

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 4266 / November 16, 2015

INVESTMENT COMPANY ACT OF 1940
Release No. 31901 / November 16, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16959

In the Matter of

**VIRTUS INVESTMENT
ADVISERS, INC.,**

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTIONS 203(e) AND 203(k) OF
THE INVESTMENT ADVISERS ACT OF
1940, AND SECTIONS 9(b) AND 9(f) OF
THE INVESTMENT COMPANY ACT
OF 1940, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Virtus Investment Advisers, Inc. (“Respondent” or “Virtus”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over Respondent and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

1. This matter arises from misstatements made by registered investment adviser Virtus to certain of its mutual fund clients, to those funds' shareholders, and to clients in separately managed accounts concerning its subadviser F-Squared Investments, Inc.'s ("F-Squared") materially inflated, and hypothetical and back-tested, performance track record.

2. AlphaSector is a sector rotation strategy based on an algorithm that yields a "signal" indicating whether to buy or sell nine industry exchange-traded funds ("ETFs") that together made up the industries in the S&P 500 Index. Between September 2009 and May 2015, Virtus advised six mutual funds and certain separately managed accounts ("SMAs") that used AlphaSector (collectively, the "Virtus AlphaSector Funds"). The Virtus AlphaSector Funds grew quickly, with assets under management increasing from \$191 million at the end of 2009 to approximately \$11.5 billion by 2013.

3. From May 2009 to September 2013, in certain client presentations, marketing materials, filings with the Commission, and other communications, Virtus falsely stated that: (a) the AlphaSector strategy had a history that dated back to April 2001 and had been in use since then; and (b) the track record had significantly outperformed the S&P 500 Index from April 2001 to September 2008. In fact, no F-Squared or other client assets had tracked the strategy from April 2001 through September 2008. In addition, F-Squared miscalculated the historical performance of AlphaSector from April 2001 to September 2008 by incorrectly implementing signals in advance of when such signals actually could have occurred. As a result of this inaccurate compilation of historical data, Virtus advertised the AlphaSector strategy by using hypothetical and back-tested historical performance that was substantially inflated over what performance would have been if F-Squared had applied the signals accurately.

4. Virtus also failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, as required by Section 206(4) of the Advisers Act and Rule 206(4)-7. Specifically, Virtus's compliance policies and procedures with respect to performance advertising and the retention of books and records supporting the performance or rate of return of managed accounts in performance advertisements addressed Virtus's obligations with respect to advertising the performance of Virtus's clients' accounts but not the performance obtained by other advisers or sub-advisers in performance advertisements directly or indirectly circulated or distributed by Virtus. Given its manager of managers business model, Virtus failed to adopt and implement policies and procedures regarding: (a) the accuracy of third-party produced performance information and third-party marketing materials; and (b) the reporting and assessment of concerns about the accuracy of statements in Virtus's marketing materials and other disclosures.

¹ The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

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.

5. In addition, Virtus violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder by publishing, circulating, and distributing advertisements that contained untrue statements of material fact. Virtus likewise failed to make and keep true, accurate and current records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of returns that it circulated and distributed, as required by Section 204 of the Advisers Act and Rule 204-2(a)(16) thereunder.

Respondent

6. **Virtus Investment Advisers** (SEC File No. 801-5995) is an investment adviser registered with the Commission since September 1969 and is headquartered in Hartford, Connecticut. Virtus provides advice to mutual funds and separately managed accounts that employ a variety of investment strategies. As of March 31, 2015, Virtus had regulatory assets under management of approximately \$36 billion.

Other Relevant Entities

7. **Virtus Investment Partners, Inc.** is the parent company of Virtus and is headquartered in Hartford, Connecticut. The common stock of Virtus Investment Partners is registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 and is listed for trading on NASDAQ using the ticker VRTS.

8. **F-Squared Investments, Inc.** (“F-Squared”) (SEC File No. 801-69937) is an investment adviser registered with the Commission since March 2009 and is headquartered in Wellesley, Massachusetts. In October 2008, F-Squared launched its first AlphaSector index. F-Squared sub-licenses its approximately 75 AlphaSector indexes to unaffiliated third parties who manage assets pursuant to these indexes. On December 22, 2014, the Commission instituted a settled fraud action against F-Squared in which F-Squared admitted, among other things, to making the materially false claims that (a) the signals that formed the basis of the AlphaSector index returns had been used to manage client assets from April 2001 to September 2008; and (b) the signals resulted in a track record that significantly outperformed the S&P 500 Index from April 2001 to September 2008.

