CLIENT ALERT

Fifth Circuit Vacates Major Rule Changes for Private Fund Advisers

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On June 5, 2024, a panel of judges on the United States Court of Appeals for the Fifth Circuit unanimously vacated major rule changes for private fund advisers that were adopted by the Securities and Exchange Commission (the "SEC") in August 2023.[1] The private fund adviser rules (the "Final Rules") would have substantially modified existing regulatory requirements and created significant new compliance obligations for investment advisers to private funds as early as September 14, 2024. The court vacated the Final Rules in their entirety.

The SEC has not yet announced whether it will seek review of all or portions of the court's decision. The SEC could petition for rehearing before the full Fifth Circuit, which would occur only if a majority of all active Fifth Circuit judges agreed. In addition, the SEC could urge the United States Solicitor General to file a petition for certiorari with the Supreme Court. The Final Rules could not go into effect unless the SEC prevailed before the full Fifth Circuit or the Supreme Court ruling on appeal (except in the unlikely event that the SEC were to obtain a stay of the court's order vacating the Final Rules). Although the immediate effect of the decision is a reprieve for private fund advisers from complying with the Final Rules, the full scope of implications for future rulemaking and existing regulation of private fund advisers by the SEC remains under consideration.

In this Client Alert, we provide a brief background of the Final Rules and an overview of the court's opinion, and we discuss potential implications of the decision on the regulation of private fund advisers.

[1] National Association of Private Fund Managers v. SEC, 5th Cir. No. 23-60471, available here.

Background on the Final Rules

The SEC adopted the Final Rules on August 23, 2023.[2] The Final Rules would have required registered private fund advisers to:

- Provide investors with quarterly statements reporting standardized private fund performance and detailing private fund fees and expenses, under new Rule 211(h)(1)-2 (the "Quarterly Statement Rule");
- Obtain an annual audit for each private fund, under new Rule 206(4)-10 (the "Private Fund Audit Rule"); and
- Obtain a fairness opinion or valuation opinion for adviser-led secondary transactions, under new Rule 211(h)(2)-2 (the "Adviser-Led Secondaries Rule").

The Final Rules also would have prohibited all private fund advisers, whether or not registered with the SEC, from:

- Engaging in certain proscribed activities and practices without disclosure to (and in some cases, without obtaining the consent of) investors, under new Rule 211(h)(2)-1 (the "Restricted Activities Rule"); and
- Providing certain types of preferential treatment that have a material, negative effect on other investors and other types of preferential treatment without disclosure to current and prospective investors, under new Rule 211(h)(2)-3 (the "Preferential Treatment Rule").

Additionally, the Final Rules would have required all SEC-registered investment advisers, including those that do not advise private funds, to document in writing the annual review of their compliance policies and procedures. The Final Rules also would have amended the recordkeeping requirements in Rule 204-2 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") to require advisers to retain books and records related to the above provisions of the Final Rules.

On September 1, 2023, a coalition of private fund industry trade groups (collectively, the "Private Fund Trades")[3] filed a petition for review of the Final Rules with the court, seeking to invalidate the Final Rules. The Private Fund Trades asserted that (i) the SEC exceeded its statutory authority under the Advisers Act, (ii) the Final Rules were not a logical outgrowth of the rules as proposed, (iii) the Final Rules were arbitrary and capricious under the Administrative Procedures Act, and (iv) the SEC failed to adequately consider the Final Rules' impact on efficiency, competition, and capital formation.

[2] Private Fund Advisors; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 6383 (Aug. 23, 2023), 88 Fed. Reg. 63206 (Sept. 14, 2023) (the "Adopting Release"), available here.

[3] The Private Fund Trades included the National Association of Private Fund Managers, Alternative Investment Management Association, Ltd., American Investment Council, Loan Syndications and Trading Association, Managed Funds Association, and National Venture Capital Association.

The Court's Opinion

The court held that the SEC exceeded its statutory authority under the Advisers Act in promulgating the Final Rules and therefore did not reach the other issues raised by the Private Fund Trades.[4] The SEC relied on Section 211(h) and Section 206(4)[5] of the Advisers Act in promulgating the Final Rules.[6] The court's analysis focused on whether Section 211(h) or Section 206(4) provides sufficient statutory authority for the SEC to adopt the Final Rules.

Section 211(h)

In promulgating the Final Rules, the SEC relied in part on Section 913(h) of the Dodd-Frank Act, codified at Section 211(h) of the Advisers Act.[7] The court determined that Section 913 of the Dodd-Frank Act "has nothing to do with private funds." The court rejected the SEC's argument that the use of the term "investor" in Section 211(h) means that the provision should be interpreted to apply to a broader range of persons than retail customers, stating that it is "unlikely that Congress meant to switch to 'investor' 'in the middle of a provision otherwise devoted' to retail investment," and thus "investor" as used in Section 211(h) could not be interpreted to apply to private fund investors.

