Someone Else's Fraud Is Your Problem Too: Potential Investment Adviser Liability After *F-Squared*

By Jay G. Baris and Matthew J. Kutner

"When an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact."

– Andrew J. Ceresney,
Former Director of the SEC Enforcement Division.[1]

Introduction

Since December 2014, investment advisers have become intimately familiar with the direct ramifications of *In the Matter of F-Squared Investments, Inc*.[2] Reduced to its most basic principle, *F-Squared* is a not-so-gentle reminder to investment advisers to approach performance advertising with extreme caution. The real (and more eye-opening) lesson from *F-Squared*, however, appears in enforcement actions stemming from investment advisers that relied on an adviser's representations and those advisers' potential liability for second-tier publication of allegedly false and misleading performance. Caution! Another investment adviser's performance advertising could be your problem too. In this article, we provide an overview of *F-Squared*, and some of its progeny, in addition to summarizing the general legal landscape regarding performance advertising. Last, we address some practical implications for investment advisers seeking to mitigate potential liability.

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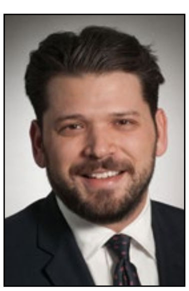

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In the Matter of F-Squared Investments, Inc.

From October 2008 to September 2013, F-Squared Investments, Inc. ("F-Squared"), a registered investment adviser, and the firm's former CEO marketed an exchange-traded fund ("ETF") sector rotation strategy called "AlphaSector." AlphaSector was based on an algorithm that yields a "signal" indicating whether to buy or sell certain ETFs. While marketing the product, F-Squared allegedly falsely advertised a successful seven-year track record for the strategy based on purported actual performance. F-Squared specifically stated that the performance was not "back-tested." In actuality, however, the performance *was* back-tested and there were significant performance calculation errors resulting in substantial performance overstatements.

Ultimately, in an enforcement action initiated by the U.S. Securities and Exchange Commission ("SEC"), F-Squared admitted that it violated numerous sections of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and its related rules. These errors swept up certain mutual funds subadvised by F-Squared into alleged violations of Section 34(b) of the Investment Company Act of 1940, as amended (the "1940 Act"). In addition to admitting to the violations and agreeing to cease and desist from committing or causing further violations, F-Squared agreed to pay disgorgement of $30 million and a civil money penalty of $5 million.

Reduced to its most basic principle, F-Squared is a not-so-gentle reminder to investment advisers to approach performance advertising with extreme caution.

Adviser Performance Advertising – Summary of Laws and Regulations

The Advisers Act and Related Rules

Investment advisers, whether they are registered or not, are subject to general antifraud provisions contained in the federal securities laws. Sections 206(1) and 206(2) of the Advisers Act prohibit investment advisers from employing devices, schemes, or artifices to defraud clients and prospective clients, and from engaging in transactions or practices that operate as a fraud or deceit upon clients and prospective clients.[3] Section 206(4) of the Advisers Act broadly prohibits investment advisers from engaging in "fraudulent, deceptive, or manipulative" activities.[4] In addition, Section 207 of the Advisers Act prohibits any person from willfully including any untrue statement of material facts (or willfully omitting them) in a registration statement or other filing with the SEC.[5]

The SEC relies on the broad antifraud provisions of Section 206 to regulate advertising by registered investment advisers and advisers "required to register" under the Advisers Act. Rule 206(4)-1 under the Advisers Act provides guidance related to certain advertising practices that the SEC deems to be *per se* fraudulent.[6] In addition, under Rule 206(4)-1, an advertisement "which contains any untrue statement of a material fact, or which is otherwise false or misleading" will be deemed to violate Section 206.[7]

Rule 206(4)-7 under the Advisers Act requires, among other things, that registered advisers "adopt and implement written policies and procedures reasonably designed to prevent violation . . . of the [Advisers] Act and the rules [under the Advisers Act]."[8] Moreover, Rule 206(4)-8 under the Advisers Act prohibits fraud committed against "investors" in "pooled investment vehicles" (including private funds relying on an exception from the definition of an investment company under 1940 Act).[9]

