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SEC Antifraud Rule Applicable to Investment Advisers to "Pooled Investment Vehicles" Becomes Effective

On September 10, 2007, new Rule 206(4)-8 (the "Rule")[1] under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), became effective. The Rule, adopted by the Securities and Exchange Commission ("SEC") on August 3, 2007,[2] is the latest SEC effort to gain greater regulatory oversight of hedge funds and other so-called "private investment companies" — investment entities which are organized so as to be exempt from SEC registration (and hence regulation) under the Investment Company Act of 1940, as amended. The SEC's previous effort in this regard was thwarted in 2006 when the D.C. Court of Appeals decision in *Goldstein v. Securities and Exchange Commission*[3] vacated a rule adopted by the SEC which required investment advisers to "private funds" to register under the Advisers Act.

Key elements of the new Rule are:

- It is applicable to investment advisers to "pooled investment vehicles" — a term broadly defined to included both investment companies registered under the Investment Company Act and entities which rely on either Section 3(c)(1) or 3(c)(7) for exemption from registration under the Investment Company Act;

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1 The full text of the new rule is reproduced in Annex A.

2 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628, File No. S7-25-06 (August 3, 2007), available at http://www.sec.gov./rules/final/2007/ia-2628.pdf

3 451 F. 3rd 873 (D.C. Cir. 2006), hereafter, *Goldstein*, vacating Investment Advisers Act Rule 203(b)(3)-2.

- It applies to investment advisers whether or not they are registered under the Advisers Act;
- It broadly prohibits any "act, practice, or course of business conduct that is fraudulent, deceptive, or manipulative;" and
- The scope of the Rule covers conduct towards both investors and prospective investors.

The SEC states in the Adopting Release that there is no private right of action under the Rule.[4] Therefore, any future enforcement of the Rule will be by way of SEC initiated action.

Perhaps the most controversial element surrounding the adoption of the Rule is the attempt by the SEC to impose its own gloss on the Rule by way of comments made in the Adopting Release to the effect that it would "not need to demonstrate that an adviser ... acted with scienter" in order to bring an enforcement action under the Rule. The SEC further states that: "We believe use of a negligence standard also is appropriate as a method reasonably designed to prevent fraud."[5] The effort by the SEC to impose its interpretation on the Rule prompted Commissioner Paul S. Atkins to publish his own objections to that aspect of the Adopting Release even though he concurred in the adoption of the Rule.[6]

A brief discussion of the SEC's rationale in adopting the Rule and the Rule's provisions follows.

I. Regulatory History

The SEC stated that it adopted the Rule to "clarify" the SEC's antifraud enforcement authority in light of the opinion of the D.C. Court of Appeals in *Goldstein*. While examining the scope of a regulatory exemption from the provisions of the Advisers Act, the court took the position that the word "client" referred to the investment pool that an investment adviser serves, not to the individual investors in such pool. The SEC asserted in the Adopting Release that *Goldstein* could therefore be read as creating a gap in the Advisers Act antifraud framework as follows: if the client of an investment adviser is the investment pool but not the investors, then fraudulent activity that targeted investors or potential investors may not necessarily be illegal under the Advisers Act. The SEC explained that in an effort to close that asserted "gap," it adopted the Rule pursuant to authority granted under Advisers Act Section 206(4). Since Section 206(4) contains a blanket prohibition on any fraudulent, deceptive, or manipulative "act,

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4 Adopting Release at 14.

5 Adopting Release at 13.

6 Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, available at http://www.sec.gov./rules/final/2007/ia-2628-psaconcurrence.pdf

practice, or course of business" and grants the SEC broad rulemaking authority to adopt rules and regulations "reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative," the SEC was of the view that it had sufficient regulatory authority to adopt the broad antifraud provisions of the Rule.[7]

II. Prohibited Statements and Conduct

The Rule prohibits false and misleading statements as well as fraudulent, deceptive, or misleading conduct. Investment advisers are, therefore, prohibited from making any untrue statement of a material fact, as well as from failing to state a material fact necessary to make the statement not misleading in light of the circumstances under which it was made.[8] Moreover, Rule 206(4)-8(a)(2) makes it illegal to engage in any "act, practice, or course of business that is fraudulent, deceptive, or manipulative" with respect to any investor or prospective investor in a pooled investment vehicle.

