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SEC Adopts New Antifraud Rule for Investment Advisers

The Securities and Exchange Commission (the "SEC") has adopted Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act"), prohibiting investment advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled investment vehicles.

The SEC has adopted this rule in response to the opinion of the Court of Appeals in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) ("*Goldstein*"). The *Goldstein* case created uncertainty regarding the application of Sections 206(1) and 206(2) of the Advisers Act in situations where investors in a pool are defrauded by an investment adviser to that pool. Prior to the *Goldstein* decision, the SEC had brought enforcement actions against advisers alleging false and misleading statements to investors under Sections 206(1) and (2) of the Advisers Act. However, the Court of Appeals in the *Goldstein* decision expressed the view that, for purposes of Sections 206(1) and (2), the "client" of an investment adviser to a fund is the fund itself, not an investor in the fund. As a result, it became unclear whether the SEC would be able to continue to rely on Sections 206(1) and (2) to bring such enforcement actions in the future.

Rule 206(4)-8 makes it a fraudulent, deceptive or manipulative act, practice or course of business for any investment adviser to a pooled investment vehicle either: (1) to 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 (2) 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. A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider that fact as having significantly altered the total mix of information available. Importantly, the rule applies to both registered and unregistered investment advisers.

The rule defines "pooled investment vehicle" as any investment company within the meaning of Section 3(a) of the Investment Company Act of 1940 (the "Company Act"), or any company that would be an investment company but for the exclusions provided by Section 3(c)(1) or 3(c)(7) of the Company Act. As a result, the rule covers advisers to hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities. The rule prohibits false or misleading statements made, for example, 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.

Most importantly, the new rule prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors or prospective investors in the pool regardless of whether the pool is offering, selling or redeeming securities. Examples of prohibited conduct include making 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 adviser follows in the operation of its advisory business, such as how the adviser allocates investment opportunities.

The potential breadth of the rule in application is considerable. The SEC takes the position that the new rule is designed to broaden the definition of deceptive conduct to include both statements and nonverbal conduct by advisers. In addition, this rule will permit the SEC to bring enforcement action against an investment adviser that violates a fiduciary duty imposed by other law (such as state partnership 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) of the Advisers Act. Importantly, unlike the violations of Rule 10b-5 under the Securities Exchange Act of 1934, Rule 206(4)-8 does not require scienter.

The adopting release is available at http://www.sec.gov/rules/final/2007/ia-2628.pdf

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