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# SEC Sanctions Mutual Fund Advisers for Using Faulty Quant Models and Failing to Let Investors Know

[31363]

August 30, 2018 TO: Chief Compliance Officer Committee
SEC Rules Committee RE: SEC Sanctions Mutual Fund Advisers for Using Faulty Quant Models and Failing to Let Investors Know

The SEC has settled an enforcement action with four affiliated firms – two investment advisers, a broker-dealer, and a dually-registered adviser and broker-dealer – in a case involving defective quant models.[1] Based on the Respondents' violation of the Investment Advisers Act of 1940 (Advisers Act), the Securities Act of 1933 ('33 Act), the Investment Company Act of 1940 ('40 Act), and rules thereunder, they were censured and ordered to pay disgorgement, prejudgment interest, and civil monetary penalties totaling $97,602,040.[2] The facts of this case as set forth in the Order are briefly described below.

## The SEC's Findings

According to the Order, in 2010, one of the Respondents tasked an analyst who had recently earned his MBA but who had no experience in portfolio management or any formal training in financial modeling with developing quantitative models for use in managing investment strategies. The models would be used to make investment allocations and trading decisions. Notwithstanding the fact that the analyst did not follow any formal process to confirm the accuracy of his work and that the firm failed to provide him meaningful guidance, training, or oversight when he developed the models – including confirming that they worked as intended – the firm used the models to manage various of its products and strategies. In 2011, an internal audit found that the firm did not have formal controls or policies and procedures governing its quantitative model development, including ensuring that its models function as expected. The audit also noted that the firm did not periodically perform independent validation of the modeling results and, therefore, "transparency to modeling errors is potentially impaired and at worst may be concealed." In response to these findings, the firm's senior managers estimated that the problems could be resolved by March 2012, and the firm began taking steps to adopt and implement a formal validation process. In the meantime, however, it continued to use the unvalidated models.

In addition to continuing to use the unvalidated models, the firm decided to launch another

product with an unvalidated model, notwithstanding concerns raised by an employee in 2011 with the firm launching a product based on a model prior to the model's validation. Within three days' launch of this new product, the firm discovered "several glaring errors" with it – "such as the fact that the allocation weights did not add up to 100% as they should have." While these errors were corrected, formal validation of the model did not begin until 2013. According to the Order, the firm did not create, adopt, or implement a written model validation policy until July 2013. Interestingly, while the firm's parent had a policy requiring its subsidiaries to test models before using them to manage assets, the firm failed to do so.

Following deployment of the models, the various Respondents used marketing materials that discussed the models, including the benefits of managing assets through them. According to the Order, these statements were made without a reasonable basis and the Respondents failed to disclose recognized risks associated with using the quantitative models, "which rendered the statements misleading." While the marketing materials emphasized the use of models, the prospectuses did not reference the models or disclose any of the risks associated with them until March 2014, after the discovery of significant errors in the models.

During the time that the models remained unvalidated, the firm continued to launch new products that were reliant on models. Also, the analyst who had developed the models stated in a public podcast that the firm constantly looked at and tested the models and annually tested the model indicators to see if the level of accuracy they were getting in the predictions held true.

By the summer of 2013, the firm had determined that the allocation models it used to manage funds and portfolios contained material errors, including numerous errors in logic, methodology, and basic math, which rendered them not fit. When the firm stopped using a model to manage a fund in September 2013, it neglected to disclose this decision or the discovery of errors to the fund's board, shareholders, clients, and others. When some of the Respondents discovered that use of the models had been discontinued due to model errors, this information was not disclosed to investors. Nor was the information disclosed to fund boards when they were gathering information in the spring of 2014 as part of the 15(c) process. The firm did, however, revise the products' prospectuses to state, for the first time, that they "may" use a "proprietary quantitative model" and they also discontinued using certain marketing materials because they "did not accurately reflect the current process being used to manage these funds." Other disclosure was revised to indicate that, rather than using a quantitative econometric model, the funds instead used "a combination of qualitative and quantitative factors." One of the firms distributing the products that relied on the models did not learn until August 2014 of the problems with the models and that, as a result, the models were no longer being used.

In March 2015, one of the Respondents recommended termination of the firm's contract with one of the Respondents that had the model problems that was subadvising the fund. Following the termination, investors were informed of it, but not of the problems with the models.

According to the Order, the Respondents who relied on the models to manage fund and investor assets failed to disclose to investors and to the fund boards material information about the management of assets, including the individuals responsible for managing such assets and how they were being managed. For example, the person listed as the "Senior Manager" for certain of the products was not involved with them and, when he learned that he has been designated as the Senior Manager, he objected and asked to be removed from

all disclosures and marketing materials related to the product. The firm's Chief Investment Officer declined to remove the Senior Manager's name. Two other named portfolio managers similarly lack meaningful roles in – and fundamental knowledge about – the management of products they were allegedly responsible for.

