

Hedge Fund Alert

A periodic update on trends and developments affecting the industry

SEC Adopts New Anti-Fraud Rule for Private Funds as Proposed

The SEC has adopted a new anti-fraud rule directed primarily at advisers of private investment funds. The impetus for the new rule was the June 2006 decision of the U.S. Court of Appeals for the District of Columbia (the “Goldstein decision”) striking down Rule 203(b)(3)-2 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), which required many hedge fund managers to register with the SEC as investment advisers. (See Goodwin Procter’s June 26, 2006 Hedge Fund Alert, [“U.S. Court of Appeals Vacates Hedge Fund Adviser Registration Rule But Withholds Mandate.”](#)) The new rule, which was adopted in the same form as originally proposed, is effective September 10, 2007. The rule highlights the SEC’s ongoing emphasis on policing the activities of advisers and managers of hedge funds and other private investment funds.

Executive Summary

The new rule signals that the SEC continues to focus intently on the fund activities of both registered and unregistered investment advisers, in particular with respect to their unregistered funds. The SEC has commented that the new rule does not expand the responsibilities of, or standards applicable to, advisers under the Advisers Act. It is, however, an indicator of the SEC’s enforcement intentions, and advisers should review their compliance programs, particularly as they relate to communication and other interaction with current and prospective fund investors, in light of the new rule.

Discussion

The SEC adopted the new anti-fraud rule in part to remove any doubt raised by the Goldstein decision about its ability to bring enforcement actions under the Advisers Act against an adviser to a hedge fund or other pooled investment vehicle based on allegations that the adviser defrauded the pool’s investors or prospective investors. The new rule is very broad in scope and presents many issues that fund advisers should consider (or revisit) in view of the SEC’s continuing focus on regulation of private investment vehicles and their managers, including the following:

- *Types of Advisers.* Unlike the rules previously adopted under Section 206 of the Advisers Act, the new anti-fraud rule applies to any manager or adviser of a “pooled investment vehicle” that is an “investment adviser” under the Advisers

Act, including *unregistered advisers* and advisers registered only with state regulatory authorities.¹

- *Types of Funds.* The “pooled investment vehicles” subject to the new anti-fraud rule are funds of any strategy, structure or jurisdiction that are “investment companies” under Section 3(a) of the Investment Company Act of 1940, as amended (the “1940 Act”), or rely on the exclusions in Section 3(c)(1) or (7) of the 1940 Act. The release adopting the rule (the “Adopting Release”) specifically contemplates the rule’s application to advisers to hedge funds, private equity funds, venture capital funds and other types of privately offered pools that invest in securities and rely on the aforementioned exclusions, as well as to advisers with respect to mutual funds and other registered investment companies they advise. The Adopting Release provides the following examples of topics on which advisers might make statements that run afoul of the new rule:
 - investment strategies a pooled investment vehicle will pursue (including strategies an adviser may pursue for the pool in the future)
 - an adviser’s experience and credentials (or those of its personnel)
 - the risks associated with an investment in a pool
 - the performance of a pool or other funds advised by the same adviser
 - valuations provided for a pool or investor accounts in a pool
 - an adviser’s practices in operating its advisory business, *e.g.*, how it allocates investment opportunities
- *Applies with Respect to Potential Investors.* The new rule applies to statements made not only to investors, but also to potential investors in, for example:
 - private placement memoranda
 - offering circulars
 - responses to requests for proposals, electronic solicitations and personal meetings arranged through capital introduction services
- *Fraud Whether or Not Related to a Securities Transaction.* The new rule prohibits material misstatements or omissions to investors, using language similar to that of existing anti-fraud Rule 10b-5 under the Securities Exchange Act of 1934, as amended. Unlike Rule 10b-5, however, the new rule applies to untrue statements made outside of the context of a securities transaction, *i.e.*, they need not be made “in connection with” the purchase or sale of a security to fall within the new rule’s scope. For example, the new rule would cover

¹ In response to public comments seeking clarification regarding the rule’s application to offshore advisers’ interactions with non-U.S. investors, the SEC release adopting the new rule indicates that the rule’s adoption does not alter the SEC’s jurisdictional authority.

account statements and reports provided to investors at times when a fund is not offering, selling or redeeming securities.