9. **Howard Brian Present** (“Present”), age 54, resides in Wellesley, Massachusetts. In 2006, Present co-founded F-Squared and was the President and CEO until his separation in 2014. As of August 2015, Present owned approximately 20.5% of F-Squared Investment Management, LLC, of which F-Squared is a wholly-owned subsidiary. On December 22, 2014, the Commission filed a complaint against Present in the United States District Court for the District of Massachusetts.

Facts

Virtus Hired F-Squared to Subadvise Its Investment Products

10. In early 2009, Virtus and F-Squared began discussions to have F-Squared subadvise two Virtus-advised mutual funds, which would follow the AlphaSector sector rotation strategy. F-Squared marketed AlphaSector to Virtus as an ETF sector rotation strategy that was based on an algorithm that yields a “signal” indicating whether to buy or sell nine industry ETFs.² If the algorithm produced buy signals for three or fewer sector ETFs, the AlphaSector strategy provided for some or all of the assets to be invested in cash equivalents.

11. Present and F-Squared described the strategy falsely to Virtus by, among other things, representing that: (a) the AlphaSector strategy had been used to manage client assets from April 2001 to September 2008, often calling it a “live” track record; and (b) the track record had significantly outperformed the S&P 500 Index from April 2001 to September 2008. In reality, no assets tracked the strategy until 2008 and the back-tested track record was substantially overstated.

12. Virtus was negligent in not knowing that the F-Squared track record and performance were false. At the outset of the potential relationship with F-Squared, Virtus expressed skepticism about AlphaSector’s so-called “live” track record. Nevertheless, Virtus took no steps to determine whether F-Squared’s buy or sell signals were generated or used in any trading decisions during the April 2001 through September 2008 period.

13. Rather, Virtus recommended that the boards of trustees of the Virtus mutual funds and those funds’ shareholders approve the change in management and strategy to F-Squared and AlphaSector, respectively, based, at least in part, on the false historical performance of AlphaSector. Virtus presented materials to one fund board of trustees that stated: “The strategy has a model portfolio track record utilizing the actual signals of the quantitative model dating back 2001.” In correspondence to a different board of trustees, Virtus represented falsely that the “Premium AlphaSector strategy has a track record that started in 2001.” In documents provided to investors and included in certain funds’ 2009 proxy filed with the Commission, it was also falsely stated that F-Squared had “managed investments using the [AlphaSector] strategy since 2001.” Following Virtus’s advice and recommendation, the boards of trustees and shareholders eventually approved the transition of the mutual funds to AlphaSector.

² F-Squared has created several AlphaSector strategies and sub-licenses approximately 75 AlphaSector indexes. The AlphaSector indexes that are the subject of this matter, including the AlphaSector Premium Index and the AlphaSector Rotation Index, are based on investments in U.S. Equity ETFs. As with all indexes, the performance of the AlphaSector Premium and AlphaSector Rotation indexes are inherently hypothetical in the sense that the index does not purport to reflect the performance of any particular client or account. However, the AlphaSector Premium Index and AlphaSector Rotation Index were advertised as being based on a strategy that had been in place since 2001 and therefore the performance of these indexes was advertised as “not backtested” when in fact the performance *was* backtested.

Virtus’s Marketing Efforts Contained Misleading Statements

14. From 2009 through September 2013, Virtus used the claimed “live” eight-year track record of AlphaSector as a lead marketing point for Virtus’s AlphaSector products despite warnings in 2009 from a regulator that the track record in marketing materials was back-tested.

15. On October 1, 2009, the Financial Industry Regulatory Authority (“FINRA”) raised issues with Virtus about the track record of the AlphaSector Rotation Index after Virtus included it in mutual fund marketing materials. FINRA informed Virtus that “[b]ack-tested performance is misleading.” On November 24, 2009, FINRA notified Virtus that the “performance prior to October 13, 2008, when NASDAQ OMX began publishing and disseminating the [AlphaSector Rotation Index] value on a daily basis, is back-tested. We are concerned that the process could be manipulated to obtain desired outcomes.” Virtus nonetheless included the misleading “returns” of the back-tested AlphaSector index in appendices to certain Virtus AlphaSector Funds’ prospectuses and marketing materials, including detailing the purported performance on a year-by-year basis in the following manner.

