

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 5346 / September 16, 2019

ADMINISTRATIVE PROCEEDING
File No. 3-19455

In the Matter of

AST Investment Services, Inc.
and PGIM Investments LLC,

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTIONS 203(e) AND 203(k)
OF THE INVESTMENT ADVISERS ACT OF
1940, MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against AST Investment Services, Inc. (“ASTIS”) and PGIM, Investments LLC (“PI” and, together with ASTIS, “Respondents”).

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (“Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondents' Offer, the Commission finds¹ that:

Summary

1. These proceedings arise out of two different issues that financially harmed certain funds after they were reorganized in 2006 and converted from being taxed as regulated investment companies (RICs) to partnerships for federal income tax purposes so that Respondents' parent company and its affiliates could take advantage of certain tax benefits.

2. Respondents serve as investment advisers to 94 series funds (the "Funds") offered through the Advanced Series Trust ("AST") and The Prudential Series Fund ("PSF"), which are open-end series trusts that served as investment vehicles for participating insurance companies writing variable annuity and variable life insurance contracts. Shares in the Funds were offered as investment options to purchasers of those products.

3. First, from approximately July 2005 to November 2015, Respondents directed the Funds' securities lending agent to recall securities on loan from the Funds in advance of the securities' dividend record dates. The sole purpose of the recall directive was to increase the tax benefit to Respondents' parent Prudential Financial, Inc. ("Prudential") and to Prudential insurance affiliates from dividends received on securities held by the Funds, *i.e.*, the dividend received deduction ("DRD"). However, the recall practice resulted in the Funds not receiving securities lending revenue the Funds would have earned had the securities not been recalled. During this period, Prudential received more than \$229 million in tax benefits due to this recall practice while the Funds did not receive an estimated \$72 million in securities lending revenue and additional investment income they would have made on that revenue. Respondents failed to disclose the conflict of interest between Prudential and the Funds resulting from the recall practice to the Funds' boards of trustees, or to the variable annuity and variable life insurance contract holders who were the beneficial owners of the Funds' shares, rendering certain disclosures Respondents made concerning the securities lending program materially misleading. As a result, Respondents breached their fiduciary duties and failed to satisfy their disclosure obligations to the Funds, and investors and prospective investors in the Funds.

4. Second, from approximately January 2006 to March 2018, Respondents failed to reimburse the Funds as promised for higher taxes in certain foreign jurisdictions. In particular, because of the change in tax status of the Funds from RICs to partnerships for U.S. federal income tax purposes, the Funds received less favorable tax treatment in certain foreign jurisdictions. After the Respondents proposed the reorganization to the Funds' boards of trustees in 2005 and prior to effectiveness of the reorganization in 2006, Respondents represented to the boards that they would take steps so that Prudential would reimburse the Funds for these additional taxes or other adverse effects resulting from timing differences in the receipt of refunds from foreign tax authorities. By March 2018, however, Prudential owed the Funds more than \$58.6 million in past-due foreign tax reimbursements for the periods from January 2006 to March 2018 and the Funds did not receive approximately \$25 million in additional investment income they would have earned on that revenue had it been paid when due.

¹ The findings herein are made pursuant to Respondents' Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

5. Based on the foregoing conduct, Respondents violated Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder.

Respondents

6. **ASTIS**, a Connecticut corporation and Prudential affiliate with its principal place of business in Shelton, Connecticut, has been registered with the Commission as an investment adviser since 1992. As of December 31, 2018, ASTIS reported more than \$138 billion in regulatory assets under management.

7. **PI**, a New York limited liability corporation and Prudential affiliate with its principal place of business in Newark, New Jersey, has been registered with the Commission as an investment adviser since 1987. As of December 31, 2018, PI reported more than \$273 billion in regulatory assets under management. PI manages PSF and, together with ASTIS, co-manages AST.

Other Relevant Entities

8. **Prudential Financial Inc.**, a New Jersey corporation with its principal place of business in Newark, New Jersey, is a publicly-held company offering (through its subsidiaries) insurance, annuities, retirement, investment management, and other financial products. Prudential's common stock trades on the New York Stock Exchange under the symbol PRU.

