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SEC Affirms Its Enforcement Authority With New Anti-Fraud Rule Under the Advisers Act

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The Securities and Exchange Commission (the "SEC") has a new anti-fraud tool at its disposal. As we reported to you earlier this year,[1] the SEC proposed Rule 206(4)-8 (the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") in response to a ruling by the Court of Appeals for the D.C. Circuit Court in *Goldstein v. SEC*.[2] The SEC was concerned that the Court's ruling created uncertainties with regard to the SEC's enforcement authority and the application of certain anti-fraud provisions of the Advisers Act to advisers to investment pools.

On July 11, 2007, the SEC unanimously adopted the Rule as proposed to clarify its power to bring enforcement actions against advisers who defraud investors or prospective investors in connection with pooled investment vehicles. On August 3, 2007, the SEC issued the release adopting the Rule.[3] The new Rule does not impose additional filing, reporting or disclosure obligations; nor does it create a private right of action or impose additional fiduciary duties on advisers. Advisers to pooled investment vehicles should take note, however, that the new Rule potentially increases the risk of enforcement action for negligent conduct, in addition to reckless or deliberately deceptive conduct, in connection with a finding of fraudulent activity.

Scope of the Rule

Applies to Registered and Unregistered Advisers. The Rule applies to registered *and unregistered* investment advisers to registered *and unregistered* 'pooled investment vehicles' regardless of the investment strategy or structure. The Rule defines 'pooled investment vehicle' to mean any investment company registered under Section 3(a) of the Investment Company Act of 1940 (the "Company Act") and any private investment pool that is excluded from the definition of investment company pursuant to either Sections 3(c)(1) or 3(c)(7) thereof.[4] Consequently, the Rule applies to advisers to mutual funds, closed-end funds, hedge funds, private equity funds, and venture capital funds. Despite arguments made by the mutual fund industry that the Rule added an unnecessary layer of compliance to a highly regulated investment vehicle, the SEC declined to distinguish between registered and unregistered pooled investments. In the SEC's view, all investors should be protected, not just sophisticated and wealthy investors. The Rule does not apply to foreign advisers with respect to their dealings with non-U.S. clients.[5]

Applies to Investors and Potential Investors. The Rule applies to false and misleading statements made to both investors *and potential* investors in pooled investment vehicles. Rejecting arguments that investors are not harmed by fraud until they actually invest, the SEC declined to exclude potential investors from the Rule's protections. Rather, the SEC seeks to protect potential investors who may be enticed into an investment decision by false or misleading statements or fraudulent conduct. The SEC staff maintains that the Rule's coverage is not overbroad by citing to creditors as an example of a group that would not be protected by the Rule.[6] But the far-reaching implications are clear: penalties for false or misleading statements may be imposed even if an investor did not invest or suffer any damages by actually investing in the pooled vehicle.

Broader Scope than Other Anti-Fraud Rules. The Rule prohibits any materially false or misleading statements or omissions to investors in an investment pool, regardless of whether the pool is offering, selling, or redeeming securities. This broad scope differs from other anti-fraud rules, such as Rule 10b-5 under the Securities Exchange Act of 1934, in that the fraudulent conduct need not occur in connection with the purchase or sale of a security. For example, the Rule encompasses misconduct such as distribution of false account statements or shareholder reports that misrepresent the value of assets held by or the performance of a pooled investment vehicle. With respect to side-letter agreements, which are commonly used by private fund advisers, the SEC staff takes the position that whether failure to disclose such agreements is fraudulent is a facts-and-circumstances-based analysis.[7]

The Rule prohibits any investment adviser to a pooled investment vehicle from engaging in any fraudulent "act, practice, or course of business."[8] The SEC declined to be more specific in the Rule, fearing that identifying specific practices could provide a roadmap to those wishing to engage in fraudulent conduct that it failed to identify.

