SEC Enacts New Anti-Fraud Rule for Funds

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On July 11, 2007, the Securities and Exchange Commission ("SEC") approved new anti-fraud Rule 206(4)-8 (the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). The new Rule is a direct response to a possible regulatory gap in the SEC's enforcement authority suggested by the Court of Appeals in its opinion overturning the SEC's highly controversial rule requiring hedge fund managers to register as investment advisers (the "hedge fund rule").

Section 206 is the anti-fraud provision of the Advisers Act. In overturning the hedge fund rule, the Court of Appeals expressed its view that investors in a pooled vehicle should not be considered "clients" of the adviser for purposes of Section 206 of the Advisers Act because an adviser cannot owe a fiduciary duty to both the pool and the investors. This raised an issue as to whether the SEC has the power to bring Section 206 anti-fraud actions involving investors in funds because Sections 206(1), (2) and (3) of the Advisers Act each expressly refer to fraud against clients. However, the Court noted in its opinion that under Section 206(4), the SEC has the power to enact anti-fraud rules that apply to a broader class than "clients." The SEC followed the roadmap suggested by the Court and enacted Rule 206(4)-8 with the intent of preserving authority it had historically believed existed.

New Rule 206(4)-8 provides that it shall constitute a fraudulent, deceptive or manipulative act, practice or course of business for an investment adviser to a "pooled investment vehicle":

(1) to make any untrue statement of a material fact,

(2) to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to any investor in the pooled investment vehicle, or

(3) 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.

The Rule defines a pooled investment vehicle as any registered investment company, 3(c)(1) fund or 3(c)(7) fund.

While the language in the new anti-fraud Rule is very similar to that in Rule 10b-5 under the Securities Exchange Act of 1934 (which is also applicable to offerings of private funds), there are a few notable differences. In particular, Rule 10b-5 applies only to fraudulent statements made in connection with the purchase and sale of a security. The new Rule applies to statements made in an offering memorandum as well as in investor letters, account statements, requests for proposals, responses to due diligence questionnaires and other communications, whether such statements are made to prospective or existing investors and regardless of whether a fund is currently offering its securities. Additionally, unlike Rule 10b-5, a violation of the new Rule does not

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require that an investment adviser have knowledge that a statement is false or misleading or that an action is fraudulent, deceptive or manipulative. The new anti-fraud Rule creates a new enforcement tool for the SEC. Consistent with federal court precedent, there is no private right of action under the new Rule.

If you have a question, please contact one of the Investment Management partners or counsel listed on the right or your regular Drinker Biddle Investment Management Group contact.

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