

STATE OF ILLINOIS
SECRETARY OF STATE
SECURITIES DEPARTMENT

IN THE MATTER OF: WELLS FARGO ADVISORS, LLC; Now
Known As WELLS FARGO CLEARING
SERVICES, LLC

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) File No. 1500252
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NOTICE OF HEARING

TO THE RESPONDENT: Wells Fargo Advisors, LLC, CRD 19616
N/K/A Wells Fargo Clearing Services, LLC
c/o Steven M. Malina
Greenberg Traurig, LLP
77 W. Wacker Dr., Suite 3100
Chicago, IL 60601

You are hereby notified that pursuant to Section 11.F of the Illinois Securities Law of 1953, [815 ILCS 5/1 et seq.,] (the "Act") and 14 Ill. Adm. Code 130, Subpart K (the "Code"), a public hearing will be held at 421 E. Capitol Ave., 2nd Floor, Springfield, Illinois, 62701, on the 17th day of January, 2018 at the hour of 10:00 a.m. or as soon thereafter as counsel may be heard, before Abby Sgro or such other duly designated Hearing Officer of the Secretary of State.

Said hearing will be held to determine whether an Order should be entered against the Respondents granting such relief as may be authorized under the Act, including, but not limited to, imposition of a monetary fine in the maximum amount, pursuant to Section 11.E(4) of the Act.

The grounds for this administrative action are as follows:

1. Wells Fargo Advisors has been registered as a Federally Covered Investment Advisor since 1991, notice-filed as a Federally Covered Investment Adviser in Illinois since 1999, and registered as a dealer in Illinois since 1989.
2. Wells Fargo Advisors has approximately 9,600 Financial Advisors ("FAs") in the traditional brokerage channel with branch offices in all 50 states and the District of Columbia.
3. Among the securities products and investment advisory services provided by Wells Fargo Advisors are Separately Managed Accounts ("SMAs"). A SMA is a portfolio of assets managed by a professional management firm.

4. Wells Fargo Advisors has two broad categories of SMA programs, those that are internally managed and those that are externally managed. Only externally managed Wells Fargo Advisors SMA programs are relevant to this Stipulation and the Consent Order.
5. Externally managed SMAs are accounts managed by other financial services firms (money managers) who are described by Wells Fargo Advisors as partners, or, alternatively, as money managers or advisers, and are subdivided into three broad programs. Two of these programs were named Masters and Diversified Managed Allocations (“DMA”).
6. DMA is described by Wells Fargo Advisors as a unified managed account offering investors access to a variety of investment strategies offered by money managers on a single wealth management platform. Many of the money managers that were listed on the Masters platform were also included on DMA.
7. Money managers on the Masters program roster were all cleared and could be recommended by Wells Fargo Advisors FAs to their clients. The Masters program was further subcategorized as Masters Select or Masters Expanded. The names of these subcategories were changed in 2014 to Masters Recommended and Masters Supported.
8. Both Masters Select and Masters Expanded money managers went through a due diligence process before being added to the specific rosters. However, the Masters Select due diligence process is a different and more extensive due diligence review process than that for Masters Expanded. The difference in the due diligence review processes were disclosed to clients in Wells Fargo Advisors’ Wrap Fee Brochure for SMA Programs and in Wells Fargo Advisors’ Form ADV, which was sent to every client who invested through the SMA program.
9. F-Squared Investments, Inc. (“F-Squared Investments”) was a financial advisory firm located in Massachusetts and founded in 2006.
10. F-Squared Investments was a Federally Covered Investment Adviser registered with the SEC from March 2009 to 2016 and notice-filed in Illinois until 2015.
11. F-Squared Investments marketed a money manager strategy based upon certain Exchange Traded Funds (“ETFs”) and market signals called AlphaSector.
12. AlphaSector was advertised by F-Squared Investments as having an inception date of 2001, along with performance information and periodic holding snapshots dating back to that year. Additionally, the performance and holdings information was advertised as being not backtested, *i.e.* that it was based upon actual investment management results and performance.
13. In fact, the AlphaSector results were backtested and were not based upon actual live results. Additionally, in the process of backtesting the results, a 16-year-old intern working for F-Squared Investments committed a data error with the investment strategy which resulted in the backtested calculations being reported as having a performance significantly better than if the investment strategy had been properly applied and reported.

