INVESTMENT ADVISERS

SEC Rule 206(4)-8; Steadman Revisited

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Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, more than 1,500 advisers to pooled investment vehicles ("PIV"s) have recently registered with the SEC. These newly registered advisers, and others, will need to become familiar with the regulatory rules of the road. One rule, relating to communications with investors of PIV advisory clients, requires particular attention due to the risk that negligent acts may be deemed acts of "fraud," a surefire way to damage a reputation and a business. In this respect, SEC Rule 206(4)-8 (the "Rule") represents a clear and present danger to inadvertent mistakes by PIV advisers.

Since the Rule's adoption in 2007, the SEC has used it more than a hundred times to redress allegedly negligent misrepresentations. Yet, in none of those cases was the Rule subject to a merits challenge. Consequently, it remains a potent, if questionable, enforcement tool allowing the SEC to label as fraud, and bring an enforcement action, for careless or imprecise representations, even if they do not rise to the level of intentional or reckless conduct. As discussed below, however, the Rule was promulgated under a provision that may well require a showing of scienter, notwithstanding an appellate court ruling to the contrary, a ruling short on definitive guidance.

Rule 206(4)-8 The Rule was promulgated under Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") in response to the D.C. Circuit Court of Appeals' opinion in Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006). The SEC's purpose in promulgating the Rule was to close a regulatory gap made apparent by the Goldstein decision, which held that the SEC's regulatory authority under Sections 206(1) and 206(2) of the Advisers Act is limited to conduct directed at clients of PIVs (i.e., funds), and does not extend the next level down, to conduct directed at those clients' underlying investors. This decision came as a shock to the SEC, which had long relied on Sections 206(1) and 206(2) to regulate adviser conduct. To bridge the gap,


2 The Rule has been cited in more than 20 district court opinions, none of which none address its validity.


the SEC cobbled together, proposed and adopted the Rule.

The Rule contains two subsections. Subsection 1(a) mirrors Rule 10b-5(b)’s prohibition against material misstatements and omissions (i.e., fraud). Subsection 1(b) essentially mirrors the prohibition of Section 206(4), under which the Rule was promulgated. That section prohibits any adviser to “engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative” with respect to any current or prospective PIV investor. Despite the seemingly obvious fraud orientation of the two subsections, one mirroring 10b-5 and the other prohibiting fraudulent, deceptive and manipulative conduct, the SEC maintained that violation of the Rule would not require scienter. Some commentators disagreed, arguing that the SEC could not promulgate a rule that, in essence, eviscerates the scienter requirement of the section under which it was promulgated.6 In response the SEC invoked the D.C. Circuit’s opinion in SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992), which found that Section 206(4) does not require scienter, i.e., a mental state embracing an intent to deceive or defraud,7 to establish a violation.

In fact, Steadman which, like the Rule, has not been challenged nor further explained, provides no definitive answer. Because Section 206(4) undergirds a rule which has been widely used and which stands ready to be used against the wave of newly registered advisers, a second look at Steadman is both timely and appropriate.

**Steadman**

Steadman involved an appeal from an injunction entered against an investment adviser that failed to register several of its managed funds under state blue sky laws and further failed to maintain proper custodial ac-

5 Id. at 12-13 ("We noted in the Proposing Release that, unlike violations of rule 10b-5 . . ., the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter").

6 Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007) at 4-5 ("Congress included a rulemaking directive [under Section 206(4)] in order to give the SEC the necessary authority to provide clarity in this area about the types of practices covered by the statute’s broad prohibition, not to alter the standard of care that Congress selected through the language it used") (available at http://www.sec.gov/rules/final/2007/ia-2628-psaconcurrence.pdf); American Bar Association, Comments Regarding Proposed Rule 206(4)-8 Under the Investment Advisers Act of 1940 and Proposed Rules 509 and 216 Under Regulation D, File No. ST-25-06 (Mar. 12, 2007) at 3-4 ("[The] language [of Section 206(4)] gives the Commission rulemaking power to prescribe rules to prevent fraud, not to expand the concept of fraud itself beyond its original meaning, which is not negligent conduct, but instead, conduct that has some element of scienter or deliberateness") (available at http://www.sec.gov/comments/st-25-06/st2506-884.pdf). The SEC took a similar position in Ernst & Ernst v. Hochfelder, where it argued that Rule 10b-5 prohibited negligent misrepresentations. 425 U.S. 185, 212 (1976). The Supreme Court disagreed. The Court concluded that the SEC did not have authority to promulgate a rule that established a different standard than Section 10b, which requires scienter. Id. at 213.


