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Fund Heads Seek Toss Of Investors' Suit Over S&P 500 Short

By **Dean Seal**

Law360 (June 6, 2018, 6:00 PM EDT) -- The leaders behind a hedge fund-turned-mutual fund on Tuesday asked a New York federal judge to dismiss an investor suit claiming the fund was disguised as "low-risk" without revealing that it had shorted the Standard & Poor's 500 for an eventual $600 million loss, saying they never misrepresented its investment strategy.

Catalyst Hedged Futures Strategy Fund's registrant, adviser, executives and underwriter argued that the investors' attempt to "manufacture claims" that the fund leaders lied about its investment objectives and the risks of its strategy are disproven by a history of largely positive returns, despite periodic drawdowns. The "perfect storm" of conditions that led to the $600 million drawdown was not unprecedented for its investment strategy, the fund heads said, and doesn't form a basis for claims that the fund's offering documents were misleading.

"The fund accurately described its investment objective, trading strategy and the many risks of investing, including the possibility of 'potentially unlimited losses,'" the Catalyst defendants said. "Its portfolio was publicly disclosed, and anyone interested in the fund's strategy knew that its written call options were not fully hedged or 'covered.'"

The investors said in **their 2017 lawsuit** that Catalyst, once a hedge fund, had been billed in prospectuses and registration statements as having low volatility but failed to mention its high-risk investments, including a bet that the S&P 500 would not rise significantly in value. When the market rallied in February 2017, the fund's value decreased by 15 percent, leading to the investors' claim that the fund's purported strategy of "capital appreciation and capital preservation in all market conditions" was a lie.

"The Catalyst futures fund continued to invest as if it were a hedge fund, taking massive directional bets against U.S. stock market indexes through complex derivative instruments, thereby exposing investors to the heightened risk of loss of capital," the investors said last year.

The Catalyst defendants fired back on Tuesday, saying that the investors were trying to recast the fund as low-risk and conservative merely so they could knock it down. The offering documents provided to investors fully disclosed the fund's investment strategy and risks, including its ability to write and execute 'uncovered' call options on S&P 500's futures contracts that exposed the fund to drawdowns, the Catalyst defendants said. The investors' assertion that the uncovered call options were "not readily apparent to retail investors" is "absurd," the fund leaders said, because a cursory review of the investment schedules showed that the fund was writing call options on S&P futures without covering them with underlying futures contracts or offsetting call options.

Investors were forewarned of the risks associated with that strategy, the fund heads said, citing the fund prospectus' section titled "Options Risk," in which Catalyst explicitly stated that unhedged calls exposed the fund to "potentially unlimited losses." Catalyst never promised investors that its risk controls were perfect and said only that it intended to provide consistent returns and mitigate losses, the fund leaders said.

All that aside, the Catalyst defendants said, the claims are time-barred by the Securities Act's requirement that investor claims must be filed within one year after the discovery of an untrue statement or omission that should have been made through reasonable due diligence. The fund's offering documents have indicated since 2014 that its investment schedules included uncovered call options and warned in 2015 that the rapidly rising market was not ideal for its investment strategy. The investors were thus too late when they filed their action in April 2017, the Catalyst defendants said.

Representatives for the parties did not immediately respond to request for comment on Wednesday.

The investors are represented by Samuel H. Rudman, Evan J. Kaufman, William J. Geddish, David C. Walton and Brian E. Cochran of Robbins Geller Rudman & Dowd LLP, James W. Johnson, Michael H. Rogers and John J. Esmay of Labaton Sucharow LLP, and Frank J. Johnson and W. Scott Holleman of Johnson & Weaver.

The Catalyst defendants are represented by James F. Moyle and Jacob A. Englander of Lazare Potter Giacovas & Moyle LLP, Michelle Gitlitz of Blank Rome LLP, Brian C. Devine and Mark Holland of Goodwin Procter LLP, and Zachary J. Ziliak of Ziliak Law LLC.

The case is Emerson et al. v. Mutual Fund Series Trust et al., case number 2:17-cv-02565, in the U.S. District Court for the Eastern District of New York.

--Additional reporting by Adam Rhodes. Editing by Stephen Berg.
