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Fifth Circuit Strikes Down Private Fund Adviser Rules

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In a significant decision released Wednesday morning, a unanimous three-judge panel for the U.S. Court of Appeals for the Fifth Circuit vacated what have come to be known as the Private Fund Adviser Rules, a set of rules and amendments adopted by the Securities and Exchange Commission (SEC) in August 2023. The rules had been heavily criticized by private fund advisers and various related industry groups as being unduly burdensome and costly and were widely viewed as among the most significant and impactful regulatory requirements to be imposed on this industry in the post-Dodd-Frank era.

The vacated rules include the following:

- The Preferential Treatment Rule
- The Restricted Activities Rule
- The Quarterly Statement Rule
- The Adviser-Led Secondaries Rule
- The Private Fund Audit Rule
- Amendments to the Compliance Rule
- Related amendments to the Books and Records Rule

Background

The SEC had adopted the Private Fund Adviser Rules in an attempt to address what it identified as three failings across a broad range of private funds in the market: (i) lack of transparency to private fund investors, (ii) under-disclosed or failures to disclose conflicts of interest and (iii) governance structures within private funds that were not designed to prioritize investor oversight of the fund's investment adviser. Claiming authorization under Sections 211(h) and 206(4) of the Investment Advisers Act and citing the potential for investor harm as well as instances of investor harm observed by the SEC in examinations and enforcement actions, the SEC passed a number of new and amended Rules intended to address these issues. For more information about these Rules including an overview of their requirements, please see our earlier posting: SEC Adopts Private Fund Adviser Rules (August 24, 2023).

Shortly following the Rules' adoption, six trade associations brought a petition seeking to have the Rules vacated on the basis that they exceeded the SEC's authority, were passed with insufficient notice and opportunity to comment, and were otherwise arbitrary and capricious, all in violation of requirements for SEC rulemaking under the Advisers Act. For more information about this lawsuit, please see our earlier posting: Lawsuit Challenges Private Fund Adviser Rules (September 6, 2023).

The Court's Decision

The court's decision vacates the Rules on the grounds that the SEC exceeded its statutory authority, finding that neither Section 211(h) nor Section 206(4) granted the SEC the authority to adopt these Rules. While the plain language of Section 211(h) seemingly grants broad authority to the SEC to enact rules such as these (including the power to enact rules requiring "simple and clear disclosures to investors . . . including any material conflicts of interest" as well as rules "prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes"), the court applied principles of statutory interpretation to conclude that Congress had intended to limit such rulemaking authority only to the context of investment adviser interaction with retail customers, not private funds or private fund investors. Thus, the SEC could not rely upon Section 211(h) to issue these Rules.

The court came to the same conclusion in analyzing Section 206(4), which requires the SEC to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative" regarding "any investment adviser." The court emphasized the statute's requirement that the SEC must first "define" an act, practice or course of business to be "fraudulent, deceptive, or manipulative," noting that only after the SEC has "defined" the problematic conduct would the SEC then become empowered by this section of the statute to adopt rules intended to prevent that conduct. The court then concluded that the SEC had simply failed to meet that burden: "The Commission largely fails to "define" the fraudulent acts or practices that the Final Rule purportedly is designed to prevent."[1] The court also found that the Rules did not meet the "reasonably designed" requirement, citing to what it viewed to be clear legislative intent to regulate investment advisers' conduct towards private funds and private fund investors more lightly: "By congressional design, private funds are exempt from federal regulation of their internal "governance structure." . . . The Commission cannot promulgate rules under the guise of section 206(4) that affects this internal governance structure."

Finding that the SEC had no statutory authority on which to rely, the court then vacated the Rules.

What Comes Next

Further proceedings: The court's ruling became effective immediately upon filing, providing a reprieve from the requirements that would have been imposed by the Private Fund Adviser Rules and will stand unless overturned on appeal. As of this posting, the SEC has not indicated whether it intends to petition for *en banc* rehearing at the Fifth Circuit or appeal the decision to the Supreme Court. If the SEC does decide to appeal, it would need to file its petition for review within 45 days of the decision for an *en banc* Fifth Circuit review or within 90 days of the decision for an appeal to the Supreme Court.

Exam/Enforcement effects: It is worth bearing in mind that the SEC has long considered problematic the underlying conduct targeted by the Rules. That conduct has been the focus of SEC examination and enforcement efforts for many years and can be expected to remain a focus going forward, particularly because the panel criticized the SEC for failure to present sufficient evidence of fraudulent conduct by private fund advisers. The decision removes the Rules' additional bright-line requirements and prohibitions that the SEC could have wielded in its examination and enforcement efforts, but the SEC's focus on such conduct is likely to continue under existing fiduciary/disclosure concepts.

Effect on other rules: Less certain are the implications of this ruling on other pending, recent and past SEC rulemaking. By its terms, this ruling is limited to the Private Fund Adviser Rules and does not expressly affect any other SEC rules. Nevertheless, the court's findings are at a minimum likely to cause further delay in the adoption of any new rules by the SEC as it reevaluates its basis for adopting them. It remains to be seen whether this ruling and the court's reasoning will have any impact beyond that, such as in contexts involving other Advisers Act rules.

For a summary of recently proposed and adopted SEC rules, please see our earlier posting: Examining the SEC's Slew of Recent Rules and Amendments (March 26, 2024).

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[1] Notably, the court criticized the SEC for presenting little to no evidence of actual fraud: "And while some conduct could involve fraud, the Commission only has observed misconduct by about 0.05% of advisers. …The Commission's vague assertions fall short of the definitional specificity that Congress has required."

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