In the Adopting Release, the SEC cites the following as illustrative examples of communications that could potentially include materially false or misleading statements:

- the investment strategy an investment pool will pursue;
- the risks associated with an investment in the pool;
- the historic performance of an investment pool;
- the past returns generated by an individual investment adviser;
- the credentials of an investment adviser; and
- the valuation of an investor pool or accounts within such pool.[9]

III. Investors and Prospective Investors

The prohibitions of the Rule apply to statements or conduct directed at investors or *prospective investors*. The SEC disagreed with commenters who argued that the Rule should not apply to prospective investors since no actual harm is suffered until an investment is made. As a policy matter, the SEC took the position that prohibiting false or misleading statements made to, or other fraud on, any prospective investors is a "means reasonably designed to prevent fraud" and therefore properly should come within the prohibitions of the Rule.[10]

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[7] The full text of the Advisers Act Section 206 is reproduced as Annex B.

[8] Rule 206(4)-8(a)(1).

[9] Adopting Release at 10.

[10] Adopting Release at 6.

IV. Registered and Unregistered Investment Advisers

The Rule applies to both registered and unregistered investment advisers. In this regard, the SEC asserted that the Rule does not affect the SEC's existing jurisdiction under Section 206 which broadly applies to investment advisers whether or not registered.

V. Definition of a "Pooled Investment Vehicle"

The Rule defines a pooled investment vehicle as any "investment company," as that term is defined by Section 3(a) of the Investment Company Act, as well as any company that would be an investment company under the Investment Company Act but for the exemptions provided by Section 3(c)(1) or Section 3(c)(7) of that Act.[11] The definition therefore covers investment vehicles that are structured to come within either of those exemptive provisions and thus includes hedge funds, private equity funds, venture capital funds, and other types of private capital investment vehicles. The SEC notes that it has brought antifraud enforcement action against some of these types of entities since at least 1995[12] as apparent justification for this aspect of the Rule's scope.

VI. SEC Asserts Negligence Standard Applies

Perhaps the most controversial aspect of the Adopting Release is the requisite state of mind which would give rise to a violation of the Rule. The SEC asserts that it would "not need to demonstrate that an adviser ... acted with scienter" in order to bring an enforcement action under the Rule.[13] Absent a scienter requirement, the Rule would make negligent conduct illegal under the Advisers Act. Thus, according to the SEC, an investment adviser with no intent to mislead or defraud could nonetheless face liability, for example, for negligently distributing sales information containing false or misleading information to potential investors. In addition, because the Rule applies to prospective investors as well as actual investors, an adviser could face liability even if no securities are actually bought or sold and no damages are incurred.[14] If

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[11] Section 3(c)(1) exempts a company having 100 or fewer security holders and which is not making and does not propose to make a public offering of its securities. Section 3(c)(7) exempts a company whose securities are owned at the time of acquisition solely by "qualified purchasers" (as defined) and which is not making and does not propose to make a public offering of its securities.

[12] Adopting Release at Footnote 22.

[13] Adopting Release at Footnote 36 citing Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. IA 2576, File No. S7-25-06 (December 27, 2006) Footnote 2, available at http://www.sec.gov/rules/proposed/2006/33-8766.pdf

[14] Adopting Release at 6.

the SEC's view is sustained by a court, the standard of conduct under the Rule would be higher than that applied in Rule 10b-5 securities fraud cases and in actions brought under other Federal securities laws. However, until a court test of the Rule arises and is decided, the SEC has put investment advisers on notice of the conduct standard to which the SEC will hold advisers in enforcing the Rule.

The SEC's position regarding the negligence standard to be used in applying the Rule prompted Commissioner Paul S. Atkins to release a separate concurrence, as noted above, in support of the Rule but challenging the application of a negligence standard to evaluate investment adviser conduct under the Rule. Commissioner Atkins' statement suggests that the SEC may lack the necessary statutory authority to adopt a negligence standard in terms of adviser conduct. Moreover, from a policy perspective, Commissioner Atkins believes the negligence standard could have the unintended effect of misdirecting the SEC's enforcement efforts and, as a result, chill necessary communications among investment advisers and investors. We expect that the evidence of internal disagreement as to the appropriate standard of care required by the Rule will provide some basis for mounting arguments challenging the Rule or at least its application to particular facts in future SEC enforcement actions.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at (212) 701-3100 or jmark@cahill.com; or Mason L. Allen at (212) 701-3607 or mallen@cahill.com.

Annex A

Rules and Regulations promulgated under the Investment Advisers Act of 1940 -- Rule 206(4)-8 -- Pooled Investment Vehicles

(a) Prohibition. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:

> (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
>
> (2) 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.

(b) Definition. For purposes of this section "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7)).

Annex B

The Investment Advisers Act of 1940

Prohibited Transactions by Investment Advisers

Section 206. It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly:

(1) To employ any device, scheme, or artifice to defraud any client or prospective client;

(2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) Acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.