Re-Learning the Lessons of Watergate: The Cover-Up Is Worse Than the Crime

On February 3, 2011, the SEC severely sanctioned two affiliated investment advisers and their parent for failing to promptly correct an error in a quantitative model used to manage client accounts and making misleading statements about the benefits of the quantitative model after the error was detected.[1] In settling the SEC action, the advisers agreed to pay injured clients almost $217 million, to adopt numerous compliance enhancements, and to pay a fine of $25 million.

The Error in the Model

The advisers developed three computer models which were used together as the exclusive means of selecting investments in managed accounts. One model, the Alpha Model, evaluated public companies based on their earnings and valuations. A second model, the Risk Model, evaluated risks based on numerous factors. A third model, the Optimizer Model, combined the first two models and recommended specific investments based on a benchmark chosen by the client.

In April 2007, a new version of the Risk Model was developed. Due to an inadvertent error in computer coding, which was not detected for over two years, the Risk Model sent information to the Optimizer Model in a form that produced errors in the selection of stocks for investment. This error resulted in stock selections that were inconsistent with selections that would have been made if the model had worked properly.

The Alleged Cover-Up

Beginning in June 2009, two groups within the advisers independently detected the error and reported it to senior officers. Nonetheless, a senior officer did not insist that the error be corrected and did not disclose its existence within the organization. Later in 2009, the error was reported to the CEO of the parent and was investigated by outside counsel. The error was not disclosed to the SEC until after the SEC announced that it would commence an inspection of the advisers in March 2010. (The error was disclosed to clients in April 2010.) The advisers and their parent also allegedly misled clients about the error and its impact on the application of the models after the error was detected. According to the SEC, "[a]fter discovery of the error in June 2009, the Respondents made material misrepresentations and omissions concerning the error to [adviser's] clients, including (i) omitting to disclose the error and its impact on client performance, (ii) attributing the Model's underperformance to market volatility rather than the error, and (iii) misrepresenting the Model's ability to control risks. The Respondents also made misrepresentations and omissions about the scope and application of their compliance policies and procedures . . . both before and after the discovery of the error. " The SEC also alleges that the advisers failed to follow their procedures for disclosing and escalating errors to senior management.

[1] http://www.sec.gov/news/press/2011/2011-37.htm

The Sanctions

The companies were found to have violated non-scienter based provisions of the Securities and Advisers Act as well as the Compliance Rule under the Advisers Act. As remedies, the companies were ordered to comply with undertakings to pay almost $217 million to clients injured as a result of the error, to pay a $25 million fine, to adopt enhanced compliance procedures, to employ an independent compliance consultant, and to cooperate with further SEC investigations and litigation related to this matter.

Lessons

The SEC did not allege that the companies violated the law when the error first occurred. Rather, the violations arose because of the alleged cover-up of the error after it was detected. This was the case even though the companies eventually reported the error to the SEC and clients, although the SEC alleged that this self-reporting came too late because it came after the SEC had announced that it was commencing an inspection of the advisers. The lesson here seems clear: when an error is detected, it should be corrected promptly and communications with clients and any communications with regulators should be consistent with the error's detection.

The SEC also used this case as an opportunity to announce its heightened scrutiny of advisers that use quantitative models. In the press release announcing this action, the SEC staff stated the following: "'Quant managers must be fully forthcoming about the risks of their model-driven strategies, especially when errors occur and the models don't work as predicted,' said Bruce Karpati, Co-Chief of the Asset Management Unit in the SEC's Division of Enforcement. Rosalind R. Tyson, Director of the SEC's Los Angeles Regional Office, added, 'Quant managers need to ensure that their compliance policies and procedures are tailored to the risks of their model's strategies, and that compliance personnel are integrated into the development and maintenance of their investment models.'"

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