



Legal Update

SEC PASSES NEW RULES ON ADVISOR FRAUD

On August 3, 2007, the U.S. Securities Exchange Commission (the “SEC”) passed Rule 206(4)-8 of the Investment Advisers Act of 1940¹ (“the “Advisers Act”). The new Rule prohibits securities investment advisers to pooled investment vehicles from “(i) making false or misleading statements to investors or prospective investors in those pools or (ii) otherwise defrauding those investors or prospective investors².” See this link for the full text of the [Adopting Release](#).

The Rule is intended to clarify the Commission’s ability, in light of the ruling in *Goldstein v. SEC*³, to bring enforcement actions under the Advisers Act against advisers who defraud investors or prospective investors in hedge funds and other pooled investment vehicle⁴. Prior to *Goldstein*, the Commission prosecuted enforcement actions based on false or misleading statements made to fund investors under sections 206(1) and 206(2) of the Advisers Act⁵. However, the *Goldstein* Court’s declaration that the term “client,” for the purposes of Section 206(1) and 206 (2), referred to the pool itself, and not an investor in the pool, created confusion as to whether the Commission could continue to bring enforcement actions based on allegations by individual fund participants⁶.

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New Rule 206(4)-8 (the “Rule”) reiterates that an advisor has an obligation to refrain from fraud with respect to the ultimate investor in a pooled vehicle, and that under the Advisers Act the SEC may initiate civil and administrative enforcement actions against advisers who do not adhere to this duty.⁷

SCOPE OF NEW RULE 206(4)-8

In particular, the Rule makes it unlawful for an adviser to a pooled investment vehicle to: “(i) 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 (ii) 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.”⁸



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ADVISOR FRAUD

In adopting the new Rule, the SEC was exercising its authority under Section 206(4) to “promulgate general anti-fraud rules⁹.” The Rule has drawn criticism from observers who believe that it expounds a definition of fraud that is too broad. The SEC, however, has defended this approach, pointing out that the “legal authorities identifying...[fraud] are numerous” and therefore the conduct prohibited by the rule is already “well understood.”¹⁰

EXISTING AND PROSPECTIVE INVESTORS

The scope of Rule 206(4)-8 covers fraudulent conduct with respect to both existing and prospective investors. According to the Commission, “frauds by advisers are no less objectionable when made in an attempt to draw in new investors than when made to existing investors.”¹¹

The Rule, for instance, prohibits false or misleading statements made to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to “requests for proposals,” electronic solicitations, and personal meetings arranged through capital introduction services¹².

UNREGISTERED INVESTMENT ADVISORS

The application of Rule 206(4)-8 extends to both registered and unregistered investment advisers. As noted in its Adopting Release, many of the SEC’s enforcement cases against advisers to pooled investment vehicles have been brought against advisers who are not registered under the Advisers Act¹³. The SEC views it as essential that they have the authority to bring actions against unregistered advisers that manage pools and that defraud investors in those pools. Unlike RIAs, unregulated advisors are generally not subject to regulatory and administrative enforcement proceedings, and the SEC would in most cases need to sue such advisors in Federal court in order to enforce the provisions of the new Rule.

FOCUS ON POOLED INVESTMENT VEHICLES

The Rule applies to advisers to hedge funds, private equity funds, venture capital funds, advisers to investment companies that are registered with SEC, and other types of privately offered pools that invest in securities.¹⁴ The Rule’s focus on pooled investment vehicles¹⁵ significantly overlaps the pre-existing antifraud provisions of section 34(b) of the Investment Company Act of 1940, and section 10(b) of the Securities Exchange Act of 1934.

Section 34(b), for instance, prohibits an adviser from making fraudulent material statements or omissions in a fund’s registration statement or other required records, while 10(b) covers any fraud that relates to the purchase or sale of a security (presumably encompassing the purchase of the equity units of any pooled vehicle, regardless of the nature of the fund’s underlying investment).

According to the SEC, however, 206(4)-8 is distinguishable from these anti-fraud provisions because unlike 34(b) and 10(b), 206(4)-8 specifically targets fraud by advisers with respect to investors in pooled investment vehicles— its applicability does not turn on the existence of a document or the execution of a sale¹⁶.

PROHIBITION ON FALSE OR MISLEADING STATEMENTS

Under the Rule an investment advisor commits fraud when he either (i) makes any untrue

statement of a material fact or (ii) omits 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.

The SEC has for this purpose defined a material act as one for which there is “a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available.”¹⁷

The SEC cites issuing materially false or misleading statements regarding investment strategies the pooled investment vehicle will pursue, the experience and credentials of the adviser (or its associated persons), the risks associated with an investment in the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool or investor accounts in it, and methods by which the adviser allocates investment opportunities, as examples of prohibited conduct under the Rule¹⁸.