8 Steadman, 967 F.2d at 638.

9 Id. at 646.

10 Id. at 646-47. (citing Ernst & Ernst, 425 U.S. at 214).

11 In relevant part, Sections 17(a)(1) and 17(a)(3) prohibit, respectively, any person in the offer or sale of any securities “(1) to employ any device, scheme, or artifice to defraud” or “(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” Id. at 647.

12 See, e.g., Ernst & Ernst, 425 U.S. 188, 199 n.20, where the Court defined “device” to mean “(0)that which is devised, or formed by design; . . .; often, a scheme to deceive; a stratagem; an artifice.” Id (quoting Webster’s International Dictionary (2d ed. 1934)). See also, e.g., Aaron v. SEC, 446 U.S. 680, 696 n.13 (1980), where the Court defined “scheme” as “[a] plan or program of something to be done; an enterprise; . . . a business scheme[, or] crafty, unethical project,” and “artifice” as a “[c]rafty device; trickery; also, an artful stratagem or trick; artfulness; ingenuity.”

13 Steadman, 967 F.2d at 647 (citing Aaron, 446 U.S. at 695-97).

14 Id. (emphasis in original).

15 425 U.S. at 197.

16 Id. at 214. The legislative history of 206(4) reflects no more expansive intent on this issue than the plain language of the section.
fraudulent, deceptive or manipulative conduct, carried out via a device or contrivance, reflects a clear intent to harm or offend. What Steadman implies, however, with its emphasis on the “more neutral ‘act, practice, or course of business’ language” of Section 206(4) is that intent to harm, or scienter, is not present where offending conduct is brought about in a neutral or non-offending manner, i.e., not involving a device, scheme or artifice. This, however, completely ignores the character of the conduct itself; conduct which is harmful irrespective of the manner in which it is brought about, and which the plain language of the statute expressly prohibits. As the Supreme Court noted in Ernst, for example: the term manipulative “connotes intentional or willful misconduct designed to deceive or defraud investors.”18 This connotation is equally true for fraudulent and deceptive conduct.19 “[It is a] ‘familiar principle of statutory construction that words grouped in a list should be given related meaning.’” 20 Thus, it is the nature or character of the conduct itself, not the manner in which it brought about, that determines whether it is intentional, requiring a showing of scienter, or the result of negligence, such that scienter need not be shown.21

Second, the Steadman court’s reference to Aaron to emphasize the effect of the conduct, rather than its harmful character, appears to misread the Supreme Court’s holding. What the Aaron Court focused on in 17(a)(3) to determine that it did not require scienter was the language “operates or would operate as a fraud or deceit,” not the transaction, practice or course of business language highlighted in Steadman.22 In other words, the sole basis on which the D.C. Circuit concluded that Section 206(4) does not require scienter, namely, the similarity between 206(4) and 17(a)(3) regarding the manner in which offending conduct is brought about, completely overlooks the Supreme Court’s focus on the conduct’s potential to have a fraudulent effect.

**Analogous Provisions: Section 14(e) and Rule 10b-5**

While Steadman is the only appellate opinion to have considered whether Section 206(4) requires scienter, other courts have found that a similarly worded prohibition, namely, Section 14(e) of the Securities Exchange Act of 1934, does require scienter. These opinions further demonstrate that Steadman does not resolve whether Section 206(4) requires scienter.

Enacted only eight years after Section 206(4)23, Section 14(e) was adopted, along with several other disclosure provisions, as part of the Williams Act, to ensure informed decision making by investors.24 Like Section 206(4), Section 14(e) contains a prohibition against “fraudulent, deceptive, or manipulative” acts or practices.25 In relevant part, Section 14(e) makes it unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading or to engage in any fraudulent, deceptive, or manipulative acts or practices. . . .”26

One of the first cases to consider whether Section 14(e) requires scienter was Chris-Craft Industries, Inc. v. Piper, 480 F.2d 341 (2d Cir. 1973). In reaching the conclusion that 14(e) does require scienter, the Second Circuit in Chris-Craft relied on congressional intent suggested by the inclusion of a prohibition against material misstatements and omissions.27 The court noted that this portion of Section 14(e) mirrored the prohibition against material misstatements or omissions found in Rule 10b-5.28

