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SEC ADOPTS RULE ON FRAUD BY ADVISERS TO POOLED INVESTMENT VEHICLES; DEFERS ON STANDARDS FOR ACCREDITED INVESTORS IN CERTAIN PRIVATE INVESTMENT VEHICLES

On August 3, 2007, the Securities and Exchange Commission (the "Commission") issued Release No. 1A-2628 (the "Release"), in which it adopted a new rule designed to provide additional investor protections that would affect pooled investment vehicles, including hedge funds.

The rule, the "Adviser Anti-Fraud Rule," would prohibit advisers to pooled investment vehicles, including advisers that are not required to be registered as investment advisers with the Commission under the Investment Advisers Act of 1940 (the "Advisers Act"), from making false or misleading statements to investors or prospective investors in pooled investment vehicles or otherwise defrauding investors or prospective investors in pooled investment vehicles.

The Commission deferred consideration of proposed rules that would redefine "accredited investor" as it relates to natural persons until it has had the opportunity to evaluate comments on more general proposed amendments to the definition of "accredited investor."

As a result of the decision in *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006), which nullified the Commission's hedge-fund adviser registration rule, the Commission adopted the Adviser Anti-Fraud Rule to clarify that the Commission has the authority to bring enforcement actions against investment advisers who defraud investors or prospective investors in pooled investment vehicles.

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This rule should significantly affect how advisers to pooled investment vehicles, including private equity funds, hedge funds, hedge funds of funds, venture capital funds, collateralized loan obligation funds, structured investment vehicles, real estate funds, and other funds, operate and communicate with investors.

ADVISER ANTI-FRAUD RULE FOR POOLED INVESTMENT VEHICLES

Under the Adviser Anti-Fraud Rule, the Commission would be able to bring enforcement actions against an investment adviser to a "pooled investment vehicle" for (1) making any untrue statement of a material fact or omitting 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 or prospective investor in a pooled investment vehicle or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a pooled investment vehicle.

The Adviser Anti-Fraud Rule applies to any pooled investment vehicle that is exempt from the Investment Company Act of 1940 (the "Investment Company Act") pursuant to the exclusions provided by either Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Pooled investment vehicles that meet this definition generally include hedge funds, hedge funds of funds, venture capital funds, private equity funds, certain real estate funds, collateralized loan obligation funds, structured investment vehicles, and any other private investment fund relying on either the Section 3(c)(1) or 3(c)(7) exemption under the Investment Company Act. Under Section 3(c)(1), a fund is generally excluded from the definition of "investment company" if its securities are not publicly offered and its securities (other than short-term paper) are owned by not more than 100 persons. Under Section 3(c)(7), a fund is generally excluded from the definition of "investment company" if its securities are not publicly offered and at the time of acquisition are owned only by "qualified purchasers" (*i.e.*, natural persons with $5 million or more in investments or institutions with $25 million or more in investments).

The Adviser Anti-Fraud Rule is intended to apply to investment advisers to these pooled investment vehicles, whether or not these advisers are registered as investment advisers under the Advisers Act. The rule would enable the Commission to bring enforcement actions for violations of this rule against advisers to pooled investment vehicles.

The types of false and misleading statements that could trigger enforcement actions would not necessarily have to be linked to the offering of interests in the pooled investment vehicles. Such actions could be triggered by false and misleading statements in periodic reports and other communications with investors or potential investors. The types of false and misleading statements that the Commission cited in the Release include statements regarding the description of current and prospective investment strategies; the experience and credentials of the adviser and its personnel; the risks associated with investing in the pool; the performance of the pool or other funds advised by the adviser; the valuation of the pool or investor accounts; and the practices followed by the adviser in the operation of its advisory business, such as investment opportunity allocations, use of soft dollar arrangements, and investor side letters.

The Adviser Anti-Fraud Rule would also give the Commission broad authority to bring enforcement actions for acts, practices, or courses of business that the Commission determines are fraudulent, deceptive, or manipulative with respect to investors or prospective investors in pooled investment vehicles. The Adviser Anti-Fraud Rule is deliberately broad in its terms and enables the Commission to bring enforcement actions in unspecified areas it finds to be justified.

Enforcement actions by the Commission do not necessarily have to involve offerings of securities but can include any communications to investors as well as investment-adviser practices with regard to the operation of pooled investment vehicles. In addition, the Commission does not have to require a finding of scienter (*i.e.*, intent by the adviser to deceive, manipulate, or defraud) to bring such enforcement actions.

The Release states that the Adviser Anti-Fraud Rule is not intended to create a private right of action against the adviser.

Lastly, the Release makes clear that the Adviser Anti-Fraud Rule would not in and of itself create a fiduciary duty to investors or prospective investors that is not otherwise imposed by the law, nor would it modify other federal or state laws or regulations relating to investors in a pooled investment vehicle.

Despite the request for clarification in the commentary on the Adviser Anti-Fraud Rule as originally proposed, the Commission did not give specific details about the types of fraud that were prohibited, the effect of the Adviser Anti-Fraud Rule on non-U.S. investment advisers with both U.S. and non-U.S. clients, who was an "investor" in a pooled investment vehicle, or whether non-U.S. holders of equity or debt securities of a pooled investment vehicle were "investors" for this purpose. These issues remain to be clarified as the Commission begins to enforce the Adviser Anti-Fraud Rule.

DEFERRAL OF AMENDMENTS TO THE PRIVATE OFFERING RULES UNDER THE SECURITIES ACT

The Commission originally proposed rules to redefine "accredited investor" as it relates to natural persons as investors in private investment vehicles (other than certain venture capital funds) for purposes of meeting the private placement exemption of Regulation D promulgated under the Securities Act of 1933 (the "Securities Act") as well as for meeting the small-offering exemption from registration under the Securities Act.

As a result of the Commission's broader effort to revise the limited offering exemption in Regulation D promulgated under the Securities Act of 1933 (see Release No. 33-8828, promulgated on August 3, 2007), the Commission plans to defer consideration of the concept of "accredited natural person" originally proposed alongside the Adviser Anti-Fraud Rule until it has had the opportunity to fully evaluate comments it receives on the broader proposed reforms under Regulation D.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

David M. Mahle
1.212.326.3417
dmmahle@jonesday.com

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