The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 31441

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SEC Sanctions an Adviser for Using Advertising Relating to Its Blended Research Stock Ratings That Misstated or Omitted Material Information

[31441]

October 17, 2018 TO: ICI Members
Investment Company Directors
Chief Compliance Officer Committee
Compliance Advisory Committee
Investment Advisers Committee SUBJECTS: Compliance
Investment Advisers
Litigation & Enforcement RE: SEC Sanctions an Adviser for Using Advertising Relating to its Blended Research Stock Ratings that Misstated or Omitted Material Information

The Securities and Exchange Commission has announced the settlement of an enforcement proceeding against an adviser (the Respondent) that arose "from material misstatements and omissions the Respondent made to certain of its advisory clients and others concerning hypothetical stock returns associated with [the Respondent's] blended research stock ratings.[1] These material misstatements and omissions resulted in the Respondent violating Sections 206(2) and (4) of the Investment Advisers Act, which are the antifraud provisions, and Rule 206(4)-1(a)(5) under the Act, which prohibits a registered investment adviser from using any advertising that contains an untrue statement of a material fact.

Because the Order found that the Respondent's violations were due, in part, to the Respondent's failure to adopt and implement written compliance policies and procedures that were reasonably designed to prevent violation of the Advisers Act and the rule thereunder, the Respondent was also found to have violated Section 206(4) and Rule 206(4)-7, the compliance rule. Based on these violations, the Respondent was censured, ordered to cease and desist, and ordered to pay a civil penalty of $1.9 million. In settling this case, the Order notes that the Respondent had voluntarily retained a compliance consultant to, among other things, conduct a comprehensive review of the Respondent's written policies and procedures relating to the publication, circulation, or distribution of the Respondent's advertisements concerning its investment models, research ratings, or strategies. The facts of this case are briefly summarized below.

According to the Order, the Respondent is an investment adviser that utilized a blended research process that involved making investment decisions based on both fundamental and quantitative research ratings. It constructed blended research portfolios by combining these research ratings to arrive at a blended stock score and by using a portfolio optimization process that considered the blended scores along with risk and other portfolio constraints. The Respondent developed several different blended research strategies that it used to manage several mutual funds and separate accounts. In 2003, the Respondent developed an internal analysis that it used to calculate annualized returns since February 1995 for six hypothetical baskets of stocks. This analysis was updated every quarter. From 2006 - 2015, the Respondent used its analysis to create data, including bar charts, that was included in certain advertisements and in written marketing materials that were directed to institutional investors and financial intermediaries, including in RFPs. The Respondent used this data to support its philosophy that "over time, blended stock ratings provided better return potential than fundamental or quantitative ratings alone" and to advertise a "clear alpha benefit" from combining it fundamental and quantitative research.

The Order found that the Respondent's advertisements failed to disclose that the charts it was using based on the data included quantitative ratings that were determined by back-testing the Respondent's quantitative model. They also failed to disclose that the back-tested period contributed to the superior performance of the Respondent's hypothetical blended portfolios. According to the Order, using the back-tested period "made the annualized cumulative returns from the hypothetical fundamental-quant intersection significantly better relative to the comparable returns from the quant model alone." The Order also found that the Respondent falsely claimed that its quantitative research dated back to the mid-1990s when, in fact, the Respondent "did not generate its own quantitative models or research before 2000." In late 2015, the Respondent's compliance staff decided to cease using this information in advertisements.

The Order found that the Respondent failed to adopt and implement policies and procedures that were reasonably designed to prevent inaccurate statements regarding its data in its advertisements. The Respondent's staff who were familiar with the data and its creation failed to clearly and consistently communicate to the Respondent's staff who were responsible for preparing and reviewing advertisements containing such data. In at least one case, the architect of the Respondent's data flagged as "not true" representations in an RFP that the Respondent's quantitative ratings dated to the mid-1990s. While the statement in the RFP was revised, the person who flagged it was not asked to review the revised version for accuracy and, according to the Order, "it remained misleading."

The Order expressly finds that the Respondent's "compliance personnel were unaware that some of the quantitative ratings were back-tested, and thus lack pertinent facts when determining whether [the Respondent's] advertisements complied with the federal securities laws." Also, the Respondent's use of different groups of compliance personnel to review the blended research advertisements prepared for different audiences contributed to advertisements describing the history of the Respondent's ratings in different ways. "As a result, compliance personnel reviewing one type of marketing document did not know that another type of advertisement described the history of [the Respondent's] quantitative ratings in a different way." According to the Order, this resulted from the Respondent's failure to adopt and implement policies and procedures reasonably designed to prevent false and misleading advertisements.

Based on this conduct, the SEC found that the Respondent willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder and imposed the

sanctions discussed above.

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endnotes

[1] *See In the Matter of Massachusetts Financial Services Company, Respondent*, SEC Release No. IA-4999 (Aug. 31, 2018) (the “Order”), which is available at: https://www.sec.gov/litigation/admin/2018/ia-4999.pdf.