SEC Adopts Antifraud Rule Applicable to Advisers of Pooled Investment Vehicles, Including Hedge Fund and Private Equity Fund Advisers

From the Investment Management Practice Group

I. BACKGROUND

The Securities and Exchange Commission (“SEC”) has adopted new rule 206(4)-8 which prohibits fraudulent and deceptive practices by investment advisers (whether registered or unregistered) to many types of pooled investment vehicles. The SEC proposed this new antifraud rule as a direct result of the D.C. Circuit Court’s decision in Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006) (“Goldstein”), which invalidated rule 203(b)(3)-1, the hedge fund adviser registration rule.

The necessity for the new rule, in the SEC’s view, arose from the Court’s holding in Goldstein that a “client” of an investment adviser managing an investment pool, as that term is used in section 206(1) and (2) of the Investment Advisers Act of 1940 (the “Advisers Act”), is the pool itself, rather than the investors in the pool. This holding, the SEC pointed out in its December 2006 release (http://www.sec.gov/rules/proposed/2006/33-8766.pdf) proposing new rule 206(4)-8, “created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act.”

The new rule, adopted pursuant to the SEC’s rulemaking authority under section 206(4) of the Advisers Act, is designed to provide the SEC with unambiguous authority to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle. According to the SEC, the new rule is not intended to add or modify any existing obligations or requirements under the Advisers Act.

II. SCOPE: WHO IS COVERED?

A. Advisers (Registered or Not) to Hedge Funds, Private Equity Funds, Mutual Funds and Other Pooled Investment Vehicles

New rule 206(4)-8 applies to an investment adviser to a pooled investment vehicle, regardless of whether or not the adviser is registered or required to be registered under the Advisers Act. This includes advisers to privately offered pools such as hedge funds, private equity funds and venture capital funds, as well as advisers to investment companies that are offered to the public, such as mutual funds. In adopting the rule, the SEC rejected arguments by the Investment Company Institute that (1) the rule need not cover advisers to mutual funds, as mutual fund investors are well protected by existing laws and rules, and (2) the new rule would be redundant.

B. Clients and Prospective Clients

The new rule applies to statements made to, or other fraud on, both clients and prospective clients. This means that the rule covers not only statements made to existing fund investors, such as in account statements, but also those made in communications to prospective fund investors, such as private placement memoranda or offering circulars.

III. EFFECT: WHAT IS COVERED?

A. False or Misleading Statements

Under the new rule, it constitutes “a fraudulent, deceptive, or manipulative act, practice or course of business” for any adviser to a pooled investment vehicle...
to make any untrue statement of a material fact to any investor or prospective investor in the pool, or to omit a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. This wording is similar to that of many other antifraud rules. However, there are a few key features of this rule that are worth particular note.

**B. Broad Coverage of Other Frauds**

First, this rule prohibits advisers not only from making fraudulent statements, but also from otherwise engaging “in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor.” This language is very broad and picks up patterns of conduct that may not involve statements.

**C. Not Limited to Fraud in Connection with Purchase and Sale of a Security**

It is also important to be aware that, unlike rule 10b-5 under the Securities Exchange Act of 1934, new rule 206(4)-8 is not limited to fraud in connection with the purchase and sale of a security. This means that the rule covers statements to investors regardless of whether the pool is offering, selling or redeeming securities.

**D. No Foreign Jurisdiction**

The staff of the SEC has confirmed that the new rule will not apply to a foreign adviser’s dealings with clients or prospective clients outside of the United States, even if the foreign adviser is registered under the Advisers Act.

**E. No Private Right of Action**

The new rule does not create a private cause of action against an adviser. Only the government, and not private litigants, will have the right to bring actions to enforce the rule.

**F. No Scienter Requirement**

Unlike rule 10b-5, new rule 206(4)-8 does not depend on the element of scienter, or the mental state of fraudulent intent. This means that an adviser could be found to be in inadvertent violation of the rule without ever having intended to defraud investors or prospective investors.

Advisers should review their compliance policies and programs to ensure that they clearly address compliance with the new rule. If you have any questions regarding the new antifraud rule, please do not hesitate to contact any member of our Investment Management Practice Group.
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