

Responding to allegations of model errors: SEC enforcement trends



Businesses frequently rely upon models to support investment decisions, ensure accurate financial reporting, perform customer transaction monitoring, support CRM systems, engage in capital stress testing, and more. In 2011, the Office of the Comptroller of the Currency published Supervisory Guidance on Model Risk Management (MRM). Over time, the Securities and Exchange Commission (SEC) and other regulators have embraced its concepts, and regulatory enforcement has increased proportionally, both domestically and abroad.

SEC enforcement actions

The SEC has engaged in enforcement actions against companies who have used and relied upon models, but which were later discovered to have had errors, inadequate controls, and poor governance. Recent cases (summarized on the reverse) have resulted in sanctions and penalties.



100% of all cases financial penalties were levied



67% of the cases investors and clients were paid



50% of the cases a monitor was appointed

What should you be thinking about when allegations of model errors arise?

Circumstances surrounding alleged error

- From an independent perspective, is the allegation of an error true?
- How and when was the error first introduced into the business environment?
- How and when was the error discovered? Was it corrected in a timely manner?
- Does the model contain other errors?
- Does the company use other models which may contain the same or similar errors?

Materiality and harm

- Was the error material, and did it impact any business decisions or disclosures, or cause any harm to customers or shareholders?

Controls

- Why was the error not prevented or detected sooner?
- What steps has the company taken to enhance controls to prevent, detect, and correct future model errors?
- What should the company be doing to demonstrate reasonable controls over its models? Reasonable effectiveness of its models?

Awareness and disclosure

- How and when should the board be briefed?
- Should the company pre-emptively self-disclose to its regulators, auditors, and/or other stakeholders?
- How should the harms, if any, be redressed?

Recent case summaries: SEC enforcement

In 2011, a private investment firm and related entities were charged with securities fraud for concealing an error that caused substantial investor losses.

\$25 million in civil penalties paid by company
\$2.5 million in civil penalties paid by CEO or investment manager
\$216.8 million in payments to clients and investors
 Imposition of a monitor

An analyst with no experience in portfolio management or financial modeling developed a quantitative model to manage investment strategies. Several errors were discovered that were not adequately corrected or disclosed.

\$36.3 million in civil penalties paid by company
\$53.3 million in payments to clients and investors
\$8 million in interest paid

Legal proceedings arose after a company violated the Investment Company Act's prohibition on cross trades between investment companies and first or second degree affiliated persons. Its compliance systems were inadequate and failed to identify the disallowed cross trades.

\$1 million in civil penalties paid by company
\$7.4 million in payments to clients and investors
 Imposition of a monitor

A company's model for rating residential mortgage-backed securities lacked adequate controls and oversight, and it was unable to timely detect and prevent numerous model errors in a timely fashion.

\$16.25 million in civil penalties paid by company
 Imposition of a monitor

Company allocated shares in block trades among clients based upon the clients' chosen investment model portfolios and the clients' account balance. The Company's system was not compatible with a custodian's system resulting in inaccurate record keeping and widespread client losses.

\$100,000 in civil penalties paid by company
\$25,000 in civil penalties paid by CEO or investment manager
\$20,000 in payments to clients and investors
\$2,000 in interest paid

A company received a deficiency letter issued by the SEC and after an SEC examination was cited for failure to maintain and preserve certain books and records and adopt an adequate compliance program.

\$50,000 in civil penalties paid by CEO or investment manager

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