund financial statements and performance reporting. How would those GAAP NAV/Swung NAV issues impact separate account financial statements and performance reporting?

The SEC's failure to consider and address these and other questions, which could have significant implications for investors and beneficiaries, further undermines the Proposal.

Wrongly Marginalizes Retirement Plan Investing – We also object to the manner in which the Proposal marginalizes the concerns of retirement plan sponsors, recordkeepers, and participants. In the Proposal, the SEC dismisses the legitimate concerns associated with retirement plans as simply a matter of money and effort. We assure the SEC that the problems with its Proposal do not boil down to cost and time – there are structural flaws in the proposed framework. In addition, we submit that the SEC should be more sensitive to the concerns of retirement plans given the decades-long U.S. public policy focus on encouraging retirement plan investing. As most recently reflected in the adoption of the SECURE Act 2.0, Congress in a

bipartisan fashion has repeatedly affirmed and reaffirmed its intent to make retirement investing easier for Americans. Nonetheless, the SEC seems to prioritize an untested swing pricing/hard close framework above Congress's bipartisan support for retirement plan investing.

Ignores Key Differences Between U.S. and Europe – We understand that swing pricing/hard close is not entirely unprecedented and may work in some European jurisdictions. However, there are crucial differences between Europe and the U.S.[11] that the SEC has glossed over in the Proposal but should be paramount considerations. For example, it is our understanding that**:**

- The use of swing pricing, at least in several jurisdictions, is optional and far less rigid than what the SEC proposes.
- Europe has a significantly smaller population of retail investors compared to the U.S. Most investors in Europe are sophisticated institutional investors.
- Europe has far fewer NAV-dependent products, and their NAV-dependent products and plans function differently. For example, in Europe, at least some NAV-dependent orders may be converted into monetary values based on NAVs for the prior day. In the U.S., NAV-dependent orders generally cannot be processed without first having NAVs for the current business day.
- European trades are submitted largely on the basis of currency (*e.g.*, euros), whereas U.S. trades are submitted not only on the basis of dollars, but also of shares/units and percentages.
- The defined contribution retirement plan infrastructure in the U.S., which includes participant directed investing, is exponentially larger and more complicated than in Europe.
- Europeans generally rely upon defined benefit schemes for retirement savings, and Europe's retail investors tend to be less reliant on financial intermediaries than U.S. investors.

We believe that these significant differences strongly indicate that a European-based swing pricing/hard close model will not work in the U.S.

Widespread Early Cut-Offs are Not Good for Investors or the U.S. Markets – Our members strongly believe that widespread early cut-offs would be harmful to individual investors (who by and large participate in the market through intermediaries) and mutual fund investing. Individual investors in the U.S. value and expect same day pricing. They have come to know that they are guaranteed same day pricing if they submit their orders before 4 p.m. Indeed, for variable product owners, the vast majority are contractually *entitled* to a 4:00 p.m. cut-off. Investors do not expect or want to grapple with early cut-off times, especially since they will inevitably vary among companies, products, and intermediaries.[12]

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[11] *See, e.g.*, Comment letter of the ICI on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Nos. S7-16-15 and S7-08-15) (Oct. 15, 2015). *See also*, ICI, Evaluating Swing Pricing: Operational Considerations (Nov. 2016).

[12] Because different products, services, and firms require different processes, there would be a range of cut-off times for investors to contend with. Investors would not be the only ones to face this challenge of varied cut-offs, but other participants in the market, such as retirement plan sponsors and recordkeepers, would be forced to either reconcile the varied timing or alter their product offerings to include only those products and services that share a single cut-off

In relation to early cut-offs, the SEC states "[t]he extent to which the hard close proposal would affect investors largely depends on the value investors place on their ability to obtain same-day pricing," and that because most fund shareholders are long-term investors, "[their] orders are not time sensitive."[13] We respectfully submit that Americans greatly value same day pricing and will therefore view hard close and early cut-offs (and, in the context of redemptions, the potential delay in receipt of distribution proceeds) as adversely affecting them. Also, we submit that investors view their orders as being very time sensitive. If a long-term investor has made the decision to exit their investment, they often have important financial needs for that money and would not want to be exposed to increased market risk by losing same day pricing. It is wrong to assume that short-term investment decisions are not important to long-term investors.

The complexity and inequities of the proposed framework will also harm investor trust in the financial system. Swing pricing and the reasons for hard close are complicated and unintuitive. While ordinary investors generally will not understand the rationales for swing pricing and hard close, they will nevertheless be upset when they do not receive same day pricing due to an early cut-off. They will be particularly upset when they lose money due to a market event that occurs after their early cut-off but before close of the next business day. In that regard, the SEC should not expose investors to greater market risk by making it harder to get same day pricing. Exposing investors to greater market risk is inconsistent with the SEC's investor protection mandate.

Furthermore, early cut-offs would treat individual investors as second-class citizens. Unlike individual investors, institutional investors (who have direct feeds for trades) would not be subject to early cut-offs and would have unfair market access and advantages between cut-off and 4 p.m. Moreover, individual investors living in western U.S. time zones would be tertiary citizens because, as a practical matter, they may lose same day pricing entirely due to early cut-offs occurring while they sleep. Consequently, if the SEC were to adopt hard close in contemplation of widespread early cut-offs, individual investors would see the SEC as adopting rules that favor "wall-street" investors over "main street" investors.

Widespread early cut-offs would breed confusion, harm, and distrust among individual investors. It is likely that they would become skeptical of mutual fund investing and would look for other ways to invest their money, as other avenues would be viewed as providing a more investor-friendly experience. In trying to protect individual investors from dilution risk, the SEC may actually drive swaths of investors from mutual funds entirely.[14] That would certainly be a terrible and untenable consequence for a country with such a rich history of mutual fund investing.

Late Trading is Not a Rational Justification – With respect to hard close, the SEC proffers prevention of late trading as a secondary justification. The SEC does not present any evidence that a late trading problem exists today, either in the mutual fund sector or the variable product

time. This inconsistency across product offerings would likely lead to significant operational and legal challenges (including potentially fiduciary duty issues as plan sponsors would be forced to rank the import of a timing mechanism versus the cost of reconciling different times, alongside their primary fiduciary duty when selecting their plan offerings).

[13] *See* 87 FR 77172, p. 213

[14] The SEC acknowledges that this could be an actual problem with the Proposal, and yet it proposed the new framework without even an estimation of how many investors may exit the mutual fund space. The SEC states in the Proposal: "we cannot predict the number of investors that would choose to keep their investments in the mutual fund sector nor the number of investors that would exit mutual funds and instead invest in other fund structures such as ETFs, closed-end funds, or CITs." *See* 87 FR 77172, p. 256.

sector. In fact, the most recent enforcement action cited by the SEC occurred in 2005.[15] In this respect, the SEC's late trading justification for hard close is hollow at best.

Overall, the SEC has failed to carefully consider and analyze the magnitude and extent of the significant harms that the proposed swing pricing/hard close framework would cause not only to investors but also to the various stakeholders in the U.S. financial marketplace and to the health of the U.S. markets. The potential harms of the proposed framework far outweigh the potential benefits. The SEC should not sacrifice the current longstanding and functioning framework in favor of a single anti-dilution tool, as the SEC has not proved it necessary and has not adequately considered the harms this Proposal would cause.[16]

III. COMMENTS SPECIFIC TO VARIABLE CONTRACTS, VARIABLE CONTRACT INVESTORS, AND INSURANCE COMPANIES

a. Background Information on Variable Contracts

i. The Importance of Variable Contracts to Americans

Variable contracts have been offered by U.S. life insurance companies for over 60 years. At their core, variable contracts provide for tax-deferred asset accumulation, where account values and benefits reflect the investment experience of a pooled investment separate account. Variable contracts also provide standard and optional insurance guarantees, such as annuity payouts, guaranteed living benefits, and/or guaranteed death benefits.

Variable contracts play a vital role in the private retirement planning and financial security for millions of Americans.

- With respect to variable annuities, other than Social Security and defined benefit plans, annuities are the only investment products that offer Americans lifetime income benefits that guarantee they will not outlive their retirement income. That protection alone makes them vital components of retirement security for millions of Americans and their families. The U.S. variable annuity market is substantial. As of December 31, 2021, Americans had approximately $2.1 trillion invested in variable annuity products.[17]
- With both the SECURE Act and SECURE 2.0 Act, Congress had demonstrated, with bipartisan support, its interest in facilitating access to annuities and the income guarantees and longevity protections inherent in these products.
- With respect to variable life insurance policies, Americans heavily rely on life insurance to ensure that their families will be financially secure after they have passed or in the

[15] *See* 87 FR 77172, p. 209, fn. 226.

