

**FINANCIAL INDUSTRY REGULATORY AUTHORITY  
LETTER OF ACCEPTANCE, WAIVER AND CONSENT  
NO. 2014042360001**

TO: Department of Enforcement  
Financial Industry Regulatory Authority ("FINRA")

RE: VALIC Financial Advisors, Inc., Respondent  
Member Firm  
CRD No. 42803

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent VALIC Financial Advisors, Inc. ("VFA," "Respondent" or "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described herein.

**I.**

**ACCEPTANCE AND CONSENT**

- A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

**BACKGROUND**

VFA has been a FINRA member firm since June 1997. VFA currently has approximately 1,700 registered individuals, which includes 1,350 registered sales representatives and 350 home office support personnel, and 182 branch offices. VFA is headquartered in Houston, Texas, and engages in several types of business, including acting as a retailer of mutual fund shares, variable life insurance, annuities, and corporate debt securities; acting as a municipal securities broker; and providing investment advisory services. VFA is a subsidiary of The Variable Annuity Life Insurance Company ("VALIC").

**RELEVANT DISCIPLINARY HISTORY**

VFA has no prior relevant disciplinary history.

## OVERVIEW

VFA's business platform consists of two primary divisions: (1) group employer sponsored retirement plan accounts which are invested in variable annuities ("VAs") issued by VALIC ("Retirement Plan(s)") or in mutual fund retirement plans; and (2) retail financial services. When employees separate from their employer and are no longer eligible to contribute to their Retirement Plan accounts, they may elect to move their Retirement Plan account assets into individual retirement accounts (IRA) or other investment vehicles thereby becoming retail brokerage customers of VFA. In 2014, individuals surrendered VAs issued by VALIC totaling approximately \$5.8 billion, 11% of this amount was rolled into VFA retail accounts.

From October 2011 through October 2014, however, VFA's supervisory system failed to identify and reasonably address certain conflicts of interest in VFA's compensation policy where customers elected to move assets out of their Retirement Plan and other VALIC VAs. Specifically, the Firm's compensation policy provided for limited or no compensation for certain investments where the proceeds were transferred from a VALIC VA. However, the Firm's compensation policy did provide for the payment of compensation if those proceeds were rolled into the Firm's Managed Investment Program ("MIP"), a fee-based investment advisory services program, or the Power Index Plus ("PIP"), a fixed index annuity. During this time period, there was growth in new business being directed to the MIP and PIP.

Despite the fact that in 2013 and 2014 alone, VFA sold more than \$3.8 billion in VAs, the Firm, from October 2011 through December 2014, also failed to establish, maintain and enforce a system to adequately supervise certain aspects of the sale of individual VA contracts. More specifically, the Firm's supervision of the purchase and exchange of VAs was inadequate in that: (1) VFA's systems did not provide principals reviewing and approving VA transactions sufficient information to consider all of customers' existing assets and holdings prior to approving VA transactions; (2) the Firm failed to enforce its existing procedures relating to the review of required customer information on the Firm's Annuity Transaction Disclosure Form ("ATDF"); (3) the Firm established a "Pay at 0" policy that allowed principals to approve and finalize VA transactions before obtaining all documentation for the principal's review; and (4) the Firm failed to enforce its written supervisory procedures ("WSPs") requiring heightened review, with documentation, of VA transactions that exceeded certain concentration levels.

Furthermore, from January 2013 through December 2014, VFA failed to have WSPs or supervisory systems in place providing registered representatives and supervisory personnel with guidance relating to the suitability of VAs with multiple share classes, particularly L-share contracts which have a shorter surrender period as compared to B-share contracts. During this same time period, the Firm failed to provide its registered representatives and principals with adequate training and guidance on the sale of VAs with multiple share classes.

In addition, from January 2009 through August 2014, the Firm failed to enforce its WSPs requiring review of emails flagged through the Firm's email surveillance system. Also, from October 2011 through December 2014, the Firm failed to establish, maintain and enforce a reasonable supervisory process to ensure that the Firm accurately and timely reported customer complaints in FINRA's 4530 Complaint Reporting System and on its registered representatives'

Uniform Application for Securities Industry Registration or Transfer (“Forms U4”) and Uniform Termination Notice for Securities Industry Registration (“Forms U5”). Finally, from January 2000 through November 2015, the Firm failed to send almost 25,000 account notices required pursuant to Rule 17a-3(a)(17) of the Securities Exchange Act of 1934, as amended.

