

# BUSINESS ENTERPRISES ALERT

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## SEC CLARIFIES ABILITY TO BRING ENFORCEMENT ACTIONS UNDER ADVISERS ACT WITH NEW ANTI-FRAUD RULE

The Securities and Exchange Commission (SEC) has adopted new Rule 206(4)-8 under the Investment Advisers Act of 1940 (Advisers Act). This new Rule affects both registered and unregistered investment advisers as well as managers of hedge funds, private equity funds and venture capital funds. The Rule was adopted 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 whether investors in a pooled investment vehicle were “clients” entitled to the protections afforded by Sections 206(1) and 206(2) of the Advisers Act.

Rather than try to resolve the uncertainty created by the decision in *Goldstein* that investors in a pooled vehicle were not clients under the Advisers Act, the SEC exercised its rulemaking authority (granted pursuant to Section 206(4) of the Advisers Act which governs the conduct of investment advisers) and created a new Rule 206(4)-8 to prevent fraud by advisers. The new Rule prohibits advisers, whether registered or unregistered, 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 fraud does not have to constitute knowing or deliberate conduct: negligently or recklessly deceptive conduct also violates Rule 206(4)-8. The types of conduct that are prohibited by the Rule include false or misleading statements to investors in account statements or to prospective investors in offering documents or in personal meetings. The SEC’s desire to prevent fraud extends applicability of the Rule to communications with prospective investors even if they never invest. The Rule applies whether the investment pool is offering, selling or redeeming securities. The types of prohibited activities include false and misleading statements regarding:

- potential investment strategies of the pooled vehicle;
- the experience or credentials of the investment adviser;
- the risks of investing in the pool;
- the performance of the pool or the adviser;
- the valuation of the pool; and
- business practices of the adviser such as the allocation of investment opportunities.

The Rule defines a pooled investment vehicle as any investment company as that term is defined in Section 3(a) of the Investment Company Act and any entity excluded from that definition pursuant to the exemptions afforded by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

Through this new Rule, the SEC is affirming its authority to prevent fraudulent activity by managers of investment pools that affects investors in the pool and to bring civil and administrative enforcement actions against such managers.

The practical effect of the new Rule will be to require all managers of investment vehicles to examine their communications to investors or prospective investors and the procedures used in connection therewith to make sure that all disclosures, whether written or oral, are not deceptive.

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