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Insights

FIFTH CIRCUIT COURT OF APPEALS VACATES THE SEC'S PRIVATE FUND ADVISER RULES

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On June 5, 2024, a three-judge panel of the Fifth Circuit Court of Appeals (the "Court") vacated the Private Fund Adviser Rules ("PFAR")[1] that the Securities and Exchange Commission (the "SEC") had adopted by a divided vote[2] in August 2023.

Promptly after PFAR was adopted, several groups representing advisers to different types of private funds filed a petition with the Court for review of PFAR. The Court concluded that the SEC's adoption of PFAR "exceeded its statutory authority" and emphatically held that "no part of it can stand." This decision represents a resounding win for the private fund industry and, conversely, a major blow to the SEC's private fund adviser regulatory agenda. Its implications are likely to be far-reaching.

In its opinion, the Court first laid out its description of private funds and the differences between private funds and other publicly offered pooled vehicles, such as mutual funds. It noted that mutual funds open to retail customers are themselves subject to extensive substantive regulation under the Investment Company Act of 1940, as amended (the "Investment Company Act"), while private funds designed for more sophisticated investors are expressly outside the regulation of that Act. The Court then addressed the application of the Investment Advisers Act of 1940, as amended (the "Advisers Act") to private fund advisers and their relationship with their private funds:

> Advisers to private funds…may be regulated in specific, limited respects through the …Advisers Act…The Advisers Act recognizes a fiduciary duty between an investment adviser and his client…In the private fund context, that client is the fund itself—***not the fund's investors***. *See Goldstein v. SEC,* 451 F.3d 873, 881 (D.C. Cir. 2006) (Emphasis added).

This background description reflected the Court's receptivity to the private fund industry's argument that a sharp statutory line exists between funds that serve retail investors and private funds.

The Court then focused on the SEC's attempted reliance on the following statutory provisions of the Advisers Act to authorize its adoption of PFAR:

- Section 211(h) added by the Dodd-Frank Act (certain disclosures, conflicts of interest and compensation rulemaking authority) and
- Section 206 (antifraud rulemaking authority).

With respect to Section 211(h), the Court acknowledged that:

> [Section 211(h)] seemingly grants the …[SEC] the power to 'facilitate the provision of simple and clear disclosures to [*all*] investors…including any material conflicts of interest' and 'promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes' for *any* investment advisers that the …[SEC] deems contrary to the 'the protection of investors.'

However, the Court added that:

> the words of a statute must be read in their context and with a view to their place in the overall statutory scheme. [Citation omitted]

Accordingly, the Court considered Section 211(h) in its overall context. In response to the SEC's claim that PFAR regulates the relationship between private fund advisers and fund investors, the Court observed that the Investment Company Act "preserves the market-driven relationship between a private fund adviser, the private fund, and outside investors. The Dodd-Frank Act only stepped towards regulating the relationship between the advisers and the private funds they advise."

The Court also discussed the extensive use of the term "retail customer" throughout the Dodd-Frank Act which led to its holding that Section 211(h) applies to retail customers, **not** private fund investors. As a result, the Court held that the SEC exceeded its statutory authority in adopting PFAR.

Section 206(4) authorized the SEC to "define and describe means reasonably designed to prevent such acts …as are fraudulent." The SEC argued that PFAR was designed to prevent fraudulent acts by advisers to private funds. The private fund industry countered that the SEC failed to articulate a "rational connection" between fraud and PFAR, and the Court agreed. The Court found that the SEC's "vague assertions" failed to define fraudulent acts that PFAR was supposedly designed to prevent. The Court also found that the general language in this Section did not authorize additional disclosure or reporting because there were other provisions that specifically dealt with those matters. Finally, the Court found that PFAR was not "reasonably designed" because it "does not fit within the statutory design" or have a "close nexus with statutory aims."

According to the Court, private funds are exempt from the Investment Company Act by statutory design; therefore, they are free from the SEC's prescriptive requirements. Also, according to the Court, there could be no close nexus with statutory aims to prevent fraud—the statutory aim is to prevent a client from being defrauded by an adviser's failure to disclose material information. Since the adviser's client is the private fund, its duty to disclose runs only to the private fund.

It remains to be seen whether the SEC will seek to have this decision reviewed by the entire Fifth Circuit or file a petition for certiorari with the Supreme Court.

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[1] National Association of Private Fund Managers, et al v. Securities and Exchange Commission. 2024 WL 2836655. For a discussion of PFAR, see our prior client alert.

[2] The Court's opinion in many respects echoed the views of the dissenting Commissioners in respect of the adoption of PFAR. See Statement of Commissioner Peirce and Statement of Commissioner Uyeda respectively.

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