## **FACTS AND VIOLATIVE CONDUCT**

### **VFA's Failure to Address Conflicts of Interest in its Compensation Policy**

From at least October 2011 through April 2014, VFA’s compensation policy prohibited registered representatives from receiving compensation if they recommended that clients move funds to non-VALIC VAs, mutual funds or other non-VALIC products from Retirement Plans and other VALIC VAs. In certain instances, customers had the option of remaining invested in their current Retirement Plan accounts; however, Retirement Plan accounts generally provided limited compensation to VFA’s registered representatives once customers had separated from their employers and were no longer eligible to contribute to their Retirement Plan accounts. As a result, VFA’s compensation policy created a conflict of interest between registered representatives and customers by giving representatives financial incentive to recommend that certain customers move funds from their Retirement Plan to the Firm’s fee-based account platform, MIP, where customers pay annual fees, or to the PIP fixed index annuity.

MIP accounts, which are fee-based, subjecting customers to annual fees, allow customers to access investment advisory services and other investments. If registered representatives, who are also investment adviser representatives (IARs), moved customers into an MIP account, the registered representatives would receive a portion of VFA’s annual fees on the assets under management (“AUM”). VFA’s Form ADV stated that the Firm’s annual advisory fees on MIP ranged from 0.75 to 3% of the AUM. For 2013 and 2014, VFA’s MIP customers paid the Firm a median advisory fee of 0.99%. IARs received approximately 0.51% of the MIP AUM. The result of VFA’s compensation policy was that registered representatives had a financial incentive to recommend the MIP platform instead of advising the client to purchase other potentially suitable non-VALIC products, or continuing to service customers who had separated from their employer and were no longer eligible to contribute to their Retirement Plan account.

In October 2013, VFA added the PIP to the list of available products. In April 2014, VFA amended its commission schedule to pay commissions to representatives on transfers out of a Retirement Plan to PIP. At that time, the Firm also began requiring its customers to sign a “VFA Compensation Disclosure Form” when the client was purchasing either a PIP fixed index annuity or enrolling in an MIP account, which disclosure stated, in part:

VFA offers a wide range of products and services, some of which are provided by VALIC and its affiliated companies (proprietary products), while others are from companies that are not affiliated with VALIC (non-proprietary products). Your VFA financial advisor is paid in connection with the sale of products and services, receiving sales commissions for some products and ongoing fees for other products or services, such as investment advisory services. Thus, your financial advisor’s compensation will vary based on the products and services provided to you. Accordingly, your VFA financial advisor may have a financial incentive to

recommend certain products or services because of the commissions and other payments he/she may receive when you rollover or transfer funds from a VALIC product to a non-VALIC product. In this regard, your financial advisor will generally be paid more favorable compensation if your funds rollover or are transferred from a VALIC annuity product to the Managed Investment Program (MIP) advisory product and/or proprietary products issued by VALIC and its affiliates.

During the time period at issue, VFA saw growth in the MIP and PIP. From January 2012 through December 2013, approximately 64% (\$283 million) of assets from individual surrenders of VALIC VAs were transferred to the MIP. Prior to the compensation change in April 2014, VFA sold 292 PIP fixed index annuities for approximately \$32 million during the six-month period in which PIP was available for sale. From April 2014 through December 2014, VFA sold 2,101 PIP fixed index annuities for approximately \$299 million. During this seven month-period, new PIP sales as well as new money moved into PIP fixed index annuities grew by 610% and 834%, respectively, compared to the six months prior to the change.

From at least October 2011 through October 2014, the Firm, however, did not have a reasonable system or procedures designed to address, analyze or review the conflict of interest in its compensation program. In addition, the Firm failed to provide any training for supervisory personnel or registered representatives to ensure that the conflict did not compromise the basis of a recommendation to move assets in a Retirement Plan to a PIP. Furthermore, there was no process or system in place to ensure that balanced disclosures (or any disclosures prior to April 2014) regarding this information was provided to the investors.

Based on the foregoing, VFA violated NASD Rule 3010(a) and (b) and FINRA Rule 2010.

