

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”),¹ 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.² 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 Release³ related to the requisite mental state for violation of the rule.⁴

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.”⁵ 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 scienter⁶ 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

¹ 15 U.S.C. 80b.

² 17 CFR 275.206(4)-8. Paragraph (a) of the new rule provides:

Prohibition. It shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 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.

Paragraph (b) of the rule defines a “pooled investment vehicle” to include any investment company and any company that relies on an exclusion from the definition of “investment company” in Section (3)(c)(1) or (3)(c)(7) of the Investment Company Act [15 U.S.C. 80a-3(c)(1) or (7)].

³ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007) (“Adopting Release”).

⁴ See Section II.D of the Adopting Release. I agree with the Section’s conclusions with respect to fiduciary duty (Rule 206(4)-8 does not create a fiduciary duty) and private rights of action (Rule 206(4)-8 does not create any private rights of action).

⁵ Adopting Release, at text accompanying note 36.

⁶ “Scienter” is “a mental state embracing intent to deceive, manipulate, or defraud.” Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976). Recklessness has also been found to satisfy a scienter standard.

Court of Appeals for the District of Columbia Circuit in SEC v. Steadman.⁷ 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.⁸ 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.”⁹ 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.’”¹⁰ 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.¹¹

The language of Section 206(4), like the language of Section 10(b), would seem then to suggest a scienter requirement.

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).”¹² 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 1933,¹³ which makes it unlawful

⁷ SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992).

⁸ U.S. v. O'Hagan, 521 U.S. 642, 672-73 (1997).

⁹ Adopting Release at Section II.D.

¹⁰ Schreiber v. Burlington Northern, Inc. 472 U.S. 1, 8 (1985) (quoting Securities Industry Assn. v. Board of Governors, FRS, 468 U.S. 207, 218 (1984)).

¹¹ Hochfelder, 425 U.S. at 199 (footnote to dictionary definition omitted). Hochfelder considered whether scienter was a necessary component of a private action under Section 10(b). In a subsequent case, the Court considered whether scienter was a necessary element of an injunctive action by the SEC and concluded that it was. Aaron v. SEC, 446 U.S. 680, 691 (1980) (“the rationale of Hochfelder ineluctably leads to the conclusion that scienter is an element of a violation of §10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.”).

¹² Steadman, 967 F.2d at 647.

¹³ 15 U.S.C. 77a et seq.

“to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”¹⁴ 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.¹⁵ The Supreme Court in Aaron, however, placed considerable weight on the terms “operate” or “would operate,” neither of which appears in Section 206(4).¹⁶ In fact, Section 206(4) instead uses the affirmative word “is,” which would seem to de-emphasize effect.¹⁷ 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 1960,¹⁸ was modeled on Section 15(c)(2) under the Securities Exchange Act of 1934.¹⁹ 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.”²⁰ Hence, as the legislative history of Section 206(4) noted, Section 206(4) “is comparable to section 15(c)(2).”²¹ 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.²² 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.²³ The Schreiber Court noted that the addition of the rulemaking authorization to Section 14(e) did not

¹⁴ 15 U.S.C. 77q(a)(3).

¹⁵ Steadman at 647.

¹⁶ Aaron, 446 U.S. at 696-97 (“the language of § 17(a)(3), under which it is unlawful for any person to ‘engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit,’ quite plainly focuses upon the effect of particular conduct ... rather than upon the culpability of the person responsible.”) (emphasis in original).

¹⁷ Section 206(4) makes it unlawful “to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.” (Emphasis added.)

¹⁸ S. REP. NO. 86-1760, at 4 (1960) (“The proposal has precedent in similar authority granted to the SEC over brokers and dealers by the Securities Exchange Act of 1934.”).

¹⁹ 15 U.S.C. 78a et seq.

²⁰ 15 U.S.C. 78o(c)(2).

²¹ H.R. REP. NO. 86-2179, at 8 (1960). See also S. REP. NO. 86-1760, at 8 (1960) (“almost the identical wording of section 15(c)(2)”).

²² 15 U.S.C. 78n(e).

²³ Schreiber, 472 U.S. at 12 (“We hold that the term, ‘manipulative’ as used in § 14(e) requires misrepresentation or nondisclosure. It connotes ‘conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.’”) (citing Hochfelder, 425 U.S. at 199).

“suggest[] any change in the meaning of ‘manipulative’ itself.”²⁴ 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.’”²⁵ 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.²⁶ 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.²⁷

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.²⁸ 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,²⁹ not to

²⁴ Id. at 12 n.11.

²⁵ O’Hagan, 521 U.S. at 672-73.

²⁶ O’Hagan dealt with Rule 14e-3(a), which governed trading on non-public, material information in connection with a tender offer. Steadman dealt with Rule 206(4)-2, the investment advisor custody rule.

²⁷ O’Hagan, 521 U.S. at 673-74.

²⁸ 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.

²⁹ Up until now under Section 206(4), we have done exactly this. We have adopted rules covering advertisements [17 CFR 275.206(4)-1], custody of client funds and securities [17 CFR 275.206(4)-2], cash payments for client solicitations [17 CFR 275.206(4)-3], disclosure of financial and disciplinary information [17 CFR 275.206(4)-4], proxy voting [17 CFR 275.206(4)-6], and compliance procedures [17 CFR 275.206(4)-7].

alter the standard of care that Congress selected through the language it used.³⁰ 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.”³¹

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.”³² By an extension of that same logic, a strict liability standard would evoke even more care by advisers. 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 advisers from serving their investors.

³⁰ See H.R. Rep. No. 2179 at 7 (1960) (identifying as the “problem” that Section 206(4) was intended to remedy: “there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit.”).

³¹ Adopting Release at Section II.D.

³² Adopting Release at Section II.D.