9. **AST**, a Massachusetts business trust with its principal place of business in Shelton, Connecticut, has been registered with the Commission as an investment company since 2004. AST is an open-end series trust offering shares in variable life and annuity mutual funds (referred to in its prospectus as portfolios). It is governed by a board of trustees.

10. **PSF**, a Delaware statutory trust with its principal place of business in Newark, New Jersey, has been registered with the Commission as an investment company since 2003. PSF is an open-end series trust offering shares in variable life and annuity mutual funds (referred to in its prospectus as portfolios). It is governed by the same board of trustees as AST.

11. AST, PSF, and each of their 94 respective portfolios are open-end diversified management investment companies as defined by the Investment Company Act of 1940 ("ICA"). The Funds' shares are registered under the Securities Act of 1933. Through a manager-of-managers structure, Respondents select and manage one or more subadvisers for each of the portfolios.

Facts

A. Respondents' Securities Lending Practices

12. From approximately July 2005 to November 2015, the Funds served as investment vehicles for Prudential-affiliated and other participating insurance companies writing variable annuity and variable life insurance contracts. Among other things, the Funds made money by lending securities held in their portfolios to various third parties. Fund shares were held in the

name of the participating insurance companies, in separate accounts, for the benefit of variable annuity and variable life insurance contract holders. For federal tax law purposes, the participating insurance companies owned the shares in the separate accounts, included income from the separate accounts on their federal tax returns, and paid any corresponding taxes on that income. Consequently, certain tax benefits, including the DRD and foreign tax credits, accrued to the benefit of the participating insurance companies, not the individual contract holders.

13. In mid-2005, Prudential proposed to the Funds' boards of trustees that PSF be reorganized as a Delaware statutory trust, and that the federal tax status for PSF and AST be converted from RICs to partnerships. Prudential informed the boards that the purpose of the proposed reorganization was to increase the tax benefit Prudential and its insurance affiliates would receive from the DRD, by increasing the amount of dividend income eligible for the deduction.

14. In July 2005, the Funds' affiliated securities lending agent asked personnel from Respondents' fund administration group for guidance concerning which securities, if any, on loan from the Funds should be recalled ahead of their dividend record dates. The fund administration group escalated the question to Prudential's tax department, which directed fund administration to have the lending agent recall all securities on loan from the Funds in advance of their dividend record dates to preserve the character of the dividends for tax purposes.

15. This recall practice created a conflict of interest between Prudential and its insurance affiliates that stood to gain additional tax benefits, and the Funds that would, as a result, not receive securities lending revenue and additional investment income they would have received on that revenue.

16. Respondents failed to identify, or took inadequate steps to escalate, this conflict between their parent company and its affiliates and their clients (*i.e.*, the Funds). Shortly thereafter, an employee of the securities lending agent raised the conflict of interest directly with Prudential's tax department. The tax department, considering the question from a tax perspective only, repeated the recall directive. At no time prior to 2015, were compliance personnel at Respondents consulted on the recall practice.

17. In August and September 2005, personnel from various Prudential affiliates, including Respondents, participated in presentations to, and responded to questions from, the Funds' boards of trustees. They informed the Funds' boards that the reorganization would provide a more efficient tax structure, benefitting the Prudential enterprise through an increase in the receipt of dividends eligible for the DRD benefit, and in response to questions from the boards, noted that the reorganization would not increase fees or otherwise negatively impact the Funds' shareholders. Respondents failed to disclose to the Funds' boards that they would recall securities on loan, which would result in a reduction of lending revenue to the Funds. The Funds' boards were also informed that Prudential would bear all costs associated with the reorganization. The Funds' boards approved the reorganization, effective January 1, 2006.

18. From July 2005 to November 2015, materials furnished to the Funds' boards of trustees in support of the annual review and renewal of the advisory and subadvisory agreements for the Funds described the DRD as a benefit that accrued to Respondents and their affiliates as a

result of their relationship with the Funds, but did not disclose either the recall practice or the conflict of interest. Materials furnished to the Funds' boards for the annual review and renewal of the affiliated securities lending agency agreement likewise did not disclose the conflict of interest. Beginning in 2013, those materials noted the recall practice, but without sufficient context to identify the conflict of interest.