14. In 2013, F-Squared Investments began the process to be cleared as a manager for the Masters Expanded program.
15. In August 2013, two F-Squared Investments products, specifically created for Wells Fargo Advisors, were cleared for the Masters Expanded roster: F-Squared AlphaSector Allocator Select and the F-Squared AlphaSector Global Select.
16. In October 2013, Wells Fargo Advisors was notified by F-Squared Investments that F-Squared Investments was being investigated by the Securities and Exchange Commission ("SEC").
17. On December 22, 2014, F-Squared Investments entered into an Administrative Consent Order with the SEC in which F-Squared Investments admitted to the following (amongst others) facts.
 - a. From October 2008 to September 2013, F-Squared [Investments, Inc.] marketed an ETF sector rotation strategy called AlphaSector that was based on an algorithm that yields a "signal" indicating whether to buy or sell nine industry ETFs.
 - b. F-Squared and [Howard] Present [then CEO of F-Squared Investments] began advertising the AlphaSector strategy via an index in September 2008. From inception, F-Squared stated in advertisements that AlphaSector is an ETF sector rotation strategy that (i) invests in as many as nine U.S. equities industry ETFs, with an algorithm or quantitative engine determining whether, based on ETF sector trends and volatility, the portfolio would invest in none, some, or all of the nine ETFs; (ii) holds equal ownership of any of the nine ETFs with a positive trend and no ownership of any of the nine ETFs with a negative or neutral trend; (iii) rebalances periodically, either weekly or monthly, and only when at least one of the nine ETFs show a change in trend; and (iv) applies a 25% cap per ETF (*i.e.*, no ETF would hold more than 25% of the total assets in the strategy) at the time of rebalancing, with the remainder of the portfolio invested in a short-term treasury ETF (representing cash).
 - c. Present created and was responsible for all of F-Squared's AlphaSector advertisements, which included PowerPoint presentations describing the strategy and its past performance, including for the period April 2001 to September 2008. The relevant slides from F-Squared's August 2013 standard presentation for the AlphaSector Premium Index was available on F-Squared's public website until the end of September 2013. F-Squared posted the presentations and other AlphaSector performance advertisements and marketing materials on its public website and sent them to numerous prospective and current clients from September 2008 to September 2013.
 - d. From AlphaSector's inception in October 2008 through September 2013, F-Squared advertised AlphaSector's past performance as index performance. Even though F-Squared did not create AlphaSector until late 2008, F-Squared made two materially false claims in its AlphaSector advertisements and Forms ADV, namely that:

