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Practice Update

Fifth Circuit Strikes Down SEC's Private Fund Advisers Rule

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On June 5, 2024, the Fifth U.S. Circuit Court of Appeals (the Fifth Circuit) ruled, in a unanimous 3-0 decision, to vacate the U.S. Securities and Exchange Commission's (SEC) much maligned Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews final rule (the Final Rule).[1] In reaching its decision, the Fifth Circuit ruled that the SEC lacked the statutory authority to adopt the Final Rule. While the immediate effect of the Fifth Circuit's decision is to invalidate the SEC's most recent attempt to impose additional regulation on private funds and their advisers, the rationale behind the decision could have wide-ranging consequences for existing and future SEC rulemaking.

In this legal alert, we outline the Fifth Circuit's decision and analyze the impact, both immediate and potential, on private funds and their advisers.

Background

In August 2023, the SEC adopted the Final Rule with the stated goal of enhancing the regulation of private fund advisers and the protection of private fund investors by (i) requiring increased visibility into certain practices involving compensation schemes, sales practices, and conflicts of interest through disclosure; (ii) restricting certain activities that the SEC deemed contrary to the public interest and harmful to investors; (iii) restricting the ability of

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private fund advisers to offer certain investors preferential treatment with respect to redemptions and access to information; (iv) requiring certain requirements with respect to adviser-led secondaries; and (v) requiring annual audits for private funds.[2]

Due to the increased regulatory requirements and new prohibitions, the Final Rule threatened to significantly alter the manner in which private fund advisers and private funds operate. In fact, the Fifth Circuit stated that the SEC estimated that the Final Rule would cost the private funds industry $5.4 billion and millions of hours of employee time.[3]

In adopting the Final Rule, the SEC claimed statutory authority pursuant to Section 206(4) of the Investment Advisers Act of 1940 (the Advisers Act) and Section 211(h) of the Advisers Act.[4] In September 2023, the National Association of Private Fund Managers, Alternative Investment Management Association, Ltd., American Investment Council, Loan Syndications and Trading Association, Managed Funds Association, and the National Venture Capital Association (collectively, the Petitioners) petitioned the Fifth Circuit for review of the Final Rule under the Administrative Procedure Act (the APA) and Federal Rule of Appellate Procedure 15(a) asserting that (i) the SEC exceeded its statutory authority in adopting the Final Rule; (ii) the Final Rule is not a logical outgrowth of the Proposed Rule; (iii) the Final Rule is arbitrary and capricious under the APA; and (iv) the SEC failed to adequately consider the Final Rule's impact on efficiency, competition, and capital formation.[5]

The Fifth Circuit's Decision

The Fifth Circuit ultimately agreed with the Petitioners that the SEC exceeded its statutory authority in adopting the Final Rule under both Sections 206(4) and 211(h) of the Advisers Act and, accordingly, was not required to reach a decision with respect to the remaining issues raised by the Petitioners.[6]

The SEC's Lack of Authority Pursuant to Section 211(h) of the Advisers Act

In reaching its decision with respect to the SEC's statutory authority pursuant to Section 211(h), the Fifth Circuit discusses the Dodd-Frank Wall Street Reform Act (Dodd-Frank), which added Section 211(h) to the Advisers Act, and notes that, while Dodd-Frank does include certain provisions enhancing the regulation of private fund advisers, Title IX of Dodd-Frank, in which Section 211(h) appears, relates almost exclusively to "retail customers." The Fifth Circuit further notes that Title IX explicitly prohibits the SEC from defining "customer" to mean an "investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser."[7] The Fifth Circuit contrasts Title IX's seemingly exclusive focus on retail customers against Title IV's careful and limited imposition of additional requirements on private fund advisers.[8] In light of this context, the Fifth Circuit ruled that Section 211(h) of the Advisers Act was intended by Congress to apply to retail customers.[9]

The Commission's Lack of Authority Pursuant to Section 206(4) of the Advisers Act

