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SEC uses F-Squared saga to drive home due diligence message

Telling advisers to never assume enough is enough when it comes to research

By Jeff Benjamin | *November 10, 2016 - 12:01 am EST*

By now, the financial advice industry should be familiar with the story behind the rise and fall of F-Squared Investments, especially the fall part that left 13 advisory firms saddled with SEC fines.

The short version of the story is that F-Squared was caught producing inaccurate performance data for its AlphaSector strategy that invested in exchanged-traded funds. The trouble rippled into the financial advice industry when the SEC started dinging firms that repeated the performance data without conducting enough due diligence to check the validity.

While it would be easy to challenge the motivations of the regulators — and some are doing just that — the message being sent by the Securities and Exchange Commission could not be more clear.

"The SEC says when you hire a subadviser for your clients you have the responsibility to test it and do the due diligence," said Tina Mitchell, lead compliance consultant at Core Compliance & Legal Services.

"The SEC has been sending this message since before Bernie Madoff [was caught running a Ponzi scheme in 2008], but it really started to kick in after Madoff," she added.

An SEC spokeswoman declined to comment for this story, but it is clear that the F-Squared saga is not over, and the full impact is still reverberating across the financial advice industry.

"At the end of the day, the buck stops at the advisory firm's desk, as far as the end client is concerned," said Kashif Ahmed, president of American Private Wealth.

"If the numbers just seem too good to be true, and if the back-testing assumptions are just too rosy, stop," he added. "Wait until the firm has proven itself. Advisers foolishly rely on glossy brochures and glitzy sponsor events to potentially jeopardize their book of business, and thus their careers."

It might be too early to know if the fines, ranging from $100,000 to $500,000, will impact future business and client relationships at the impacted firms. But the SEC's actions suggest it is more about sending a message and altering the way firms do business than it is about punishing the advice industry.

AssetMark was the sole firm ordered to pay $500,000, while BB&T Securities, Banyan Partners, Hilliard Lyons, Ladenburg Thalmann Asset Management and Shamrock Asset Management will each pay the next largest penalty of $200,000, according to the statement.

Congress Wealth Management, Constellation Wealth Advisors, Executive Monetary Management, HT Partners, Prospera Financial Services, Risk Paradigm Group, and Schneider Downs Wealth Management Advisors were fined $100,000 each.

The entire incident has drawn attention to Morningstar for the way it was unwittingly publishing the inaccurate F-Squared performance numbers.

But even as other publications had quoted and repeated the performance data that was published by Morningstar and other firms, financial advisers learned their responsibility is not diluted by referencing published data from a reputable source.

In a statement, Morningstar said it learned of the SEC investigation from F-Squared in 2013.

"Since then, we've removed performance figures for all separate accounts that we classify as ETF managed portfolios that weren't associated with actual client assets from our database," Morningstar stated. "In our quarterly ETF Managed Portfolios Landscape Report we highlight the characteristics of the return information we display, including assets under management."

"Our separate account database is based on self-reported information from separate accounts that cannot, as a practical matter, be independently verified," the statement continued. "Our database is designed to provide sophisticated, professional investors with tools and data to help them screen and compare investments. These tools do not replace due diligence, especially where unregistered products are concerned. We state this in our disclaimers and methodology documents."

"The fines were relatively small, so I think the SEC was trying to send a message to the industry to not just rely on third-party data at face value," said Amy Lynch, president of FrontLine Compliance.

"But what those advisory firms did, by not doing the research to confirm those performance numbers, that's a common practice," she added.

According to Ms. Lynch, the SEC is saying that the common practice of disclosing the source of the performance data will not dilute liability or responsibility to conduct thorough due diligence.

"This was purposeful fraud by F-Squared, and the SEC is saying those firms using that performance data should have looked at it and had some idea that something was amiss. When something looks too good to be true it usually is."

F-Squared Investments, which filed for Chapter 11 bankruptcy in July 2015, in some respects represents a flash in the pan of the financial services industry.

In 2008 the company launched a separately managed account platform, providing advisers with access to five different actively-managed portfolios.

By 2013, the popularity of the low-fee platform and a touted index-beating performance record helped drive assets under management above $20 billion.

But the wheels started to come off the bus that same year when a routine examination led to SEC charges in 2014.

In December 2014, F-Squared agreed to pay $35 million to settle SEC charges related to misleading performance reporting, including back-tested data that was being reported and reproduced as actual performance.

Ms. Mitchell views the SEC's enforcement action as a clear statement reflecting a history of not liking back-tested performance data.

"The SEC doesn't like back-testing and they never have, usually because the disclosures are not clear enough," she said. "The SEC is very pro showing examples of enforcement. It's almost become enforcement by example of enforcement."

However, even such a seemingly clear-cut example of fraud can introduce gray areas that will require added vigilance on the part of financial advisers.

Due diligence "is one of those gray areas that exists within the regulatory securities world, and negligence, in many cases, is in the eye of the SEC," said David Chase, a lawyer and former SEC prosecutor.

"At what point can a firm have a level of comfort that they won't be facing an enforcement action?" he added. "If a firm simply accepted F-Squared's calculations without doing any due diligence, we can probably all agree that's negligence. But what about accepting verification and backup data and accepting that at face value? You could fight over whether or not that is sufficient due diligence."

Ms. Mitchell agrees that the SEC might be setting an awkward enforcement precedent that could require specific interpretations going forward.

"In the past, what we've seen is that the SEC will be somewhat reasonable if there are strong policies and procedures in place and the firm just didn't catch the fraud," she said.

In essence, there is due diligence to the level of protecting your advisory firm and there is due diligence to the level of protecting your clients. And the SEC is leaving the distinction up to the advisory firms.

"The obligations are what they are, so that means advisers are going to have to up their compliance game," said Todd Cipperman, principal at Cipperman Compliance Services.

"The SEC is saying you have to do due diligence on any third-party product, and you have to get the data to back it up," he added. "It was arguably unclear before F-Squared that you had

to do that, but it's still not clear how much backup data you need, and whether you can still use a product without completely re-engineering the performance claims."

As Mr. Chase sees it, advisers should not expect to see an "absolute bright line" from the SEC regarding when and where to start and stop due diligence. And that's probably one of the points being made by the SEC.

"I kind of get the SEC's position on this, and now the question becomes how much due diligence is a true representation of due diligence," he said. "Practical advice to advisers is if you're going to reiterate any information on which your clients or prospective clients are going to rely, you need a level of assurance that it's accurate. And if you don't have that, don't use it. Sorry, life ain't fair."

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