- i. the in/out ETF signals that formed the basis of the AlphaSector index returns had been used to manage client assets from April 2001 to September 2008; and
 - ii. the in/out ETF signals resulted in a track record that significantly outperformed the S&P 500 Index from April 2001 to September 2008.
- e. F-Squared's AlphaSector advertisements emphasized algorithmic-based models that purportedly supported both the hypothetical and actual track record beginning in July 2008, but in reality the AlphaSector track record for the period April 2001 to June 2008 was based only on changes in 41-week and 61-week simple moving averages.
- f. F-Squared created the pre-October 2008 "historical track record" incorrectly by implementing all the purchases and sales dictated by the ETF trend signals one week before they should have been implemented. Because the signals were detecting price momentum, F-Squared's incorrectly implementing the signals one week early meant that AlphaSector's "historical track record" was based on its selling before price drops that had already occurred and buying before price increases that had already occurred. As described below, virtually all of AlphaSector's claimed outperformance relative to the S&P 500 Index for the pre-October 2008 period is attributable to this erroneous calculation.
- g. The inaccurate compilation of historical data substantially improved the AlphaSector's strategy's advertised back-tested and hypothetical historical performance for the pre-October 2008 period. If an investor made a hypothetical investment of \$100,000 on April 1, 2001 (assuming a reinvestment of dividends and no further contributions or withdrawals), the investment would have been worth approximately \$128,000 on August 24, 2008 if invested in the S&P 500 Index. With accurately timed (but still hypothetical and back-tested) signal implementation, the same investment in F-Squared's hypothetical ETF sector rotation strategy would have been worth \$138,000. However, by implementing the hypothetical and back-tested signals one week early, F-Squared advertised the investment as worth \$235,000.
- h. F-Squared's advertisements stated that the inception date of the AlphaSector indices "is based on an active strategy with an inception date of April 2001. Inception date is defined as the date as of which investor assets began tracking the strategy."
- i. Starting in late 2009, F-Squared's AlphaSector advertisements also explicitly claimed that the track record for the period April 2001 to September 2008 was not back-tested. For example, even as of September 2013, F-Squared's advertisements stated: "The process of converting the active strategy to an index implies that the returns presented, while not backtested, reflect theoretical performance an investor would have obtained had it invested in the manner shown and does not represent returns that an investor actually attained, as investors cannot invest directly in an index."
- j. From September 2008 to September 2013, F-Squared advertised that AlphaSector indices had outperformed the S&P 500 Index, particularly for the period from April 2001 to September 2008.

- k. F-Squared also claimed that it was responsible for AlphaSector's buy and sell decisions for the pre-October 2008 period. For example, in September 2013, F-Squared's public website featured news articles with statements such as:
 - i. "Back in mid-2007, well before the financial debacle that began with the collapse of the investment bank Bear Stearns, Howard Present, co-founder, president and CEO of F-Squared Investments in Boston, had a strategy that determined that financial stocks were becoming too risky. But they didn't just sell down the financial holdings, which at the time represented one-ninth of his strategy's investments. He sold *all* his financial holdings."
 - ii. "We eventually dropped the tech sector in 2001," says Present.
 - ii. "Financials in 2006, [Present] notes, had moved from a historic average of about 15% of the S&P to 28%, or nearly double, which was another sign of a bubble that F-Squared was able to avoid. . . And when [Financials] started to show signs of decline, F-Squared dropped its entire financials allocation like a hot potato."
 - l. F-Squared's various Forms ADV filed during the period October 2008 to September 2013 inaccurately claimed that the investment models underlying the index had been used to manage actual client assets between April 2001 and September 2008.
18. From late December 2009 to May 2012, certain employees of Wells Fargo Advisors received and in some case reviewed and/or analyzed certain attachments sent to them by F-Squared Investments. The attachments sent to them contained the same information which the SEC found to be false and misleading in the Administrative Consent Order entered into by F-Squared Investments.
 19. In early 2013, F-Squared Investments began discussions with Wells Fargo Advisors to include two F-Squared Investments' money manager strategies on the Masters Expanded list.
 20. As part of its due diligence process, Wells Fargo Advisors requested and F-Squared Investments provided copies of the audit reports that Ernst & Young LLP had prepared since 2008. Ernst & Young LLP issued clean audits and verified that F-Squared Investments was in compliance with the Global Investment Performance Standards ("GIPS") for the years 2008-2013. GIPS compliance indicates actual returns based on live assets.
 21. In addition, as part of the due diligence process, F-Squared Investments submitted answers to a due diligence questionnaire and exhibits.
 22. The exhibits included the following documents, containing the same false and misleading information referenced in the SEC Administrative Consent Order:
 - a. A printout of an Excel spreadsheet which is titled "Allocation in the model Portfolio at time of rebalancing" and from March 31, 2001 - March 31, 2013. The top of the first page contained the following statement: "See important information on the final page." The final page contained 9 paragraphs of small print. The third paragraph

contained the same false paragraph that was cited in the SEC Administrative Consent Order regarding data dating back to 2001 and not backtested.