Section 206(4) of the Advisers Act grants the SEC general authority to adopt regulation to prevent fraudulent, deceptive, or manipulative business practices.[10] While the Fifth Circuit notes that Section 206(4) does indeed confer on the SEC authority to adopt regulation reasonably designed to prevent fraud or deception (even if the acts themselves are not fraudulent), it ultimately determined that the SEC did not articulate any rational connection between fraud and any part of the Final Rule. In supporting this determination, the Fifth Circuit notes that Section 206(4) explicitly requires the SEC to define the supposed fraudulent act before it may adopt regulation prescribing means to prevent such act, and further notes the conspicuous absence of any such definition in the Final Rule.[11] Accordingly, Fifth Circuit ruled that the SEC failed to act with the specificity required by Congress. The Fifth Circuit further explains that Section 206(4) does not authorize the SEC to require any disclosure and reporting obligations and contrasts this to other parts of the Advisers Act that explicitly provide for reporting and disclosure of specific information.[12] Lastly, the Fifth Circuit ruled that the Final Rule lacked a "close nexus," meaning the SEC conflated a "lack of disclosure" with "fraud" or "deception" when a failure to disclose cannot be deceptive without a duty to disclose. This duty to disclose extends to the client alone (which is the fund and not the investors in the fund).[13]

What This Means for Private Fund Advisers

The most obvious impact of the Fifth Circuit's decision is that, at least for now, private fund advisers will not be required to comply with the Final Rule. Given the SEC's own estimates regarding the cost of compliance with the Final Rule in both dollars and hours, this will allow private fund advisers to devote precious resources to ensuring compliance with existing regulatory requirements.

However, as noted above, the Fifth Circuit's decision may have potential impacts on other existing and pending regulation. In fact, several of the SEC's recently proposed regulations targeting private fund advisers, such as the Safeguarding Rule, rely on either Section 206(4) or Section 211(h) of the Advisers Act for the SEC's statutory authority. Furthermore, prior SEC rulemakings relying on Section 206(4) that impact private fund advisers, such as certain provisions of the Marketing Rule, may face potential challenges under the precedent established by the Fifth Circuit.

Conclusion

While the ruling handed down by the Fifth Circuit represents a clear win for the private funds industry and a step in the direction of reasonable and prudent regulation, it remains to be seen if the SEC will attempt to appeal the decision. Absent an appeal, the SEC may attempt to re-propose the rule with claims of statutory authority pursuant to other provisions of the Advisers Act.

Some industry observers believe the SEC could take the avenue of "regulation by enforcement" by using its existing examination and enforcement authority to crack down on the same fraudulent activities it attempted to regulate in the Final Rule. This could mean additional examination "sweeps" conducted by the Division of Examinations and referrals to the Division of Enforcement. While private fund advisers may have success fighting such examination and enforcement actions, the costs and reputational risk associated with potential SEC enforcement action could have a chilling effect on the industry.

In any event, we believe that the SEC will keep private fund advisers and private funds within its examination and enforcement focus. In light of the uncertainty surrounding the SEC's next steps, private fund advisers should continue to ensure compliance with existing regulatory requirements and remain prepared to respond to new regulatory hurdles.

For additional information please contact Paul Foley, Chair of Akerman's Investment Management Practice Group.

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[1] *See* National Association of Private Fund Managers et. al. vs. Securities and Exchange Commission, No. 23-60471 (5th Cir. 2024).

[2] *See* Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews, 88 FR 63296 (Aug. 2023).

[3] *See* National Association of Private Fund Managers et. al. vs. Securities and Exchange Commission, No. 23-60471 at 13.

[4] *Id* at 63213.

[5] *See* National Association of Private Fund Managers et. al. vs. Securities and Exchange Commission, No. 23-60471 at 14-15.

[6] *Id* at 15.

[7] *Id* at 10 (citing 124 Stat. at 1829).

[8] *Id* at 9.

[9] *Id* at 22.

[10] *See* Section 206(4) of the Investment Advisers Act of 1940, as amended.

[11] *See* National Association of Private Fund Managers et. al. vs. Securities and Exchange Commission, No. 23-60471 at 23.

[12] *Id.*

[13] *Id.* at 24 and 25.