19. During this same period, disclosures made to investors and prospective investors in the Funds' Statement of Additional Information, prospectuses, and financial statements included general descriptions of the securities lending program, the fact that the securities lending agent was a Prudential affiliate that received compensation from the Funds for its services, and that the Funds may recall securities on loan for certain events such as a vote. However, these disclosures were materially misleading because they did not inform investors and prospective investors in the Funds of the practice of recalling securities in advance of the dividend record date resulting in the Funds' lost lending revenue and Prudential's financial interest in such recalls.

20. In 2014, Respondents' securities lending practices for the Funds were the subject of an examination by the Commission. During the examination, Respondents' personnel, including some who were aware of the recall practice, did not disclose or fully describe the recall practice in their responses to questions from the Commission examination staff regarding Respondents' securities lending practices.

21. In 2015, the securities lending agent employee mentioned the conflict to the Respondents' Chief Compliance Officer ("CCO"), advising him that, since 2005, Prudential had been recalling securities on loan from the Funds before the dividend record date to enhance certain tax benefits to Prudential and Prudential-affiliated insurance entities and that, as a result, the Funds were not receiving certain securities lending revenue. The CCO escalated the conflict to Prudential's most senior legal and compliance professionals, who initiated an internal investigation.

22. From approximately July 2005 to November 2015, Prudential received more than \$229 million in tax benefits due to the conflicted securities recall practice. During this same period, the Funds did not receive securities lending revenue and additional investment profits they would have made on that income, which in aggregate totaled approximately \$72 million.

23. In February 2016, Respondents and Prudential self-reported the issue to the Commission staff. In addition, in June 2016, after consultation with the Funds' boards, Prudential voluntarily paid approximately \$72 million to the Funds, reflecting securities lending revenue and additional investment profits they would have received but for the recall practice.

B. Respondents' Foreign Tax Reimbursement Failures

24. At meetings in December 2005 and February 2006 of the Funds' boards of trustees, and in a January 2006 memorandum to the boards concerning the proposed change in the federal tax status of the Funds resulting from their conversion from RICs to partnerships, Respondents and Prudential affiliates informed the boards that, in certain foreign jurisdictions, withholding tax rates for dividend and interest income may be higher as a result of the conversion and, to the extent such taxes were refundable from the foreign taxing authority, it could take partnerships longer than

RICs to receive a refund. Respondents advised the boards that since the reorganizations were being proposed for Prudential's benefit, Respondents would take steps so that Prudential would reimburse the Funds the amounts necessary to make them whole.

25. In particular, Prudential proposed to reimburse the Funds in two situations. First, Respondents told the boards that whenever the Funds were subject to a higher foreign tax rate by virtue of being partnerships instead of RICs, Respondents would have Prudential reimburse the Funds the difference by month-end. Second, when such higher foreign taxes were refundable, but partnerships were subject to delays in receiving refunds (as compared to RICs), Respondents would cause Prudential to reimburse the Funds the refundable amount within two business days of the date a RIC would have received the refund. If and when the refund was ultimately received by a Fund, the Fund would then pay such amount to Prudential.

26. Contrary to their assurances to the Funds' boards, Respondents failed to have Prudential reimburse the Funds in a timely manner. Instead, over time, the Funds recorded the amounts Prudential owed them for the foreign tax reclaims on their books and records as receivables. Receivables are reflected as Fund assets on the Funds' books and records, and are fixed obligations that are owed to the Funds. These receivable balances grew over time. Because a receivable cannot be invested in other securities, the Funds did not have the opportunity to earn investment income on the amounts carried as receivables.

27. Respondents' written policies and procedures regarding the reimbursements and payments from Prudential, adopted in 2006, were not reasonably designed or implemented as required and, as a result, Prudential did not make the promised payments as set forth in the procedures and within the time frames contained in the procedures.

28. In February 2018, Prudential determined that the Funds had accumulated unfunded foreign withholding tax receivables in the amount of \$42.3 million. In March 2018, during the course of the Commission's investigation into the conduct discussed in Paragraphs 12 to 23 above, Prudential advised the Funds' boards about the issue, self-reported the issue to Commission staff and paid \$42.3 million in receivables to the Funds. Prudential thereafter calculated the lost investment returns on the outstanding receivables to be \$11.5 million, and after consultation with the Funds' boards, paid that amount to the Funds in June 2018.

