

Client Alert

SEC Adopts New Antifraud Rule For Investment Advisers to Pooled Investment Vehicles

On July 11, 2007, the Securities and Exchange Commission (SEC) unanimously adopted a measure designed to curb fraudulent conduct by investment advisers with respect to “pooled investment vehicles” including hedge funds, private equity funds and venture capital funds.¹ On August 3, 2007, the SEC published its final release adopting new Rule 206(4)-8 under the Investment Advisers Act of 1940.² The rule prohibits investment advisers from (1) making false or misleading statements to prospective or actual investors in pooled investment vehicles; or (2) otherwise defrauding those investors. The rule is effective thirty days after publication in the Federal Register. According to SEC Chairman Christopher Cox, this rule will provide the SEC with an important mechanism to regulate the hedge fund market in which managers trade trillions of dollars of investor assets.³

Background

Generally, advisers to pooled investment vehicles are exempt from registration under the Investment Advisers Act of 1940⁴ (the “Act”) if they have less than fifteen clients, do not offer advisory services to the general public, and do not advise registered investment companies. In 2004, the SEC sought to bring hedge fund advisers under the registration requirements by adopting a new rule (the “Hedge Fund Rule”) that expanded the meaning of “client” to include “the shareholders, limited partners, members or beneficiaries” of a hedge fund. Most hedge fund advisers who had more than fifteen clients under the modified definition and did not otherwise fit within the limited exceptions to the rule were required to register. In turn, these investment advisers were required to appoint a chief compliance officer and set up a compliance program to meet the new regulatory requirements.

Goldstein Decision

An important decision of the Court of Appeals for the D.C. Circuit called into question the SEC’s authority to regulate hedge fund advisers in this manner. Philip Goldstein, a principal in an investment advisory firm, challenged the Hedge Fund Rule on the grounds that equating “investor” with “client” was improper. The Court of Appeals agreed, finding that such a reading of the

¹ SEC Press Release 2007-133 (July 11, 2007).

² Investment Adviser Act Release No. 2628 (August 3, 2007).

³ SEC Press Release 2007-133 (July 11, 2007).

⁴ 15 U.S.C. § 80b-1 et seq.

statutory term “client” was arbitrary and could not be justified by either the text or the history of the Act.⁵ Notably, the court emphasized the nature of the relationship between investment adviser and client as determinative of which parties would constitute a client. Since limited partners in hedge funds are passive investors whose investment decisions are limited to choosing to supply capital to the fund, the “fiduciary, person-to-person relationships” that characterized the “investment adviser-client relationship” were not present. Instead, the court found that the fund itself is the client of the investment adviser, who owes fiduciary duties to the fund.

Although the court sympathized with the SEC for wanting “a hook on which to hang more comprehensive regulation of hedge funds,” it declared that this goal could not be achieved through manipulating the meaning of “client.” While this decision was somewhat controversial, the SEC determined not to appeal but stated that it would consider what, if any, additional regulation would be necessary to address this issue. In addition to the registration issue, the SEC was also concerned that the *Goldstein* decision called into doubt the ability to rely on the general antifraud provisions in Sections 206(1) and 206(2) of the Act to bring actions where investors in a pooled investment vehicle were defrauded by the adviser to the pool.

Impact of the New Antifraud Rule

Rule 206(4)-8 is the SEC’s first response to the *Goldstein* case. A second proposal to change the standards for accredited investors has not yet been passed by the SEC.⁶ Under the new rule, the SEC may bring an enforcement action against any investment adviser to any pooled investment vehicle within the scope of the rule, including hedge funds, private equity funds and venture capital funds. The rule applies to registered as well as unregistered investment advisers. In addition, the rule applies to registered investment companies as well as unregistered funds and applies to actual investors as well as potential investors in the funds.

The SEC is authorized to enforce the rule through civil and administrative enforcement proceedings. Notably, Rule 206(4)-8 may be violated even where the investment adviser does not act knowingly or deliberately.⁷ The SEC stated that the “use of a negligence standard is ... appropriate as a method reasonably designed to prevent fraud.”⁸ Significantly, the new rule does not create a private right of action for individual investors.

Since Rule 206(4)-8 protects prospective investors in funds, it is broad enough to prohibit misleading statements made in offering circulars or private placement memoranda. The new rule prohibits, for example, materially false and misleading statements regarding investment strategies

⁵ *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

⁶ The Commission is soliciting additional comments on the definition of “accredited natural person” for certain pooled investment vehicles in Securities Act Rules 216 and 509 that it proposed in December 2006. *See*, Securities Act Release No. 8828; Investment Company Act Release No. 27922 (Aug. 3, 2007).

⁷ *See* Investment Advisers Act Release No. 2628, *supra*, p. 13.

⁸ *Id.*

the pooled investment vehicle will pursue, the experience and credentials of the adviser and its associated persons, the risks associated with certain investments, the performance of the pool or other funds under advisement, the valuation of the pool or the investor accounts in the pool, and the practices the adviser follows including how the adviser allocates investment opportunities. The practical impact on investment advisers will be to require careful attention to the information they provide to investors through better monitoring of oral, electronic and written communications with those investors and potential investors.

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New York

Laura Friedrich
+1 (212) 408-5423
lfriedrich@chadbourne.com

Gerard Citera
+1 (212) 408-5176
gcitera@chadbourne.com

Dorollo Nixon, Jr.
+1 (212) 408-5488
dnixon@chadbourne.com