

***Page 140. After the block quotation and before the Discussion Topics, insert the following:***

**Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles**  
Investment Advisers Act Release No. 2628 (Aug. 3, 2007), 72 Fed. Reg. 44,756  
(Aug. 9, 2007)\*

I. Introduction

On December 13, 2006, we proposed a new rule under the Advisers Act that would prohibit advisers to pooled investment vehicles from defrauding investors or prospective investors in pooled investment vehicles they advise. We proposed the rule in response to the opinion of the Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*, which created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser to that pool. In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of “client” as used in that section, the Court of Appeals expressed the view that, for purposes of sections 206(1) and (2) of the Advisers Act, the “client” of an investment adviser managing a pool is the pool itself, not an investor in the pool. As a result, it was unclear whether the Commission could continue to rely on sections 206(1) and (2) of the Advisers Act to bring enforcement actions in certain cases where investors in a pool are defrauded by an investment adviser to that pool.

In its opinion, the Court of Appeals distinguished sections 206(1) and (2) from section 206(4) of the Advisers Act, which is not limited to conduct aimed at clients or prospective clients of investment advisers. Section 206(4) provides us with rulemaking authority to define, and prescribe means reasonably designed to prevent, fraud by advisers. We proposed rule 206(4)-8 under this authority.

We received 45 comment letters in response to our proposal. Most commenters generally supported the proposal. Eighteen endorsed the rule as proposed, noting that the rule would strengthen the antifraud provisions of the Advisers Act or that the rule would clarify the Commission’s enforcement authority with respect to advisers. Others, however, urged that we make revisions that would restrict the scope of the rule to more narrowly define the conduct or acts it prohibits. . . .

Today, we are adopting new rule 206(4)-8 as proposed. The rule prohibits advisers from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors. The rule clarifies that an adviser’s duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors and that the Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled investment vehicles.

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\* Footnotes omitted.

## II. Discussion

Rule 206(4)-8 prohibits advisers to pooled investment vehicles from (i) making false or misleading statements to investors or prospective investors in those pools or (ii) otherwise defrauding those investors or prospective investors. We will enforce the rule through civil and administrative enforcement actions against advisers who violate it.

Section 206(4) authorizes the Commission to adopt rules and regulations that “define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.” In adopting rule 206(4)-8, we intend to employ all of the broad authority that Congress provided us in section 206(4) and direct it at adviser conduct affecting an investor or potential investor in a pooled investment vehicle.

### *A. Scope of Rule 206(4)-8*

Some commenters questioned the scope of the rule, arguing that the Commission should define fraud. We believe that we have done so, only more broadly than some commenters would have us do. As the Proposing Release indicated, our intent is to prohibit all fraud on investors in pools managed by investment advisers. Congress expected that we would use the authority provided by section 206(4) to “promulgate general antifraud rules capable of flexibility.” The terms material false statements or omissions and “acts, practices, and courses of business as are fraudulent, deceptive, or manipulative” encompass the well-developed body of law under the antifraud provisions of the federal securities laws. The legal authorities identifying the types of acts, practices, and courses of business that are fraudulent, deceptive, or manipulative under the federal securities laws are numerous, and we believe that the conduct prohibited by rule 206(4)-8 is sufficiently clear and well understood.

#### 1. Investors and Prospective Investors

Rule 206(4)-8 prohibits investment advisers from making false or misleading statements to, or engaging in other fraud on, investors or prospective investors in a pooled investment vehicle they manage. The scope of the rule is modeled on that of sections 206(1) and (2) of the Advisers Act, which make unlawful fraud by advisers against clients or prospective clients. Rule 206(4)-8 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.

Some commenters argued that the rule should not prohibit fraud against prospective investors in a pooled investment vehicle, asserting that such fraud does not actually harm investors until they, in fact, make an investment. We disagree. False or misleading statements and other frauds by advisers are no less objectionable when made in an attempt to draw in new investors than when made to

existing investors. For similar policy reasons that we believe led Congress to apply the protections of sections 206(1) and (2) to prospective clients, we have decided to apply those of rule 206(4)-8 to prospective investors. We believe that prohibiting false or misleading statements made to, or other fraud on, any prospective investors is a means reasonably designed to prevent fraud.