In addition to the above findings, the Order also finds that:

- Two of the Respondents included a return of capital in their dividend payments, without disclosing this fact to investors and sending them the required notice under Section 19(a) of the '40 Act;
- Two of the Respondents added volatility overlays to two portfolios without adequate disclosure and without confirming the overlays' accuracy; and
- One of the Respondents "negligently relied upon and distributed to its advisory clients marketing materials regarding a Respondent's use of econometric models and [another adviser's] materially inflated, and hypothetical and back-tested, performance track record."[3]

With respect to this last point, the Order expressly found that one of the Respondents offered strategies managed by another Respondents "without having in place or implementing written compliance policies and procedures reasonably designed to determine it had a reasonable basis for its public disclosure regarding these strategies."

## The Respondents' Violations

Based on the above, the Order finds that the Respondents violated:

- Section 17(a)(2), of the '33 Act, which prohibits misleading omissions or statements in connection with the offer or sale of a security;
- Section 15(c) of the '40 Act, which requires an adviser to a fund to furnish to the fund's board the information necessary for it to evaluate the terms of any contract related to advisory services;
- Section 206(2) of the Advisers Act, which prohibits fraudulent or deceitful conduct;
- Section 206(4) of the Advisers Act, which prohibits the use of advertisements containing untrue, false, or misleading information;
- Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder;
- Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibits misleading omissions or statements involving an investor in a pooled investment vehicle; and
- Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder, which requires advisers to maintain true and accurate records.

The Order notes the Respondents' cooperation with the SEC's investigation, including assisting the SEC in collecting evidence that otherwise might not have been available to the staff. It also notes that the Respondents voluntarily retained a compliance consultant to assist them in resolving the issues that resulted in the violations and they have begun revising and improving their compliance and due diligence policies and procedures relating to the use of models and the creation and use of marketing materials, product development, and investment management.

## Related Actions

While no individuals were named as Respondents in the Order, the SEC brought two related

actions against individuals associated with the Respondents for the roles they played in the violations. In particular:

- Bradley J. Beman, who serviced as a Respondent's Global Chief Investment Officer from 2010 through January 2015, was found to be a cause of the Respondent's violation of Sections 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. This finding was based on his failure to: confirm that the models worked as intended; disclose the analyst's role in managing four of the Respondent's products; and adopt or implement certain compliance policies and procedures to address the risks identified in the internal audit report relating to model validation and functioning.[4]
- Kevin Giles, the Director of New Initiatives of one Respondent from October 2006 through July 2015, was found to be a cause of the Respondent's violation of Sections 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. This finding was based upon his failure to take reasonable steps to revise the Respondent's compliance policies and procedures relating to the firm's use of models and to address the risks associated with model validation and functioning. For this, he was censured, ordered to cease and desist from further violations, and fined $25,000.[5]

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**endnotes**

[1] *See In the Matter of Aegon USA Investment Management, LLC, Transamerica Asset Management, Inc., Transamerica Capital, Inc., and Transamerica Financial Advisors, Inc.,* SEC Release Nos. 33-10539, 34-83947, IA-4996, and IC-33215, SEC (August 27, 2018) (Order). A copy of the Order is available at: https://www.sec.gov/litigation/admin/2018/33-10539.pdf.

[2] A portion of this amount will be used to establish a Fair Fund under Section 308(a) of the Sarbanes-Oxley Act to reimburse shareholders who purchased or held any interest in any of the Respondents' products that are the subject of this action.

[3] Interestingly, the ICI is mentioned in the Order. According to Paragraphs 50-54 of the Order, one of the Respondents relied on the marketing efforts of F-Squared Investments, Inc. [F-Squared is not named as a Respondent in the Order but it is listed in it under "Other Relevant Entities."] The Order discusses how the Respondent relied on F-Squared's performance calculations without independently verifying them. According to Paragraph 54 of the Order, the Respondent that relied on F-Squared's information "learned that the Investment Company Institute had published an article claiming that F-Squared 'clearly overstated' past returns in its marketing materials." In fact, the ICI has published no such article. We did, however, in an appendix to a 2016 comment letter to the SEC on is business continuity and succession planning proposal, state as follows:

> F-Squared Investments, Inc. is an adviser that the SEC charged with advertising a materially inflated, and hypothetical and back-tested, performance track record for its investment strategy. Among other things, the December 2014 SEC settlement required F-Squared to pay $30 million in disgorgement and $5 million in civil penalties. In July 2015, F-Squared filed for bankruptcy.

A footnote to this excerpt in the ICI's comment letter states as follows:

*See, e.g.,* Trevor Hunnicutt, F-Squared Files for Bankruptcy, Investment News (July 8, 2015), available at www.investmentnews.com/article/20150708/FREE/150709926/f-squared-files-for-bankruptcy (noting that after settling charges with the SEC, F-Squared's assets under management declined by nearly $8 billion for the year ended March 31, 2015, and then fell by nearly $6 billion more when Virtus Investment Partners Inc. terminated F-Squared as sub-adviser for five Virtus mutual funds).

[4] *See In the Matter of: Bradley J. Beman, Respondent,* SEC Release No. IA-4997 (August 27, 2018), which is available at: https://www.sec.gov/litigation/admin/2018/ia-4997.pdf.

[5] *See In the Matter of: Kevin A. Giles, Respondent,* SEC Release No. IA-4998 (August 27, 2018), which is available at: https://www.sec.gov/litigation/admin/2018/ia-4998.pdf.

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