SEC Cracks Down on Pension Fund Advisers' Undisclosed Compensation and Conflicts

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In August 2020, the SEC issued two orders against VALIC Financial Advisors Inc. (VFA) related to VFA's management of 403(b) and 457(b) plans. These matters arise out of two of the SEC's enforcement initiatives, the Teachers and Military Service Members' Initiative and the Share Class Selection Disclosure Initiative. VFA is a registered investment adviser and broker-dealer with approximately $21.1 billion in assets under management and services defined contribution retirement plans for Florida public school teachers, among other plans. These two orders follow a sweep of letters sent by the SEC in fall of 2019 to several third-party administrators and affiliates, including broker-dealers and registered investment advisers that work with 403(b) and 457(b) plans. While these actions are the first to come out of the SEC's Teachers' Initiative, they are unlikely to be the last.

The Misconduct

The first order against VFA alleges that its parent company made undisclosed payments to a for-profit company owned by Florida K-12 teachers' unions. In exchange, the company (1) made VFA its preferred financial services partner for members, who were teachers and other school employees, (2) gave VFA increased opportunities to sell its investment products and services to the members over other advisers, and (3) allowed three full-time employees of VFA's parent, called Member Benefit Coordinators (who referred teachers to VFA), to be identified as the union-affiliated company's own employees.

The SEC found that VFA's failure to disclose this information to clients violated Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act), one of the Act's anti-fraud provisions. In addition, the SEC found that VFA's conduct violated Advisers Act Section 206(4) and Rules 206(4)-3 and 206(4)-7. Rule 206(4)-3, the "cash solicitation rule," prohibits a registered adviser from paying a third party (such as the teachers union) to solicit clients on its behalf without complying with provisions of the rule. The rule includes provisions requiring the adviser to enter into a contract with the solicitor requiring the solicitor to deliver to the person being solicited a current copy of the adviser's brochure and a statement by the solicitor that explains the source of its compensation. Rule 206(4)-7, the "compliance rule," requires that registered investment advisers have compliance policies and procedures that are reasonably designed to prevent violations of the Advisers Act.

The second order alleges that VFA directed third-party managers in a wrap fee program it sponsored to allocate client assets to higher cost "no-transaction fee" share classes, when in most cases lower-cost share classes were available. The "no-transaction fee" share classes paid VFA higher 12b-1 fees or revenue sharing and permitted VFA to avoid sales loads and other transaction fees it was obligated to pay under the wrap fee program. The SEC alleged that VFA had provided false or misleading disclosure to its clients about the fees the clients were charged and that VFA had failed to disclose the payments VFA received.

According to the SEC, this conduct breached VFA's fiduciary duty to the clients, including its obligation to seek best execution of client transactions, in violation of Section 206(2) of the Advisers Act. Additionally, the SEC found that VFA's conduct also constituted willful violations of Section 206(4) of the Advisers Act and Rule 206(4)-7. The SEC asserted that the misconduct yielded VFA over $13.2 million in financial benefits since January 1, 2014.

The Remedies

VFA agreed to pay a total of $40 million as part of the two settlements. Additionally, VFA consented to be censured and to cease-and desist any further violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-3 and 206(4)-7. The $4.5 million penalty imposed under the second order presumably reflects the failure to self-report as part of the Division of Enforcement's 2018 Share Class Selection Disclosure Initiative, which permitted advisers to avoid civil penalties by self-reporting. The order noted that VFA did not self-report its 12b-1 fee practices, although it was eligible to do so.

The first order has an additional, and more unusual, component worth noting. As part of the negotiated settlement, VFA agreed to an undertaking capping its management fees at 45 basis points for all Florida K-12 teachers who currently participate (and, in some cases, those who prospectively participate) in its advisory product in Florida's 403(b) and 457(b) retirement programs. The cap will remain in effect for the duration of the clients' enrollment in the programs.

The Takeaways

Be On Notice. As it has in recent enforcement initiatives, the SEC put market participants on notice that it would be looking closely at the administration of 403(b) and 457(b) plans whose beneficiaries are "main street investors," despite that they are administered, in many cases, by large government agencies. And like other initiatives, the announcement was followed by examinations and investigations. We expect that the SEC will use these settlements as templates for future settlements coming out of the Teachers' Initiative. These initiatives reflect SEC Chairman Jay Clayton's continued focus on retail investors, whose protection was listed again in OCIE's 2020 examination priorities.

Participants in these spaces should analyze potential risks and use these warnings as an opportunity to reflect on and closely examine their business practices. If shortcomings or misconduct are discovered, such early action will allow the investment adviser more time to consider options such as self-reporting or remedial actions in consultation with counsel.

Compliance Programs are Important. In both enforcement actions, the SEC alleged violation of Rule 206(4)-7 and, as is typical, did not explain the nature of the violation. One explanation is that the Commission assumes that if there is a violation of any provision of the Advisers Act or rules, *a fortiori*, there was also a violation of the compliance rule. In the cases involving VFA, however, it may be assumed that its chief compliance officer was not involved in the decision to direct third party managers to purchase no-transaction fee classes of shares (in the case of the second order) and to make what were essentially kick-back payments to the union-owned company (in the case of the first order). An effective compliance program led by a knowledgeable and involved chief compliance officer remain the best insurance policy for an investment adviser to avoid becoming a poster child in the SEC's next enforcement initiative.

Disclosure is Key. None of the business practices of VFA would have been unlawful if they had been fully and fairly disclosed to clients and prospective clients; the SEC does not suggest otherwise in either of its two settlements. Last year, the SEC issued an interpretive release that suggested that the full and fair disclosure of all material facts regarding a conflict of interest may not be sufficient to satisfy the adviser's fiduciary duty if the actions of the adviser were not in the best interest of the affected clients. The position, of course, begs the question of who is competent to determine what is in the best interest of the client if not the client who has consented to the conflict. To the knowledge of the authors of this blog posting, the SEC has never brought an enforcement action alleging violation of the Advisers Act anti-fraud provisions in such circumstances, and we suspect it never will. Unlike many other obligations imposed by the securities laws, full and fair disclosure is an inexpensive curative.

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