## 2. Unregistered Investment Advisers

Rule 206(4)-8 applies to both registered and unregistered investment advisers. As we noted in the Proposing Release, many of our enforcement cases against advisers to pooled investment vehicles have been brought against advisers that are not registered under the Advisers Act, and we believe it is critical that we continue to be in a position to bring actions against unregistered advisers that manage pools and that defraud investors in those pools. The two commenters that expressed an explicit view on this aspect of the proposal supported our application of the rule to advisers that are not registered with the Commission.

## 3. Pooled Investment Vehicles

The rule we are adopting today applies to investment advisers with respect to any “pooled investment vehicle” they advise. The rule defines a pooled investment vehicle as any investment company defined in section 3(a) of the Investment Company Act and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of the Investment Company Act. As a result, the rule applies to advisers to hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as advisers to investment companies that are registered with us.

Several commenters supported applying the protection of the new antifraud rule to investors in all these kinds of pooled investment vehicles, noting, for example, that every investor, not just the wealthy or sophisticated that typically invest in private pools, should be protected from fraud. Some other commenters urged us not to apply the rule to advisers to registered investment companies, arguing that the rule is unnecessary because other provisions of the federal securities laws prohibiting fraud are available to the Commission to address these matters. They expressed concern that application of another antifraud provision with different elements would be burdensome. These commenters claimed that the rule would, for example, make it necessary for advisers to conduct extensive reviews of all communications with clients. But the other antifraud provisions available to us contain different elements because they were not specifically designed to address frauds by investment advisers with respect to investors in pooled investment vehicles. In some cases, the other antifraud provisions may not permit us to proceed against the adviser. As a result, the existing antifraud provisions may not be available to us in all cases. As we discussed above, before the *Goldstein* decision we had brought actions against advisers to mutual funds under sections 206(1) and (2) for defrauding investors in mutual funds. Because, before the *Goldstein* decision,

advisers to pooled investment vehicles operated with the understanding that the Advisers Act prohibited the conduct that this rule prohibits, we believe that advisers that are attentive to their traditional compliance responsibilities will not need to alter their business practices or take additional steps and incur new costs as a result of this rule's adoption.

### *B. Prohibition on False or Misleading Statements*

Rule 206(4)-8(a)(1) prohibits any investment adviser to a pooled investment vehicle from making an untrue statement of a material fact to any investor or prospective investor in the pooled investment vehicle, or omitting to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they were made, not misleading.

The provision is very similar to those in many of our antifraud laws and rules that, depending upon the circumstances, may also be applicable to the same investor communications. Sections 206(1) and (2) have imposed similar obligations on advisers since 1940 and, before *Goldstein*, were commonly accepted as imposing similar requirements on communications with investors in a fund. For these reasons, and because the nature of the duty to communicate without false statements is so well developed in current law, we believe that commenters' concerns about the breadth of the prohibition or any chilling effect the new rule might have on investor communications are misplaced. Advisers to pooled investment vehicles attentive to their traditional compliance responsibilities will not need to alter their communications with investors.

Rule 206(4)-8(a)(1) prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling, or redeeming securities. While the new rule differs in this aspect from rule 10b-5 under the Exchange Act, the conduct prohibited is similar. The new rule prohibits, for example, 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.

### *C. Prohibition of Other Frauds*

Rule 206(4)-8(a)(2) makes it a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to a pooled investment vehicle 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." As we noted in the Proposing Release, the wording of this provision is drawn from the first sentence of section 206(4) and

is designed to apply more broadly to deceptive conduct that may not involve statements.

Some commenters asserted that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under the new rule. We believe our authority is broader. We do not believe that the commenters' suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors. That approach would have us adopt the rule prohibiting fraudulent communications but not fraudulent conduct. But, section 206(4) itself specifically authorizes us to adopt rules defining and prescribing "acts, practices and courses of business," (*i.e.*, conduct), and does not explicitly refer to communications, which, nonetheless, represent a form of an act, practice, or course of business. In addition, rule 206(4)-8 as adopted would provide greater protection to investors in pooled investment vehicles.

Alternatively, commenters would have us adopt a rule prohibiting identified known fraudulent conduct or would have us provide detailed commentary describing specific forms of fraudulent conduct that the rule would prohibit. Either approach would fail to prohibit fraudulent conduct we did not identify, and could provide a roadmap for those wishing to engage in fraudulent conduct. This approach would be inconsistent with our historical application of the federal securities laws under which broad prohibitions have been applied against specific harmful activity.