#### *VFA's Systemic Failures in the Supervision of Variable Annuities*

From October 2011 through December 2014, VFA failed to maintain adequate systems and procedures to supervise the sale of VAs to its retail brokerage customers in multiple respects. Prior to April 2014, VFA's systems did not provide principals reviewing and approving VA transactions sufficient information to consider all of customers' existing assets and holdings prior to approving VA transactions. Although VFA provided supervisors with a Customer Account Form showing a customer's total assets in various types of accounts, the form did not provide information about surrender schedules, fees or details about the other products held by the clients. Beginning in April 2014, principals began using a tool that provided comparative data regarding features of each customer's current annuity product.

During the October 2011 through December 2014 period, the Firm failed to enforce its existing procedures relating to the review of required customer information on the Firm's ATDF. In certain instances, registered representatives submitted the ATDF without all information necessary for suitability review, including riders, fees, and remaining CDSCs on existing VA contracts. The Firm did not take adequate steps to ensure that the information on the ATDF was complete and accurate.

During the October 2011 through December 2014 period, the Firm also failed to enforce its WSPs requiring that complete information be submitted to the VFA principals prior to the principal approving a VA transaction. Specifically, the Firm had a "Pay at 0" policy that was inconsistent with its WSP requirements. In at least one instance, the Firm allowed a principal to withhold a commission on a VA transaction from a registered representative, but processed the transaction before obtaining all documentation and completing the suitability review.

Finally, although the Firm's WSPs required heightened review of VA transactions where the VA to customer net worth ratio exceeded 35% and required specific documentation of the rationale for approval of such concentration, the Firm failed to reasonably enforce this procedure. For example, the Firm approved the following VA transactions without sufficient documentation of heightened review related to net worth: (1) customer AB invested \$128,157 in a VA transaction which was 78% of her stated net worth of \$165,000; and (2) customer CD invested \$500,000 in a VA transaction which was 70% of his stated net worth of \$710,000.

Based on the foregoing, VFA violated NASD Rule 3010(a) and (b) (for conduct before December 1, 2014) and FINRA Rules 2330(c) and (d), 3110(a) and (b) (for conduct on and after December 1, 2014) and 2010.

*Failure to Establish Written Supervisory Procedures Relating to the Sale of Multi-Share Class VAs*

VFA sells VA contracts with the option of various different shares classes. The B-share contract is the most common and typically has a seven-year surrender period. L-share contracts are designed for investors with short-term time horizons. The L-share contract provides the flexibility of a shorter surrender period of three to four years, and the fees associated with L-share contracts, which are assessed for the life of the contract, are typically between 35 and 50 basis points higher annually than most B-share contracts. If a purchaser fails to surrender an L-share contract during the surrender period, the purchaser will continue to pay a higher annual fee for the life of the contract, unless the contract provides for a "persistence credit."<sup>1</sup>

From January 2013 through December 2014, VFA sold individual VAs totaling more than \$3.8 billion in principal investments. Of those VA sales, more than 11%, totaling more than \$466 million in investments, were L-share contracts. More significantly, these L-share contracts were more than 70% of the non-VALIC VAs sold by VFA during this time period. The Firm, however, did not establish, maintain and enforce a reasonable supervisory system and WSPs related to the sale of multi-share class VAs. VFA also failed to provide training to its registered representatives and principals on the sale and supervision of multi-share class VAs.

<sup>1</sup> Some L-share contracts have a specific provision, commonly called a "persistence credit", which reduces the annual fees so it is comparable to a B-share contract after the product is held for a certain period of time, generally seven to ten years

VFA's WSPs and training materials failed to provide registered representatives and principals guidance or suitability considerations for sales of different VA share classes. More specifically, the Firm did not provide training or guidance to its registered representatives on the features of various available share classes, the associated fees and surrender charges, and did not provide them with adequate information to compare share classes in order to make suitability determinations. Because of this lack of training and guidance, registered representatives were not provided the tools to present potential purchasers with a side-by-side comparison of the fees and surrender charges or other information detailing the potential impact of the increased fee if the L-share contract was held by the customer for a long term.

In addition, the Firm failed to establish, maintain, and enforce WSPs or provide sufficient guidance or training to its registered representatives and principals on the sale of long-term income riders, such as long-term income riders with L-share contracts.