[16] We note that in Question 114 the SEC requested comment on whether insurance company separate accounts and retirement plans should be excepted from the proposed hard close requirement. *See* 87 FR 77172, p. 214. As discussed throughout this letter, our members believe strongly that the proposed swing pricing/hard close framework reflects bad public policy, and that the SEC should not move forward with the proposed framework in any respect. As such, and given the intractable problems arising under the Proposal for variable products and retirement plans, in no way should insurance company separate accounts and retirement plans become subject to a hard close requirement.

[17] *See* Insured Retirement Institute, Retirement Fact Book 2022.

event of long-term care. Variable life insurance has been an important part of the overall life insurance market since the 1970s.

Given the importance of variable contracts to Americans and the size of the variable contract market, it is deeply concerning that the SEC failed to consider the significant negative impacts the Proposal would have on variable contract investors and U.S. life insurance companies, as explained throughout this letter.

ii. The Nature and Regulation of Variable Contracts and Separate Accounts

Variable contracts are legally enforceable contracts between insurance companies and investors. Neither party can unilaterally take away or limit the contractual rights of the other party. As such, variable contracts are individual investment contracts, which is fundamentally different than virtually all other pooled investment company products, such as mutual funds which are changeable depending on decisions of management, boards of trustees/directors, and/or shareholders.

Like all insurance products, variable contracts are primarily regulated by the states. All states have laws regulating the design and operation of variable contracts, and as part of those regulations, all states require that insurance companies allocate amounts supporting variable contracts to one or more separate accounts. To ensure that each variable contract provides benefits that reflect the performance of the assets held in the supporting separate account (i.e., pass through performance), state laws define variable contracts as contracts that provide benefits that vary according to the investment experience of a separate account and require every variable contract separate account to be insulated from the insurance company's general account. More specifically, as specified in the National Association of Insurance Commissioners' ("NAIC") Variable Contract Model Law (#260), state laws require that all income, gains, and losses, realized or unrealized, from assets allocated to the separate account shall be credited to or charged against the separate account, without regard to other income, gains, or losses of the insurer. In addition, the NAIC Variable Annuity Model Regulation (#250) requires that to the extent provided in the contract: "[the] portion of the assets of a separate account equal to the reserves and other contract liabilities with respect to the account shall not be chargeable with liabilities arising out of any other business the company may conduct."

This same concept of separate account insulation is echoed under the federal securities laws. Section 2(a)(37) of the 1940 Act defines "separate account" to mean "an account established and maintained by an insurance company . . . , under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company." A similar definition of "separate account" is included in Rule 0-1(e) under the 1940 Act,[18] and Forms N-4 and N-6 (the two principal SEC registration forms

[18] Rule 0-1(e) sets forth a definition of "separate account" and also states that in order to rely on a series of applicable rules "the separate account shall be legally segregated, the assets of the separate account shall . . . have a value at least equal to the reserves and other contract liabilities with respect to such account, and at all other times, shall have a value approximately equal to or in excess of such reserves and liabilities; and that portion of such assets having a value equal to, or approximately equal to, such reserves and contract liabilities shall not be chargeable with liabilities arising out of any other business which the insurance company may conduct."

for variable contracts) require disclosure regarding separate account insulation.[19]

Thus, both state and federal law contemplate that separate account values and the variable benefits provided by variable products, are to be fully and solely supported by the assets of the separate account without ongoing or substantial support from the insurer's general account. Because the Proposal will result in daily breakage for variable contract separate accounts, the Proposal is incompatible and inconsistent with separate account insulation as required by state and federal law, as explained in more detail below.

iii. The Structure of Separate Accounts

Separate accounts supporting variable contracts can be structured in two basic ways.

- First, there are two-tier separate accounts, where, if registered, the separate account is classified as a unit investment trust under the 1940 Act ("UIT separate accounts"). UIT separate accounts typically invest all of their assets in the shares of one or more designated underlying mutual funds, which are themselves registered open-end investment companies under the 1940 Act. The underlying funds, in turn, invest directly in an actively-managed portfolio of securities or other investments.

- Second, there are one-tier registered separate accounts ("managed separate accounts"). These separate accounts invest directly in an actively-managed portfolio of securities or other investments.

Today, the vast majority of registered separate accounts are UIT separate accounts.

Unregistered separate accounts supporting variable contracts are similarly structured. They can be either one-tier or two-tier, but most separate accounts supporting unregistered group annuity contracts offered in the retirement market are two-tier separate accounts. As with registered separate accounts, these two-tier unregistered separate accounts typically invest in the shares of designated underlying mutual funds that are registered as open-end investment companies under the 1940 Act.

Because the vast majority of separate accounts supporting variable products have a two-tier structure, unless otherwise specified, our comments, as they relate to variable contracts, assume a two-tier separate account structure.

iv. How Two-Tier Separate Accounts are Structured and Operate

The insurmountable problems the Proposal would create for variable contracts relate to the basic structure and operation of two-tier separate accounts, which in turn are based upon the legally enforceable contractual relationships among the contract owners, separate accounts, and underlying funds.

[19] Both forms require disclosure indicating that: "(1) income, gains, and losses credited to, or charged against, the [separate account] reflect the [separate account]'s own investment experience and not the investment experience of the [insurer]'s other assets; (2) the assets of the [separate account] may not be used to pay any liabilities of the [insurer] other than those arising from the Contracts; and (3) the [insurer] is obligated to pay all amounts promised to investors under the Contracts." *See* Item 6 of Form N-4 and Form N-6.

As previously noted, two-tier separate accounts invest all of their assets in one or more underlying funds. While all two-tier separate accounts provide for at least one investment option, the vast majority provide for multiple investment options. Two-tier separate accounts that provide for multiple investment options are divided into accounting divisions (or subaccounts), with each subaccount constituting a single investment option. Each subaccount invests in the shares of a single underlying fund (or a single class of shares, in the case of multi-class funds). If the underlying mutual fund trust has multiple series, each subaccount invests in the shares of a single series.

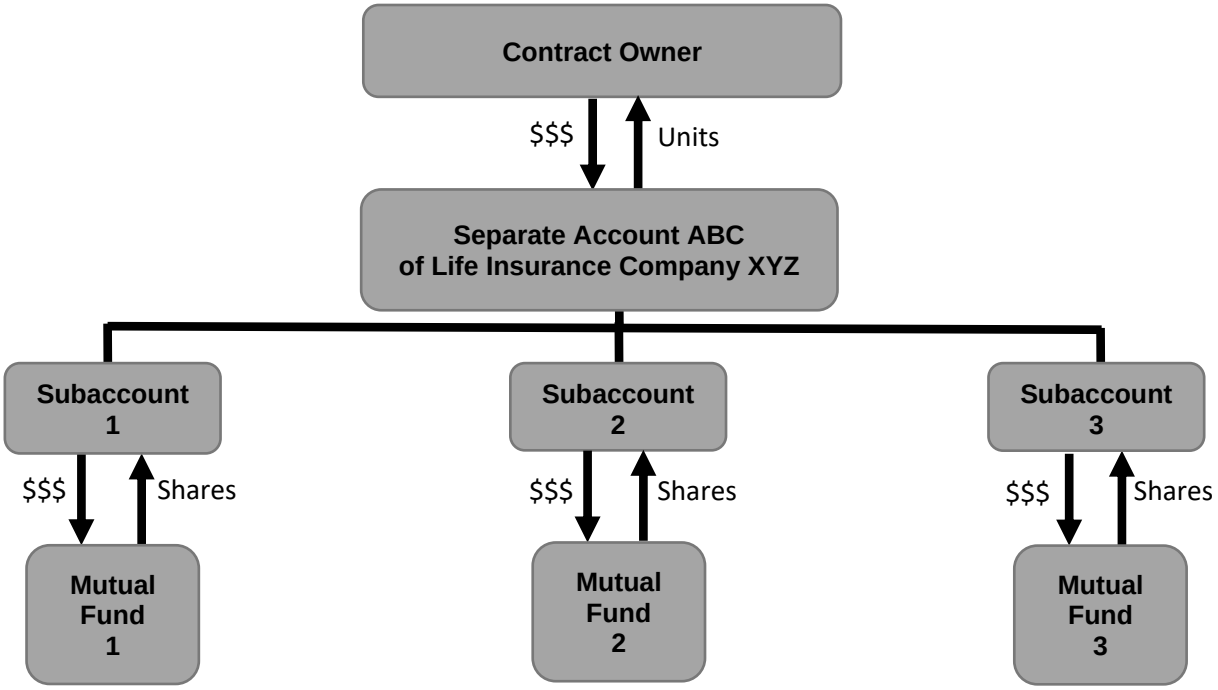
A variable contract supported by a two-tier separate account has a menu of variable investment options. Contract owners choose which options on the menu to invest in. The variable investment options are the subaccounts of the separate account. When the contract owner invests money in the separate account, the insurer allocates those amounts among the subaccounts that the contract owner has designated for investment. When the contract owner takes money out of the separate account, the insurance company pulls those amounts from the subaccounts that the contract owner has designated for withdrawal. When the contract owner decides to transfer money from one subaccount to another, the insurance company processes that transaction as a withdrawal from one subaccount and a new allocation to another subaccount.