In making its determination with respect to the Final Rules, the court relied on Congress's "clear" intent to not regulate private funds in the Advisers Act's "sister statute" – the Investment Company Act of 1940, as amended (the "Investment Company Act") – and the statutory construction of the Dodd-Frank Act. The court explained that Section 211(h) should not be interpreted to grant to the SEC authority to regulate private fund advisers and their investors in light of the Investment Company Act's express exclusion of private funds from the controls and restrictions of that Act.[8] The court stated that "Congress clearly chose *not* to impose the same prescriptive framework [of the Investment Company Act] on private funds"

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4 The court also briefly addressed the issues of venue and standing. The court found that venue was proper because the National Association of Private Fund Managers is incorporated and has its principal place of business within the Fifth Circuit. The court found that the Private Fund Trades had standing because "[e]ach [Private Fund Trade] is affected" by the Final Rules by virtue of representing private fund advisers affected by the Final Rules.

5 Section 211(h) of the Advisers Act provides that "The Commission shall (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." Section 206(4) of the Advisers Act provides that "It shall be unlawful to any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, . . . (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

6 The SEC also relied on Section 204 of the Advisers Act in adopting the amendments to the recordkeeping requirements in Rule 204-2. The court stated that "[b]ecause adopting the amendment as to which records must be maintained is obligated by the challenged rules, and the court vacates those rules, it follows that the amendment governing records maintenance must be vacated."

7 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

8 Most private funds rely on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act to be exempt from the definition of "investment company" under the Investment Company Act, thereby exempting private funds that rely on those exemptions from virtually the entire Investment Company Act.

and "the makeup of the [Investment Company Act] preserves the market-driven relationship between a private fund adviser, the fund, and outside investors."

Instead, the court determined that the Dodd-Frank Act "only stepped towards regulating the relationship between the advisers and the private funds they advise." In finding that Section 913(h) of the Dodd-Frank Act applied to retail customers, the court noted that the Dodd-Frank Act introduced provisions to regulate private fund advisers in Title IV; however, the SEC cited as the basis of its authority Title IX, "over 250 pages of statutory text later" from Title IV, and Title IX mentions "retail customer" at least 30 times.

Section 206

The SEC also relied on Section 206(4) of the Advisers Act in promulgating the Final Rules. The court, citing to the language in Section 206(4), concluded that Section 206(4) authorizes the Commission to issue rules that "define," and prescribe means reasonably designed to prevent, acts, practices, and courses of business that are fraudulent, deceptive, or manipulative. The court found that the SEC's invocation of 206(4) anti-fraud authority in support of the Final Rules was "pretextual" because the SEC failed to define a fraudulent act or practice that the Final Rules were designed to address.[9]

The court went on to state that Section 206(4) "fails to authorize [the SEC] to require disclosure and reporting" saying that "a failure to disclose cannot be deceptive without a duty to disclose." According to the court, because other parts of the Advisers Act expressly provide for disclosure and reporting of certain information,[10] the absence of a requirement in Section 206(4) shows that Congress did not intend to provide for reporting and disclosure of information in Section 206(4), absent the SEC identifying fraudulent conduct that the disclosure is reasonably designed to address.

Finally, the court agreed with the Private Fund Trades that the Final Rules were not reasonably designed pursuant to Section 206(4) and do not fit within the statutory design of the Investment Company Act and the Advisers Act because the Final Rules sought to restrict what the court called the "governance structure" of private funds. Specifically the court said, "the Investment Company Act purposefully exempted private funds from the prescriptive framework of that Act, thereby permitting private funds to freely negotiate fund agreements concerning investor access to financial reports, investor input on advisory fees, and redemption terms." The court concluded that the SEC does not have authority under Section 206(4) to issue rules that would affect this internal governance structure, given Congress's decision to exempt private funds from the Investment Company Act.

[9] The court stated that "[c]omplying with the 'fund's governing agreements' is not fraud, nor is disagreement over 'discretionary violations.' And while some conduct could involve fraud, the Commission only has observed misconduct by about 0.05% of advisers."

[10] *See, e.g.*, Section 203(c)(1), Section 204(b)(3) and Section 211(h)(1) of the Advisers Act.

Implications

Effect on Proposed and Existing SEC Rules. The court's holding with respect to the SEC's lack of statutory authority under Section 206(4) and Section 211(h) for the Final Rules could lead to changes for certain SEC rules that have been proposed but not yet adopted. The SEC recently proposed multiple rules for which the SEC based its statutory authority on either Section 206(4) or Section 211(h). This includes proposed rules regarding predictive data analytics and outsourcing by investment advisers, and the proposed Safeguarding Rule that would amend the Custody Rule (Rule 206(4)-2).[11] Given the court's ruling and industry opposition to those proposed rules, the SEC could re-open the comment periods for the proposed rules, withdraw and repropose the rules with significant modification, or completely withdraw the proposed rules. However, it is not yet known if the SEC will decide to seek review of all or a portion of the court's ruling or the extent to which the SEC will treat aspects of the court's opinion as dicta that do not bind SEC action.

