September 24, 2018

SEC Sues Asset Managers for Using Untested, Error Filled Quantitative Investment Models

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On August 27, the Securities and Exchange Commission (SEC) brought actions against four affiliated entities—including two registered investment advisers, one dually registered investment adviser and broker-dealer and a registered broker-dealer and two of their senior executives—alleging negligence in connection with their use of faulty quantitative models to manage client accounts. More than $98 million in total monetary penalties were imposed. The cases are significant for advisers who use models to manage client accounts, as well as signal the SEC's continued focus on retail investors.

The SEC order states that "an inexperienced quantitative research analyst" who had no portfolio management experience or formal training with developing quantitative investment models developed the models. The advisers and related broker-dealers then offered products, including mutual funds, variable life insurance and variable annuity investment products, and separately managed accounts, managed by the models. These firms marketed the investment products "as 'managed using a proprietary quant model,' and highlighted, when marketing certain of the products and strategies, their 'emotionless,' 'model-driven,' or 'model-supported' investment management process and described how the models were supposed to operate." According to the SEC, "[t]hese claims necessarily implied that the models worked as intended."

SEC's Findings

The SEC complained that the representations regarding the models were misleading because the advisers and broker-dealers "launched the products and strategies without first confirming that the models worked as intended and/or without disclosing any recognized risks associated with using the models." This last statement implies that the SEC expects an adviser to disclose the risks associated with the use of any models to manage a portfolio, no matter how carefully the models are tested and monitored. Later, the advisers discovered that the models were not working as intended and stopped using the models. The SEC alleged that the advisers should have disclosed the models' errors and the decision to stop using them to the boards of the funds managed using the models and to affected fund shareholders and advisory clients.

The SEC also criticized the advisers for failing to disclose the role of the research analyst in developing the models. Instead, the SEC alleged that the advisers identified a senior officer as the "portfolio manager" of the products, when in fact the analyst's models managed the products.

Additionally the SEC alleged that the advisers "disclosed the use of the Volatility Overlays [which were models designed to limit portfolio exposure in times of greater volatility] in the Index Portfolios' May 1, 2011 prospectuses, but it did not disclose associated risks or explain that the Volatility Overlays were controls that would dictate the portfolios' asset allocations in certain markets, instead referring to them as 'guidelines.'" When errors discovered in the Volatility Overlays were corrected, neither investors nor the fund board was notified of the errors.

Furthermore, the SEC alleged that the advisers failed to provide required notices to shareholders of one of the mutual funds using the models that a portion of the dividend payments received from the fund included an estimated return of capital. Relatedly, in filings with the SEC, it was stated that the primary objective of the fund was high current income with a goal of relatively consistent monthly dividend in the range of 4 percent to 7 percent. However, according to the SEC, the advisers did not determine if the fund's holdings could support such a dividend.

Finally, the SEC alleged that the advisers were negligent in marketing certain products managed by another manager, F-Squared, which had previously been accused of fraudulent performance advertising. "Having taken insufficient steps to confirm the accuracy of F-Squared's performance data and not having obtained sufficient documentation that would have substantiated F-Squared's advertised performance and performance-related claims in the F-Squared advertising materials distributed by [one of the advisers], [the adviser] failed to have a reasonable basis to believe that F-Squared's performance was accurate when it distributed advertisements to clients considering F-Squared's strategies."

Conclusion

According to the SEC, the two senior executives were charged because they caused certain advisers' violations and because they caused each of the advisers to fail "to adopt and implement certain compliance policies and procedures, including failing to take reasonable steps to ensure that: (1) its quantitative models worked as intended both before the Products launched and on a periodic basis after they launched; (2) it adopted and implemented reasonable controls regarding the testing, approval, and documentation of any changes to its quantitative models; and (3) the Products' portfolio managers' discretion to depart from model-directed trades was defined, monitored, and documented."

Key Takeaways

The SEC actions signify the following:

1. Representations that a model is in use to manage a portfolio imply that the model has been tested and validated.
2. Advisers must test a model before it is first used and periodically thereafter.
3. When a model is used to manage a portfolio, if individuals are being identified to investors as responsible for the management of the portfolio, then it is important to identify the model as the portfolio manager, and not just identify a senior executive with overall supervisory responsibility.
4. When errors are detected in a model, these should be disclosed to investors and fund boards, not merely corrected.
5. Use of a model should not be identified as "guidelines" if the model is actually managing the portfolio.
6. When another adviser is recommended to clients, the adviser must take reasonable steps to verify the other adviser's performance claims.

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