The immutable essence of variable contracts is that they contractually guarantee a pass through of separate account investment experience, which in turn is contractually tied to contemporaneous underlying fund investment experience. Insurers effect this through unitization. In this regard, a contract owner's separate account contract value is driven by two factors: (1) the number of each subaccount's units attributable to his/her contract and (2) the value of those units. In general:

- With respect to the number of units, subaccount units may be acquired by allocating new money to a subaccount (through premium payments or transfers), and subaccount units may be redeemed through withdrawals, contract-level charges, or transfers.
- With respect to the value of units, because variable contracts are pass through performance products, the value of a subaccount's units will fluctuate daily, up or down, based on changes in the NAV of the underlying fund.

In order to align separate account liabilities with separate account assets, such that each subaccount holds a number of underlying fund shares that are approximately equal in value to the subaccount's potential redemption obligations as required by law, insurers support contract owner purchase, redemption, and transfer activity in the subaccounts by buying and selling the underlying fund shares held in the separate account.

The following illustrates the basic structure of a two-tier separate account, assuming a contract owner who allocates a premium payment among three variable investment options:



The illustration above is an oversimplification. The actual landscape for separate accounts is far more expansive and complicated. For example:

- Variable contracts typically offer many variable investment options, often dozens and sometimes a hundred or more.
- Most insurance companies have several separate accounts, particularly different separate accounts for variable annuity contracts and variable life insurance policies.
- Most insurance companies have several different variable product lines, each with its own menu of variable investment options.
- Even within the same separate account, an insurer very often has different subaccounts (or classes of subaccount units) for the same underlying fund to reflect different separate account asset-based charges.

As a result of these complexities, for a given insurance company, there easily can be dozens of variable contracts supported by several different separate accounts, and those separate accounts can have thousands of subaccounts and hundreds of underlying funds. The immense breadth of these structures, the many different administrative systems that support them, and their associated costs should not be underestimated.

v. Current Procedures for Pricing Units, Calculating Account Values and Processing Unit Transactions, and Transmitting Underlying Fund Orders

Variable products are NAV-dependent contracts between insurance companies and investors. For that reason, insurance companies' procedures for striking unit values, calculating account values and processing unit transactions, and transmitting underlying fund orders must begin

with the dissemination of the underlying funds' NAVs. The Proposal does not work because it fails to recognize that NAV-dependent products like variable contracts cannot function within the proposed hard close framework. In this respect, the Proposal also completely fails to consider the legally enforceable rights and expectations of variable contract investors.

Each business day, an insurer receives orders from its contract owners, either directly or through a financial intermediary. Generally, pursuant to the terms of the contracts, any orders received at or after 4:00 p.m. on the previous business day until 3:59 p.m. on the current business day are deemed to be received on the current business day. The orders may be for purchases, withdrawals, transfers, other transactions permitted under the contract (*e.g.*, annuitization or death benefits), or other pre-planned systematic activity (*e.g.,* automatic asset rebalancing, dollar-cost averaging, RMDs, or employer contributions). In addition, the orders may be in terms of dollars, units, or percentages. These customer orders are unit transaction orders – they are not orders to directly purchase, redeem, or exchange fund shares.

The virtually universal procedures that insurance companies employ to strike variable contract unit values, calculate account values and process unit transactions, and submit underlying fund orders are as follows:

- **Step One:** The insurance company waits until the underlying funds disseminate their NAVs for the current business day. The underlying funds disseminate their NAVs no earlier than 4 p.m. As a practical matter, funds disseminate their NAVs well after 4 p.m.
- **Step Two:** The insurance company takes the disseminated NAVs and strikes unit values for the separate account. The insurer will strike one or more unit values for each subaccount. The unit value is determined by a formula set forth in the variable contract. That formula dictates that the unit value that the insurance company strikes for each subaccount is determined by taking the underlying fund's NAV and then deducting any applicable asset-based variable contract charges, which may include mortality and expense risk charges, administrative and recordkeeping charges, cost of insurance charges, optional benefit charges, and other separate account charges. The formula also includes adjustments for dividends, capital gain distributions, and taxes attributable to the separate account.[20]
- **Step Three:** The insurance company calculates contract owner account values and processes unit transactions for the current business day based on the applicable unit values struck in step two.
- **Step Four:** Once the unit transactions for the current business day have been processed, the insurance company then calculates and transmits a net purchase/redemption order for each underlying fund based on the unit transactions that occurred in step three. Of course, this happens well after 4 p.m. Many insurance companies submit their net purchase/redemption orders in the early morning on the next business day (before 9 a.m.).

Under the current long-established framework, even though the insurer transmits its net orders to the funds after 4 p.m., the insurer still obtains "same day pricing" on those orders because the related contract owners orders were received by the insurer prior to 4 p.m. Same day pricing is essential because, in order to avoid separate account breakage, the NAVs used to strike unit

[20] For most insurers, this step is reflected in the application of a "net investment factor" to unit values for the previous business day.

values (in step two) must be the same NAVs used to price the fund orders (in step four). Insurers receive same day pricing on their orders because they are deemed agents of the underlying funds for purposes of receiving fund purchase and redemption orders, both in the parties' participation agreements and under federal law principles.[21] In other words, because insurers' fund orders reflect unit transactions based on customer orders received before 4 p.m., insurers have always obtained the same day pricing on their fund orders.

Variable products are NAV-dependent contracts because step one in the process above is the dissemination of the underlying funds' NAVs. The process cannot start without NAVs for the underlying funds. The Proposal effectively presupposes that step four can come before step one. However, the order of operations is not a matter of discretion. The order of operations is inherent to the structure and operation of variable contracts and is embodied in insurers' outstanding policy forms that set forth the contractual relationship between insurance companies and their variable contract investors.

Also, the process above is based on longstanding principles reflected in Rule 22c-1. Registered separate accounts are themselves directly subject to the pricing and processing requirements of Rule 22c-1, and the procedures above are compliant with Rule 22c-1 as currently in effect. Even though unregistered separate accounts are not legally subject to the pricing and processing requirements of Rule 22c-1, unregistered variable contracts supported by unregistered separate accounts often set forth pricing and processing procedures that are consistent with current Rule 22c-1 requirements.

Of course, regardless of whether variable contracts are supported by registered or unregistered separate accounts, the pricing of the fund orders transmitted by the insurance company (in step four) is subject to Rule 22c-1. Again, under Rule 22c-1 as currently in effect, the orders receive same day pricing. Under the Proposal, these orders stand to receive next day pricing because insurance companies issuing variable contracts are not deemed to be "designated parties" with respect to the underlying funds.

b. Bad Swing Factors: The Proposal Will Produce Bad Swing Factors for Underlying Funds, Passing on Transaction Costs to the Wrong Investors

The SEC's goal for swing pricing is "to pass on costs stemming from shareholder purchase or redemption activity to shareholders engaged in that activity."[22] If the proposed swing pricing/hard close framework is adopted, the SEC will fail to accomplish that goal in the context of variable products. Rather, contract owners who transact "today" will bear the transaction costs generated by contract owners who transacted "yesterday." The reason for this problem: every business day, 100% of insurance-dedicated fund orders will be transmitted after 4 p.m. As explained above, variable products are inherently and immutably NAV-dependent products. An insurer cannot calculate and transmit net purchase/redemption orders to the underlying funds until after its variable contracts' unit transactions have been processed, the unit transactions cannot be processed until the separate accounts' unit values have been struck, and the separate account unit values cannot be struck until the underlying funds have disseminated their NAVs. Therefore, insurers cannot transmit their net purchase/redemption orders to the underlying funds until after the underlying funds have disseminated their NAVs.

[21] *See, e.g., New York Life Fund, Inc.*, SEC Staff No-Action Letter (May 6, 1971).

[22] *See* 87 FR 77172, pp. 172, 215.

If the SEC were to adopt hard close as proposed, the underlying funds would continue to disseminate their NAVs no earlier than 4 p.m. In turn, insurance companies would continue to transmit their underlying fund orders after 4 p.m., same as they do today under the current framework. And because insurance companies are the only shareholders in insurance-dedicated mutual funds, insurance-dedicated funds would receive 100% of their orders after 4 p.m., same as they do today under the current framework.

