

MEMO# 30456

December 6, 2016

SEC Sanctions an Adviser for Misleading Investors About ETF Performance

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TO: ICI Members
Investment Company Directors
Accounting Policy Subcommittee
Accounting/Treasurers Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
Independent Directors Council SUBJECTS: Exchange-Traded Funds (ETFs)
Valuation RE: SEC Sanctions an Adviser for Misleading Investors About ETF Performance

The Securities and Exchange Commission has sanctioned an investment adviser for violating the Investment Company Act of 1940 and the Investment Advisers Act of 1940 by misleading investors about the performance of one of its first actively managed exchange-traded funds (ETFs) and failing to accurately value certain fund securities between its launch date, February 29, 2012, to June 30, 2012 (the “Relevant Period”).[\[1\]](#) Based upon the adviser’s violations, the adviser was ordered to cease and desist from further violations of law, censured, and fined nearly \$20 million. The adviser also agreed to complete various undertakings, including retaining an independent compliance consultant. A brief summary of the case is described below.

Background

According to the SEC’s order, to help increase the ETF’s initial performance, the adviser used a strategy that involved purchasing odd lot positions of non-agency mortgage-backed securities that traded at discounts to institutional round lot positions and then marking those odd lot positions at the round lot evaluated price provided by a third-party pricing vendor. The vendor considered an institutional round lot size for bonds as having at least \$1 million current face value. As part of this “odd lot” strategy, the adviser purchased approximately 156 odd lot positions. At the end of each trading day, the ETF received a performance increase reflected by the difference between the purchase price for the odd lot position and the higher vendor mark used to value the position in the ETF. For 43 of these odd lot positions, the SEC’s order found that the adviser valued these positions at the vendor’s mark despite not having a reasonable basis to believe that the vendor’s mark accurately reflected the exit price the ETF would receive for the odd lot positions.

Moreover, the SEC’s order found that the adviser’s pricing policies and procedures were not reasonably designed to consider these issues or odd lot pricing in general. The adviser’s pricing policies also did not provide the adviser’s traders—who were responsible for determining when to report to the adviser’s pricing committee any price that did not reasonably reflect market value—any guidance regarding when to raise or elevate significant pricing issues, such as odd lot pricing. The SEC’s order also found that despite indications that the adviser knew it was inaccurately pricing the ETF’s bonds, the odd lot pricing issue was never discussed at any management pricing committee or board valuation committee during the Relevant Period.

The SEC’s order also found that the adviser negligently made misleading disclosures to investors about the ETF’s initial performance. Specifically, despite knowing that the ETF’s initial performance was largely attributable to the adviser’s use of the “odd lot” strategy, which was not sustainable as the fund grew in size, the adviser in monthly and annual reports to investors provided other, misleading reasons for the ETF’s early success. Finally, the SEC’s order contends that the adviser failed to disclose the existence and impact of the “odd lot” strategy to the ETF’s board of trustees.

Violations

As a result of the conduct described above, the SEC found that the adviser violated Sections 206(2) and 206(4) of the Advisers Act, Rules 206(4)-7 and 206(4)-8 under the Advisers Act, and Section 34(b) of the Investment Company Act, and Rule 22c-1 under the Investment Company Act.

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endnotes

[1] See In the Matter of Pacific Investment Management Company, LLC, SEC Release No. IA-4577 and IC-32376 (December 1, 2016) (the “order”), which is available at <https://www.sec.gov/litigation/admin/2016/ia-4577.pdf>.

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