



# GlobalNote

## FINAL RULE TO PROHIBIT FRAUD BY INVESTMENT ADVISERS TO CERTAIN POOLED INVESTMENT VEHICLES ADOPTED<sup>1</sup>

**To:** Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP

**Date:** August 9, 2007

### I. Summary

On August 3, 2007, pursuant to its July 11, 2007 unanimous vote, the U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) published a release adopting rule 206(4)-8 (the “Rule”), an anti-fraud rule under the Investment Advisers Act of 1940, as amended, (the “Advisers Act”) that prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles.<sup>2</sup> This Rule was designed to clarify, in light of the recent decision in Goldstein v. Securities and Exchange Commission<sup>3</sup> (“Goldstein”), the Commission’s ability to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in a pooled investment vehicle (which includes certain hedge funds, private equity funds, and other types of privately offered pools that invest in securities as well as registered investment companies).

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<sup>1</sup> This memorandum provides general information on the subject matter described herein, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects addressed herein.

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

<sup>3</sup> 451 F.3d 873 (D.C. Cir. 2006).

Rule 206(4)-8 was adopted as it was initially proposed by the Commission on December 13, 2006<sup>4</sup>. The Rule prohibits 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 those investors or prospective investors. The Rule clarifies that an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors and that the Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled vehicles. The Commission received forty-five (45) comment letters in response to the Proposing Release and responded to some of the issues raised by the comment letters in the Adopting Release.

## II. Legal and Factual Background

Section 206 of the Advisers Act is usually referred to as the "anti-fraud" rule. For purposes of this discussion, there are three relevant subsections – 206(1), 206(2) and 206(4).

Sections 206(1) and (2) of the Advisers Act prohibit investment advisers from engaging in fraudulent behavior with respect to their clients. In Goldstein<sup>5</sup>, the Court of Appeals for the District of Columbia Circuit stated that an investment adviser's "client" refers to the investment vehicle it advises, not the vehicle's individual investors. As the SEC noted in the Proposing Release, Goldstein's definition of "client" created uncertainty with respect to the SEC's ability to bring enforcement actions under section 206(1) or (2) against investment advisers who engage in fraudulent conduct with respect to investors in their pooled investment vehicles.

Pursuant to section 206(4) of the Advisers Act, the SEC is authorized to adopt rules designed to prevent any act, practice or course of business that is fraudulent, deceptive or manipulative. The SEC's authority under this section is not limited to conduct aimed at "clients." This section, in the Commission's view, provides it with the authority to adopt rule 206(4)-8. Rule 206(4)-8 makes it unlawful for any 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 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."<sup>6</sup>

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<sup>4</sup> Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. IA-2576 (Dec. 27, 2006) [72 FR 400 (Jan. 4, 2007)] (the "Proposing Release"). In the Proposing Release, the SEC also proposed two new rules that would define the term "accredited natural person" under Regulation D and section 4(6) of the Securities Act of 1933 [15 USC 77d(6)] (the "Securities Act"). As proposed, these rules would add to the existing definition of "accredited investor" and apply to private offerings of certain unregistered investment pools. On May 23, 2007, the SEC voted to propose more general amendments to the definition of accredited investor. The SEC has deferred its consideration of the proposal for the time being.

<sup>5</sup> Supra note 3; in Goldstein, the Court of Appeals for the District of Columbia Circuit struck down the controversial rule 203(b)-3 requiring certain hedge fund advisers to register.

<sup>6</sup> Rule 206(4)-8(a).

### III. Scope of Rule 206(4)-8

In response to comments questioning the scope of the Rule and indicating the need to define “fraud,” the Commission states that the intent of the Rule is to prohibit all fraud on investors in pools managed by investment advisers.<sup>7</sup> Congress’ expectation was that the SEC use the authority provided by section 206(4) to “promulgate general anti-fraud rules capable of flexibility.”<sup>8</sup> The Commission states that, in its opinion, a definition of fraud is not necessary, as the legal authorities identifying the types of acts, practices, and courses of business that are fraudulent, deceptive or manipulative under the federal securities laws are numerous.<sup>9</sup>

#### A. Investors and Prospective Investors

Rule 206(4)-8 prohibits an investment adviser from making false or misleading statements to, or engaging in other fraud on, investors or prospective investors alike in a pooled investment vehicle it manages. For example, rule 206(4)-8 would prohibit 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 services. In response to comments that the Rule should not prohibit fraud against prospective investors, the Commission asserted 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.”<sup>10</sup> The Commission explained that the scope of the Rule is modeled on sections 206(1) and (2) of the Advisers Act, which make unlawful fraud by advisers against clients or prospective clients.<sup>11</sup>

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<sup>7</sup> See, Adopting Release, p. 5.