Given that insurance-dedicated funds would receive all of their underlying fund orders after 4 p.m. under the new framework, the funds' swing pricing will effectively always be one day behind. Every business day, an insurance-dedicated fund would be assessing whether to swing price and would be calculating its swing factor based entirely on contract owner transaction activity that occurred on the previous business day. In other words, an underlying fund will be using "yesterday's" unit transaction activity to strike "today's" NAV. However, that NAV—which reflects yesterday's unit activity—will be rolled up into today's unit values and will be used to process today's unit transactions. Accordingly, contract owners who transact based on today's unit values will be bearing the costs of contract owners who transacted yesterday.

Example of Bad Swing Factors **– Assume on Day 1 that Subaccount A in a variable product issued by Insurance Company X has 1% net unit outflows. Given the NAV-dependency of variable contracts, Insurance Company X will not be able to process the unit transactions in Subaccount A until Underlying Fund A has disseminated an NAV for Day 1. Unavoidably, Insurance Company X will have to transmit its net redemption order to Underlying Fund A after 4 p.m.[23] On Day 2, Underlying Fund A will not receive *any* other orders prior to 4 p.m. When Underlying Fund A calculates its NAV for Day 2, the swing factor will be based entirely on the 1% net unit outflows from Day 1. That stale swing factor will be reflected in Subaccount A's unit values on Day 2, so any contract owner who transacts in Subaccount A on Day 2 will indirectly realize a swing factor based on Day 1 transaction activity. Furthermore, the stale swing factor will even impact non-transacting contract owners, as it will become reflected in, *e.g.*, account values, benefit values, and even optional benefit reset features.**

This result would be highly inequitable for investors and counter to the SEC's general intent, especially for two reasons:

- First, it is unfair to require investors who transact on Day 2 to bear the transaction costs generated by investors who transacted on Day 1. The degree and direction of flows will change from day to day. Indeed, the swing factor may not only be stale, it could also be completely opposite to the unit flows for today. Granted, under the current framework, non-transacting investors bear the transaction costs of transacting investors, but at least the current framework has been in place for several decades and has been proven to work. The current framework should not be replaced with a flawed framework that would not, in fact, "pass on costs stemming from shareholder purchase or redemption activity to shareholders engaged in that activity."

- Second, a primary aim of swing pricing is to remove "first-mover advantage," which "can lead to increasing outflows, and as the level of outflows from a fund increases, the incentive for remaining shareholders to redeem may also increase."[24] Because the swing factor will always be on a one-day lag for the reasons explained, the Proposal will not

[23] For purposes of this example, assume that Insurance Company X is the only insurance company shareholder.

[24] *See* 87 FR 77172, p. 199.

remove first-mover advantage in the context of variable contracts. If a contract owner wishes to avoid transaction costs, they will want to be the first one out.

Bad swing pricing in the context of variable products is a flaw that goes to the heart of the proposed swing pricing/hard close framework. The SEC cannot justify eschewing the current framework for a new framework that would entirely fail to achieve the policy objectives that the SEC hopes to achieve as part of this rulemaking and would so unfairly and illogically burden this class of investors.

c. Breakage: Hard Close Will Expose Separate Accounts to Significant Breakage Risk

i. Hard Close Will Create Daily Breakage Within Separate Accounts

Hard close was not viable in the context of variable contracts when the SEC proposed it in 2003,[25] and it isn't viable now for the same basic reason: breakage. If the SEC were to adopt hard close as proposed, the SEC would expose separate accounts to significant and uncertain breakage risk *every business day*. As we explain below, this breakage risk would present insurance companies with an impossible situation that would, in turn, inevitably harm investors and give rise to systemic financial and legal risk for insurance companies.

As noted above, variable product separate accounts are unitized. A contract owner's interest in a separate account is represented by the number of units attributable to their contract and the value of those units. The NAV-dependent formula for determining the value of those units is clearly and unambiguously set forth in the variable contract policy form. Because separate account units are redeemable, outstanding units represent a financial liability for the separate account, and that liability changes from day to day as units are valued, purchased, and redeemed. To support its unit liability, a separate account holds underlying fund shares as an offsetting asset. Every business day, the insurance company (on behalf of the separate account) purchases and redeems the underlying fund shares in a manner that offsets the change in the separate account's unit liability – a unit liability that, again, is determined by the unit value formula set forth in the variable contract. The structure and operation of two-tier separate accounts and the unit value calculation are purposefully and fundamentally designed so that the separate account can support its own redemption obligations.

Breakage arises when a separate account has an asset-liability mismatch, most notably when the potential liability (*i.e.*, the value of the outstanding units) exceeds assets (*i.e.*, the value of the underlying fund shares). The complexity and magnitude of the systems used to strike unit values, process unit transactions, and calculate fund orders—systems that work to avoid breakage in the separate account—cannot be understated.[26] Many insurance companies have at least several separate accounts, dozens of products, and hundreds or even thousands of subaccounts and underlying funds, not to mention several current and legacy systems

[25] *See* Comment Letter of the CAI on Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Feb. 6, 2004) (commenting on the need for a conduit fund exception from hard close, "some provision of that type appears essential for insurance companies to continue to meet their contractual obligations under most variable annuities in force today without incurring significant unanticipated and indeterminate business risks as a result of 'breakage' that would occur if underlying fund shares cannot be purchased at the price computed on the day of receipt by the insurance company of transaction orders.").

[26] It is noteworthy that many insurance companies rely on third-party administrators' systems and therefore do not "own" the systems used to administer their separate accounts, which further exacerbates the problems with the Proposal.

developed over many decades. These are complicated transactions that occur every business day, and the processes that underlie these transactions are not only hardwired into insurance companies' systems, they are hardwired into the innate structure of variable contracts and separate accounts.

Yet, while the systems that support separate accounts are complex, the reason why separate accounts avoid breakage today is simple: same day pricing. Under the current framework, separate accounts avoid breakage because, every business day, that day's NAV of the applicable underlying fund is used to both (i) strike unit values for the separate account and (ii) price the insurer's net purchase/redemption order to the underlying fund. *Even though* the fund orders are transmitted after 4 p.m., the fund orders still receive *same day pricing*. The alignment of liabilities and assets is possible because the insurer receives same day pricing from the underlying funds.

Under the proposed framework, separate accounts would be exposed to breakage risk because, every business day, the insurer would strike unit values based on "today's" NAV for the applicable underlying fund, but the insurer's net purchase/redemption order to the underlying fund would get "tomorrow's" NAV. For the reasons explained above, given that variable contracts are NAV-dependent products, even if the SEC adopts hard close, insurance companies will necessarily continue to transmit their fund orders after 4 p.m. Consequently, insurance companies would lose same day pricing on their fund orders, and the loss of same day pricing would expose separate accounts to breakage risk every business day. In fact, daily breakage risk would exist within every subaccount of every two-tier separate account.

Example of Breakage **– The following example illustrates how the current framework avoids breakage and how the proposed hard close framework creates breakage. Assume the following:**

- **A single subaccount (Subaccount) and single underlying fund (Underlying Fund)**
- **Underlying Fund NAV on Day 1: $10.00 per share**
- **Subaccount unit value on Day 1 (based on Underlying Fund NAV on Day 1): $9.00 per unit**
- **Net Subaccount unit flow on Day 1: Net purchases, 1,000 units with a total value of $9,000**

Based on these assumptions, after the insurance company processes the unit transaction and determines the net flow for the Subaccount, the insurer would submit a purchase order (after 4 p.m.) for $9,000 in shares.

- **Under the current framework, the purchase order would receive the Underlying Fund's NAV on Day 1. There would be no breakage because the order placed by the insurance company on behalf of the separate account obtained same day pricing.**
- **Under the proposed framework, the purchase order would receive the Underlying Fund's NAV on Day 2. Breakage will arise at the end of Day 2 when the order is priced. The breakage will be the percentage difference between the Underlying**

Fund's NAV on Day 1 versus Day 2.[27]

At the end of Day 2, assume that the Underlying Fund's NAV has increased by 10% from $10.00 to $11.00 per share.