The tables below show performance of the AlphaSector Rotation Index as compared with the performance of the S&P 500 Index. The AlphaSector Rotation Index and the S&P 500 Index are not available for direct investment and their performance does not reflect the fees, expenses or taxes associated with the active management of an actual portfolio. Both indexes are calculated on a total return basis with dividends reinvested.

	<u>AlphaSector Rotation Index</u>	<u>S&P 500 Index</u>	
Annual Returns (calendar year)			
2002	-8.18%	-22.10%	
2003	9.38%	28.68%	
2004	13.89%	10.88%	
2005	5.65%	4.91%	
2006	14.40%	15.79%	
2007	14.18%	5.49%	
2008	-8.54%	-37.00%	
2009	25.37%	26.46%	
2010	15.50%	15.06%	
	<u>1 Year</u>	<u>5 Years</u>	<u>Since Inception of AlphaSector Rotation Index (4/1/01)⁽¹⁾</u>
Average Annual Total Return (for the periods ended 12/31/10)			
AlphaSector Rotation Index	15.50%	11.58%	7.94%
S&P 500® Index	15.06%	2.29%	2.77%

⁽¹⁾ The Index inception date is April 1, 2001; it commenced daily calculation and dissemination by NASDAQ OMX with a base value 1,000.00 on October 13, 2008.

Virtus caused the funds to amend their prospectuses to include this past performance. Virtus also published and distributed marketing materials for separately managed accounts that included the misleading returns of the back-tested AlphaSector indexes. In addition, Virtus circulated this past performance through other means. For example, Virtus wholesalers emailed financial advisors links to presentations contained on the F-Squared website and directed them to the specific pages that contained the performance of the AlphaSector indexes for periods that included 2001-2008.

16. Certain Virtus wholesalers—who were the public face of the Virtus AlphaSector products—marketed the AlphaSector track record, which they characterized inaccurately. Virtus

wholesalers' talking points stated that "[AlphaSector] Index returns are not back tested as the track record is based on the actual model signals at the time they occurred since 2001" and falsely characterized the index as "live" or "running live assets."

17. Certain Virtus wholesalers also represented that a private wealth advisor had employed the strategy to invest real assets over the same securities and time period represented in the index—essentially, the index was a proxy for the track record of accounts that followed AlphaSector.

18. Virtus did not take adequate steps to correct the misstatements of its sales force and wholesalers even though some within Virtus had contradictory understandings of how to describe accurately the historical performance of AlphaSector. For example, Virtus's Product Management group understood that the AlphaSector Premium and AlphaSector Rotation indexes had no assets and never traded. The Virtus product manager responsible for AlphaSector also believed that the algorithm that drove the price momentum model underlying the AlphaSector strategy had been used since 2001, but on a different portfolio construction, including possibly different securities and trading rules. This product manager understood the AlphaSector strategy's then-current portfolio construction was not established by Present until 2008, meaning that no "live" assets could have been traded using the AlphaSector strategy prior to 2008 using the portfolio construction employed by the Virtus AlphaSector Funds. Virtus did not adequately communicate this understanding to Virtus's wholesalers.

Virtus Failed to Respond to Concerns about AlphaSector and F-Squared

19. While F-Squared and Present lied to Virtus about the history and performance of AlphaSector, Virtus did not adequately investigate concerns about the representations Present and F-Squared had made. For example, beginning in 2011, market participants told certain Virtus wholesalers that the AlphaSector indexes were backtested and "live" assets had not been tracking these indexes since 2001. When Virtus questioned Present about this, Present did not provide answers to many of the questions, but Virtus did not follow up to obtain the requested information or change how it used and marketed AlphaSector.

20. Virtus also received conflicting representations from Present about the origins of the strategy, including who created the strategy. Virtus asked Present to address these issues, but Present never answered them and Virtus did not otherwise follow up to obtain answers.

**Virtus Failed to Respond to Allegations Concerning
The Accuracy of The AlphaSector Index Track Record**

21. In May 2013, principals for the firm that provided F-Squared with the signals for AlphaSector (the “Data Provider”) informed Virtus that they believed the AlphaSector index’s track record may have been miscalculated. The Data Provider’s principals informed Virtus that it had attempted to recreate the advertised track record covering the 2001 through 2008 period, but could not. Virtus took no steps to follow up on the concerns raised by the Data Provider’s principals.

