STRADLEY RONON

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Client Alert | Investment Management

As Summer Approaches, Fifth Circuit Sends Private Funds Rule on Vacation

On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit vacated the new private funds rules[1] adopted by the U.S. Securities and Exchange Commission (SEC) on August 23, 2023 (collectively, the Private Funds Rule). In a unanimous decision, the court held that the SEC had exceeded its statutory authority under the Investment Advisers Act of 1940 (the Advisers Act) in adopting the Private Funds Rule.[2]

What Was Vacated

The Private Funds Rule was composed of a variety of new requirements that would have overhauled private fund regulation in the United States. Specifically, the restricted activities rule and preferential treatment rule would have applied to all private fund advisers, whether registered with the SEC or not, and the quarterly statement rule, private fund audit rule and adviser-led secondaries rule would have applied to SEC-registered advisers.[3] Larger private fund advisers (with more than $1.5 billion in private fund assets under management) would have been required to comply with the restricted activities rule, preferential treatment rule and adviser-led secondaries rule by September 14, 2024, and with the quarterly statement rule and private fund audit rule by March 14, 2025. All other private fund advisers would have been required to comply with all of these provisions by March 14, 2025.[4]

Fifth Circuit Rejects SEC's Rulemaking Authority

The court held that in promulgating the Private Funds Rule, the SEC exceeded the scope of the rulemaking authority granted to the agency by Congress pursuant to Sections 206(4) and 211(h) of the Advisers Act, the two provisions the SEC relied upon to justify its rulemaking.[5]

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1 See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 6383, 88 Fed. Reg. 63206 (August 23, 2023) (the Adopting Release).

2 *National Association of Private Fund Managers v. Securities and Exchange Commission*, No. 23-60471 (5th Cir. 2024).

3 For more information about the details of the Private Funds Rule, see our prior client alert on this topic: SEC Adopts Sweeping Private Fund Adviser Reforms (September 13, 2023).

4 Adopting Release at 63290 et seq.

5 *National Association of Private Fund Managers*, No. 23-60471. at 25.

Advisers Act Section 206(4): General Anti-Fraud: Section 206(4) of the Advisers Act is a general anti-fraud provision that prohibits investment advisers from engaging in any fraudulent, deceptive or manipulative conduct and requires the SEC to "define" an act, practice or course of business that is "fraudulent, deceptive, or manipulative." The SEC, in this instance and others, has relied upon this provision to support rulemaking.

On this point, the court ruled that the SEC cannot rely upon this general anti-fraud provision to impose substantive governance requirements on private funds, particularly given that such funds have been expressly carved out from the applicability of the Investment Company Act of 1940's more prescriptive provisions.[6] The court found that the SEC had "conflate[d] a 'lack of disclosure' with 'fraud' or 'deception'" and emphasized that a "failure to disclose 'cannot be deceptive' without a 'duty to disclose.'"[7] The court noted that "[b]y congressional design, private funds are exempt from federal regulation of their internal 'governance structure'" and held that the SEC "cannot promulgate rules under the guise of Section 206(4) that affect[] this internal governance structure."[8] The court, relying upon the U.S. Court of Appeals for the D.C. Circuit's decision in *Goldstein v. SEC*[9] also emphasized that under the Advisers Act, an adviser's duty (including the duty to disclose material information) is to its client (i.e., the private fund itself) and not the investors in the fund.[10]

Advisers Act Section 211(h): Dodd-Frank (Retail) Investor Protection: Section 211(h) of the Advisers Act, enacted pursuant to Section 913(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, directs the SEC to "'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 [SEC] deems contrary to the public interest and the protection of investors.'" The court noted, however, that Section 913(h) of Dodd-Frank was part of Title IX, which applies only to "retail customers," rather than Title IV, the only Dodd-Frank provision that explicitly addresses private funds.[11]

On this point, the court rejected the SEC's argument that the reference to the "protection of investors" in Section 211(h) should be read more broadly than "retail investors." Rather, the court held that "statutory language 'cannot be construed in a vacuum'" and found that it was "unlikely that Congress meant to switch to 'investor' 'in the middle of a provision otherwise devoted' to retail investment."[12] The court also again emphasized the existence of "extensive" requirements under the Investment Company Act for registered funds and the fact that Congress "clearly chose not to impose the same prescriptive framework on private funds."[13]

Additional Thoughts

A spokesperson for the SEC stated that the agency is reviewing the decision and determining its next steps; it is not yet clear whether the SEC will appeal the decision or attempt a re-proposal.