#### *D. Other Matters*

We noted in the Proposing Release that, unlike violations of rule 10b-5 under the Exchange Act, the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter. Commenters questioned whether the rule should encompass negligent conduct, arguing that it would "expand the concept of fraud itself beyond its original meaning." We read the language of section 206(4) as not by its terms limited to knowing or deliberate conduct. For example, section 206(4) encompasses "acts, practices, and courses of business as are \* \* \* deceptive," thereby reaching conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive. In addition, the Court of Appeals for the District of Columbia Circuit concluded that "scienter is not required under section 206(4)." We believe use of a negligence standard also is appropriate as a method reasonably designed to prevent fraud. As the Supreme Court noted in *U.S. v. O'Hagan*, "[a] prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited." In *O'Hagan*, the Court held that under section 14(e) "the Commission may prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent \* \* \* acts and practices [that] are fraudulent.'" Along these lines, the prohibitions in rule 206(4)-8 are reasonably designed to prevent fraud. We believe that, by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception. Since the Commission clearly is authorized to prescribe conduct that goes beyond fraud as a means reasonably designed to prevent fraud, prohibiting deceptive conduct done negligently is a way to accomplish this objective.

Rule 206(4)-8 does not create under the Advisers Act a fiduciary duty to investors or prospective investors in a pooled investment vehicle not otherwise imposed by law. Nor does the rule alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation, or any state law or regulation (including state securities laws) to investors in a pooled investment vehicle it advises. The rule, for example, will permit us to bring an enforcement action against an investment adviser that violates a fiduciary duty imposed by other 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).

Finally, the rule does not create a private right of action.

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#### Concurrence of Commissioner Paul S. Atkins to the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles

New Rule 206(4)-8 under the Investment Advisers Act of 1940 (“Advisers Act”), which we adopt today, prohibits advisors from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors. Although the SEC has other ways to reach fraud by advisors, this new rule will fill in gaps in the coverage of other transaction-based, anti-fraud provisions so that the SEC may pursue advisors of pooled investment vehicles who have defrauded investors and prospective investors in the course of their acting as fund advisors. I support the new rule, but I am writing separately to express my disagreement with the conclusions in the Adopting Release related to the requisite mental state for violation of the rule.

In discussing the mental state required for violation of the rule, the Adopting Release states that “the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter.” According to the Adopting Release, therefore, the rule covers negligent conduct as well as intentional conduct. My objections to this interpretation of the rule’s scope are twofold. First, I do not believe that a negligence standard is consistent with the Commission’s authority under Section 206(4). Second, even if a negligence standard were within our authority, for policy reasons, we should require a finding of scienter as part of establishing a violation under this anti-fraud rule.

The Adopting Release offers several arguments in support of a negligence standard. First, it argues that the language of section 206(4) is not limited to knowing or deliberate conduct. In support of this argument, it cites the decision by the United States Court of Appeals for the District of Columbia Circuit in *SEC v. Steadman*. Second, the Adopting Release contends that use of a negligence standard is an appropriate method reasonably designed to prevent fraud. In support of this contention, it cites *U.S. v. O’Hagan*. I will discuss each of these in turn.

The language of Section 206(4) does not reach negligent conduct. Section 206(4) makes it unlawful for an advisor “to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative” and directs the Commission “by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”

The Adopting Release maintains that, because Section 206(4) “encompasses ‘acts, practices, and courses of business as are \* \* \* deceptive,’ “ it reaches “conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive.” As the Supreme Court has said, however, “it is a ‘familiar principle of statutory construction that words grouped in a list should be given related meaning.’ “ Hence, it is inappropriate to base a conclusion that negligent conduct is reached by looking at the term “deceptive” apart from its companion terms.

In the Section 10(b) context, the Supreme Court has accorded special significance to the term “manipulative”:

Use of the word “manipulative” is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities. n66

The Adopting Release, however, cites for the contrary conclusion a decision by the United States Court of Appeals for the District of Columbia. Indeed, it is true that in *SEC v. Steadman*, the court held that “scienter is not required under section 206(4).” The court reached its conclusion by comparing the language of Section 206(4) to the language of Section 17(a)(3) under the Securities Act of 1933, which makes it unlawful “to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” The *Steadman* court drew a comparison between Section 17(a)(3)’s “transaction, practice, or course of business” and Section 206(4)’s “act, practice, or course of business.” The court, relying on the Supreme Court’s decision in *Aaron*, held that, in both cases, the focus was on effect. The Supreme Court in *Aaron*, however, placed considerable weight on the terms “operate” or “would operate,” neither of which appears in Section 206(4). In fact, Section 206(4) instead uses the affirmative word “is,” which would seem to de-emphasize effect. Further, while Section 17(a)(3) speaks of only “fraud” and “deceit,” Section 206(4) also includes “manipulative.”