- b. A brochure marked "Sample" on all pages and titled "AlphaSector Premium Index." It contained the same chart that was cited in the SEC Administrative Consent Order, except this chart was through December 2012 and the SEC's chart was through June 2013. Additionally, one page was titled "Important Information" and contained the same language that was cited in the SEC Administrative Consent Order regarding an inception date of April 1, 2001.
23. Responses to the questionnaire included or omitted certain information regarding F-Squared Investments and the performance of AlphaSector:
 - a. Question 1 on page 3 asked when the firm was founded. F-Squared Investments stated that it was founded in 2006, but the trading and performance information for AlphaSector stated that the inception date was 2001.
 - b. F-Squared Investments provided an organizational chart which listed five firms that were clearly investment advisers, or other entities required to be registered, but only provided the ADVs for two of the entities: F-Squared Institutional Advisors, LLC and F-Squared Capital, LLC. It did not provide the ADV for F-Squared Investments, LLC, even though that entity was the main entity and was registered as a Federally Covered Investment Adviser during the relevant time period.
 - c. Question 9 on page 17 asked: "Do the rates of return represent live results or simulated/model results? If results are not live, please explain why." The Answer was: "F Squared Investments reports index performance for the AlphaSector Indices. In addition, F Squared has GIPS-compliant performance tracking a number of individual indices in the AlphaSector suite." However, the GIPS reports prepared by Ernst & Young LLP were for October 2008 through 2012 and did not cover any prior period.
 - d. Question 12 on page 18 stated: "Please complete the table below." The table requested information regarding Composite Assets, Composite Accounts and Firm Assets. The table was from 2001 through 2013. The table was blank, except for a note for 2013 which stated: "For questions 8 and 12, please see attached GIPS documentation."
24. Wells Fargo Advisors' employees stated they either did not recall receiving or never received the documents described in paragraphs 22 and 23 and that they never reviewed or conducted any analysis of the charts or information provided in the documents.
25. However, Wells Fargo Advisors' emails indicated that certain Wells Fargo Advisors employees were aware of the charts and documents in question and, in some cases, reviewed the information or forwarded the documents to another for review.

26. Wells Fargo Advisors, however, did not utilize F-Squared Investments' inaccurate historical performance data in connection with its decision to onboard F-Squared Investments' strategies to its Masters platform and did not incorporate any inaccurate F-Squared Investments performance data in Wells Fargo Advisors' advertisements or program marketing materials.
27. Section 12.A of the Act provides, *inter alia*, that it shall be a violation of the Act for any person to offer or sell any security except in accordance with the provisions of the Act.
28. Wells Fargo Advisors' conduct, as described above, violated Section 12.A of the Act.
29. Section 11.E(4) of the Act provides, *inter alia*, that if the Secretary of State, after finding that any provision of the Act has been violated, may impose a fine as provided by rule, regulation, or order; an order of censure; and charge all reasonable expenses as costs of investigation.
30. By virtue of the foregoing, the Respondent could be subject to (i) a fine of up to \$10,000 per violation and (ii) an order of censure.

You are further notified that you are required pursuant to Section 130.1104 of the Code to file an answer to the allegations outlined above or other responsive pleading within ten (10) days of the receipt of this Notice. A failure to do so within the prescribed time shall be deemed an admission of the allegations contained in the Amended Notice of Hearing and waives your right to a hearing.

You may be represented by legal counsel, present evidence, cross-examine witnesses and otherwise participate. However, a failure to appear shall constitute default.

Delivery of Notice to the designated representative of the Respondent constitutes service upon such Respondent.

ENTERED: This 21st day of December, 2017



JESSE WHITE
Secretary of State
State of Illinois

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