SEC Adopts Rule Prohibiting Fraud by Investment Advisers to Pooled Investment Vehicles


Background

Sections 206(1) and 206(2) of the U.S. Investment Advisers Act of 1940 (the “Advisers Act”) make it unlawful for an investment adviser to defraud clients or prospective clients. Until 2006, the SEC relied on these sections to bring enforcement actions against advisers for defrauding investors in various investment vehicles. In Goldstein v. SEC, however, the U.S. Court of Appeals for the District of Columbia Circuit found that a pooled investment vehicle, and not the ultimate investors in that vehicle, is the adviser’s “client” for purposes of Sections 206(1) and 206(2) of the Advisers Act. As a result of this decision, some commenters questioned whether the SEC could bring actions under the Advisers Act against an adviser for defrauding investors in a pool. In reaction, the SEC adopted Rule 206(4)-8 to expand the antifraud provisions of the Advisers Act and to confirm the SEC’s authority to bring enforcement actions against investment advisers who defraud investors or prospective investors in hedge funds and other pooled investment vehicles.

During the rule’s public comment process, the SEC’s authority to proceed with its rulemaking was questioned by commenters who called the rule proposal vague and overbroad. In response, the SEC characterized the adoption of the rule as an exercise of “all [its] broad authority that Congress provided [the SEC] in Section 206(4).” That section authorizes the SEC to adopt rules that “define and prevent . . . fraudulent, deceptive, or manipulative” practices. Emphasizing this point, the rule was adopted exactly as proposed, without accepting any of the public comments suggesting modifications to the proposal.

3 At the time Rule 206(4)-8 was proposed, the SEC also proposed two rules that would raise the eligibility requirements for individuals to invest in securities offerings of certain private investment pools and create a new category of accredited investor — to be called “accredited natural persons.” In response to extensive comments, the SEC currently is reconsidering the specifics of this new category of investors and has not yet adopted a final rule.

We followed the public comment process regarding both Rule 206(4)-8 and the proposed new accredited investor standard closely. Our summary of the process is titled “The SEC’s Latest Hedge Fund Rulemaking: More Than 600 Comments Later . . . ” and is available at http://www.shearman.com/publications/am042707/.

1 451 F.3d 873 (D.C. Cir. 2006) (“Goldstein”).

2 The SEC’s enforcement authority under the antifraud provisions of other federal securities laws was undisturbed by Goldstein. For example, notwithstanding Goldstein, the SEC could have brought — and can still bring — actions against investment advisers pursuant to Section 17(a) of the U.S. Securities Act of 1933 and Section 10(b) and Rule 10b-5 (further discussed below) under the U.S. Securities Exchange Act of 1934.
Overview of the New Antifraud Rule

Rule 206(4)-8 prohibits investment advisers from (1) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (2) otherwise defrauding these investors. Some of the more notable aspects of the rule are:

- The rule applies to both registered and unregistered investment advisers to “pooled investment vehicles,” which include registered funds and many privately-offered funds, such as hedge funds, private equity funds and venture capital funds.

- Because the rule prohibits false or misleading statements to both current and prospective investors, it covers marketing materials as well as routine communications to current investors and could apply regardless of whether a prospective investor ultimately makes an investment in the pooled vehicle.

- By generally prohibiting all fraudulent conduct, the rule applies to actions taken by an adviser with respect to an investment pool managed by the adviser even if the pool is not currently offering, selling or redeeming securities.

- The rule does not create new fiduciary duties to investors or prospective investors.

- The rule would address conduct not commonly thought of as “fraud” in that the SEC would not have to establish scienter (i.e., intent or recklessness) in bringing enforcement cases under the rule. Rather, the rule covers both intentional and negligent fraud.

- The rule does not create a private right of action.

Discussion

Rule 206(4)-8 makes it unlawful for a registered or unregistered 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.

Are all pooled vehicles covered?

No. Rule 206(4)-8 defines “pooled investment vehicles” to include funds registered as investment companies under Section 3(a) of the U.S. Investment Company Act of 1940 Act (the “Investment Company Act”), as well as funds that are excluded from the definition of “investment company” by virtue of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.4 As a result, Rule 206(4)-8 applies to advisers to (1) most private funds that offer their securities in private placements, including hedge funds, private equity funds and venture capital funds and (2) registered investment companies that offer their securities to the general public.