PROHIBITION ON OTHER FORMS OF FRAUD

The application of the Rule, however, is not limited to misleading or deceptive statements. Rule 206(4)-8(a)(2) also makes it a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to a pooled investment vehicle to “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.”¹⁹

Section 206(4) expressly authorizes the Commission to set forth general rules detailing and prescribing “acts, practices, and courses of business—” there is no qualification that these rules relate to specifically to communications.

NO SCIENTER REQUIREMENT

One of the more potentially alarming aspects of the new Rule from an RIA’s standpoint is that the Rule also does not require proof that an adviser acted with *scienter* (broadly defined as mindful intent). In other words, a 206(4)-8 violation will be supported by a finding that the adviser’s deceptive or fraudulent conduct was the result of simple negligence. According to the Commission, imposition of a negligence standard forces advisers to exercise additional caution with respect to both actual and prospective investors²⁰.

NO FIDUCIARY DUTY OR PRIVATE RIGHT OF ACTION

Rule 206(4)-8 stops short, however, of imposing a fiduciary duty with respect to investors or prospective investors in a pooled investment vehicle not otherwise mandated by law²¹. Nor does the rule alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation, or any state law or regulation (including state securities laws) to investors in a pooled investment vehicle it advises.

Instead, the Rule facilitates enforcement action against an investment adviser who violates a fiduciary duty imposed by other law if the violation of such law or obligation also constitutes an act, practice, or course of business that is fraudulent, deceptive, or manipulative within the meaning of the rule and section 206(4).

Finally, the Rule does not create a private right of action – the ability of private parties to sue the Advisor in civil court for alleged violations of the Rule.

CONCLUSION

U.S. investment regulators frequently rely upon the broad applicability of anti-fraud rules in enforcement situations, especially where registration-based compliance systems fall short, or fraud is charged on the part of advisors or intermediaries who are exempt from registration. The Commodity Futures Trading Commission, for example, successfully filed numerous antifraud civil enforcement actions against unregistered OTC currency dealers after federal courts upheld registration exemptions for such operatives (*Dunn v. CFTC, US Sup. Ct. 1995*). Being subject to such vague standards may carry a certain level of discomfort for the unregistered fund manager, however, relative to operating within clearly stated compliance rules. The absence of a *scienter* requirement in the new Rule adds to this ambiguity, and raises the standard of care both registered and

unregistered securities advisors should apply in ensuring the integrity of representations and conduct with respect to existing and prospective investors alike. Compliance manuals and disclosure materials may require amendment in response to the new Rule.

15 USCS § 80b-6.

² Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628, p. 1 (Aug. 3, 2007) [17 CFR Parts 275] (the “Adopting Release”).

³ 451 F/3d 873 (D.C. Cir. 2006)

⁴ Adopting Release, p. 1.

⁵ Id. at 2 n 4. (citing SEC v. Kirk S. Wright, International Management Associates, LLC, Litigation Release No. 19581 (Feb. 28, 2006); SEC v. Wood River Capital Management, LLC, Litigation Release No. 19428 (Oct. 13, 2005); SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC; Bayou Accredited Fund, LLC; Bayou Affiliates Fund, LLC; Bayou No Leverage Fund, LLC; and Bayou Superfund, LLC, Litigation Release No. 19406 (Sept. 29, 2005); SEC v. Beacon Hill Asset Management LLC, Litigation Release No. 18745A (June 16, 2004)).

⁶ Id. at 2.

⁷ Adopting Release, p. 4.

⁸ 17 CFR 275.206(4)-8.

⁹ S. Rep No. 1760, 86th Cong. 2d. Sess. (June 28, 1960) at 4. See rule 206(4)-1(a)(5) [17 CFR. 275.206(4)- 1(a)(5)] under the Advisers Act; rule 17j-1(b) [17 CFR 270.17j-1(b)] under Investment Company Act of 1940 [15 U.S.C. 80a-1] (the “Company Act”); and rule 13e-3(b)(1) [17 CFR 240.13e-3(b)(1)] under the Securities Exchange Act of 1934 [15 U.S.C. 77a] (the “Exchange Act”).

¹⁰ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628, p. 6 (Aug. 3, 2007) [17 CFR Parts 275] (the “Adopting Release”).

¹¹ Id.

¹² Id.

¹³ Id. at 7.

¹⁴ Id. at 8.

¹⁵ A “pooled investment vehicle” as defined in Rule 206(4)-8 refers to any investment company as defined in section 3(a) of the Company Act or any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of that Act.

¹⁶ Adopting Release at 9 n 25.

¹⁷ Id. at 9. (Citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

¹⁸ Adopting Release at 9.

¹⁹ Id. at 11.

²⁰ Id. at 13.

²¹ Id. at 14.