The court noted the “major congressional policy behind securities laws in general, and the antifraud provision[s] in particular, is the protection of investors who rely on the completeness and accuracy of information made available to them.”29 Under such policy, the federal securities law often place on those providing information to investors a duty to disclose material facts.30 This would certainly be true for a registered investment adviser, in providing information to a client. A knowing or reckless failure to discharge this duty creates liability under Rule 10b-5. Thus, based upon these shared prohibitions, the Second Circuit in Chris-Craft concluded that Section 14(e), like Rule 10b-5, requires scienter.31

Other courts have reached the same conclusion.32 One year after Chris Craft, the Fifth Circuit in Smallwood v. Pearl Brewing Co. reached this conclusion, ob-

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18 Id. at 199.
21 Compare 17(a)(1) “employ any device, scheme or artifice to defraud” (focusing on the objective or motive of the conduct, i.e., to defraud – requiring scienter) with 17(a)(2) “obtain money or property by means of” any misstatement or omission (focusing on the method by which the conduct is effected – not requiring scienter) and 17(a)(3) prohibit any “transaction, practice or course of business which operates or would operate as a fraud or deceit” (focusing on the effect of the conduct, not its objective/motive – not requiring scienter).
22 See Aaron, 446 U.S. at 697.
25 The legislative history both 206(4) and 14(e) suggests they were modeled on Section 15(c)(2) of the Exchange Act. See H.R. Rep. No. 86-2179, at 4 (1960) (noting Section 206(4) contains “almost identical wording of [S]ection 15(c)(2)’’); H.R. Rep. No. 86-2179 at 5 (noting Section 206(4) “is comparable to [S]ection 15(c)(2)”). The legislative history behind Section 14(e) suggests a similar inspiration. See H.R. Rep. No. 1655, reprinted in 1970 U.S. Code Cong & Admin. News 5025, 5028 (while amending Section 14(e) to include its rulemaking authority, Congress noted “The language of the addition to Section 14(e) is identical to that contained in section 15(c)(2)”).
26 15 U.S.C. § 78n(e) (emphasis added). This formulation is similar to Section 206(4)’s, and the Rule’s, prohibition to “engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.”
28 Id.
30 Id.
31 Id.
32 See, e.g., Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp., 565 F.3d 200, 207 (5th Cir. 2009); In re Digital Island Sec. Litig., 357 F.3d 322, 328 (3rd Cir. 2004); SEC v. Ginsburg, 362 F.3d 1292, 1297 (11th Cir. 2004).
serving that “Congress adopted in Section 14(e) the substantive language of . . . Rule 10b-5 and in so doing accepted the precedential baggage those words have carried over the years.”

The common language of Section 206(4) and Section 14(e) and courts’ consistent ruling that Section 14(e) requires scienter provides strong support for a court to distinguish the holding in Steadman. While the referenced opinions rely on a linguistic similarity between Section 14(e) and Rule 10b-5 that Section 206(4) does not share, this hardly detracts from their persuasive value. The prohibition against material misstatements, which Section 14(e) and Rule 10b-5 both share, and the prohibition against “fraudulent, deceptive, or manipulative” acts appear within the same provision of Section 14, i.e., subsection (e). In finding that subsection (e) requires scienter, the courts were evaluating the subsection as a whole; they did not parse the language or their analyses, and thus implicitly found the entirety of it to require scienter, including the prohibition against “fraudulent, deceptive, or manipulative” acts. To suggest that only part of subsection (e) requires scienter is nonsensical and unsupported by the legislative history or the case law.

In short, persons confronted with a Section 206(4) or Rule 206(4)-8 charge have a credible basis to distinguish Steadman and to present the court with an alternative avenue to find that scienter is in fact required for the SEC to prevail on the claim.

Conclusion

An adviser facing a claim for having violated the Rule may take refuge in the fraud oriented language of the Rule’s two subsections to argue that the SEC is required to prove scienter. Section 206(4), under which Rule 206(4)-8 was promulgated, focuses on conduct that “is” by nature, fraudulent, deceptive or manipulative. Therefore, the SEC may not adopt a rule that reduces the state of mind requirement that Congress intended this language to impose. If the character of the challenged conduct does not infer scienter, then an adviser faced with the threat of enforcement action under Rule 206(4)-8 should seriously consider a challenge to the not well founded negligence standard articulated in Steadman.

33 Smallwood v. Pearl Brewing Co., 489 F.2d 579, 605 (5th Cir. 1974).

34 See Ernst & Ernst, 425 U.S. at 214.