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New SEC Antifraud Rule: Utmost Tool in Subprime Crisis?

The convergence of two events—the subprime meltdown and the passage of a new Securities and Exchange Commission (SEC) antifraud rule directed at hedge funds—should give the hedge fund industry significant pause. The new antifraud rule represents perhaps the ultimate enforcement tool at the SEC's disposal in the subprime crisis.

That the SEC is increasing its scrutiny of the hedge fund industry's role in the subprime crisis is beyond doubt. The SEC's Chairman, Christopher Cox, announced in March 2007 that a 25-member enforcement unit had been formed with the specific directive to investigate potential fraud in the subprime market.[1] Just two months later, Chairman Cox disclosed that a dozen investigations had been launched targeting collateralized debt obligations—a mortgage-backed security that certain hedge funds have heavily invested in.[2] Finally, as recently as April 3, 2008, Chairman Cox disclosed that "[t]o coordinate the efforts of all of the Commission's Divisions and Offices, Erik Sirri, the Director of the Division of Trading and Markets, is leading an agencywide Subprime Task Force composed of senior leadership from each of the relevant disciplines within the SEC, including the Division of Enforcement."[3]

Further, the very passage of the new antifraud rule, Rule 206(4)-8 of the Investment Advisers Act of 1940,[4] demonstrates the SEC's increased interest in scrutinizing and regulating hedge funds generally. In fact, Rule 206(4)-8 itself was an unexpected consequence of a decision by the U.S. Court of Appeals for the District of Columbia Circuit which thwarted the SEC's attempt to gain regulatory oversight over virtually all hedge fund advisers by requiring them to register under the Investment Advisers Act.

In *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the SEC had attempted to pass a new rule that would have classified each investor in a fund as a "client" for purposes of the Investment Advisers Act. The practical effect would have been to require virtually all hedge fund advisers to register under the act, as they would have no longer met the "fewer than 15 clients" exemption from registration found in §203(b)(3). The court rejected the SEC's new definition of "client" on the primary grounds that (i) legislative history and case law did not

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support this understanding of "client," and (ii) the SEC's proposed rule would create conflicts of interests for advisers owing fiduciary duties to two sets of "clients"—the fund and the individual investors therein. Id. 881-84. The unexpected

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consequence of *Goldstein* was that it called into question whether existing antifraud rules under the Advisers Act, namely Rules 206(1) and (2), which prohibit defrauding a "client or prospective client," were applicable to the interaction between hedge fund advisers and individual fund investors, whom the court deemed could not be considered "clients." This uncertainty led to the adoption of Rule 206(4)-8.

Proof in Traditional SEC Actions

Under the traditional enforcement tools at its disposal, such as Rule 10b-5, the SEC must prove two principal things to be successful in a civil securities action: (i) a false or misleading statement; (ii) that was made with scienter.[5] The new antifraud rule, according to the SEC, eliminates element (ii) as to hedge fund advisers, historically the most challenging element for the SEC to establish.

The first element, a false or misleading statement, is the basis of any SEC investigation or enforcement action in the subprime area. Absent a false or misleading disclosure, there would be no impetus for action by the SEC in the first instance. Historically, the SEC has focused on investigating misstatements in formal disclosure documents, such as offering memoranda. In the subprime context, such misleading disclosures usually take the form of misstatements as to the extent of a funds investment in securitized subprime mortgages or the risk of any such investment. In defending against such claims, an SEC target will often argue that such alleged misstatements are not misleading when viewed in light of other disclosures made, especially as to the risk of the investment generally.[6] Further, a target may argue that certain risk disclosures are forward-looking statements protected by the securities laws' "safe harbor."[7]

The second element, proof of scienter, has historically been the most difficult element to prove. Making a misstatement with scienter means making the misstatement "recklessly or knowingly," i.e., the writer/speaker knew the disclosure was false or made the disclosure recklessly in light of facts that should have been obvious.[8]

Rule 206(4)-8

• ***Negligence That Results in No Loss as Fraud.*** Under Rule 206(4)-8, the SEC only has to establish one of the elements discussed above—that a false or misleading disclosure was made. The extraordinary potential detriment to a hedge fund adviser targeted by the SEC is obvious.

The new anti-fraud rule provides as follows:[9]

> **§206 (4)-8 Pooled investment vehicles.**
>
> (a) *Prohibition.* It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of §206(4) of the act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:
>
> (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective

investor in the pooled investment vehicle; or

(2) 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.

(b) *Definition.* For purposes of this section "pooled investment vehicle" means any investment company as defined in §3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) or any company that would be an investment company under §3(a) of the act but for the exclusion provided from that definition by either §3(c)(1) or §3(c)(7) of that act (15 U.S.C. 80a-3(c)(1) or (7)).[10]

Although only applied to date in actions alleging textbook cases of fraud,[11] the new antifraud rule is much broader in its potential application.[12]

• ***First,*** the very breadth of conduct subject to the rule is sweeping. The rule applies to fraudulent or misleading statements in any context. It is not limited to the purchase or sale of a security like Rule 10(b)-5.