- **Under the current framework, the separate account liabilities and assets remain in sync. The Subaccount units issued on Day 1 and the Underlying Fund shares purchased on Day 1 will both increase in value by 10%. Both will have a total value of $9,900. There is no breakage.**
- **Under the proposed framework, the separate account liabilities and assets fall out of sync. The Subaccount units issued on Day 1 will have increased in value by 10% to $9,900 due to the contractual formula linking the unit value for that business day to the underlying fund's NAV for that business day; however, the Underlying Fund shares purchased on Day 1 will only be worth $9,000 because the insurer's purchase order got next day pricing. With respect to the units issued on Day 1, the separate account will therefore have a liability that is 10% greater than the additional assets it purchased to support those units, and this breakage will exist unless and until additional shares necessary to offset that breakage were purchased or cash was contributed to support the separate account's redemption obligations. But who could make these purchases or contribute this cash?**

Of course, this example is an oversimplification of a much larger, complicated, and indeterminable potential breakage problem. Many companies have several separate accounts, dozens of products, and hundreds or thousands of subaccounts and underlying funds. Under a hard close framework, every single subaccount will have its own breakage risk every day. There would be an extraordinary amount of daily separate account breakage.[28]

ii. Daily Breakage Would Give Rise to Systemic Financial and Legal Risk, Resulting in an Impossible Situation and Ultimately Harming Investors

As explained above, the proposed hard close framework would expose two-tier separate accounts to daily breakage risk. The breakage would arise from the asset-liability mismatch created by the contractually mandated unit value formula and the loss of same day pricing. The daily breakage risk—*which would exist within every subaccount of every separate account on every business day*—would result in an impossible situation.

The impossible situation would boil down to the following: (a) whether the separate account would bear the daily breakage, where the assets and liabilities of the separate account permanently fall out of sync, with the extent of the overall breakage depending entirely on day-

[27] On any business day, any subaccount could experience breakage depending on changes in the underlying fund's NAV. In volatile markets, however, the breakage for a single business day could be enormous. For example, in the March and April 2020 period that is the focus for the Proposal, the S&P 500 Index had nine one-day market moves of 5% or more. Similar levels of volatility over even a short period could generate staggering separate account breakage.

[28] It is true that breakage could be in the separate account's "favor" on a given day. In the example above, if the Underlying Fund NAV on Day 2 were lower than on Day 1, the separate account's liabilities on Day 2 would be lower than its assets. Therefore breakage could cut in different directions on a day-to-day basis. However, the proper and legal functioning of separate accounts cannot depend on the uncertainty of day-to-day market fluctuations.

to-day changes in the underlying funds' NAVs, or (b) whether the insurance company could and, if so, would absorb the breakage by contributing cash from its general account to true-up the separate account's assets or otherwise support the separate account's redemption obligations. Neither option is viable and both would ultimately harm investors.

For the reasons explained further below, inevitably the costs from separate account breakage would make it far more difficult and expensive for contract owners to save for retirement and achieve their financial goals. This would be a terrible result for investors. Variable annuities and variable life insurance policies play a critical role in the financial markets and the financial security of Americans.

On one hand, if the separate accounts themselves were to bear the breakage, investors and insurers would be exposed to significant harm and risk. In this regard, we highlight the following:

- Investors would be harmed because, in the absence of financial support from the general account, the separate account may not have sufficient assets to support contract owner account values and the separate account's redemption obligations. This would increase the risk that investors would not realize the benefits of their contracts.
- The insurer might be viewed as being in breach of contract, as the failure to absorb the breakage could be construed as inconsistent with the unit valuation and transaction processing provisions set forth in the insurer's contracts with its customers.
- The insurer may be seen as operating the two-tier separate account in a manner that violates both state and federal law requirements.
    - Under state and federal law, insurance companies' separate accounts may not be permitted to incur this breakage in the first instance. As previously noted, state and federal variable contract laws and regulations do not contemplate separate accounts bearing any breakage. Indeed, as pointed out earlier, both state and federal law require that separate accounts maintain assets approximately equal to contract liabilities and be fully insulated from the general account.
    - Insurers might be viewed as violating state law and fundamental provisions in applicable variable annuity and variable life insurance regulations insofar as the contractual unit value formulas would no longer reflect the investment experience of the separate account. For registered separate accounts, the contractual unit value formula may be regarded as no longer representing a proportionate interest in the UIT separate accounts' net assets as required by Section 2(a)(32) of the 1940 Act. Likewise, any inability of a registered separate account to meet its redemption obligations due to an asset-liability mismatch would be a violation of several provisions of the 1940 Act relating to the redeemable nature of separate account units.

On the other hand, if the insurer instead were to absorb the breakage by providing financial support to the separate account, the insurer would be exposed to untenable financial and legal risks, and the financial burden would inevitably fall upon investors.

- The financial risk to insurers would be entirely unacceptable, especially from the viewpoint of state insurance departments that regulate the solvency of insurers. Insurance companies have not priced their products in contemplation of any breakage,

let alone daily breakage within every subaccount of every separate account on every business day. Insurers simply cannot take on and reserve for such uncertain and potentially staggering cumulative breakage. In the short and long term, the breakage would have to be passed onto customers to the extent possible. Insurers would be effectively forced to increase charges on existing contracts up to their maximum limits and impose higher/additional charges on future contracts. In addition, it is reasonable to assume that insurers would have to include novel breakage charges or account value true-up mechanisms in future contracts.

- The subsidization of separate account investment operations by insurers' general accounts would be fundamentally inconsistent with the state-mandated segregated and insulated nature of variable contract separate accounts. Indeed, we find no support in state insurance laws for insurance companies to use the assets in their general accounts to support breakage in their separate accounts. To reiterate, state insurance laws generally require that the "[i]ncome, gains and losses, whether or not realized, from assets allocated to a separate account shall, in accordance with the applicable agreement or agreements, be credited to or charged against such account without regard to other income, gains or losses of the insurer."[29]

- As subsidization differs from subaccount to subaccount, and business day to business day, the insurer could be seen as engaging unlawful discrimination under state insurance laws. Insurance companies are not permitted, under state insurance law, to unfairly discriminate between policy owners and amongst the separate accounts. Requiring a general account to fund breakage may result in violations of such laws.[30]

- Breakage also raises significant issues under the Employee Retirement Income Security Act of 1974 ("ERISA"). An insurance company, in determining if, when, and how to resolve breakage, may likely be seen as exercising discretionary authority or control over ERISA plan assets, thereby acting as a functional ERISA fiduciary. As such, any financial transactions between the insurer and an ERISA plan or ERISA plan participant may be seen as a prohibited transaction under ERISA, as it would result in a plan fiduciary dealing with the assets of the plan its own interest or for its own account, in violation of ERISA section 406(b).

In addition, in either case, the breakage could call into question the tax treatment of the separate account. Variable contracts supported by the separate account may no longer meet the three-prong definition of "variable contracts" under 26 U.S.C. § 817(d). That definition references state law, stating that it is a contract "which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company" and under which "the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account." Insurance companies would be left to grapple with the tax implications of breakage.

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[29] *See* N.Y. Ins. Law § 4240(a)(1); *see also, e.g.,* Cal. Ins. Code § 10506(a); Iowa Code Ann. § 508A.1(1); Neb. Rev. Stat. Ann. § 44-402.02; Mass. Gen. Laws Ann. ch. 175, § 132G; Del. Code Ann. tit. 18, § 2932(a)(1); Wash. Rev. Code Ann. § 48.18A.020(1); and 27 R.I. Gen. Laws Ann. § 27-32-3.

[30] *See, e.g.,* N.Y. Ins. Law § 4240(a)(6) ("The insurer shall not, in connection with the allocation of investments or expenses, or in any other respect, discriminate unfairly between separate accounts or between separate and other accounts ….").

To the extent that separate account breakage causes in-force contracts to be in violation of applicable law, and putting aside the significant questions that would raise under the impairments of contracts clause in the U.S. constitution, the Proposal could call for millions of insurance contracts to be changed. Or, even if separate account breakage does not result in direct violations of applicable law, insurers may want to amend contracts to mitigate the risks associated with breakage. Yet, as the Commission knows and further discussed below, little can be done with respect to in-force contracts. Variable products are strictly enforceable contracts[31] between insurers and annuity contract owners that are closely regulated by state insurance regulators. State law generally prohibits insurance companies from unilaterally amending or endorsing in-force insurance contracts in a way that would take away or limit contract owner rights.[32] The right to amend insurance contracts is limited and is a matter of contract law between consumers and the insurance companies.[33]

Overall, the Commission has not addressed the financial, contractual, legal, and capital market ramifications of the daily separate account breakage that would arise under the Proposal. The Proposal does not provide clarity on how the Commission expects breakage to be addressed, and without more clarity and time, our members cannot fully address all the issues associated with breakage. However, one thing is clear: breakage would result in substantial harm to investors, significant harm to insurers, and an exceptional number of intractable legal issues.

d. No Way to Avoid Bad Swing Factors and Breakage Under the Proposal

i. Insurance Companies are Constrained by Existing Policy Forms, Investor Disclosures, and Applicable Law

As we have noted above, variable products are fundamentally different than mutual funds. Unlike mutual funds, every variable product is a written contract between the insurer and the contract owner. Among many other provisions, variable contracts set forth how two-tier separate account unit values are to be struck and how unit transactions are to be processed. Those contractual provisions are based on the inherent design of variable contracts, state insurance law, and long-standing principles under the 1940 Act, including Section 22(c) and Rule 22c-1 as currently in effect. Even assuming that entirely novel pricing and processing procedures could be invented from whole cloth, insurers could not unilaterally limit the rights of contract owners under in-force contracts by changing the pricing and processing procedures set forth therein.

