PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the Firm

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SEC Adopts New Antifraud Rule Under The Investment Advisers Act of 1940

On December 27, 2006, the Securities and Exchange Commission ("SEC" or the "Commission") released a proposed new rule under the Investment Advisers Act of 1940 (the "Advisers Act") to specifically prohibit fraud by investment advisers to pooled investment vehicles. The SEC proposed the rule to clarify, in light of the *Goldstein v. U.S. Securities and Exchange Commission*[1] decision vacating the hedge fund adviser registration rule, its ability to bring antifraud enforcement actions under the Advisers Act against unregistered investment advisers who defraud current or prospective investors in a pooled investment vehicle. On July 11, 2007, the SEC voted unanimously to adopt the new antifraud rule. The new antifraud rule – Rule 206(4)-8 – prohibits an adviser (whether registered or not) of a pooled investment vehicle from making any false or misleading statements or otherwise defrauding any investor or prospective investor.

New Antifraud Rule Under Section 206(4) of the Advisers Act

The new rule, using language similar to that of Rule 10b-5 under the Securities Exchange Act of 1934, prohibits an investment adviser from making materially false statements or misleading statements to any current or prospective investor in a pooled investment vehicle. Most significantly, however, unlike Rule 10b-5, the rule is not limited to fraud in connection with the purchase or sale of securities. Accordingly, the rule applies to advisers regardless of whether the pooled investment vehicle is offering, selling or redeeming securities. Thus, routine statements made by an adviser, whether in quarterly reports to investors or offering documents or in marketing materials to prospective investors, will be subject to the rule.

The rule also prohibits any practice or course of business by an investment adviser to a pooled investment vehicle that is fraudulent, deceptive, or manipulative with respect to any current or prospective investor, even if the conduct does not involve any oral or written statements.

More importantly, consistent with the U.S. Supreme Court's view of Section 17(a) of the Securities Act of 1933, liability under the rule does not require the SEC to prove that the adviser acted with *scienter* (*i.e.*, the adviser acted with the intent to deceive, manipulate or defraud), as in a Rule 10b-5 case. This means that in antifraud actions under the rule, the SEC is only required to demonstrate simple negligence rather than a heightened state of mind – *i.e.*, that the statement or omission was made with the intent to deceive, manipulate or defraud, or was made recklessly.

The rule defines a "pooled investment vehicle" as any investment company or any company that would be an investment company under Section 3(a) of the Investment Company Act of 1940 but for the exclusion provided by Section 3(c)(7) (for vehicles held exclusively by qualified purchasers and not offered publicly) or Section 3(c)(1) (for vehicles held by no more than 100 beneficial owners and not offered publicly). The new rule, therefore, applies not only to investment advisers of mutual funds, but also to advisers of hedge funds, private equity funds, and venture capital funds.

The new antifraud rule does not create new obligations for pooled investment vehicles, nor does the rule create a private right of action against advisers, thus limiting enforcement of the rule to the SEC.

[1] 451 F.3d 873 (D.C. Cir. 2006).

In light of the broad sweep of new Rule 206(4)-8, however, now would be a good time for advisers to review current reports, offering documents and marketing materials provided to prospective and existing investors to ensure the accuracy of such materials.

The Final Rule has not yet been published. The new rule will take effect 30 days after its publication in the Federal Register. We will notify clients when the Final Rule has been published.

Kathy H. Rocklen
212.969.3755 – krocklen@proskauer.com

Thomas V. Sjoblom
202.416.5805 (DC) – tsjoblom@proskauer.com
212.969.3110 (NY)

Jacqueline Wood Perrell
202.416.5821 – jperrell@proskauer.com