

## “No Runway for These Models”

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On January 16, 2025, the SEC instituted administrative and cease-and-desist proceedings against an \$80 billion hedge fund. The proceedings were initiated pursuant to Section 21C of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940.

The fund was fined \$90 million in penalties and required to reimburse clients \$165 million. Ouch!

### What Happened?

The SEC’s investigation revealed that the fund failed to exercise reasonable care in addressing known material vulnerabilities within the fund’s computer-based algorithmic investment models; a breach of its fiduciary duty of care to its clients.

Two fund employees found material security issues with its models that allowed modifications to be made to the models without going through the fund’s standard approval process. Fund personnel had unfettered read and write access to model parameters that could affect investment decisions for clients.

The two employees provided fund management with proposed solutions, which, unfortunately, the fund did not implement. Two years later, a different employee working with the models was able to manipulate the models so that certain funds and managed accounts overperformed by \$400 million, while others underperformed by \$165 million with the result that the rogue employee enhanced his bonuses by several million dollars. These model manipulations went on for almost two years before being detected.

### What Were the Consequences?

- **Monetary Penalties:** The fund was required to pay a civil monetary penalty of \$90 million and required to reimburse adversely affected clients \$165 million.
- **Retention of an Independent Consultant:** The fund was required to engage an independent compliance consultant to review and recommend improvements to its policies and procedures, particularly those related to the development, testing, and validation of its investment models.
- **Enhanced Disclosures:** The fund was mandated to provide enhanced disclosures to its clients regarding the nature and risks associated with its investment models, including any material vulnerabilities and the steps taken to address them.
- **Public and Client Impact:** The fund suffered a real black eye publicly given the magnitude of the over and underperformance and size of the penalty levied. As you can imagine, clients were more than perturbed to hear about this security lapse and its economic consequences.



## Take-aways for the Rest of Us

This enforcement action underscores the SEC's commitment to ensuring that investment advisers uphold their fiduciary responsibilities, especially in the context of increasingly complex and technology-driven investment strategies. Firms utilizing algorithmic models are reminded of the importance of rigorous oversight, timely remediation of identified issues, and transparent communication with clients regarding potential risks.

In light of this proceeding, it is advisable for hedge funds and investment advisory firms to re-evaluate their internal controls and compliance frameworks related to algorithmic trading and model risk management. Proactive measures working with experienced, objective third-party advisors not only help in adhering to regulatory expectations but also in safeguarding client interests and maintaining trust in the client/advisory relationship.

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