



Client Alert

The SEC's New Anti-Fraud Rule (Rule 206(4)-8)

Introduction

In order to address a potential gap in its enforcement authority created by the US Court of Appeal's decision in *Goldstein v. Securities and Exchange Commission*,¹ on August 3, 2007, the Securities and Exchange Commission (the "SEC") adopted rule 206(4)-8 (the "new Rule"),² a new anti-fraud rule under the Investment Advisers Act of 1940 (the "Advisers Act"). The new Rule prohibits registered and certain unregistered advisers to pooled investment vehicles, which includes hedge funds, from: (i) making false or misleading statements of material fact to current or prospective investors, or (ii) engaging in any other fraudulent conduct with respect to a fund's investors. The SEC enacted the new Rule in response to the *Goldstein* decision, which created uncertainty regarding the SEC's ability to enforce the anti-fraud provisions of the Advisers Act against investment advisers. The new Rule potentially broadens exposure for advisers. The SEC has indicated that the standard for enforcement of the anti-fraud rules will be a negligence standard and will not require scienter on the part of the adviser. The new Rule also explicitly identifies each underlying investor in the fund as clients of the investment adviser for the purpose of enforcement of the new Rule; however, the new Rule may have application beyond those parties specifically named in the Advisers Act. The effective date of the new Rule will be September 10, 2007.

Scope of the new Rule

Under the new Rule, "it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80-b-6(4) for any investment adviser to a pooled investment vehicle to . . . 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." As a catch-all provision, Rule 206(4)-8(a)(2) applies where the investment adviser is otherwise engaged in fraudulent conduct with respect to the investor, even without an affirmative statement.

The White & Case Investment Funds Alert provides a brief overview of some of the latest legislative, regulatory and judicial actions, policy statements and decisions that affect investment funds.

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¹ 451 F.3d 873 (D.C. Cir. 2006) For a detailed discussion of the *Goldstein* decision, see, http://www.whitecase.com/files/Publication/b6c157d4-3f4a-4724-b0f4-fc6250b3b9ec/Presentation/PublicationAttachment/b2f9f9e2-a75f-49f8-a1b2-005fee0b4b45/IF_ClientAlert_Appeals_Court_Overturns_June_2006.pdf.

² The final rule and the SEC's release accompanying the rule are posted on the SEC's website, <http://www.sec.gov/rules/final/2007/ia-2628.pdf>

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The SEC provided the following examples of statements or conduct by advisers that are prohibited under the new Rule:

- fraudulent information in account statements, private placement memoranda, offering circulars, or responses to requests for proposals, electronic solicitations, and personal meetings arranged through capital introduction services;
- fraudulent information regarding the adviser's current or future investment strategies;
- fraudulent information regarding the adviser's or associated persons' experience or credentials; and
- fraudulent information regarding the risk of the investment, the valuation of the pool or the performance of the pool or other funds advised by the adviser.

Accordingly, advisers should review offering documentation, information including biographical information and experience of management, information and valuation of past returns, and policies regarding disclosure to some groups of investors (for example, if there is a side letter regarding certain disclosure and that disclosure is not made, that omission would raise serious issues under the new Rule).

All Advisers—Registered and Unregistered—Are Subject to Enforcement

The SEC has explicitly stated that under the broad application of the new Rule, **all** advisers to pooled investment vehicles, irrespective of whether a particular adviser is registered, or

required to be registered, will be subject to enforcement of the new Rule.

The SEC further stated that enforcement under the new Rule is not limited by the type of pooled investment vehicle or the investment strategy or structure employed by the investment adviser. To that end, the SEC defined a pooled investment company broadly, as any investment company, including any registered investment company, and any privately offered pooled investment vehicle that would be categorized as an investment company, but for its exclusion from such status under Sections 3(c)(1) or (3)(c)(7) of the Investment Company Act.³

Therefore, the rule applies to all investment advisers, including unregistered advisers regardless of their location, who advise funds with US clients.

