

SEC ISSUES NEW ANTI-FRAUD RULE

On August 3, 2007, the Securities and Exchange Commission issued a release adopting, as proposed, Rule 206(4)-8 (the “Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”).¹ The Rule prohibits advisers to “pooled investment vehicles,”² which include registered and unregistered funds, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles.

Anti-Fraud Standards

The adoption of the Rule represents the most recent consequence of the decision in the *Goldstein* case.³ In *Goldstein*, the U.S. Court of Appeals for the District of Columbia Circuit overturned a rule that required many hedge fund managers to register with the Commission as investment advisers. In that decision, the Court suggested that an investment adviser to a private fund owes a fiduciary duty to the fund, but not to investors in the fund. The Commission stated that the Rule was proposed to clarify 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.

The Rule contains two broad prohibitions applicable to all investment advisers to pooled investment vehicles, regardless of whether such advisers are registered under the Advisers Act. The Rule makes it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act for an investment adviser, registered or unregistered, to a pooled investment vehicle to make any false or misleading statement or omission of material fact to any investor or prospective investor in the pooled investment vehicle or 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. The Adopting Release confirms that the new Rule does not create a private right of action against an adviser.

¹ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628; File No. S7-25-06 (Aug. 3, 2007) (the “Adopting Release”), available at <http://www.sec.gov/rules/final.shtml>. The Commission proposed Rule 206(4)-8 in Release No. 33-8766; IA-2576; File No. S7-25-06 (Dec. 27, 2006) (the “Proposing Release”), available at <http://www.sec.gov/rules/proposed/proposedarchive/proposed2006.shtml>. See also Willkie Farr & Gallagher LLP Client Memorandum, “SEC Proposes New Anti-Fraud Rule Under the Investment Advisers Act of 1940 and Higher “Accredited Investor” Standards for Natural Persons Who Invest in Private Funds” (January 3, 2007), available at <http://www.willkie.com/firm/pubs.aspx>.

² A “pooled investment vehicle,” for purposes of the Rule, means any investment company as defined in Section 3(a) of the Investment Company Act of 1940 (the “1940 Act”) or any company that would be an investment company under Section 3(a) of the Act but for the exclusions in Sections 3(c)(1) or 3(c)(7) of the 1940 Act. As such, the Rule applies to investment advisers to hedge funds, private equity funds, venture capital funds and mutual funds.

³ *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). See also Willkie Farr & Gallagher LLP Client Memorandum, “U.S. Court of Appeals Overturns Hedge Fund Adviser Registration Rule” (June 23, 2006), available at <http://www.willkie.com/firm/pubs.aspx>.

Negligence Standard

The Rule incorporates a negligence standard of liability, in contrast to Rule 10b-5 under the Securities Exchange Act of 1934, which requires scienter (intent to deceive, manipulate, or defraud).

Scope of the Rule

The Rule does not enumerate specific types of fraud that would constitute violations. The Commission stated in the Adopting Release, however, that the meanings under the federal securities laws of the terms material false statement or omission and acts, practices, and courses of business that are fraudulent, deceptive, or manipulative are well-developed and the legal authorities identifying such acts are numerous. Thus, the Commission believes that its description of the type of conduct that is prohibited by the Rule is sufficiently clear. At the meeting adopting the Rule, in response to Commissioner Paul S. Atkins' concern regarding the Rule's lack of specificity, Robert E. Plaze, Associate Director, Division of Investment Management, observed that if the Rule explicitly prohibited only specific types of fraud, the Commission might find itself in the awkward position of having to amend the Rule or the interpretation of its scope every time a new type of fraud is uncovered.

The Rule is not limited to statements to investors, but also covers statements to prospective investors. The Rule prohibits false or misleading statements made, for example, to existing investors in account statements. The Rule also prohibits such statements when made to prospective investors in private placement memoranda, offering circulars, responses to "requests for proposals," electronic solicitations, and personal meetings arranged through capital introduction services. The Rule prohibits advisers from making materially false or misleading statements regardless of whether the pool is offering, selling, or redeeming securities.

In the Adopting Release, the Commission stated that the Rule prohibits, for example, 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 adviser follows in the operation of its advisory business such as how the adviser allocates investment opportunities.

Finally, the Commission stated in the Adopting Release that the Rule does not create under the Advisers Act a fiduciary duty to investors or prospective investors in a pooled investment vehicle not otherwise imposed by law, 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.

Effective Date

Rule 206(4)-8 will be effective on September 10, 2007.

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