

November 24, 2015

Victim of Fraud Sued for Fraud

On November 16, 2015, the Securities and Exchange Commission (SEC) sued an investment adviser, Virtus Investment Advisers, Inc., who had hired another adviser, F Squared Investments, Inc., to sub-advise certain mutual funds Virtus managed and to assist Virtus in managing certain separately managed accounts. *In re Virtus Investment Advisers, Inc.*, Admin. Pro. No. 3-16959 (Nov. 16, 2015).

This action follows upon an action by the SEC on December 24, 2014, in which the SEC sued F Squared, alleging that, in 2008, it had created a signaling algorithm to rebalance a portfolio of exchange-traded funds (ETFs). F Squared allegedly falsely claimed that the signaling algorithm had been developed in 2001, falsely claimed that the back-tested performance it calculated for the algorithm was actual performance, and ignored errors in the back-tested performance calculation that resulted in a 350 percent overstatement of performance.

Virtus is alleged by the SEC to have been negligent in failing to investigate F Squared's false claims more closely. In the press release announcing the case, the SEC stated that:

“Virtus accepted F-Squared's historical performance misrepresentations at face value and ignored red flags that called these statements into question,” said Andrew J. Ceresney, Director of the SEC Enforcement Division. “If an investment adviser chooses to advertise, it is responsible for the content and accuracy of its ads.”

Julie M. Riewe, Co-Chief of the SEC Enforcement Division's Asset Management Unit, added, “By failing to take steps to verify F-Squared's claims, Virtus solicited investors using materially false and misleading AlphaSector performance data.”

Although the SEC acknowledges that F Squared lied to Virtus, the SEC accuses Virtus of negligence because it ignored the following warnings that F Squared's claims were false:

- In 2009, the Financial Industry Regulatory Authority commented on advertisements for the Virtus funds, noting that the F Squared performance was back-tested.
- In 2011, when Virtus questioned an F Squared executive about its claims, Virtus did not adequately follow up and did not insist that all its questions be answered.
- In 2013, when the firm that provided F Squared with the signals for its algorithm told Virtus that it could not recreate the F Squared track record, Virtus failed to follow up on these concerns.
- When certain wholesalers for the Virtus funds falsely claimed that actual clients had used the F Squared algorithm since 2001, Virtus failed to correct these misstatements.

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In addition to anti-fraud allegations, Virtus was alleged to have failed to adopt adequate policies and procedures to verify third-party claims that Virtus disseminated:

Virtus had no written policies and procedures for evaluating and monitoring the accuracy of third-party-produced performance information or third-party marketing materials that Virtus directly or indirectly circulated or distributed to other persons. As a result, Virtus failed to adopt and implement reasonably designed written policies and procedures regarding the retention of books and records necessary to support the basis for performance information in advertisements directly or indirectly circulated or distributed by Virtus.

The SEC also alleged that Virtus “never made or kept sufficient records or documents to form the basis or demonstrate the calculation of the performance or rate of returns of the historical performance of the” F Squared algorithm.

Virtus settled the SEC action, paying \$13.4 million in disgorgement, \$1.1 million in pre-judgment interest, and a fine of \$2 million.

The Virtus enforcement action raises the question of when an adviser can be liable for disseminating misstatements by another entity. The SEC has historically articulated the standard for such liability as follows:

Whether third-party information is attributable to an issuer depends upon whether the issuer has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information. In the case of issuer liability for statements by third parties such as analysts, the courts and we have referred to the first line of inquiry as the “entanglement” theory and the second as the “adoption” theory. Rel. 33-7856 (April 28, 2000).

Since there is no allegation Virtus “entangled” itself in the preparation of F Squared’s false statements, Virtus’ liability must rest upon the “adoption” theory of liability. Apparently, according to the SEC, “adoption” together with negligence, demonstrated by the failure adequately to follow up on warnings, is sufficient to find an adviser liable for disseminating a third-party’s false statements.

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