

## SEC Enforcement Case Summary

### Failure to Promptly Address Vulnerability in Investment Model & Whistleblower Violations

On January 16, 2025, the Securities and Exchange Commission (**SEC**) charged investment advisers, Two Sigma Investments LP and Two Sigma Advisers LP (collectively, **Two Sigma**), for breaching their fiduciary duties by failing to reasonably address known vulnerabilities in their computer-based algorithmic investment models and for related compliance and supervisory failures, as well as for separately violating the SEC's whistleblower protection rule.

Two Sigma is a large quantitative-analytics-based hedge fund manager that uses models when making investment decisions for its clients, including private funds and separately managed accounts (**SMAs**), as well as for its own proprietary funds. According to the SEC's order, on or before March 2019, Two Sigma employees identified and recognized vulnerabilities in certain Two Sigma investment models that could negatively impact clients' investment returns. Specifically, numerous Two Sigma personnel had what was described as "unfettered read and write access to a firm database that stored model 'parameters'—variable inputs that impact the stock predictions generated by models—used by certain of Two Sigma's live-trading models." Such vulnerabilities were raised by multiple parties, shared with senior management, and reinforced when an employee inadvertently overwrote important details in a model. Nevertheless, until August 2023, Two Sigma failed to adopt and implement written policies and procedures and other practices 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 Two Sigma making investment decisions that it otherwise would not have made on behalf of its clients.

In addition, the SEC's order separately found that Two Sigma violated the Rule 21F-17 whistleblower protection rule under Section 21F of the Securities Exchange Act by requiring departing individuals, in separation agreements, to state as fact that they had not filed a complaint with any governmental agency. This requirement, in effect, could identify whistleblowers and prohibit whistleblowers from receiving post-separation payments and benefits, both of which are actions to impede departing individuals from communicating directly with SEC staff about possible securities law violations, in violation of the whistleblower protection rule.

Two Sigma 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 SEC's charges.

Investment models are particularly critical in quantitative trading firms, and there have been multiple SEC cases where firms did not promptly address errors or vulnerabilities identified in such models. While such vulnerabilities are more difficult for compliance staff to identify through typical compliance monitoring and testing, it is important that such firms engage with and empower technical experts and modelers to identify vulnerabilities and take prompt steps to remediate issues when identified. In addition, even without technical expertise, compliance staff are in a position to ask specific questions regarding the controls around access to models and their firm's changes to management processes and, by doing so, potentially identify weaknesses or areas requiring written compliance policies and procedures. Moreover, the case highlights the general need for firms to promptly investigate and address potential weaknesses or concerns identified by employees or others related to business practices.

The SEC has continued to actively enforce whistleblower provisions in multiple enforcement actions in recent years, reinforcing the need for legal teams to routinely review separation agreements for language that is inconsistent with such provisions. Specifically, when departing employees have expressed any concerns regarding firm business practices, enlisting assistance from securities counsel in drafting such agreements may be prudent.

**See SEC Summary - <https://www.sec.gov/newsroom/press-releases/2025-15>**