The SEC Intends to Exercise Broad Enforcement

Generally, there is no private right of action under the Advisers Act, and the SEC did not seek to add such a right under the new Rule.⁴ The SEC will enforce this new Rule through administrative and civil actions. However, the new Rule will enhance private plaintiffs' suits under state law in cases where there are also SEC proceedings against an adviser.

Unlike other US securities rules, the new Rule is not limited to fraud in connection with the purchase, sale or redemption of a security. Indeed, under the broad scope of the new Rule, enforcement is permitted even if the investor or prospective investor never actually invests in the fund.

³ Section 3(c)(1) of the Investment Company Act applies to issuers whose securities (except short-term paper) are beneficially owned by not more than 100 persons, and there is no current or intended public offering of its securities. Section 3(c)(7) of the Investment Company Act applies to an issuer, the outstanding securities of which are owned exclusively by persons who at the time of acquisition of such securities, are qualified purchasers, and there is no current or intended public offering of its securities. The SEC indicated that it does not intend to apply the new Rule to companies that are excluded from the definition of an investment company by provisions other than Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

⁴ The Advisers Act has a very limited private right of action to void an investment adviser's contract.

⁵ 967 F.2d 636, 647 (D.C. Cir. 1992).

Furthermore, in reliance on the decision in *SEC v. Steadman*,⁵ which held that establishment of scienter (i.e., knowledge or intent to deceive, manipulate or defraud) is not required in connection with actions under the Advisers Act, the SEC asserts that it is not required to prove scienter to enforce the new Rule. The SEC has confirmed that the standard for these enforcement actions will be negligence, despite many comments opposing the use of this standard. The negligence standard will apply regardless of whether the adviser is registered or not and regardless of the location of the adviser.

However, the SEC notes that the new Rule does not “create any fiduciary duty to investors or prospective investors in the pooled investment vehicle not otherwise imposed by law, nor does it alter any duty or obligation” owed to the investor under the Advisers Act, or any other federal or state law or regulation. Financial institutions doing business with funds should not be exposed to additional liability as a result of the new Rule. Also, the SEC stipulates that the new Rule does not impose any new filing, reporting, record keeping, or disclosure requirements for investment advisers.

The American Bar Association and others in the legal community have expressed particular concern with respect to the SEC’s intent to hold investment advisers liable for fraud without proof of scienter or the actuality of an investment based on alleged material, false or misleading information. Indeed, liability may attach where the relationship between the adviser and the investor is attenuated, for example, where a sub-adviser gives an investor advice without the reasonable expectation that such advice would be relied upon in making an investment decision.

These types of concerns, based on the broad language and application of the new Rule, may be used to refute the new Rule’s applicability in the event of an enforcement action.

Commissioner Paul S. Atkins agrees. In his published concurrence opinion to the new Rule, he argues that the negligence standard may “interfere with the SEC’s ability to use the rule effectively.”

Conclusion

Generally, the SEC’s efforts to explicitly identify and protect the investor in a pooled investment vehicle following the *Goldstein* decision, and the assertion of its authority to bring actions against investment advisers who engage in fraudulent conduct against such investors has been welcomed; particularly, by investor protection groups and the plaintiffs’ bar.

The new Rule does not necessarily create additional liability for advisers; rather, it explicitly defines those who are subject to the new anti-fraud provisions. Critics of the new Rule argue that it is overbroad and lacks sufficient specificity of language or guidance to allow investment advisers to adopt proactive measures to avoid violation. These critics predict that the new Rule’s overbroad language and application may result in certain weaknesses in enforcement actions brought by the SEC.

We recommend that all advisers to funds with clients in the US review their policies and codes of ethics in light of the new Rule. Both registered and unregistered advisers alike (including non-US fund advisers with US clients) will need to have procedures addressing anti-fraud issues that resemble those of registered advisers; for example, advisers should have policies detailing document retention, review of documents and client correspondence, and education of professionals and staff regarding the anti-fraud obligations.

Please contact your White & Case lawyer with questions regarding the new Rule or for assistance in drafting appropriate policies.

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