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March 19, 2018

ACA Insight

The weekly news source for investment management legal and compliance professionals

"It is almost unprecedented for a key element of a new rule being walked back so quickly."

SEC Reverses Itself and Votes Against Public Reporting of Liquidity Classifications

In something of a turnaround, the Commission on March 14 voted, 3 to 2, to change a previously adopted liquidity classification requirement. Under the proposed amendments, funds will no longer need to publicly report the classification buckets their securities fall into. Instead, they will simply need to provide a qualitative narrative describing how their liquidity risk management programs are working.

In addition, the proposed amendments will allow funds to classify a security in more

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The SEC's Cherry-Picking Crackdown: What's Behind It

What's behind the SEC's crackdown on cherry-picking at advisory firms, other than the agency's desire to stamp out this violation wherever and whenever it's found? Certainly there are other improper actions that the Division of Enforcement has made clear it will pursue, among them share class selection or Rule 105 violations. Cherry-picking cases, however, seem to be in a case by themselves.

In the past four weeks alone, there have been two advisory firms named in SEC actions because of alleged cherry-picking violations, one in a March 8 settlement and the other less than two weeks before in a February 20 complaint in federal court.

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Failure to Place Client Interests Over Those of Affiliates May Lead to Charges

An adviser may have clients and may have affiliates, and may understandably want to do right by both. Such dual interests, however, may lead to a conflict of interest – and when that happens, client interests must come first.

That's one lesson to learn from the SEC's March 8 settlement with Arizona-based advisory firms **Voya Investments** and **Directed Services**, both subsidiaries of the same parent company. The two firms agreed to pay approximately $3.6 million in disgorgement, interest and penalties to settle charges that they failed to disclose conflicts of interest and made misleading statements.

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ments of material fact. In addition, Strong Investment Management alone was charged with violating Section 207 and its Rule 206(4)-7, the Compliance Program Rule, for failing to adopt and implement written compliance policies and procedures. Bronson and Engebretson were also charged with aiding and abetting the violations of that section and Rule.

The SEC asked the court to order the defendants to cease all improper activities, disgorge all funds received through illegal conduct, and assess civil money penalties. Attorneys representing Strong Investment Management, Bronson and Engebretson did not respond to a voice mail or email seeking comment.

Failure to Place

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The problem, according to the agency's administrative order instituting the settlement, revolved around the two advisers' practice of recalling securities they had loaned so that their affiliates could receive tax benefits. Unfortunately, according to the SEC, it appears that those recalls also deprived their funds and investors of income.

"These funds and those investing in them weren't told that they were losing income so that the [two advisory firms] could provide a tax benefit to their affiliates," said SEC Division of Enforcement Asset Management Unit co-chief **Anthony Kelly**. "Now money will be heading back to the funds to help investors."

"Investment advisers must not place the interests of their affiliates over those of clients, depriving them of information necessary to make informed investment decisions," he said.

"We are pleased to have reached this settlement," **Voya Financial**, the parent company of both advisory firms, said in a statement. "This announcement means we avoid a lengthy and costly litigation process and can focus our resources on delivering high-quality investment service to our clients."

"The SEC's latest settlement with Voya Financial is another example of the SEC's trend over the past few years to crack down on conflicts of interest and breaches of fiduciary duty," said **Lewis Baach** partner **Jason Berland**. "We are seeing a continued focus on conflicts of interest and the variety of ways in which these conflicts arise. This settlement, based on Voya's alleged failure to inform clients about revenue and fee-sharing arrangements the firm had with its clearing broker, ensures that money will ultimately be heading back to investors. This is not the first case, nor will it be the last, in which the SEC charges an advisory firm for failing to eliminate or disclose a conflict."

"Probably the most fundamental conflict of interest for an adviser is when the adviser's financial interests are in opposition to the investors' financial interests," said **Shartsis Friese** partner **Jahan Raissi**. "There is nothing necessarily wrong with having a conflict of interest, but it is a very basic tenet of the Advisers Act that the conflict must be disclosed to investors. The Voya situation clearly illustrates that the SEC always has and always will view undisclosed conflicts as a serious violation by advisers."

