

August 10, 2007

SEC Adopts Pooled Investment Vehicle Anti-Fraud Rule

On July 11, 2007, the Securities and Exchange Commission (the “SEC” or “Commission”) unanimously adopted Rule 206(4)-8 (“the Rule”), in order to clarify its authority to regulate advisers to hedge funds and similar investment vehicles. The Rule prohibits advisers of pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles. The Commission issued an adopting release (the “Adopting Release” or the “Release”) on August 3, 2007, containing background and interpretive guidance for the Rule.¹ The Rule will become effective on September 10, 2007.

Background of the Rule

The SEC proposed the Rule to clarify its authority with respect to advisers to certain pooled investment vehicles. Last year, an opinion of the United States Court of Appeals for the District of Columbia Circuit² cast doubt upon the Commission’s authority to enforce Section 206 of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), in cases where an adviser to a pooled investment vehicle commits fraud. The Rule was adopted as proposed without modification.

New Rule 206(4)-8: Language and Scope

Pursuant to authority granted to the SEC by Section 206(4) to define “fraudulent, deceptive and manipulative” acts, the Rule prohibits investment advisers from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors. The Rule defines a “pooled investment vehicle” to include any investment company as defined in Section 3(a) of the Investment Company Act of 1940, as amended (the “1940 Act”), and any privately offered pooled investment vehicle that is excluded from the definition of investment company under Sections 3(c)(1) or 3(c)(7) of the 1940 Act.³ Consequently, the Rule applies to investors in hedge funds, private equity funds, venture capital funds and other privately offered pools that invest in securities.⁴

¹ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007), available at <http://www.sec.gov/rules/final/2007/ia-2628.pdf>. (“Rel. No. 2628”).

² *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

³ Rel. No. 2628, at 7.

⁴ *Id.* at 8.

The Rule intentionally encompasses a broad range of activity. The Release notes that the Commission intends “to prohibit all fraud on investors in pools managed by investment advisers.”⁵ The wording of the provision is designed to apply to any deceptive conduct, including those that may not involve statements. Furthermore, unlike existing anti-fraud rules, the Rule is not restricted to fraudulent activity that occurs during the offer, sale or redemption of a security. Finally, the Rule eschews describing specific forms of fraud, in order to avoid implicitly approving of unidentified conduct.

The new Rule may have a significant effect on the standard of care required of advisers to pooled investment vehicles. Generally, SEC enforcement actions directed against fraudulent activities (including those under Rule 10b-5 of the Securities Exchange Act of 1934, as amended) have required scienter. The SEC asserts in the Adopting Release that the Rule does not require scienter, thereby prohibiting any deceptive conduct — whether performed intentionally or through negligence.⁶ To support this standard, the SEC notes that the language of 206(4) is not restricted to knowing or deliberate conduct because it prohibits “deceptive” acts, which may be intentional or unintentional. The SEC also cites the decision by the United States District Court of Appeals for the District of Columbia Circuit in *SEC v. Steadman*, which held that “scienter is not required under section 206(4).”⁷ Finally, the Commission states that a negligence standard is appropriate as a means reasonably designed to prevent fraud, because “by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception.”⁸

Commissioner Paul Atkins issued a concurrence that disputes the Adopting Release’s conclusions regarding the necessary mental state for the Rule’s violation.⁹ According to Commissioner Atkins, the language of Section 206(4) does not authorize the Commission to regulate negligent conduct because it prohibits “manipulative” conduct.¹⁰ Commissioner Atkins contends that in the Section 10(b) context, the Supreme Court observed that “the word ‘manipulative’ ... connotes intentional or willful conduct designed to deceive or defraud investors.”¹¹ He argues that the language of Section 206(4) thus suggests a scienter requirement. Furthermore, the commissioner maintains that a negligence standard does not represent a means reasonably designed to prevent fraud, but rather an attempt to assign new definitions to the words of the statute. Finally, Commissioner Atkins argues that even if the SEC has discretion to set the standard of care required of “fraudulent, deceptive, or manipulative” acts and practices, the selection of a negligence standard “just to be on the safe side” may misdirect SEC resources and deter well-intentioned advisers from providing helpful services.¹² The ultimate impact of the Rule on the standard of care remains to be seen.

⁵ *Id.* at 5.

⁶ *Id.* at 12.

⁷ *Id.* at 12 (citing *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992)).

⁸ *Id.* at 13.

⁹ Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles (Aug. 6, 2007).

¹⁰ *Id.* at 2.

¹¹ *Id.* at 2 (citing *Ernst. & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

¹² *Id.* at 6.

In adopting the Rule in the form proposed, the Commission rejected arguments advanced by several commentators. Some commentators had argued that the Rule should not prohibit fraud against prospective investors because no injury is suffered until an individual makes an investment. The SEC repudiated this suggestion, finding that false or misleading statements “are no less objectionable when made in an attempt to draw in new investors than when made to existing investors.”¹³

Some other commentators called for the SEC to exempt investment advisers to registered investment companies from the scope of the Rule because Section 34(b) of the 1940 Act already prohibits an investment adviser from making fraudulent material statements or omissions in a fund’s registration statement or in required records. These commentators claimed that the Rule would create an undue burden that would require advisers to extensively review all client communications. Yet the SEC found the existing anti-fraud provisions inadequate, noting that they were not specifically designed to address frauds by investment advisers with respect to pooled investment vehicles. According to the Commission, advisers to pooled investment vehicles will not need to alter their business practices or take new steps because they already understood that fraudulent conduct would be prohibited under the Advisers Act. Similarly, the SEC reasoned that the new law will not affect advisers’ communications with investors, so long as they have observed traditional compliance responsibilities.

Finally, the SEC asserts that the Rule will allow it to bring enforcement actions for violations of fiduciary duties imposed by other law (e.g., state partnership law) if the violation also involves fraud, deception or manipulation.¹⁴

Conclusion

The Rule is unlikely to cause a major overhaul of investment advising practices. According to the Commission, the Rule does not create any new fiduciary duties for investors or prospective investors. Nor does it alter any duties or obligations to investors under the Advisers Act, any other federal laws or regulations or any state law or regulation. The most significant aspect of the Rule may be the standard of care it requires of investment advisers. Yet as the difference of opinion between Commissioner Atkins and the rest of the Commission demonstrates, the consequences of this “new” standard remain unclear.

¹³ Rel. No. 2628 at 6.

¹⁴ *Id.* at 14.

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