Virtus Failed to Adopt and Implement Adequate Policies and Procedures

22. Virtus was required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. As an adviser that often relied on subadviser or other third-party-produced performance information or third-party marketing materials both in hiring or retaining subadvisers and in marketing a subadviser to its own clients or prospective clients, Virtus should have adopted and implemented policies and procedures reasonably designed to address the accuracy of such information and materials. However, 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.

Virtus Failed to Maintain Adequate Books and Records

23. Virtus was required to make and keep true, accurate and current records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of returns that it circulated or distributed to 10 or more persons. Virtus circulated and distributed the 2001-2008 historical performance of AlphaSector indexes in client presentations, marketing materials, filings with the Commission, and other communications to numerous clients, investors, and potential investors. However, 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 AlphaSector indexes.

Violations

24. As a result of the conduct described above, Respondent willfully³ violated Section 206(2) of the Advisers Act, which prohibits any investment adviser from engaging in any

³ 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.

transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. A violation of Section 206(2) may rest on a finding of simple negligence. *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, 195 (1963)). Proof of scienter is not required to establish a violation of Section 206(2) of the Advisers Act. *Id*

25. As a result of the conduct described above, Respondent willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder, which prohibit any registered investment adviser from, directly or indirectly, publishing, circulating, or distributing an advertisement which contains any untrue statement of material fact, or which is otherwise false or misleading. A violation of Section 206(4) and the rules thereunder does not require scienter. *Steadman*, 967 F.2d at 647.

26. As a result of the conduct described above, Respondent willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

27. As a result of the conduct described above, Respondent willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for any investment adviser to a pooled vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle, or to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

28. As a result of the conduct described above, Respondent willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(16) thereunder. Section 204 of the Advisers Act requires investment advisers to make and keep certain records as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 204-2 under the Advisers Act requires investment advisers registered or required to be registered to make and keep true, accurate and current various books and records relating to their investment advisory business, including all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons.

29. As a result of the conduct described above, Respondent caused certain investment companies to violate Section 34(b) of the Investment Company Act which, among other things, makes it unlawful for any person to make any untrue or misleading statement of material fact in any registration statement, application, report, account, record, or other document filed with the

Cir. 1965)).

Commission under the Investment Company Act, or to omit from any such document any fact necessary in order to prevent the statements made therein from being materially misleading.

Retention of a Compliance Consultant

30. In determining to accept Respondent's Offer, the Commission considered Virtus's retention of an Independent Compliance Consultant in April 2015. Among other things, Virtus hired an Independent Compliance Consultant to conduct a comprehensive review of Virtus's written compliance policies and procedures addressing: (i) with respect to separately managed accounts, the publication, circulation, communication, or distribution of third-party marketing materials or materials that include third-party-produced performance information, (ii) with respect to mutual funds, the publication, circulation, communication, or distribution of third-party materials or materials (including marketing materials, proxy statements, prospectuses, statements of additional information) that include third-party-produced performance information, and (iii) with respect to the initial and continuing due diligence into and retention of subadvisers, policies and procedures related to appropriate oversight of subadviser compliance with Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder and Rule 38a-1 under the Investment Company Act, as appropriate.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 204, 206(2), and 206(4) of the Advisers Act and Rules 204-2, 206(4)-1, 206(4)-7, and 206(4)-8 thereunder and Section 34(b) of the Investment Company Act.

B. Virtus is censured.

C. Virtus shall, within 10 days of the entry of this Order, pay disgorgement of \$13.4 million (\$13,400,000.00) and prejudgment interest of \$1.1 million (\$1,100,000.00) to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways:

- (1) Virtus may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Virtus may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

- (3) Virtus may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Virtus as the Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Jeffrey B. Finnell, Assistant Director, Asset Management Unit, Securities and Exchange Commission, 100 F Street N.E., Washington, DC 20549.

D. Virtus shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$2 million (\$2,000,000.00) to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Virtus may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Virtus may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Virtus may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

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Payments by check or money order must be accompanied by a cover letter identifying Virtus as the Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Jeffrey B. Finnell, Assistant Director, Asset Management Unit, Securities and Exchange Commission, 100 F Street N.E., Washington, DC 20549.

E. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To

preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Brent J. Fields
Secretary