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SEC Charges Two Investment Advisers with Failing to Address Known Vulnerabilities in its Investment Models

[35994]January 24, 2025TO:ICI Members
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On January 16, 2025, the SEC announced that it settled charges against two registered investment advisers (the "Advisers"), for breaching their fiduciary duties by failing to reasonably address known vulnerabilities in their investment models and for related compliance and supervisory failures, in addition to separately violating the Commission's whistleblower protection rule.[1] The Advisers voluntarily repaid impacted funds and accounts $165 million during the SEC's investigation and agreed to pay $90 million in civil penalties to settle the Commission's charges.

The Order

These proceedings arise out of failures by the Advisers to exercise reasonable care in addressing known material vulnerabilities to a subset of their computer-based algorithmic investment models ("Models") in breach of their fiduciary duty of care, deficiencies in their written compliance policies and procedures, and one Adviser's failure to reasonably supervise one of its employees, as well as violations of the Commission's whistleblower protection rule. The Advisers are large quantitative-analytics-based hedge fund managers that use Models when making investment decisions for its clients, including private funds and separately managed accounts (each, an "SMA"), as well as for its own proprietary funds.

According to the SEC's Order, in or before March 2019, the Advisers' employees identified and recognized vulnerabilities in certain of the Advisers' investment models that could negatively impact clients' investment returns, however the Advisers waited until August 2023 to address the issues. Further, the order finds that despite acknowledging these problems, the Advisers failed to adopt and implement written policies and procedures to address the vulnerabilities and failed to supervise one of its employees who made

unauthorized changes to more than a dozen models, which resulted in the Advisers making investment decisions that it otherwise would not have made on behalf of its clients.

Additionally, the Order separately finds that the Adviser's violated the SEC's whistleblower protection rule by requiring departing individuals, in separation agreements, to state as fact that they had not filed a complaint with any governmental agency. This requirement potentially identifies whistleblowers and prohibits whistleblowers from receiving post-separation payments and benefits, both of which are actions to impede departing individuals from communicating directly with Commission staff about possible securities law violations, in violation of the whistleblower protection rule.

Settlement

As stated above, the SEC's Order finds that the Advisers willfully violated the antifraud provisions of the Investment Advisers Act of 1940, as amended (the "Advisers Act") and the Advisers Act's compliance rule, as well as Rule 21F-17(a) under the Securities Exchange Act of 1934, which prohibits impeding an individual from communicating with SEC staff about a possible securities law violation. Without admitting or denying the SEC's findings, the Advisers agreed to a cease-and-desist order imposing a censure and a penalty of $45 million each, totaling $90 million.

Mitra Surrell
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Notes

[1] *See* In the Matter of Two Sigma Investments, LP, and Two Sigma Advisers, LP (2025)(3-22418), available at https://www.sec.gov/files/litigation/admin/2025/34-102207.pdf (the "Order").