Rule 204-2(a)(16) under the Advisers Act requires investment advisers to make and keep true, accurate and current books and records relating to their advisory business, including documents necessary to form the basis for or to demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, advertisement or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons.[10]

FINRA

Investment advisers that are also registered as broker-dealers ("dual registrants") are subject to FINRA's rules governing communication with the public (both retail and institutional investors).[11] Generally, FINRA requires that a firm's principal approve retail communications prior to their use. Institutional communications do not necessarily require principal review. Moreover, FINRA requires that certain communications be filed with it prior to use.

Global Investment Performance Standards (GIPS®)

Many investment advisers choose to follow the GIPS standards,[12] which are voluntary and based on the fundamental principles of full disclosure and fair representation of investment performance results. These widely accepted standards seek "to establish investment industry best practices for calculating and presenting investment performance that promote investor interests and instill investor confidence," among other things. It is worth noting that most institutional investors require that adviser presentations adhere to the GIPS standards. One of the fundamental tenets of GIPS compliance is that "firms must not present performance or performance-related information that is false or misleading." GIPS also sets forth "Advertising Guidelines," which provide firms with options for advertising performance. These guidelines only apply to firms that already satisfy all the requirements of the GIPS standards on a firm wide basis, and claim compliance with the GIPS standards in an advertisement. Some firms hire independent third parties to audit their GIPS compliance.

F-Squared (or Times 13)

While the fallout from *F-Squared* is certainly a cautionary tale filled with meaningful guidance, the subsequent SEC enforcement actions against investment advisers that perpetuated F-Squared's allegedly erroneous performance statistics are more alarming.

In August 2016, the SEC settled with 13 investment advisory firms for "negligently" spreading F-Squared's allegedly false AlphaSector performance claims to their clients.[13] These firms were saddled with fines ranging from $100,000 to $500,000. While these fines may appear to be small (compared to F-Squared's $35 million fine), one has to factor in the cost of damage to these firms' reputations, not to mention the legal costs incurred in defending an action — even a settled action — against the SEC.

In essence, these enforcement actions boil down to the principle that even though these advisers were not the original source of the publication of allegedly incorrect data (that fault admittedly lies with F-Squared), they either knew or should have known that the performance data presented to them was inaccurate, and in turn should not have duplicated these representations in their own distributed advertising materials. In short, the SEC appears to take the position that these advisers were negligent at the very least. A violation of Section 206(2) does not require a showing of scienter but "may rest on a finding of simple negligence."[14] In other words, a lack of knowledge is not a defense, and simply "willfully" including this information in the advertisement where the SEC can demonstrate that an adviser "should have known" is sufficient for potential liability.[15]

This may leave investment advisers feeling queasy. After all, shouldn't they be able to trust the representations of another seemingly reputable adviser's work? The short answer is that blind reliance is not enough. Investment advisers may trust, but they must independently verify (and document) too.

Practical Considerations

What are investment advisers to do to mitigate their own potential liability for the fraud of another investment adviser?

Policies and Procedures

As part of their compliance program under Rule 206(4)-7 under the Advisers Act, investment advisers should have clear and meaningful policies that govern how they conduct their due diligence of other investment advisers or subadvisers. With respect to inquiries into performance and performance calculations, these policies should assist in uncovering the veracity and reliability of performance data. Pertinent due diligence questions may include, for example:

- How is performance calculated?
- Who is responsible for the calculation, and how is the underlying data verified?
- Where are the records containing the supporting data inputs for performance calculations?
- What steps does the adviser take in the event that a performance calculation error is uncovered, and how will clients be notified?
- Are independent verification tools available?
- Does the adviser have an internal audit process?
- Are performance results audited by an independent third party?
- Is there a maker/checker process?
- Is performance dispersion across accounts checked?