Prohibited Acts & Omissions

- Materially false or misleading statements regarding:
    - Investment strategies
    - Experience or credentials of principals of the Adviser
    - Investment risk
    - Performance
    - Portfolio valuation
    - Adviser's investment opportunity allocations

Pooled Investment Vehicles Impacted

- Hedge Funds
- Private Equity Funds
- Venture Capital Funds
- Mutual Funds
- Closed-End Funds

Pooled Investment Communication Materials

- Account statements
- Private placement memoranda
- Offering circulars
- Quarterly, Semi-Annual, and Annual Reports
- Responses to requests for proposals
- Adviser biographies
- Electronic solicitations
- Personal meetings arranged through capital introductory services

No Scienter Required

The Rule potentially applies a negligence standard with regard to fraudulent conduct.[9] In effect, the Rule departs from certain other anti-fraud rules by not imposing a scienter requirement in connection with the Rule's prohibitions. The SEC supports foregoing a scienter requirement by pointing to the D.C. Circuit Court's finding in *SEC v. Steadman* that Section 206(4) is analogous to Section 17(a)(3) of the Securities Act of 1933, which does not require a finding that the wrongdoer acted with scienter.[10] Further, the absence of a scienter requirement in connection with fraud also is, in the SEC's view, consistent with other federal securities laws and rulings by the Supreme Court.[11] Under the Rule, the SEC does not have to prove that an adviser intended to engage in fraud or knew that the conduct was wrong; the SEC only has to show that the adviser was negligent or should have known that his or her actions were fraudulent.

In assessing the impact of the new Rule, the SEC assumed that advisers, as a group, already take measures to comply with the Rule in light of existing anti-fraud rules. According to the Adopting Release, the new Rule should not cause advisers to incur new or additional costs, nor should it cause advisers to change their existing business practices. However, advisers should periodically review their Form ADV and pooled investment vehicle disclosure documents, such as private placement memoranda and investor reports, to ensure the accuracy of statements made to investors and potential investors.

The Rule will go into effect on September 10, 2007. If you have questions, please do not hesitate to contact a member of Morrison & Foerster LLP's Investment Management Group or Private Equity Fund Group.

Footnotes

[1] *See* Morrison & Foerster LLP Client Alert: *SEC Proposes New Anti-Fraud Rule and Changes to the Definition of "Accredited Investor" for Private Investment Vehicles* (Jan. 22, 2007) available at http://www.mofo.com/news/updates/files/update02314.html.

[2] *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). The Court overturned the SEC's rule that would have required most hedge fund advisers to register as investment advisers.

[3] *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Release No. IA-2628 (August 3, 2007) (the "Adopting Release").

[4] Section 3(c)(1) of the Company Act excepts from the definition of an investment company any issuer whose outstanding securities are beneficially owned by not more than 100 persons and that is not making a public offering of its securities. Similarly, Section 3(c)(7) of the Company Act excepts from the definition of investment company any issuer that does not make a public offering and whose securities are owned exclusively by persons who, at the time they acquired the securities, were "qualified purchasers."

[5] SEC Open Meeting (July 11, 2007): Testimony of Robert Plaze, Associate Director, Division of Investment Management (discussing the "conduct and effects" test set forth in *Uniao de Bancos de Braseleiros S.A.*, SEC No-Action Letter (July 28, 1992)).

[6] SEC Open Meeting (July 11, 2007): Testimony of Robert Plaze, Associate Director, Division of Investment Management.

[7] *Id*.

[8] *See* Rule 206(4)-8(a)(2).

[9] *See* Speech by Commissioner Paul S. Atkins, *Remarks Before the Federal Reserve Bank of Chicago Seventh Annual Private Equity Conference* (August 2, 2007) (stating that the applicable standard is at best murky).

[10] *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992) (citing *Aaron v. SEC*, 446 U.S. 680 (1980)).

[11] *See* the Adopting Release; *see also* Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles (August 3, 2007) (supporting the Rule, in general, but disagreeing with the conclusions in the Adopting Release related to the requisite mental state for violation of the rule).