The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC Charges Insurance Fund Advisers with Failing to Disclose Conflicts and Making Misleading Disclosures to Fund Boards

[31972]

September 18, 2019 TO: ICI Members
Investment Company Directors
Chief Compliance Officer Committee
Compliance Advisory Committee
Investment Advisers Committee
Tax Committee
Variable Insurance Products Advisory Committee SUBJECTS: Compensation/Remuneration
Compliance
Disclosure
Fees and Expenses
Fund Governance
Investment Advisers
Litigation & Enforcement
Portfolio Oversight
Tax
Variable Insurance Products RE: SEC Charges Insurance Fund Advisers with Failing to Disclose Conflicts and Making Misleading Disclosures to Fund Boards

The Securities and Exchange Commission recently entered into a settled enforcement action with two registered investment advisers regarding conflicts of interest raised by the fund's securities lending practices and disclosures made to the funds' boards of trustees.[1] The investment advisers are subsidiaries of an insurance company and advise insurance-dedicated mutual funds.

The SEC's Allegations

The advisers' parent insurance company and other insurance companies utilized the funds as investment options in their variable annuity and variable life insurance products. The SEC alleged that the advisers engaged in a practice of directing the funds' affiliated securities lending agent to recall securities on loan from the funds prior to the securities' dividend record date. This practice allowed the insurance companies, which were the

record shareholders of the funds' securities, to take a tax deduction for the dividends received on the securities. Because mutual funds are not eligible to take this "dividends received deduction" (DRD), the tax benefit accrued to the insurance companies. The SEC asserted that this practice created a conflict of interest because the insurance companies benefited from the DRD, while the funds lost securities lending income during the period when the securities were recalled. The SEC alleged that the advisers failed to disclose this conflict of interest to the funds' boards of trustees, and to the variable annuity and variable life insurance contract holders who were the beneficial owners of the funds' shares. The SEC alleged that, as a result, disclosures to the funds' boards and in the funds' statements of additional information, prospectuses, and financial statements regarding the securities lending program were materially misleading.[2]

The advisers also obtained approval from the funds' boards of trustees to reorganize the funds as partnerships for US tax purposes to increase the tax benefit to the insurance company. In particular, reorganization of the funds would increase the tax benefit the insurance company received from the DRD, by increasing the amount of dividend income eligible for the deduction. The SEC alleged that the advisers informed the funds' boards that the reorganization would provide a more efficient tax structure for the organization, but would not increase fees or otherwise negatively affect the funds' shareholders. The SEC claimed that the advisers failed to disclose to the boards that the funds' securities lending agent would recall securities on loan before the dividend record date, which would result in a reduction of lending revenue to the funds. The SEC also alleged that the advisers disclosed to the boards that the insurance company would bear all costs associated with the reorganization and reimburse the funds amounts necessary to make them whole, which did not occur.[3]

Self-Reporting and Remediation

Following an SEC examination of the advisers' securities lending practices, an employee of the funds' securities lending agent mentioned the conflict of interest raised by the fund's securities lending practices to the advisers' Chief Compliance Officer. The CCO escalated the conflict to the insurance company's most senior legal and compliance professionals, who initiated an internal investigation. The advisers and the insurance company subsequently self-reported the issue to the SEC staff. After consultation with the funds' boards, the insurance company voluntarily paid approximately $72 million to the funds, reflecting securities lending revenue and additional investment profits the funds would have received but for the recall practice.

The insurance company determined that, as a result of the reorganizations, the funds had significant accumulated unfunded foreign withholding tax receivables. After consultation with the funds' boards, the insurance company self-reported the issue to the SEC staff and paid $42.3 million in receivables to the funds, as well as $11.5 million in lost investment returns. In subsequent months, the insurance company identified additional receivables and other payments owed to the funds. In total, it paid the funds more than $58.6 million in past-due foreign tax reimbursements and approximately $25 million in lost investment income.

Violations and Sanctions

The SEC found that the advisers willfully violated section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act"), as well as Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The Commission acknowledged the advisers' self-reporting, cooperation, and prompt remediation in ordering the advisers to cease and

desist, and to pay disgorgement of $27.6 million and a penalty of $5 million.

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endnotes

[1] *In re AST Investment Services, Inc. and PGIM Investments LLC,* Investment Advisers Act Release No. 5346 (Sept. 16, 2019), *available at* https://www.sec.gov/litigation/admin/2019/ia-5346.pdf.

[2] The SEC brought a settled enforcement action against insurance fund advisers last year alleging similar violations. For a summary, *please see* ICI Memorandum No. 31142 (Mar. 22, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31142.

[3] Specifically, the advisers informed the boards that, although in certain foreign jurisdictions the withholding tax rates for dividend and interest income may be higher as a result of the conversion and that any tax refunds could take partnerships longer to receive, the insurance company would reimburse the funds promptly. The SEC asserted that the advisers failed to have the insurance company reimburse the funds in a timely manner.