While the court reached its decision regarding the scope of Section 211(h) in the context of private fund investors, its statement that the section applies to "retail customers," which is defined in Section 913(a) of the Dodd-Frank Act to mean natural persons who receive personalized investment advice about securities from a broker, dealer, or investment adviser for personal, family, or household purposes, would appear to exclude investors in other types of pooled investment vehicles (such as registered investment companies) from the scope of Section 211(h). The court's interpretation of the scope of Section 211(h) could have broader implications for other SEC rules relying on Section 211(h) that would apply to pooled vehicles or investors in pooled vehicles who do not meet the definition of "retail customer" in Section 913(a) of the Dodd-Frank Act.

In addition, the court's analysis of the limits of the SEC's rulemaking authority under Section 206(4) could have broader implications for existing SEC rules. The court found the SEC's invocation of Section 206(4)'s anti-fraud was "pretextual" and observed that Section 206(4) does not authorize the SEC to require disclosure or reporting absent a defined fraudulent act or practice that a rule is reasonably designed to address. Taken on their face, these broad statements could suggest that some existing SEC rules promulgated pursuant to Section 206(4) that impose affirmative disclosure or reporting obligations (e.g., the Marketing Rule (Rule 206(4)-1)) may be subject to challenge. Industry participants could challenge existing rules in court based on similar arguments as set out by the Private Fund Trades, although we expect that these challenges are more likely to arise initially in the context of investigations and potential enforcement actions by the SEC.

Certain Adviser Misconduct. As a part of the Final Rules, the SEC did not adopt (i) a proposed prohibition on charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide in full to the portfolio investment (the "Unperformed Services

[11] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Exchange Act Release No. 97990 (July 26, 2023), 88 Fed. Reg. 53960 (Aug. 9, 2023); Outsourcing by Investment Advisers, Advisers Act Release No. 6176 (Oct. 26, 2022), 87 Fed. Reg. 68816 (Nov. 16, 2022); Safeguarding Advisory Client Assets, Advisers Act Release No. 6240 (Feb. 15, 2023), 88 Fed. Reg. 14672 (Mar. 9, 2023). Please see our Client Alerts regarding the predictive data analytics rule here, the outsourcing rule here, and the safeguarding rule here.

Prohibition”), or (ii) a proposed prohibition on an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund (the “Indemnification Prohibition”). In the Adopting Release, the SEC stated that it did not adopt the Unperformed Services Prohibition or the Indemnification Prohibition because the activities that the prohibitions sought to prevent were already inconsistent with an adviser’s fiduciary duty. Rather, the SEC provided its views with respect to the prohibitions in the Adopting Release. Although the Private Fund Trades had asserted that the SEC’s views regarding the Unperformed Services Prohibition and Indemnification Prohibition should be treated as rulemaking and vacated, the court merely noted in its opinion that those provisions were in the proposed rules but were omitted from the Final Rules. As such, it is not clear whether the SEC will consider its views regarding the Unperformed Services Prohibition and Indemnification Prohibition to be subject to the court’s vacating the Final Rules.

Future Regulation of Private Funds and Private Fund Advisers. Central to the court’s decision was its determination that the SEC lacked authority to regulate private fund advisers as set out in the Final Rules. The court appeared to generally express skepticism that the SEC should seek to protect private fund investors who are sophisticated investors and have the ability to freely negotiate their relationship with private funds and private fund advisers. As such, the court’s decision may damper future SEC attempts to impose more oversight and regulation on the private funds industry through rulemaking. Nonetheless, the SEC maintains its examination and enforcement capabilities to monitor and shape the behavior of advisers to private funds, and we expect that the SEC will continue to focus its examination and enforcement efforts with respect to, among other things:

- Disclosure, calculation, and allocation of private fund fees and expenses, including valuation of assets and potential offsetting of fees and expenses;
- Marketing and reporting of private fund performance;
- Compliance with the Custody Rule and timely completion of private fund audits and distribution of private fund audited financial statements;
- Conflicts of interest generally and in particular with respect to continuation vehicles;
- Adherence to contractual obligations regarding limited partnership advisory committees or advisory boards; and
- Impermissible waivers of federal fiduciary duty in the form of reimbursement, indemnification, or exculpation clauses.

Separately, private fund investors may use the Final Rules as a roadmap to negotiate for similar transparency or other rights that the Final Rules would have provided to private fund investors. Likewise, trade groups supportive of aspects of the Final

Rules may seek to influence the private fund industry to voluntarily adopt practices concerning some of the transparency or governance requirements that had been included in the Final Rules.

Conclusion

The Final Rules would have created a significantly altered compliance regime for private fund advisers. Although, as of now, the Final Rules will no longer go into effect, advisers to private funds should continue to be cognizant of the principles articulated by the SEC in the Final Rules with regard to their practices regarding their private funds and investors. The court's decision poses challenges for the SEC in seeking to more significantly regulate the private funds industry, but the SEC maintains its usual examination and enforcement tools for monitoring the practices it identified as problematic when promulgating the Final Rules.

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