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HEDGEMONY

THE SEC'S ANTI-FRAUD RULE COULD POSE A SERIOUS THREAT TO HEDGE FUNDS INVOLVED IN SUBPRIME

BY MARK A. BERUBE

THE CONVERGENCE OF TWO EVENTS—THE SUBprime meltdown and the passage of a new Securities and Exchange Commission anti-fraud rule directed at hedge funds—should give the hedge fund industry significant pause. The new 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. SEC Chairman Christopher Cox announced in March of last year that a 25-member enforcement unit had been formed with the specific directive to investigate potential fraud in the subprime market.

Just two months later, 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. Finally, as recently as April 3 of this year, Cox disclosed that "to 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 agency-wide Subprime Task Force composed of senior leadership from each of the relevant disciplines within the SEC, including the Division of Enforcement."

Under the traditional enforcement tools at its disposal, such as Rule 10b-5, the SEC has had to prove two principal things to be successful in a securities action: (i) a false or misleading statement; (ii) that it was made with scienter.

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 fund's investment in securitized subprime mortgages or the risk of any such investment.

The second element, that a misstatement was made with scienter, has often been the most difficult element to prove. Making a misstatement with scienter means making it "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.

According to the SEC, the new anti-fraud rule, Rule 206(4)-8 of the Investment Advisers Act of 1940, eliminates element (ii) with regard to hedge fund advisers. The SEC does not have to establish that the fund adviser acted with scienter. Negligent conduct is enough. Further, the rule applies to misstatements or deceptive conduct directed at "potential investors." 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 fund's investment in securitized subprime mortgages during a phone call with a potential investor who never decides to invest. The rule requires not just sufficient vigilance by compliance departments to prevent obviously misleading disclosures in offering documents, but also vigilance capable of preventing negligent oral disclosures made during meetings or phone calls with potential investors. And, given that the rule characterizes conduct violative of it as "fraudulent," the potential penalties are onerous.

In sum, the breadth of conduct covered by the SEC's new anti-fraud 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 regulatory power will be determined only by future litigation. ■

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