29. In subsequent months, Prudential identified an additional \$16.3 million in receivables that should have been recorded in the Funds' books and records and reimbursed to the Funds pursuant to the assurances made to the Funds' boards. Prudential calculated the lost investment opportunity on this additional amount to be approximately \$13.4 million. Prudential paid the entire \$29.7 million to the Funds. Prudential also made an additional payment of \$152,350 in unmatched reclaims to the Funds.²

30. In total, Prudential paid the Funds more than \$58.6 million in past-due foreign tax reimbursements and approximately \$25 million in additional investment income they would have

² Unmatched reclaims are a relatively small number of reclaims that cannot be matched to specific underlying foreign tax withholding transactions.

earned had the reimbursements been made when due.

Violations

31. As a result of the conduct described above, Respondents willfully³ violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from, directly or indirectly, engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. A violation of Section 206(2) may rest on a finding of simple negligence; scienter is not required. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992); *SEC v. Yorkville Advisors, LLC*, 12 Civ. 7728, 2013 WL 3989054, at *3 (S.D.N.Y. Aug. 2, 2013).

32. As a result of the conduct described above, Respondents willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for any investment adviser to a pooled investment vehicle to “[m]ake any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle.” *Steadman*, 967 F.2d at 647. Proof of scienter is not required to establish a violation of Section 206(4) of the Advisers Act. *Id.*

33. As a result of the conduct described above, Respondents willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require, among other things, that a registered investment adviser adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rule promulgated thereunder by the adviser and its supervised persons.

Respondents’ Cooperation and Remedial Measures

In determining whether a penalty is appropriate and, if so, the amount, the Commission considered Respondents’ self-reporting, cooperation, and prompt remediation. After the conflict of interest related to their securities lending practices was identified to Respondents’ CCO, Prudential and Respondents conducted an internal investigation and self-reported the facts to Commission staff. Respondents also self-reported the foreign tax withholding issue shortly after it was discovered and conducted a separate internal investigation. After each self-report, Respondents provided cooperation to the Staff by, among other things, proactively identifying key documents, witnesses and facts, which assisted the Commission staff in efficiently

³ “Willfully,” for purposes of imposing relief under Section 203(e) of the Advisers Act, “means no more than that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). The decision in *The Robare Group, Ltd. v. SEC*, which construed the term “willfully” for purposes of a differently structured statutory provision, does not alter that standard. 922 F.3d 468, 478-79 (D.C. Cir. 2019) (setting forth the showing required to establish that a person has “willfully omit[ed]” material information from a required disclosure in violation of Section 207 of the Advisers Act).

investigating the conduct. Further, Prudential remediated the harm to the Funds for the entire period of time the recall practice was in place and for the entire period of time Respondents' failed to have Prudential reimburse the Funds as promised for differences in foreign taxation based on the Funds' tax status. Nevertheless, the Commission finds some penalty is appropriate here because, among other things, (1) the misconduct related to the recall practice continued and harmed the Funds despite the issue being raised on several occasions, and (2) Respondents' credit for cooperation during the investigation must be viewed in the context of their failure to either disclose or fully describe the recall practice in the course of the Commission examination as set forth in Paragraph 20, above.

V.

In view of the foregoing, the Commission deems it appropriate, and in the public interest to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act it is hereby ORDERED that:

A. Respondents cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder.

B. Respondents are censured.

C. Respondents shall, within 14 days of the entry of this Order, pay, jointly and severally, disgorgement of \$27,632,560.00, and a civil money penalty in the amount of \$5 million, to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Section 21F(g)(3) of the Securities Exchange Act of 1934. If timely payment of disgorgement is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and if timely payment of a civil money penalty is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717.

D. Payment must be made in one of the following ways:

- (1) Respondent(s) may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent(s) may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent(s) may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch

HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying PGIM Investments LLC and/or AST Investment Services, Inc. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to C. Dabney O’Riordan, Co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 444 South Flower Street, Suite 900, Los Angeles, CA 90071, or such other person or address as the Commission staff may provide.

E. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents’ payment of a civil penalty in this action (“Penalty Offset”). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission’s counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a “Related Investor Action” means a private damages action brought against Respondent(s) by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Vanessa A. Countryman
Secretary