It is also helpful to note that Section 206(4), which was adopted in 1960, was modeled on Section 15(c)(2) under the Securities Exchange Act of 1934. Section 15(c)(2) makes it unlawful for brokers and dealers to effect transactions in or induce the purchase or sale of securities in connection with which they “engage[] in any fraudulent, deceptive, or manipulative act or practices, or make[] any fictitious quotation.” Hence, as the legislative history of Section 206(4) noted, Section 206(4) “is comparable to section 15(c)(2).” The *Steadman* opinion did not address the link between Sections 206(4) and 15(c)(2).

Section 14(e) under the Exchange Act, which relates to tender offers, also follows the Section 15(c)(2) pattern. Section 14(e), like Section 206(4), includes both a proscription against “engag[ing] in any fraudulent, deceptive, or manipulative acts

or practices” and a directive that the SEC “by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.” Because of the similarities, it is useful to look at the Supreme Court’s interpretation of Section 14(e). In *Schreiber v. Burlington Northern*, the Supreme Court relied on *Hochfelder’s* interpretation of the term “manipulative” in the Section 10(b) context to interpret that term in the Section 14(e) context. The *Schreiber Court* noted that the addition of the rulemaking authorization to Section 14(e) did not “suggest[] any change in the meaning of manipulative’ itself.” In *U.S. v. O’Hagan*, The Supreme Court again looked at Section 14(e). This time, it considered whether Rule 14e-3(a), which prohibits trading on undisclosed information in connection with a tender offer, exceeds the SEC’s authority under Section 14(e) given that the prohibition applies regardless of whether there is a duty to disclose. The Court held that Rule 14e-3(a) was within the SEC’s authority under Section 14(e) because Section 14(e) allows the SEC to “prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is ‘reasonably designed to prevent \* \* \* acts and practices [that] are fraudulent.’ “ The lesson from both of these cases is that the SEC cannot effect a change in the meaning of specific statutory terms under its comparable Section 206(4) rulemaking authority.

The Adopting Release asserts that, under *O’Hagan*, a negligence standard is a means reasonably designed to prevent fraud. As the Adopting Release notes, conduct outside of the bounds of the statutory prohibition can be prohibited by Commission rule under Section 206(4). The rule that we are adopting here, however, differs markedly from the rules at issue in *O’Hagan* and *Steadman*. Both of those rules were narrowly targeted rules that covered clearly-defined behavior. They were designed to prohibit conduct, that, although outside of the “core activity prohibited” by the statute, were designed to “assure the efficacy” of the statute.

Rule 206(4)-8(a)(2), by contrast, is as broad as the statute itself. It essentially repeats the statutory prohibition. It does not logically follow, therefore, that lowering the standard of care would be the type of “means reasonably designed to prevent” within the contemplation of the regulatory mandate within Section 206(4). Lowering the standard of care is instead an attempt to rewrite the statute by assigning new definitions to the words of the statute. A potential unfortunate consequence of the Adopting Release’s change in mental state is that it is now arguably contrary to statute and therefore might interfere with the SEC’s ability to use the rule effectively. Congress included a rulemaking directive 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. Imposing a negligence standard is particularly improper given that, as the Adopting Release notes, “Rule 206(4)-8 does not create under the Advisers Act a fiduciary duty to investors and prospective investors in a pooled investment vehicle.”

n83 See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984). The Adopting Release states: “Since the Commission is clearly authorized to prescribe [sic] conduct that goes beyond fraud as a means reasonably

designed to prevent fraud, prohibiting deceptive conduct done negligently is a way to accomplish this objective.” Adopting Release at Section II.D. This does not answer the question, however, of whether “fraudulent, deceptive, or manipulative” conduct can arise from negligent acts.

Finally, from a purely practical perspective, I dispute the regulatory approach underlying the contention that “by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception.” By an extension of that same logic, a strict liability standard would evoke even more care by advisors. Even if the SEC is authorized to pick the standard of care that applies broadly to all “fraudulent, deceptive, or manipulative” acts and practices, arbitrarily selecting a higher standard of care “just to be on the safe side” has the potential of misdirecting enforcement and inspection resources and chilling well-intentioned advisors from serving their investors.