Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

SEC Anti-Fraud Settlement Is A Warning For Fund Advisers

By **Eric Rubenfeld** (October 18, 2022, 5:50 PM EDT)

Eric Rubenfeld

A recent settlement agreement between the U.S. Securities and Exchange Commission and an unregistered California-based venture capital fund adviser serves as a timely reminder to unregistered investment advisers that the negligence-based anti-fraud provisions of the Investment Advisers Act apply to all investment advisers, registered and unregistered alike.[1]

The case serves as a particular warning to investment advisers to pooled investment vehicles to carefully review their current policies and procedures to ensure that they are in full compliance with their detailed and highly complex fund governance documents, as simple mistakes can lead to SEC action.

The Energy Innovation Case

Energy Innovation Capital Management LLC, or EIC, is an adviser to venture capital funds, and unregistered in reliance on the exemption from registration for such advisers.[2]

According to an SEC release, EIC made repeated errors in calculating its management fees, and issued quarterly capital calls to fund investors containing inaccurate and inflated management fee assessments. These miscalculations and assessments caused the funds — and ultimately, the investors therein — to pay EIC excess management fees in the amount of $678,681.

The SEC charged EIC with violating Sections 206(2) and (4) of the Advisers Act, and Rule 206(4)-8 thereunder. In both cases, the SEC noted that intent to deceive, defraud or manipulate — known as scienter — was not required to establish a violation, but that simple negligence was sufficient.

Section 206(2) of the Advisers Act states that is unlawful for any investment adviser, "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(4) of the act states that is unlawful for any investment adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

Rule 206(4)-8 states that is unlawful for any investment adviser to a pooled investment vehicle to "[m]ake 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."

EIC returned the excess management fees, plus interest, to the affected funds, and, as part of the settlement with the SEC, agreed to pay a $175,000 penalty to the commission, and to cease and desist from committing or causing any violations of Section 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

Applicable Law

While most provisions of the Advisers Act apply only to investment advisers registered under the act, the anti-fraud provisions of the act expressly apply to all investment advisers, whether registered or unregistered.

For example, Advisers Act reporting obligations apply only to investment advisers that are not "specifically exempted from registration pursuant to section 203(b) of this title."[3] Advisers Act contractual requirements apply only to investment advisers "registered or required to be registered with the Commission."[4] And Advisers Act custody provisions apply only to investment advisers "registered under this title."[5]

In contrast, the anti-fraud provisions of the Advisers Act apply to "any investment adviser" without regard to registration status.[6]

In addition, Sections 206(2) and (4) of the Advisers Act are negligence-based provisions that do not require scienter — as for, example, is required by Section 206(1) of the Advisers Act,[7] Rule 10b-5 under the Securities Exchange Act,[8] and Section 17(a)(1) of the Securities Act.[9]

Historical Context and Analysis

The general applicability of the anti-fraud provision of Section 206 to unregistered advisers is express in the language of the statute and beyond dispute. The presence or absence of a scienter requirement, on the other hand, is subtle and requires careful analysis of the statutory text.

The touchstone for scienter is the presence of the words "device, scheme, or artifice" in the statutory language. For example, Rule 10b-5, Section 17(a)(1) of the Securities Act and Section 206(1) of the Advisers Act all make it unlawful to "employ any device, scheme, or artifice to defraud."

In contrast, Section 206(2) of the Advisers Act and Section 17(a)(3) of the Securities Act,[10] make it unlawful to "engage in any transaction, practice, or course of business" which operates as a fraud or deceit. Similarly, Section 206(4) of the Advisers Act makes it unlawful to engage in "any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

While the word "fraud" or a derivative thereof appears in all these provisions, it is the nouns describing the activity, rather than the nouns, verbs or adjectives describing the effect of the activity, that are determinative of whether scienter is required.

In the case of SEC v. Capital Gains Research Bureau Inc., the U.S. Supreme Court held in 1963 that Section 206(2) of the Advisers Act did not require scienter based on a detailed analysis of Congress' legislative intent.[11]

In that case, the SEC sought an injunction in the U.S. District Court for the Southern District of New York requiring a registered investment adviser to disclose to its clients its practice of purchasing securities for its own account shortly before recommending the security for investment, and then selling such security to profit from the market rise following the recommendation.

The district court denied the injunction, on the basis that the words "fraud" and "deceit" as used in Section 206(2) of the Advisers Act required a showing of scienter. The U.S. Court of Appeals for the Second Circuit affirmed. The Supreme Court agreed to hear the case expressly to consider the scienter requirement, and overruled the district court and the court of appeals.