According to the SEC, "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.[13]

Furthermore, the rule applies to misstatements or omissions in any form; it is not limited to offering memoranda or other standard disclosure documents. And, §(2) of the rule, per the SEC, is "designed to apply more broadly to deceptive conduct that may not involve statements."[14]

In response to concerns expressed as to the breadth of this §(2), the SEC stated that "[s]ome commenters asserted that §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 no fraudulent conduct. But, §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, 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 road map 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."[15]

• ***Second,*** according to the SEC, "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."[16] Negligent conduct in enough.

• ***Finally,*** the rule applies to misstatements or deceptive conduct directed at "potential investors." In rejecting the argument that the rule should only apply to those who in fact invest, the SEC stated "[s]ome 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."[17]

As a result, the SEC is not required to establish actual harm. A deceptive statement or act is actionable even if the potential investor never in fact invests.

What does all this mean? It means that the SEC can commence an action against a fund adviser for making negligent oral misstatements or omissions regarding the funds investment in securitized subprime mortgages during a phone call with a potential investor who never decides to invest. The rule requires not just the vigilance on the part of a compliance department necessary to prevent obviously misleading disclosures in offering documents, but vigilance capable of preventing negligent oral disclosures made during meetings or phone calls with all potential investors. And, given that the rule characterizes conduct violative of it as "fraudulent," the potential penalties are onerous.

Rule 206(4)-8

• ***Potential Penalties.*** There are numerous potential adverse consequences of any "fraud" finding under the new anti-fraud rule.[18] One initial impact is that the SEC may seek to recover higher penalties under §209(e)(2) of the Advisers Act from those who violate the new rule. Under §209(e)(2), penalties are set at $5,000 for an individual and $50,000 for a business entity for each occurrence of negligent conduct. However, these penalties increase to $100,000 and $500,000, respectively, in the case of fraudulent conduct resulting in substantial losses. By labeling conduct, including negligent conduct, that violates the rule as "fraudulent," the SEC has opened the door to arguing for the imposition of the significantly higher penalties available under §209(e)(2).

Other areas of potential impact include insurance policies and indemnification agreements. Often such policies and agreements only compensate covered persons, including indemnification for judgments and the payment of defense costs, where the covered person is found not to have engaged in fraud. A finding of "fraudulent" conduct under Rule 206(4)-8 would arguably vitiate such coverage.

Finally, perhaps the most significant impact of any such fraud finding is the stigma associated with it. Such a determination would not only negatively impact a fund adviser's current employment, but also future prospects in the industry.

Conclusion

The breadth of conduct covered by the SEC's new antifraud rule, the low showing required for the SEC to successfully prosecute advisers under it, and the dire impact of any successful prosecution result in an extraordinarily powerful tool for regulating in the subprime arena. The bounds of this power will only be determined by future litigation.

1. "Regulator Favors Standards Against Predatory Lending," N.Y. Times, March 28, 2007.
2. "Chairman Denies That SEC Favors Business," N.Y. Times, June 27, 2007.
3. "Testimony Concerning Recent Events in the Credit Markets," Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, April 3, 2008, www.sec.gov/news/testimony/2008/ts40308cc.htm.
4. 17 C.F.R. §275.206(4)-8.
5. See generally Stephen J. Crimmins, Andrew J. Morris and Daniel T. Brown, "Subprime Securities Litigation: Three Threshold Legal Issues."
6. See *McMahan & Co. v. Wherehouse Entertainment Inc.*, 900 F.2d 576, 579 (2d Cir. 1990) ("The central issue…is not whether the particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have misl[ed] a reasonable investor").
7. 15 U.S.C. §78u-5(c).
8. See *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2507 n.3 (2007) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required").
9. 17 C.F.R. §275.206(4)-8. SEC, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Final Rule ("Adopting Release"), www.sec.gov/rules/final/2007/ia-2628.pdf.
10. Adopting Release at 7-8 ("[T]he 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").
11. *SEC v. Rabinovich & Assocs., LP*, 07 Civ. 10547 (GEL), S.D.N.Y., Nov. 26, 2007 (allegedly issuing bogus account statements reflecting fictitious gains to senior citizens); *SEC v. Jason R. Hyatt*, 08C 2224, N.D. Ill., April 18, 2008 (allegedly misappropriating $5.4 million in investor funds for personal use); *SEC v. Plus Money Inc.*, 08 CV 0764-H-NLS, S.D. Cal., April 28, 2008 (allegedly misappropriating investor funds); *SEC v. Robert Louis Carver*, SACV08-627 CJC (RNBx), C.D. Cal., June 6, 2008 (alleged misappropriation of investor funds and false disclosures in written offering documents, including the failure to disclose criminal history of principal).
12. It should be noted, however, that the new antifraud rule does not create a private right of action. See Adopting Release at 14.
13. Id. at 10-11.
14. Id. at 11.
15. Id. at 11-12.
16. Id. at 12.
17. Id. at 6.
18. See generally Audrey Strauss, "Redefining Negligence as Fraud: The SEC's New Rule 206(4)-8."

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