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[31] *See generally*, Fisher v. Aetna Life Ins. Co., 2020 WL 2792994 (S.D.N.Y. 2020), aff'd, 32 F.4th 124 (2d Cir. 2022) (articulating the basic principle that an insurance company "cannot deviate from th[e] language in its insurance policies.")

[32] *See, e.g.,* Colorado ("Any riders, endorsements, or amendments which limit coverage afforded by an existing policy shall not be effective unless and until the named insured or primary policyholder has signified his or her acceptance [. . .]") (3 CCR § 702-6:6-1-1); Kansas ("Consent of the policyholder is required if an endorsement or rider attached to an insurance contract or policy subsequent to the issuance date of such contract or policy reduces or eliminates coverage or benefits of the contract or policy.") (K.A.R. § 40-1-32) (emphasis added).

[33] We are not able to provide a complete analysis of the change of contract provisions for each of the 28 million contract holders, but certain language is common. For example, it is common to refer to changes required by changes to the Internal Revenue Code: ("The Company may amend any Contract term, and administer the Contract to conform to the Internal Revenue Code."). Some contracts do permit changes required by state or federal law: ("The Company reserves the right to unilaterally change the Contract for the purpose of keeping the Contract in compliance with federal or state law."). On the other hand, some contracts state the opposite: ("No change will be made in the contract unless [the contract holder] agrees.").

To amend (or endorse) in-force contracts, insurers generally must go through a rigorous, resource intensive, and lengthy state-by-state approval process. More importantly, if the SEC were to adopt the hard close proposal, it isn't at all clear whether or how insurers could amend their contracts to avoid the critical problems discussed in this letter, and the outcome of the state approval process would be entirely uncertain. In that regard, state insurance regulators could interpret the proposed amendments to Rule 22c-1 as not being a legitimate basis for companies to change their contractual pricing and processing procedures.

Even if insurers could somehow successfully navigate the state-by-state approval process, they may also be required by the states or the contracts to obtain customer consent. To the extent that customer consent is necessary, it would be practically impossible for insurers to obtain universal assent. Many contract owners would not respond. For those contract owners who are responsive, many would refuse their consent. There is no logical reason why contract owners would agree to give up their existing rights in exchange for new rights that would be much less advantageous.

Beyond the policy form restrictions, insurance companies have disclosed their pricing and processing procedures to investors prior to sale. For registered products, the procedures are described in prospectuses. For unregistered products, the procedures are described in private placement memoranda or other offering documents. In either case, if insurance companies were to change their pricing and processing procedures, the longstanding and fundamental expectations of investors who relied on past disclosures would be unfairly undermined. It would be a breach of their trust. Moreover, disappointed investors could attempt to pursue private litigation for material misstatements in violation of Rule 10b-5, Section 12, or another disclosure liability provision of the federal securities laws.

Lastly, for insurance companies with registered separate accounts, their ability to invent entirely new pricing and processing procedures would be constrained by Rule 22c-1 as currently in effect or as proposed. It is difficult to see how a novel and unconventional pricing and processing procedure could be legally permissible under Rule 22c-1.

In short, if the SEC adopts the Proposal, bad swing factors and breakage would be unavoidable. Even if insurers could totally reinvent the way that variable contracts work for future business, there is little that they could reasonably do for existing business.

ii. Early Cut-Offs Would Violate the Terms of Millions of Outstanding Variable Contracts and Would Solve Nothing

The Proposal posits that early cut-offs are a universal solution for preserving same day pricing. However, early cut-offs do not address the root problem that the Proposal fails to acknowledge: variable products are NAV-dependent contracts between insurance companies and contract owners.

The vast majority of variable contracts specify that they will credit purchase, redemption, and transfer requests that are received before the close of the New York Stock Exchange. That is, the express terms in variable contract policy forms guarantee customers a 4 p.m. cut-off time for same day pricing. As previously discussed, insurers cannot deviate from the terms of their outstanding contracts, and amending their outstanding contracts would not be a tenable option. Therefore, even if insurers wanted to impose early cut-offs, they would not be permitted to do so under their existing contracts.

Apart from the contractual issue, early cut-offs would not solve the bad swing factor and breakage problems under the Proposal. The NAV-dependent nature of variable contracts means that imposing an early cut-off on contract owners would not allow insurers to transmit underlying fund orders any earlier than they do today (*i.e.*, after 4 p.m.). Thus, if the SEC were to adopt the Proposal, insurers would continue to transmit their orders to the underlying funds after 4 p.m. It isn't a matter of cost, resources, or system enhancements – it's due to the inherent design of variable products.

Early cut-offs would not resolve the Proposal's core flaws because, from an operational perspective, they would not change the order of operations for pricing and processing under variable contracts. Referencing back to the four-step order of operations described in Section III.a.v., transmission of the underlying fund orders is step four. However, the Proposal presumes that step four can easily become step one. That's irreconcilable with how variable contracts and two-tier separate accounts necessarily must operate. The process does not begin until the underlying funds disseminate their NAVs. Underlying funds do not disseminate their NAVs until after 4 p.m., under either the current framework or the proposed framework. In turn, if the SEC adopts the proposed hard close framework and encourages intermediaries to use early cut-offs, that won't change the fact that variable products are NAV dependent. Insurance companies will continue to transmit their fund purchase/redemption orders after the funds disseminate their NAVs (*i.e.*, after 4 p.m.) because step four must come after step one (at least for millions of existing contracts). Thinking otherwise puts the proverbial cart before the horse.[34]

Because early cut-offs would not preserve insurance companies' ability to receive same day pricing on their fund orders or otherwise address the harms that would arise under the Proposal, there is no reason why insurers would implement them. Insurers would be taking on extreme costs and causing their customers to lose same day pricing for no identifiable reason.

e. Widespread Early Cut-Offs in the Variable Product Sector Would Be Harmful to Investors and Extremely Impractical, Costly, and Anticompetitive

Even though there is no clear reason why insurance companies would impose early cut-offs under the proposed framework, and putting aside the fact that millions of contract owners are contractually guaranteed a 4 p.m. cut-off, given the extent to which the SEC focuses on early cut-offs in the Proposal, widespread early cut-offs in the variable product sector would be very harmful to investors and extremely problematic for insurers.[35]

i. Widespread Early Cut-Offs Would Be Harmful to Investors

[34] For example, even if an insurer sets a 10 a.m. cut-off time, the insurer will not somehow be able to price units and process unit transactions between 10 a.m. and 3:59 p.m. such that fund orders reflecting unit transactions can be transmitted prior to 4 p.m. The insurer wouldn't be able to begin pricing units and processing unit transactions until the underlying funds disseminate their NAVs, which will be after 4 p.m. Indeed, the only thing that would change is that swaths of contract owners would lose same day pricing due to an arbitrary early cut-off time.

[35] We would also note that for registered investment companies that issue redeemable securities and also serve as financial intermediaries (such as feeder funds and registered separate accounts), those vehicles would not be permitted under Rule 22c-1, as currently in effect or as proposed, to impose early cut-off times on their investors.

In Section II above, we explain the reasons why widespread early cut-offs would represent bad public policy for American mutual fund investors. The concerns we highlighted include:

- Investors value and expect same day pricing.
- Investors do not want to grapple with early cut-offs, especially early cut-off times that will vary extensively among companies, products, and intermediaries.
- Investors will not understand why they have lost traditional same day pricing because the swing pricing / hard close framework is complicated and unintuitive.
- The SEC should not expose investors to greater market risk by making it harder to get same day pricing.

These serious concerns would apply with equal force to variable product investors. Variable product investors likewise want same day pricing. They too do not want to be inconvenienced by early cut-offs. They too would not understand why they have lost traditional same day pricing, which they have come to expect for over half a century. And they too would be exposed to greater market risk if the SEC makes it harder for them to get same day pricing. We do not believe that investors would trade traditional same day pricing in exchange for an unproven anti-dilution tool, cumbersome early-cut offs, and greater market risk.

Widespread early cut-offs would be harmful to the overall variable product market. We are concerned that the negative investor experience created by widespread early cut-offs would cause the variable product sector to shrink as investors needing the insurance benefits that variable products uniquely can provide would nonetheless look elsewhere to put their money in search of a better experience. It is also important to note that as those investors seek a better experience, they could become subject to back-end sales charges, front-end sales charges, and/or tax penalties.

