CARLTON FIELDS

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Recalls of Loaned Securities by Insurance Dedicated Funds

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In March, the SEC sanctioned the investment advisers of two funds supporting variable insurance contracts for inadequate disclosure about the funds' recalls of loaned portfolio securities in advance of the securities' dividend record dates.

The SEC reasoned that this practice resulted in a conflict of interest between the variable contract holders and the advisers, because (a) recalling the loaned securities permitted the insurance company issuers of the variable contracts, which were affiliates of the advisers, to benefit from the dividends-received tax deduction with respect to dividends paid on the securities, while (b) the funds and variable contracts supported by those funds lost the benefit of securities lending income during the period when the securities were recalled. The funds' prospectuses disclosed 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. The prospectuses, however, omitted any mention of the funds' practice of exercising their recall rights in a manner that provided tax benefits to the insurance companies and deprived the funds and the contract holders of securities lending income.

The SEC found this omission, and similar omissions in communications from the advisers to the funds' board, violated anti-fraud provisions in the Investment Advisers Act of 1940. As a result of the investment advisers' conduct, since June 2011, the insurance companies received a tax benefit of $2,635,490, while the funds lost $2,024,355 in securities lending income. Accordingly, the SEC required the advisers to disgorge the former amount plus interest and pay a $500,000 civil penalty.

Insurance dedicated funds that have not already done so should review their securities lending procedures and disclosures in light of this enforcement proceeding.