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6 *National Association of Private Fund Managers,* No. 23-60471, at 22-25.

7 Id. at 24.

8 Id.

9 451 F.3d 873, 881 (D.C. Cir. 2006).

10 Id. at 24-25.

11 Id. at 21.

12 Id. at 19, 22.

13 Id. at 19-20.

The Securities Industry and Financial Markets Association (SIFMA) notes that the SEC "is on track to propose and finalize 63 new rules by the end of [Chair Gary Gensler's] first four years in office."[14] Industry challenges to a number of proposed rules are outstanding, including, the climate rule applicable to public companies[15] and the broker-dealer rule that attempts to redefine the term "dealer" beyond the definition already included in the Securities and Exchange Act of 1934.[16]

Moreover, the Private Funds Rule defeat is just the latest in a number of recent setbacks to the SEC's rulemaking authority and agency decision-making. In February, the U.S. District Court for the District of Columbia rejected the SEC's attempt to sweep proxy advisors into the statutory framework designed to regulate proxy solicitations, holding that Congress did not intend the statute to go beyond those soliciting votes and the representations made with respect to those solicitations.[17] Further, in August 2023, the D.C. Circuit found the agency's refusal to permit the listing of the Grayscale Bitcoin Trust ETF to be arbitrary and capricious, holding that the SEC failed to explain its different treatment of similar products.[18]

This decision could further limit the SEC's reliance upon general rulemaking provisions, specifically the Advisers Act anti-fraud provisions, to justify extending its authority beyond the statutory limits set by Congress. Further, this decision, and its reliance upon *Goldstein*, could also frustrate future attempts by the SEC to regulate private funds for the purpose of protecting fund investors.

Firms should note that this ruling is not likely to impact the SEC's examination and enforcement priorities with respect to existing rules applicable to investment advisers even where they are advising private funds.

The industry should continue to consider whether the breadth of the SEC's rules exceeds the plain language of the statutes under which they have been promulgated or whether the agency's administrative decisions may be arbitrary and capricious in violation of the Administrative Procedure Act. There are limits on the SEC's ability to interpret the plain language of its governing statutes, and challenges to such rules may prove successful in circumstances where the facts align with legal arguments that courts have recently embraced.

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14 The Unprecedented Speed and Volume of SEC Rulemaking, SIFMA (September 21, 2023).

15 The Enhancement and Standardization of Climate-Related Disclosures for Investors, 17 C.F.R. §§ 210, 229, 230, 232, 239 and 249 (2024); *State of Iowa v. SEC*, No. 24-1522, Dkt. No. 1 (8th Cir. 2024); and all consolidated cases: Nos. 24-1623, 24-1624, 24-1626, 24-1627, 24-1628, 24-1631, 24-1633, 24-1634 and 24-1685.

16 Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 17 C.F.R. § 240 (2024); *National Association of Private Fund Managers; Alternative Investment Management Association v. SEC*, Complaint, No. 4:24-cv-00250, N.D. Tex. (March 18, 2024).

17 *Institutional Shareholder Services v. SEC*, 2024 WL 756783, at *16 (D.D.C. 2024); see also *Financial Planning Association v. SEC*, 482 F.3d 481, 493 (D.C. Cir. 2007) (holding that the SEC cannot rely on general rulemaking provision where it suggests no intention by Congress to ignore plain language elsewhere in the statute).

18 *Grayscale Investments v. SEC,* 82 F.4th 1239 (D.C. Cir. 2023).

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