It is reasonable to presume that as the variable product market shrinks, there would be less choice in the market and less product innovation, and ultimately fewer retirement and life insurance solutions for Americans.

ii. Widespread Early Cut-Offs Would Be Extremely Impractical, Costly, and Anticompetitive

Apart from significant contractual and other legal impediments discussed above, it would be extremely difficult and costly to implement widespread early cut-offs in the variable product sector. Indeed, the burdens and costs would extend beyond all reason. The Proposal basically calls for the entire trading system to be retrofitted just for swing pricing/hard close. The SEC has not proffered any evidence to justify how the benefit (if any) of swing pricing/hard close could possibly outweigh the burdens and costs of upending the entire mutual fund and variable product ecosystem. In addition, it is inconceivable how the SEC would expect the entire system to be rebuilt in just 24 months.

Variable products are sold almost entirely through selling firms, with many insurance companies having hundreds of distribution partners. If early cut-offs existed throughout the variable product market, there would always be at least two layers of early cut-off times: (1) an early cut-off time by the insurance company and (2) an even earlier cut-off time by the selling firm. In addition, whenever there is more than one selling firm involved, there would be at least three layers of early cut-off times. These early cut-off times would have to be negotiated and coordinated by

insurers on an intermediary-by-intermediary basis, and intermediaries would have to negotiate and coordinate early cut-off times with each other. Given how many parties would be involved, the logistical challenges associated with an early cut-off regime would be extraordinary.

While the logistical challenges would be extraordinary, the monetary and resource costs would be exponentially worse and completely unjustifiable. Insurance companies and financial intermediaries would have to build entirely new systems and trading ecosystems. We cannot begin to predict the potential costs. Nevertheless, it is not unfair to say that a complete overhaul of the existing systems and ecosystems—just to cut-off orders a few hours earlier—could cost any given insurance company millions upon millions of dollars. On an industry wide basis, the costs would easily be in the billions, costs which would likely be passed on to retail investors in some manner.

Also, widespread early cut-offs would have anti-competitive impacts. In most cases, an insurance company would not be in a position to dictate an early cut-off time to selling firms. Each selling firm will very likely settle on a standard or preferred cut-off time for mutual funds and products, and will expect insurance companies to accommodate that cut-off time. If an insurer insists on an earlier or different cut-off time, selling firms may simply stop selling that company's products. As a result, some insurers could be driven from the market for lack of distribution partners.

IV. COMMENTS SPECIFIC TO RETIREMENT PLANS

As of June of 2022, defined contribution retirement plans account for nearly $9 trillion in assets, and when IRAs and defined benefit plans are included, the asset total is nearly $32 trillion.[36] Americans have come to rely on the predictability, reliability, and availability of the private retirement plan system. Congress continues to build on the success of the private retirement system, working with employers and providers to expand access, increase savings, offer more product options, facilitate the use of annuities, and decrease costs and complexities in the administrative processes. The most recent success, the Secure Act 2.0, follows closely on the heels of the SECURE Act of 2019, both of which were passed by overwhelmingly bipartisan margins. All of these actions, along with the careful oversight of the Department of Labor under ERISA have facilitated and encouraged the U.S. private retirement system to make financial security more attainable for average American workers. Any proposed changes to this successful system must carefully weigh potential harms and benefits before moving forward.

As we have noted throughout this letter, the existential concerns with the hard close proposal are not limited to insurance company variable contracts and separate accounts. In fact, those concerns extend to any fund agent intermediary that processes significant volumes of account transaction activity across multiple funds or investment options. This is particularly true for retirement plans.

Retirement plans including 401(k), 403(b), 457(b) plans as well as SEPs and SIMPLE IRAs support long term investing. These plans receive regular ongoing contributions through payroll deductions, employer matching contributions, and regular annual contributions. They permit – and plan participants expect – same-day pricing for investment transactions to and among the

[36] *Retirement Assets Total $32.3 Trillion in Third Quarter 2022,* Investment Company Institute (December 15, 2022), https://www.ici.org/statistical-report/ret_22_q3

plan's menu of funds and for withdrawals such as loans, hardship distributions, emergency withdrawals, and income in retirement.

Many insurers provide recordkeeping services to plan sponsors as well as a variety of annuities, funds, and service features that are found within the plans. It is common for plans such as 403(b) plans to make both variable annuity and custodial account investment options available to plan participants. There are service providers, including insurers, that offer employer plan sponsors an "open architecture" menu of investment options that allows them to construct an investment menu for plan participants that includes life insurer variable annuity "UIT" separate accounts and managed separate accounts, a broad range of proprietary and non-proprietary mutual funds, and collective investment trusts. All of these arrangements currently operate seamlessly with same day pricing. The Proposal would cause these plans to address multiple investment product-dependent trading deadlines which in turn would raise a host of highly probably negative impacts including:

- the impact on participant investment behavior which may include foregoing appropriate diversification in favor of investments that have no early cut-off;
- plan fiduciaries weighing early cutoff factors in addition to the more appropriate fiduciary considerations like risk/reward, diversification and cost; and
- confusion and dissatisfaction among plan participants which could dampen plan participation and give rise to litigation.

While there are variations in contractual structures (*e.g.*, investing in underlying funds through an insurance company separate account versus investing directly in the funds), the issues and concerns discussed in this comment letter – and specifically in Section III of this letter – also are applicable broadly to retirement plans with impacts to plan sponsors, providers, and participants.[37]

Specifically, we would highlight three critical concerns for recordkeepers:

A. PROCESS

Retirement plan recordkeepers use a three-step process, which is essentially the same as the four-step process referenced in Section III.iv. minus the insertion of the separate account and its associated unit values. Otherwise, they face the same problems under the Proposal. Remittance of actual trades to a mutual fund must necessarily occur:

i. After the orders have been collected by the plan administrator prior to the 4 p.m. market close; and

ii. After the fund has struck its new NAV.

A reordering of those steps is not simply a process change; it removes the backbone of current plan activity upon which participants, plans, and service providers have relied for decades.

[37] For additional comments on the impact of the Proposal on retirement plan sponsors and recordkeepers, we anticipate you will receive more expansive comments from employer trades including the American Benefits Council and the U.S. Chamber of Commerce and from the Spark Institute representing retirement plan recordkeepers.

B. EARLY CUTOFFS

As noted in Section III.d.ii., an early cut-off cannot solve the inherent obstacles of the steps being reordered such that the final orders must be submitted before the fund has struck the day's new NAV. Absent having the current day's NAV, the plan recordkeeper cannot allocate transactions across multiple funds available under the plan (which represents the majority of the trading activity), which it must do in order to determine, and then net, the transaction activity at a fund level. This reversal of process effectively eliminates the use of omnibus trading and all of the benefits associated with that method.

C. BREAKAGE

Consistent with the discussion in Section III.c., if the recordkeeper is required to provide final transaction activity to the fund company by the 4 p.m. market close without the benefit of the fund's NAV for that day, the recordkeeper could only do so based upon transaction estimates, using a hypothetical proxy for the fund's NAV. This would give rise to breakage – the difference between what the recordkeeper assumed (with its NAV proxy) and values using the actual NAV. It is not obvious who, if anyone, would or could bear the costs or reap the gains of any such breakage (*e.g.*, the plan and its participants, the sponsoring employer, the recordkeeper, the custodian/trustee). As noted previously, it is clear that any such gains or lending of funds to cover a loss would raise prohibited transaction concerns under ERISA. The magnitude of such breakage on a given day is unknowable. However, what can be known is that the same days of outlier market activity that are the focus of the swing pricing concerns would impose the greatest breakage cost on, and could create existential concerns for, the parties involved. It is unclear how plan sponsors, recordkeepers, and custodians would reconcile the indeterminate risks present in such an arrangement.

It is important to note that many large monthly purchases are made at the direction of employers to retirement plans. Representing employee and employer contributions, these investments are not driven by market considerations but rather by plan terms as well as statutory requirements and deadlines. For example, many employees get paid either on the 15th and 30th of the month, or every two weeks on a Friday, and have monies automatically deducted from their pay checks year after year, decade after decade. These are not actions of first movers or market timers—these are the actions of regular citizens who are saving for retirement.

Millions of Americans have trillions of dollars in savings set aside in workplace retirement plans. In the 20 years since the SEC last proposed and then abandoned a similar hard close proposal, Congress has enacted three significant and overwhelmingly bipartisan legislative packages dedicated to expanding and improving the private retirement system. As recently as December of 2022 with the SECURE Act 2.0, Congress continues to push for greater access, more savings, and simplification of these workplace savings plans. Insurers, recordkeepers and other service providers have taken great strides to make the US retirement system efficient and cost effective for sponsors, savers, retirees, and their beneficiaries.