The question of the case, as stated by the high court, was:

whether Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit upon any client or prospective client,"[12] intended to require the Commission to establish fraud and deceit "in their technical sense,"[13] including intent to injure and actual injury to clients, or whether Congress intended a broad remedial construction of the Act which would encompass nondisclosure of material facts.[14]

In other words, the question was whether the presence of the words "fraud" and "deceit" in Section 206(2) meant that Congress intended a finding of scienter. The court held that Section 206(2) did not require scienter.

In reaching its decision, the court found that the Advisers Act reflected "a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,'[15] as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested,"[16] and that imposing a scienter requirement would "defeat the manifest purpose" of the Advisers Act.[17]

The court concluded that "Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client,'[18] did not intend to require proof of intent to injure and actual injury to the client."[19]

In other words, the Advisers Act did not require scienter, but rather:

Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds,"[20] not technically and restrictively, but flexibly to effectuate its remedial purposes.[21]

In 1992, in SEC v. Steadman, the U.S. Court of Appeals for the District of Columbia Circuit relied on textual analysis rather than legislative history to similarly reject a scienter requirement under Section 206(4) of the Advisers Act.[22]

The defendant in that case was a registered investment adviser that acted as an adviser to certain mutual funds. The SEC sought an injunction against the adviser for, among other things, failing to comply with maintenance and surprise auditing of certain bank accounts for client funds and securities, as required by Section 206(4) of the Advisers Act and certain rules promulgated thereunder.

The defendant argued that it did not violate Rule 206(4) of the Advisers Act because it did not act with scienter, which it argued was required by the words "fraudulent, deceptive, or manipulative" in the text.

The court disagreed, however, holding that the language of Section 206(4) did not track Section 17(a)(1) of the Securities Act, which requires scienter,[23] but rather tracked the language of Section 17(a)(3) of the Securities Act, which does not.[24] Specifically, the court stated:

Although [Section 206(4)] uses the adjectives "fraudulent, deceptive, or manipulative," section 206(4) does not speak in terms of the "device, scheme, or artifice" that the Aaron Court[25] believed connoted so strongly a knowledge or intent requirement.[26] Rather, section 206(4) uses the more neutral "act, practice, or course or business" language. This is similar to section 17(a)(3)'s "transaction, practice, or course of business," which "quite plainly focuses upon the effect of particular conduct ... rather than upon the culpability of the person responsible."[27] Accordingly, scienter is not required under section 206(4).[28]

Conclusion

All unregistered advisers are subject to the negligence-based anti-fraud provisions of the Advisers Act. Advisers to pooled investment vehicles are also subject to the negligence-based anti-fraud provisions of Rule 206(4)-8 thereunder.

Accordingly, such advisers must take special care to ensure that they are performing their obligations with reasonable prudence and care. In particular, such advisers should carefully review the obligations set forth in fund governing documents, and test their policies and procedures periodically to ensure that they are complying with the requirements thereof.

Eric Rubenfeld is a partner at Fragner Seifert Pace & Mintz LLP.

[1] Sections 206(2) and (4) of the Advisers Act, 15 USCS § 80b-6(2) and (4).

[2] Section 203(l) of the Advisers Act, 15 USCS § 80b-3(l).

[3] Section 204 of the Advisers Act, 15 USC § 80b-4(a).

[4] Section 205 of the Advisers Act, 15 USC § 80b-5(a).

[5] Section 218b of the Advisers Act, 15 USC § 80b-18b.

[6] Section 206 of the Advisers Act, 15 USC § 80b-6.

[7] 15 USCS § 80b-6(1).

[8] 17 CFR § 240.10b-5.

[9] 15 USCS § 77q(a)(1).

[10] 15 USCS § 77q(a)(3).

[11] SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963).

[12] Quoting Section 206(2) of the Advisers Act.

[13] Quoting the Southern District of New York's ruling, 197 F.Supp. at 897.

[14] 375 U.S. at 185, 186.

[15] Quoting 2 Loss, Securities Regulation (2d ed. 1961).

[16] 375 U.S. at 191-192.

[17] Id. at 192.

[18] Quoting Section 206(2) of the Advisers Act.

[19] 375 U.S. at 195.

[20] Quoting 3 Sutherland, Statutory Construction (3d ed. 1943), 382 et seq. (citing cases).

[21] 375 U.S. at 195.

[22] SEC v. Steadman, 967 F.2d 636 (1992).

[23] "It shall be unlawful for any person in the offer or sale of any securities ... to employ any device, scheme, or artifice to defraud."

[24] "[I]t shall be unlawful for any person in the offer or sale of any securities ... to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[25] Aaron v. SEC, 446 U.S. 680 (1980).

[26] See 446 U.S. at 696.

[27] Id. at 697.

[28] 967 F.2d 647.