

MEMO# 24955

February 8, 2011

SEC Sanctions Advisers For Securities Law Violations Resulting From Error In Quantitative Investment Model

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TO: COMPLIANCE MEMBERS No. 14-11

INVESTMENT ADVISER MEMBERS No. 7-11

RISK MANAGEMENT ADVISORY COMMITTEE No. 2-11

RISK MANAGEMENT COMMITTEE No. 2-11 RE: SEC SANCTIONS ADVISERS FOR SECURITIES LAW VIOLATIONS RESULTING FROM ERROR IN QUANTITATIVE INVESTMENT MODEL

The Securities and Exchange Commission has settled an administrative proceeding based on violations of the federal securities laws that resulted from an error in a quantitative investment model utilized by the Respondents, which error was concealed from the Respondents by one of the Respondent's senior officials. [\[1\]](#) The Respondents were three related investment advisers that utilized the model. According to the Order, the error adversely impacted 608 of 1421 client portfolios and caused approximately \$217 million in losses.

Of note, the Respondents each had compliance policies and procedures that required the reporting of compliance incidents to the Global CEO, Global Chief Investment Officer ("CIO"), or General Counsel. When a senior staff person deliberately violated these policies and procedures, the Commission sanctioned one of the Respondent advisers for violating the Investment Advisers Act of 1940, in part, by failing to adopt and implement written policies and procedures that were reasonably designed to prevent violation of the Act. [\[2\]](#) The facts of the case as outlined in the Order and the sanctions imposed by the Commission are briefly summarized below.

Background

This case involved three entities, a Holding Company for two SEC-registered investment advisers (the "Holding Company") and those two advisers. One of the advisers developed a code for a quantitative investment model (the "Developer") and the other was an institutional money manager that used the model exclusively to manage client portfolios (the "Institutional Manager"). In June 2009, an employee of the Developer determined that

in June 2007 an error had occurred in the computer code for the model. This error resulted in effectively eliminating one of the key components in the model for managing risk. The employee discussed these findings in a meeting with senior officials and employees of the Holding Company and the Developer. This employee asked a senior official of the Developer and Holding Company whether the Holding Company's Global CIO should be informed of the error, and the senior official "directed them to keep quiet about the error and to not inform others about it, and he directed that the error not be fixed at that time."

[3] During the time relevant to the Commission's Order, in presentations and other communication to clients and consultants, the Respondents misrepresented the model's ability to control risk and ascribed underperformance to market volatility and factors having nothing to do with the error.

Around the beginning of 2009, an investment team in London that reported to the Holding Company's CIO had begun to examine and test the model based on clients' concerns about underperformance. This investment team discussed their research and findings with the Developer's employee who had discovered the error. In early September 2009, the Developer's employee admitted the error to the London investment team. By this time, certain of the Respondents' senior officers knew about the error but failed to disclose it to the Holding Company's CEO or clients. In late September 2009, the Respondents' Investment Committee met to discuss certain changes to the model, one of which was intended to fix the error, though certain members of this Committee were not informed of the error. In October 2009, the Holding Company's Board had a discussion about the model and its underperformance, and the senior official stated "that he was 'not aware of significant' mistakes in the model." [4]

The Holding Company's CEO did not find out about the error until November 2009, when an employee of the Developer informed him. The Holding Company then conducted an internal investigation, which concluded in March 2010, and obtained the advice of outside counsel concerning its obligation to disclose the error. About this time, the SEC informed the Holding Company that it planned to conduct an examination of the Institutional Manager and the Developer. The Holding Company disclosed the error in the model to the Commission in late March 2010, and disclosed the error to its clients on April 15, 2010.

According to the Order, the policies and procedures in the Respondents' Compliance Manual "required that the error be disclosed and escalated to the senior Holding Company management, including the Holding Company's Global CEO, Global CIO, and General Counsel." [5] The Respondents' "Incident Escalation Policy" expressly required all employees of the Holding Company, the Developer, and the Institutional Manager to report to the Holding Company's Global CEO, Global CIO, or General Counsel any breakdown of "Risk Management and Internal Controls" or "failure in compliance procedures (including violations of regulatory requirements, breaches of client mandates/investment guidelines, or any other compliance requirement)" that resulted in actual loss of \$25,000 or potential loss of \$100,000. [6] This reporting requirement also applied to any "regulatory or legislative breach or similar incident that has, or could potentially, result in a formal investigation or disciplinary sanctions by local regulators, government and industry bodies and could therefore result in fines or a rise in regulatory scrutiny" or any matter which [sic] "potentially could have an adverse impact on the public reputation of" the Holding Company. [7] Notwithstanding these policies and procedures, as discussed above, information regarding the model's error was not reported as and when it should have been.

The Respondents' Violations

According to the Order, based on the above findings of the Commission, the Respondents were found to have violated the following provisions of the Federal securities laws:

- The Holding Company – The Holding Company was found to have violated the antifraud provisions of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 by: (1) misrepresenting that the model accounted for risk when, due to the undisclosed error, it did not; and (2) misrepresenting to investors “that all internal control processes and procedures that applied to [the Developer] were implemented” when they were not.
- The Institutional Manager – The Institutional Manager was found to have willfully violated Section 206(2) of the Advisers Act, which imposes on advisers a fiduciary duty as well as a duty to make full and fair disclosure of all material facts, by concealing and delaying to fix the error in the model.
- The Developer – The Developer was found to have violated Section 206(2) of the Advisers Act on the same basis as the Institutional Manager. Additionally, it violated this section by failing to conduct any meaningful materiality analysis of the error’s impact. It was also found to have violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder “by failing to adopt and implement policies and procedures reasonably designed to ensure that it did not make false and misleading statements and/or omissions to clients and investors, including failing to ensure that the model performed as represented.” [\[8\]](#)

Sanctions

Based upon these violations of law, the Respondents were ordered to cease and desist from committing further violations of these provisions and pay a civil penalty of \$25 million. In addition, they undertook, among other things, to: (1) pay approximately \$217 million to compensate clients for the harm caused by their conduct; (2) impose additional oversight on the Developer that caused and concealed the error; (3) revise their global compliance and ethics oversight structure as set forth in the Order; (4) retain an independent compliance consultant; (5) undergo a compliance review by an independent compliance consultant at the end of fiscal years 2012 and 2013; (6) certify to the SEC compliance with each of these undertakings; and (7) maintain records for at least six years documenting compliance with these requirements.

Tamara K. Salmon
Senior Associate Counsel

endnotes

[\[1\]](#) See In the Matter of AXA Rosenberg Group, LLC, ASA Rosenberg Investment Management LLC, and Barr Rosenberg Research Center LLC, Administrative Proceeding File No. 3-14224 (Feb. 3, 2011) (the “Order”), which is available at: <http://www.sec.gov/litigation/admin/2011/33-9181.pdf>. The Respondents neither admitted

nor denied the SEC's allegations.

[2] Interestingly, the senior official who was found to have deliberately concealed information and not reported it as required by the Respondents' policies and procedures was not named as a Respondent in the Commission's action.

[3] Order at p. 2.

[4] Order at p. 5.

[5] Order at pp. 6-7.

[6] Order at p. 7.

[7] Ibid.

[8] Order at p. 9.