The advisers and the practice

Voya Financial offers retirement, investment and insurance products and services to individual and institutional customers, including more than 100 mutual funds managed by Voya Advisers. Voya Investments and Directed Services, are collectively described as the "Voya Advisers" in the SEC's settlement order,

Voya Investments, which before May 2014 was known as ING Investments, had $51.8 billion in assets under management as of March 2017. Directed Services, a dually registered adviser / broker-dealer, had $38.4 billion in AUM as of March 2017, five months before it withdrew its registration as an advisory firm.

Over a stretch of more than 13 years – from August 2003 until March 2017 – the Voya Advisers "engaged in the practice of recalling, in advance of the dividend record date, portfolio securities of mutual funds they advised, including the funds, that were out on loan," the agency said.

Here's how the settlement order says it began: In order to generate additional income for its mutual funds, the

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Voya advisers instructed the funds' third-party lending agent to enter into securities-lending agreements with financial institutions such as broker-dealers and banks for the loan of portfolio securities held by their mutual funds.

During the time period when portfolio securities are out on loan, the borrower is the shareholder of record and, as such, entitled to the receipt of any dividends paid the securities. In this case, the insurance affiliates were the fund shareholders and, as such, could claim the tax reduction known as the "dividend received deduction" for any portion of the dividends the funds received. "The Voya advisers instructed their third-party lending agent to recall securities out on loan in advance of the dividend record date, which, in the case of the funds, enabled insurance affiliates to claim the . . . tax benefit for dividends received from the funds' portfolio services," the agency said.

The arrangement paid off for the affiliates, but had serious consequences for the funds.

"The recall practice benefitted the insurance affiliates who stood to receive the . . . tax benefit while the funds and their contract holders – who were not eligible to receive the dividend received deduction - lost securities income without any offsetting tax benefit," the SEC said. "As a result of the Voya Advisers' conduct, since June 2011 the insurance affiliates received a tax benefit of $2.64 million, while the funds lost $2.02 million in securities lending income."

Voya Advisers stopped recalling securities on loan in advance of the divided record date on March 6, 2017, according to the settlement order.

Disclosure questions

The real problem, as in many SEC enforcement actions, of course, is one of disclosure. The SEC "today charged two investment adviser subsidiaries . . . with *failing to disclose* [emphasis ACA Insight] conflicts of interest and *making misleading disclosures* [emphasis ACA Insight] in connection with their practice of recalling securities on loan so their affiliates could receive tax benefits," is how the agency put it in the first line of their press release on the settlement.

Those failures to disclose, according to the settlement order, were to both the funds' board of directors and investors.

The board, at various times since 2003, requested information from the Voya Advisers about conflicts of inter-

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est, as well as about fall-out benefits, which are benefits that accrue to the Voya Advisers or their affiliates because of the advisers' relationship with the mutual funds. "The Voya Advisers disclosed to the board that the dividend received deduction could be considered a fall-out benefit to affiliates of the Voya Advisers, but did not disclose that the funds and their contract holders were losing securities lending income," the SEC said. "As a result, the board was not aware of the conflict of interest related to the recall practice."

As for the investors, the funds' prospectuses, did say that a fund may lend its portfolio securities, that the loans earn income for the funds, and that the loans could be terminated or recalled at any time, according to the settlement order. However, "the Voya Advisers omitted to state in the prospectuses that they had a practice of recalling securities that provided a tax benefit to the insurance affiliates and deprived the funds and the contract holders of securities lending income," the agency said. "This omission rendered the other statements concerning securities lending materially misleading."

In sum, "Voya Advisers failed to recognize that the insurance affiliates were benefitting at the expense of the funds and their contract holders," the SEC said. "The Voya Advisers failed to take reasonable care in evaluating and disclosing all conflicts of interest arising from the recall practice."

Charges and penalties

As part of the settlement, the two Voya advisory firms were charged with having willfully violated Section 206(2) of the Advisers Act, which prohibits fraud, and Section 206(4) and its Rule 206(4)-8, which makes it unlawful for an adviser to a pooled investment vehicle to make an untrue statement of material fact or omit such a statement to any investor or prospective investor.

The firms were collectively ordered to pay disgorgement of $2.64 million and prejudgment interest of $512,000, which will go to the mutual funds involved, the agency said. In addition, they were censured and agreed to pay a civil money penalty of $500,000.

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