Due Diligence

From a liability perspective, due diligence does not mean getting to an absolute answer or always uncovering all underlying facts. Rather, it is a robust and reasonable inquiry into the entity and the facts at hand. After all, some advisers may reasonably be hesitant to reveal their "secret sauce" for success. This does not mean, however, that advisers cannot receive information about the underlying adviser's processes and obtain facts necessary to understand how the underlying adviser's performance is achieved, overseen and verified. If an adviser is promoting an investment product that beat the S&P 500 Index's performance by 350 percent for the past seven years, for example, a reasonable due diligence process should seek to uncover with as much detail as is possible the process for calculating and delivering performance. At the very least, an adviser should want to know that the advertised product *really did* achieve what it is being advertised as having done.

A lack of knowledge is not a defense, and simply "willfully" including this information in the advertisement where the SEC can demonstrate that an adviser "should have known" is sufficient for potential liability.

As mentioned above, Rule 204-2(a)(16) under the Advisers Act requires a registered investment adviser to make and keep true, accurate and current books and records, including documents necessary to form the basis for or demonstrate the calculation of an account's performance. That information should be readily available in the due diligence process, and advisers should scrutinize it closely and ask questions – many questions.

Certifications

After advisers have followed their policies and conducted thorough due diligence, and everything appears to pass muster, many may want to increase their comfort level and ask for certifications from the underlying adviser. For example, an adviser could start with asking for representations that all of the performance data presented is in accordance with all applicable securities laws and standards. No entity (or individual) likes to give blanket certifications, so the final language of such a certification will likely be the product of negotiations and careful tailoring. But if an underlying adviser refuses to provide a certification, or seeks to whittle the language down to a meaningless form, this should serve as a red flag that perhaps the data presented is too good to be true and, at the very least, advisers should inquire further.

Review of performance data requires careful scrutiny to ensure that an adviser does not become derivatively liable for the inaccuracies of its service providers.

ENDNOTES

* Jay Baris represents investment companies, broker-dealers, investment advisers and other financial institutions in the full spectrum of financial services regulation. He helps clients develop new financial products that cross over banking, commodities, insurance and securities law. Mr. Baris counsels independent directors on governance issues. He also advises mutual funds and investment advisers on mergers and acquisitions, reorganizations, compliance, exemptive applications and innovative regulatory issues. He has advised fund administrators and custodians on a wide range of contractual and operational issues.

** Matthew Kutner advises investment companies, including open-end, exchange-traded funds and unit investment trusts, investment advisers and boards of trustees on a variety of legal, business, compliance and transactional matters arising under the Investment Company Act of 1940, the Investment Advisers Act of 1940 and other applicable laws and regulations. Mr. Kutner also counsels independent board members of mutual funds on their responsibilities, including under Section 15(c) of the Investment Company Act of 1940, and regularly attends board and committee meetings. He also advises operating companies on investment company status issues, and is a frequent writer on legal and regulatory topics and best practices within the investment management industry.

1 Press Release, U.S. Securities and Exchange Commission, Investment Advisers Paying Penalties for Advertising False Performance Claims (Aug. 25, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-167.html.

2 In the Matter of F-Squared Investments, Inc. (Inv. Advisers Act of 1940 Release No. 3,988; Inv. Co. Act of 1940 Release No. 31,393) (Dec. 22, 2014), *available at* https://www.sec.gov/litigation/admin/2014/ia-3988.pdf.

3 Investment Advisers Act of 1940 §§ 206, 15 U.S.C. §§ 80b-1-80b-21 (2012).

4 17 C.F.R. § 275.206(4)-4 (2003).

5 § 207, 15 U.S.C. § 80b-7 (2012).

6 17 C.F.R. § 275.206(4)-1 (1997); *see* Inv. Advisers Act of 1940 Release No. 121 (Nov. 2, 1961).

7 § 275.206(4)-1.

8 17 C.F.R. § 275.206(4)-4 (2003).

9 17 C.F.R. § 275.206(4)-8 (2007).

10 17 C.F.R. § 275.204-2 (2007).

11 *See generally* FINRA Rule 2210, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10648.

12 *See* http://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2010.n5.1.aspx.

13 *See supra* note 1.

14 *See* SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180, 191 (1963))

15 A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id*. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).