<sup>8</sup> S. Rep. No. 1760, 86<sup>th</sup> 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 the 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”).

<sup>9</sup> Loss, Seligman, & Paredes, Securities Regulation, Chap. 9 (Fraud) (Fourth Ed. 2006); Hazen, Treatise on The Law of Securities Regulation, Vol. 3, Ch. 12 (Manipulation and Fraud – Civil Liability; Implied Private Remedies; SEC Rule 10b-5; Fraud in Connection With the Purchase or Sale of Securities; Improper Trading on Nonpublic Material Information) (Fifth Ed. 2005). See, e.g., Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 11 n. 7 (1971) (“We believe that section 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.”) (quoting A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (CA2 1967)); Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477 (1977) (“No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.”). Moreover, the established legal principles are sufficiently flexible to encompass future novel factual scenarios. United States v. Brown, 555 F.2d 336, 339-40 (2d Cir. 1977) (“The fact that there is no litigated fact pattern precisely in point may constitute a tribute to the cupidity and ingenuity of the malefactors involved but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved.”).

<sup>10</sup> See, Adopting Release, p. 6.

<sup>11</sup> The SEC specifically gives the term “prospective investor” similar scope to the term “prospective client” in sections 206(1) and (2). See, e.g., In the Matter of Ralph Harold Seipel, 38 S.E.C. 256, 257-58 (1985) (the solicitation of clients is part of the activity of an investment adviser and it is immaterial for purposes of an

## **B. Unregistered Investment Advisers**

The Rule applies to both registered and unregistered investment advisers. The SEC acknowledges that this is a departure from the other anti-fraud rules under section 206(4)<sup>12</sup> in that such other rules only apply to registered investment advisers. In its Adopting Release, the SEC noted that many of the enforcement cases against advisers to pooled investment vehicles have been brought against advisers that are not registered under the Advisers Act and that it is critical that the SEC continue to be in a position to bring actions against unregistered advisers who defraud investors in those pools.

## **C. Pooled Investment Vehicles**

Rule 206(4)-8 applies to advisers with respect to any “pooled investment vehicles”<sup>13</sup> they advise regardless of the investment strategy they employ or the structure or type of vehicle they manage. As a result, the Commission notes that the Rule applies to investment advisers subject to section 206 of the Advisers Act with respect to the hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as to investment companies that are registered with the Commission.<sup>14</sup> Some commenters urged that the SEC not apply the Rule to advisers of registered investment companies, arguing that the Rule is unnecessary because other provisions of the federal securities laws prohibiting fraud are available to the Commission to address these matters. In particular commenters noted that section 34(b) of the Company Act already prohibits an adviser from making fraudulent material statements or omissions in a fund’s registration statement or required records. The SEC, however, distinguished other anti-fraud provisions because they were not specifically designed to address fraud by investment advisers with respect to investors in pooled investment vehicles. The Commission noted specifically that in certain instances, the other anti-fraud provisions would not permit the SEC to proceed against the adviser. The SEC may not be able to proceed against the adviser, for example, with respect to section 34(b) of the Company Act, if the adviser’s fraudulent statements are not made in a document described in that section, or with respect to rule 10b-5 under the Exchange Act, if the fraudulent conduct does not relate to a misstatement or omission in connection with the purchase or sale of any security.

## **IV. Prohibition on False or Misleading Statements**

Under rule 206(4)-8(a)(1), any investment adviser to a pooled investment vehicle that 1) makes, to any investor or prospective investor in a pooled investment vehicle, any untrue

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enforcement action under sections 206(1) and (2) that an adviser is engaging in fraudulent solicitations was not successful in his efforts to obtain clients).

<sup>12</sup> Rules 206(4)-1 through 7 of the Advisers Act.

<sup>13</sup> “Pooled investment vehicles,” as defined in rule 206(4)-8, means 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.

<sup>14</sup> The Commission noted that it has brought enforcement actions under the Advisers Act against advisers to these types of funds. See e.g., In the Matter of Askin Capital Management, L.P. and David J. Askin, Investment Advisers Act Release No. 1492 (May 23, 1995) (hedge fund); In the Matter of Thayer Capital Partners, Investment Advisers Act Release No. 2276 (Aug. 12, 2004) (private equity fund); SEC v. Michael A. Liberty, Litigation Release No. 19601 (Mar. 8, 2006) (venture capital fund).

statement of a material fact, or 2) omits to state a material fact necessary to make a statement, in light of the circumstances under which it was made, not misleading, is engaging in a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of section 206(4) of the Advisers Act. The SEC noted that a fact is material if 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.<sup>15</sup>