The rule will not apply to pooled vehicles relying on exceptions from the Investment Company Act other than Sections 3(c)(1) or 3(c)(7). The rule will not, for example, apply to REITs (which typically rely on Section 3(c)(5)(C)), bank common trust and collective trust funds

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4 Sections 3(c)(1) and 3(c)(7) are among the most widely used exclusions from registration under the Investment Company Act, excluding from the definition of “investment company” issuers who are not making or proposing to make a public offering where the issuer’s securities are held by no more than 100 beneficial owners (Section 3(c)(1)) or are held exclusively by “qualified purchasers” (Section 3(c)(7)).
(which typically rely on Sections 3(c)(3) or 3(c)(11)) or many issuers of asset-backed securities (which typically rely on Rule 3a-7).

What conduct is covered?

According to the SEC, Rule 206(4)-8 is designed to broadly prohibit practices that defraud investors in covered investment funds. In keeping with this intention, the SEC declined to specifically define, or otherwise characterize through examples, the term “fraud” for purposes of the new rule.

Instead, the SEC described the concepts of fraud and fraudulent conduct as well-established under federal securities laws and generally well understood. In this regard, the SEC pointed to broad judicial and administrative interpretations of Rule 10b-5 under the U.S. Securities Exchange Act of 1934. The SEC argued that were it to define “fraud” for purposes of Rule 206(4)-8, the rule might fail to prohibit conduct not specifically identified.

Does the rule expand the fiduciary duties owed by investment advisers?

Section 206 has been construed to impose on investment advisers a fiduciary duty pursuant to which such advisers have an affirmative duty to act solely in the best interests of the “client” and to make full and fair disclosure of all material facts. The SEC was clear in adopting Rule 206(4)-8, however, that the rule “does not create” fiduciary duties owed to vehicle investors or prospective investors. Presumably this means that, while investors in pooled vehicles that are subject to the rule are protected by the antifraud scope of new Rule 206(4)-8, these investors are not within the cloak of fiduciary duty understood to underlie Section 206. That fiduciary duty appears to run only to the vehicle itself — as the client for purposes of the Goldstein case’s interpretation of Section 206 — unless a particular investor is otherwise a client of the investment adviser.

How does the rule differ from Rule 10b-5?

Despite the similarities to Rule 10b-5, there are several important differences between the two rules.

- Unlike Rule 10b-5, which relates to fraud in connection with the offering and sale of securities, the application of Rule 206(4)-8 is not limited to conduct relating to securities offerings. As an illustrative list, the SEC’s release adopting Rule 206(4)-8 characterizes the rule as applying to statements regarding the adviser’s investment strategy and qualifications, the performance of the investment pool and other funds managed by the adviser, the risks associated with an investment in the pool and valuation of the pool and investor accounts, and practices followed by the adviser in its operation of the pool (such as allocation of investment opportunities).

- Unlike Rule 10b-5, Rule 206(4)-8 applies to statements and conduct toward both current and prospective investors, regardless of whether the prospective investor purchases an interest in the pooled vehicle. Although some commenters argued that fraud does not cause harm until an investor actually makes an investment, the SEC decided not to restrict adviser liability to conduct affecting actual investors, noting that “false or misleading statements and other frauds by advisers are no less objectionable when made in an attempt to draw in new investors than when made to existing investors.” By generally prohibiting false or misleading statements to current and prospective investors, Rule 206(4)-8 could impose liability for information in account statements or periodic reports (in the case of current investors) and for statements in private placement memoranda, responses to “requests for proposals,” marketing materials and other solicitations (in the case of prospective investors).

- Unlike Rule 10b-5, the SEC will not be required in enforcing Rule 206(4)-8 to demonstrate scienter (i.e., that an investment adviser had knowledge that

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a statement was false or misleading or otherwise acted intentionally or recklessly to defraud a current or prospective investor). This is potentially the most far-reaching aspect of the new rule. The SEC has signaled that it fully understands the implications of its position, calling the rule’s standard of care desirable because “by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception.” SEC Commissioner Paul Atkins was sufficiently concerned with this aspect of the rulemaking that he devoted a separate concurrence to it.6

Can private plaintiffs invoke the rule?
The Advisers Act has a very limited private right of action to void an investment adviser’s contract. This private right of action does not further extend to violations of Section 206(4). Nonetheless, to foreclose that possibility, the SEC stated in its rulemaking that it did not intend the new rule to provide for a private right of action.

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