- *Conduct Other Than Statements.* The new rule includes a more general prohibition on acting in a manner that is “fraudulent, deceptive or manipulative” with respect to any investor or prospective investor, even if the conduct does not involve any “statements.”
- *Negligence Standard.* The Adopting Release reiterates that the new rule encompasses negligent conduct and that the SEC need not make the more difficult finding that a fund adviser or manager made a misstatement knowingly or with scienter, as required under Rule 10b-5.
- *Registered Investment Companies.* The scope of the new rule is broader than that of Section 34(b) under the 1940 Act which applies a similar anti-fraud standard to documents required under the 1940 Act to be filed with the SEC, transmitted or kept as records. Accordingly, advisers to registered investment companies will want to ensure that communications and other interactions with shareholders and potential shareholders that fall outside Section 34(b) are subject to controls and procedures designed to ensure compliance with the new rule’s standards.
- *No New Fiduciary Duty.* The Adopting Release expressly states that the new rule does not create a fiduciary duty under the Advisers Act not otherwise imposed by law and does not alter any duty or obligation an adviser has under the Advisers Act or any other law or regulation. The Adopting Release also observes that even before the Goldstein decision “advisers to pooled investment vehicles operated with the understanding that the Advisers Act prohibited the conduct that [the new anti-fraud rule] prohibits, [and therefore,] advisers that are attentive to their traditional compliance responsibilities will not need to alter their business practices or take any additional steps and incur new costs as a result of this rule’s adoption.” However, the Adopting Release also notes that the rule would permit the SEC to bring an enforcement action against an investment adviser that violates a fiduciary duty imposed by other law where the violation falls within the categories of fraud the new rule prohibits. As an example of this kind of violation, the Adopting Release cites the situation where an adviser negligently or deliberately fails to make a material disclosure to a fund investor where the adviser is subject to a duty under another law to make that disclosure.
- *No Private Right of Action.* The Adopting Release states that the new anti-fraud rule does not create a private right of action against fund advisers. This limits enforcement of the new rule to the SEC (which may act through the administrative process or the courts to seek injunctions, civil penalties, disgorgement of profits and other sanctions) and does not create a new avenue for shareholder litigation. The Adopting Release does not discuss how the SEC staff would gather evidence to pursue enforcement actions against unregistered advisers under the new rule without the benefit of the recordkeeping requirements and inspection powers to which registered advisers are subject under the Advisers Act.

Recommended Action

While, as a legal matter, the adoption of the new anti-fraud rule may not expand liability for registered and unregistered advisers under the Advisers Act, it does signal that the SEC is intently focused on the activities of registered and unregistered advisers with respect to their pooled vehicles, particularly those that are unregistered. In recent testimony before the Senate Committee on Banking, Housing and Urban Affairs, SEC Chairman Christopher Cox cited the SEC's adoption of the new anti-fraud rule as evidence that the SEC has the capability to combat fraud in the hedge fund sector. In this environment, it would therefore seem prudent for each advisory organization that advises "pooled investment vehicles," particularly advisers that are not registered, to inventory the different types of communications and other interactions that the organization has, or may from time to time have, with existing investors and potential investors in its pooled vehicles to ensure that there are adequate controls in place to prevent the types of conduct the new anti-fraud rule prohibits.

The SEC release adopting the new anti-fraud rule is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/ia-2628.pdf>

If you would like additional information about the issues addressed in this alert, please contact:

Elizabeth Shea Fries	efries@goodwinprocter.com	617.570.1559
Rufus C. King	rking@goodwinprocter.com	617.570.1880
Jackson B. R. Galloway	jgalloway@goodwinprocter.com	617.570.1050
Derek N. Steingarten	dsteingarten@goodwinprocter.com	617.570.1220
Christopher E. Palmer	cpalmer@goodwinprocter.com	202.346.4235
L. Kevin Sheridan, Jr.	ksheridan@goodwinprocter.com	212.813.8874

Full access to all articles on hedge funds prepared by Goodwin Procter is available at: <http://www.goodwinprocter.com/Publications/Full%20Publication%20Index.aspx>

Full access to all articles prepared by Goodwin Procter is available at: <http://www.goodwinprocter.com/PublicationSearchResults.aspx?search=all>

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys. Additionally, the foregoing discussion does not constitute tax advice. Any discussion of tax matters contained in this publication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending to another party any transaction or matter. © 2007 Goodwin Procter LLP. All rights reserved.