The Rule prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling or redeeming securities. While the Rule differs in this aspect from rule 10b-5 under the Exchange Act, the conduct prohibited is similar. The SEC notes in the Adopting Release that rule 206(4)-8(a)(1) prohibits, for example, 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 practices the advisor follows in the operation of its advisory business such as how the adviser allocates investment opportunities.<sup>16</sup>

## V. Prohibition of Other Frauds

Rule 206(4)-8(a)(2) 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.”<sup>17</sup> Some commenters asserted that section 206(4) provides the SEC with authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under the Rule. In its Adopting Release however, the Commission noted that the wording of (a)(2) in the Rule is drawn from the first sentence of section 206(4) and is designed to apply more broadly to deceptive conduct that may not involve statements. Section 206(4) specifically authorizes the SEC to adopt rules defining and prescribing “acts, practices and courses of business,” (i.e. conduct), and does not explicitly refer to communications.

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<sup>15</sup> Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1998); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). See also In the Matter of Van Kampen Investment Advisory Corp., Investment Advisers Act Release No. 1819 (Sept. 8, 1999).

<sup>16</sup> The SEC has previously brought enforcement actions alleging these or similar types of frauds. The SEC has brought actions alleging advisers’ material misrepresentations or omissions regarding their background or experience. See, e.g., SEC v. EPG Global Private Equity Fund, Litigation Release No. 18577 (Feb. 17, 2004); SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments, Inc., Sirens Synergy, The Synergy Fund, LLC, Litigation Release No. 18214 (July 3, 2003); SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla, Litigation Release No. 16770 (Oct. 17, 2000); SEC v. Michael Batterman, Randall B. Batterman III, and Dynasty Fund, Ltd., et al., Litigation Release No. 16615 (June 30, 2000). The SEC has also brought enforcement actions alleging advisers’ misrepresentations of the pool’s performance. See, e.g., In the Matter of Evan Misshula, Investment Advisers Act Release No. 2524 (June 21, 2006); Bayou, *supra* note 8; K.L. Group, *supra* note 14; In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc., Investment Advisers Act Release No. 2250 (June 16, 2004).

<sup>17</sup> Rule 206(4)-8(a)(2).

## VI. Scierter is Not Required

In the Adopting Release, the Commission reiterated the position taken in the Proposing Release and noted that, unlike violations of rule 10b-5 under the Exchange Act, the Commission would not need to demonstrate that an adviser acted with scienter (i.e., intent to defraud) in a rule 206(4)-8 violation. In response to some comment letters which questioned whether the Rule should encompass negligent conduct, the SEC explained that it reads the language of section 206(4) as not by its terms limited to knowing or deliberate conduct. For example, section 206(4) encompasses “acts, practices, and courses of business as are . . . deceptive,” thereby reaching conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive. One court has held that section 206(4) of the Advisers Act does not require a showing of scienter and that a violation of section 206(2) of the Advisers Act could rest on a finding of simple negligence.<sup>18</sup> The Commission noted that the use of a negligence standard is also appropriate as a method reasonably designed to prevent fraud and that “by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception.”<sup>19</sup>

Commissioner Paul S. Atkins wrote a concurrence to the Adopting Release to express his disagreement with the conclusions in the Adopting Release related to the requisite mental state for violation of the Rule.<sup>20</sup> His objections to the interpretation of the Rule’s scope are twofold: he does not believe the negligence standard is within the SEC’s authority under Section 206(4) and even if a negligence standard were within the authority of the SEC, for policy reasons he believes the Rule should require a finding of scienter as part of establishing a violation.

## VII. Other Matters

The SEC specified that rule 206(4)-8 does not create a fiduciary duty to investors or prospective investors in a pooled investment vehicle not otherwise imposed by law nor does it create any private right of action by investors or prospective investors. The SEC will enforce the Rule through civil and administrative enforcement actions against advisers that violate it.<sup>21</sup> Additionally, the Rule does not alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation or any state law or regulation to investors in a pooled investment vehicle it advises.

## VII. Analysis

Given the standard provided in rule 206(4)-8 and the lack of a scienter requirement, advisers have to take more care in reviewing any information they send to investors and potential investors alike to verify the accuracy and completeness of such information. Furthermore, advisers should consider whether changes are needed to their existing materials, including compliance manuals, as a result of the adoption this Rule.

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<sup>18</sup> See, SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992), citing Aaron v. SEC, 446 U.S. 680 (1980).

<sup>19</sup> See, Adopting Release, p. 13.

<sup>20</sup> Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, August 3, 2007 (the “Concurrence”).

<sup>21</sup> See, Adopting Release, p. 4.

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The above is merely an overview of rule 206(4)-8. If you have any questions regarding compliance with the Rule, please do not hesitate to contact us.

August 9, 2007