Based on the foregoing, VFA violated NASD Rule 3010(a) and (b) (for conduct before December 1, 2014) and FINRA Rules 2330(d) and (e), 3110(a) and (b) (for conduct on and after December 1, 2014) and 2010.

#### *VFA Failed to Enforce its WSPs Relating to the Review of Emails*

From January 2009 through August 2014, VFA's WSPs provided that all emails flagged by the Firm's email surveillance system were to be reviewed by designated Firm supervisors. In practice, however, despite the requirements of the VFA WSPs, many VFA supervisors believed they only needed to review a sample or a percentage of the emails flagged for review. As a result, some VFA regional supervisors reviewed a small percentage of the flagged emails. In a few situations, VFA regional supervisors failed to review any flagged emails in certain months. In total, approximately 12% or approximately 700,000, emails flagged by the surveillance system and assigned to supervisors were not reviewed. In addition, the Firm failed to follow up on reports that indicated supervisors were failing to review these flagged emails. Upon discovering this issue in September 2014, VFA promptly reported it to FINRA and subsequently reviewed each flagged email.

Based on the foregoing, VFA violated NASD Rule 3010(a) and (b) and FINRA Rule 2010.

#### *Supervisory Failures Related to Customer Complaint Reporting*

From October 2011 through December 2014, VFA failed to establish a reasonable system and procedures to supervise the Firm's complaint reporting responsibilities. The Firm personnel responsible for reporting and supervising complaint disclosures to FINRA lacked adequate training.

As a result of the Firm's supervisory failures, VFA experienced a significant failure in accurately reporting customer complaints to FINRA during the October 2011 through December 2014 period. Of the 945 complaints reported by the Firm, 347 were inaccurately filed as they were complaints against entities other than VFA. Of the remaining 598, more than 225 were either untimely reported or contained inaccuracies such as the problem code, dollar amount, or branch

office. Upon the re-review of the 945 complaints, VFA was required to disclose an additional 24 complaints on registered representatives' Forms U4 or Forms U5 based on the allegations and damage amounts in the complaints.

Based on the foregoing, VFA acted in contravention of FINRA By-Laws Article V, Section 2 and 3, and violated FINRA Rules 4530, 1122 and 2010.

*Failure to Send Required Customer Notices*

In November 2015, the Firm determined and reported to FINRA that it had failed to send to certain customers a notice confirming customer account opening information within 30 days of opening the account and then at least every 36 months thereafter, known as 17a-3 notices. VFA conducted an internal review and found that from January 1999 through November 2015, it failed to issue 17a-3 account notices for approximately 25,000 retail customer accounts. Specifically, the Firm failed to issue the required 30-day post-account opening 17a-3 notices for approximately 22,500 shell accounts for former Retirement Plan and mutual fund retirement plan participants whose accounts were automatically terminated because the account value was less than \$5,000. In addition to the shell accounts, VFA failed to send approximately 2,500 17a-3 notices for new retail accounts that VFA improperly coded upon opening.

Based on the foregoing, VFA violated Section 17(a) of the Exchange Act and Rule 17a-3(a)(17)(i)(B)(1), NASD Rules 3110 (for conduct before December 5, 2011) and 2110 (for conduct before December 15, 2008) and FINRA Rules 4511 (for conduct on and after December 5, 2011) and 2010 (for conduct on and after December 15, 2008).

B. Respondent also consents to the imposition of the following sanctions:

Censure and a \$1,750,000 fine.

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

**II.**

**WAIVER OF PROCEDURAL RIGHTS**

Respondent specifically and voluntarily waives the following rights granted under FINRA's

**Code of Procedure:**

- A. To have a Complaint issued specifying the allegations against it;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council (“NAC”) and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudice of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person’s or body’s participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person’s or body’s participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

**III.**

**OTHER MATTERS**

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs (“ODA”), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against it; and
- C. If accepted:
  - 1. this AWC will become part of Respondent’s permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;



2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
  3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
  4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.


The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Respondent has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

Date

10/27/2016

VALIC Financial Advisors, Inc., Respondent

By:



Name: Shawn Duffy

Title: President and Chief Executive Officer

Reviewed by:

Brian L Rubin

Counsel for Respondent  
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Accepted by FINRA:

11/28/2016  
Date

Signed on behalf of the  
Director of ODA, by delegated authority

Steve Graham

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