The SEC's hard close proposal would require a complete restructuring of plan operations, the cost of which will be borne by the retirement plan system and its participants, with no discernable benefit to balance out the harm. With this Proposal, the SEC has failed to quantify not only the costs to restructure plan recordkeeping services but also the effect of the Proposal

on retirement plan sponsorship, retirement savers' accumulations, the challenges of participant communications and the participant experience. It is reasonable to expect that the Proposal will lead to inefficiencies, narrower and fewer product offerings, a move toward proprietary fund platforms that challenge fiduciary fund selection, higher costs and less competition. Most importantly, it will harm the millions of Americans who will lose same-day pricing and will bear the cost to do so. This proposal must not be adopted as it threatens the US retirement system, its operations and costs as well as the services that retirement savers and plan sponsors have demanded and enjoy.

V. THE PROPOSAL RAISES CONCERNS UNDER THE ADMINISTRATIVE PROCEDURE ACT

We question whether the Proposal complies with the rulemaking requirements found in the Administrative Procedures Act ("APA").[38] The APA requires that federal agencies give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's deliberative process.[39] Further, rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are "fairly apprised" of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests.[40]

The Proposal is rife with examples that demonstrate that the SEC, in promulgating this proposal, is acting prematurely and does not have sufficient factual data or supporting evidence. The SEC has not – and indeed cannot, given the lack of factual data or evidence necessary to support such significant changes – justify that the benefits of the Proposal outweigh its costs. Indeed, as the Proposal includes over 250 questions seeking information and data critical to an assessment of costs and benefits, and the impact of the Proposal on investors, the Proposal is more akin to a Request for Information (RFI) which should have preceded this Proposed Rulemaking.

With specific respect to the hard close proposal, not only does the SEC fail to demonstrate that the benefits of the Proposal outweigh its costs, but the SEC includes, in the preamble to the Proposal, a list of significant problems and scenarios associated with the imposition of a hard close on funds, investors, retirement plan sponsors, recordkeepers, and participants, including:

- The hard close requirement may change operational burdens for mutual funds and other parties related to mutual fund order processing.
- Requiring a hard close may impose significant switching costs (e.g., changing business practices, computer systems, integrating new technologies, etc.) on funds, their intermediaries, and service providers that could ultimately be passed on to investors.
- Retirement plan recordkeepers and any affiliated brokers and trust companies, as well as DCS&S, would have to modify their processes and systems substantially, as these processes currently require daily price information for all investments prior to processing of any investment instructions from the plan participants.

[38] 5 U.S.C. Section §553.

[39] *Id*. at §553(c)

[40] *See, e.g., Mid Continent Nail Corporation v. United States*, 846 F.3d 1364, 1373-1374 (Jan. 27, 2017).

- Retirement plans may have to modify their provisions, and employers sponsoring these plans may need to modify payroll systems, as well as change the information (e.g., websites, manuals, and training materials) they provide to employees regarding how to submit orders, as a result of the hard close requirement.
- A large number of small plans may be disproportionally affected by the implementation costs related to the proposed hard close because they may not enjoy economies of scale. To the extent that these costs are too large relative to the size of assets under management, some of the plans may cease to exist or choose to offer other investment vehicles such as ETFs or CITs.
- To the extent that not all investors have a choice of intermediary, such as participants in employee provided retirement plans, the costs stemming from the proposed hard close requirement may be borne by either investors (i.e., plan participants) or their employers that sponsor the plan.
- To the extent that not all intermediaries may be able to comply with the hard close requirement, the investors that use these intermediaries may face a decreased ability to invest in mutual funds via certain intermediaries.
- To the extent that the strategies of the open-end funds subjected to the proposed requirement cannot be replicated or to the extent that such replication would be more costly outside of the mutual fund sector (e.g., via a separately managed account), investors may end up with either less diversified portfolios, or experience higher costs of investing.
- The hard close requirement may disadvantage certain investors that do not have a choice in their intermediary, if it precludes them from responding to market events after a specific cut-off time that is earlier than 4 p.m. ET or lengthens the amount of time for completing certain types of transactions compared to investors that submit orders directly to funds.
- To the extent that investors designate their employers to make retirement contributions to intermediaries via payroll procedures, and to the extent that payroll procedures have to be performed during a specific time frame in order for transaction to receive that day's price, the employers may experience a cost of switching the system to accommodate an earlier cut-off time for orders. These effects may be more pronounced for employers and investors in the western regions of the U.S. who may not have a sufficient time window to process contributions and/or (re)allocate their portfolios.
- To the extent that some intermediaries already impose an earlier cut-off time for investors' orders, the hard close may entail an even earlier cut-off time, which may further disadvantage investors.[41]

As the above illustrates, the SEC believes the Proposal could have a significant negative impact on funds, investors, retirement plan sponsors, recordkeepers, and participants. As such, it is essential that the benefits of the Proposal justify its costs. Yet, the Proposal fails to do so. Further, the Proposal fails to quantify many of the cost requirements associated with a hard close proposal, for a variety of reasons, and instead request comments on the costs of the hard

[41] *Id*. at 77260-77261.

close requirement, "particularly any dollar estimates of the costs that funds, intermediaries, and other affected parties will incur as a result of the rule."[42]

Given the lack of factual detail on the legal basis, rationale, and supporting evidence, we question if interested parties are "fairly apprised" of its content, the reasoning of the agency implementing them, and the manner in which the Proposal may affect their interests. Further, putting aside the total lack of analysis or detail relating to the impact of the hard close proposal on variable contracts and variable contract investors, we question whether the Proposal appropriately details the qualitative and quantitative costs that will be borne by funds, investors, retirement plan sponsors, recordkeepers, and participants. Finally, we question whether a 60-day comment period for a significant complex rulemaking, with over 250 questions, allows interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's deliberative process, as required by the APA.

VI. CONCLUSION

The SEC should not adopt hard close. For the many reasons discussed above, hard close as proposed would result in a broken financial system, particularly for variable contracts and retirement plans, and would be deeply harmful for investors, insurance companies, and the retirement plan system. The SEC should not replace a financial system that has worked for more than 80 years with a financial system that will be unworkable from day one. As such, we and our member companies strongly urge the SEC to abandon the hard close proposal entirely. In no event can insurance companies and their two-tier registered and unregistered separate accounts, nor retirement plans or retirement plan recordkeepers, be subject to any hard close rule that would result in the loss of same day pricing for fund orders transmitted after an underlying fund's pricing time.

We note again that it is extremely disappointing that the SEC made no apparent effort to consider the impacts on variable contracts, consult with the insurance industry, or consult with state insurance regulators. In fact, the Proposal's discussion of variable products is limited to a passing reference in one single question related to hard close.[43] Given the absence of any substantive discussion in the Proposal regarding variable contracts, it is highly questionable whether the SEC has a lawful basis to adopt a swing pricing/hard close framework for the variable contract sector. We respectfully submit that the absence of any substantive discussion or analysis related to variable products, and not providing interested parties with an opportunity to comment on that analysis, is fatal to the Proposal insofar as it would apply to variable contracts.

In closing, we reemphasize our strong opposition to the swing pricing/hard close framework set forth in the Proposal, as well as our strong views that the SEC is rushing arbitrarily through the rulemaking process – without fully understanding the Proposal's impacts – in a manner that fundamentally conflicts with basic principles of administrative law.

We appreciate the opportunity to comment on the Commission's proposal and thank you for considering our comments.

* * *

[42] *Id.* at 77261.

[43] *See* 87 FR 77172, p. 214 (question 114).

Respectfully submitted,

AMERICAN COUNCIL OF LIFE INSURERS

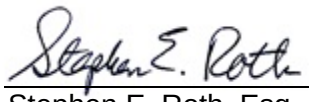


Patrick Reeder
Vice President & Deputy General Counsel
(202) 624-2195
patrickreeder@acli.com



James H. Szostek
Vice President & Deputy, Retirement Security
(202) 624-2378
jimszostek@acli.com

COMMITTEE OF ANNUITY INSURERS
For the Committee of Annuity Insurers, By:



Stephen E. Roth, Esq.
Partner, Eversheds Sutherland (US) LLP
(202) 383-0158
SteveRoth@eversheds-sutherland.us



Ronald Coenen Jr., Esq.
Partner, Eversheds Sutherland (US) LLP
(202) 383-0940
RonCoenen@eversheds-sutherland.us

cc: The Honorable Gary Gensler, Chair
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The Honorable Jaime Lizárraga, Commissioner
Mr. William A. Birdthistle, Director, Division of Investment Management

The Honorable Sherrod Brown, Chairman
The Honorable Tim Scott, Ranking Member
United States Senate Committee on Banking, Housing, and Urban Affairs

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The Honorable Patrick McHenry, Ranking Member
United States House of Representatives Committee on Financial Services