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Locke Lord QuickStudy: FUNDamentals: Fifth Circuit Vacates New SEC Private Fund Adviser Rules

FUNDamentals™ Series

WRITTEN BY

Michael K. Renetzky | Heather M. Stone | Tom Bohac

On June 5th, 2024, the United States Court of Appeals for the Fifth Circuit (the "Court") vacated the U.S. Securities and Exchange Commission's ("SEC's") private fund advisers rules (the "Rules"), which would have imposed additional reporting requirements on private investment fund advisers. In a 3-0 decision, the Court held that the SEC exceeded its statutory authority by using a provision of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") intended to protect retail investors. The Rules would impose significant additional costs and burdens on private funds. The SEC estimated that the Private Fund Adviser Rules would cost the private funds industry $5.4 billion and millions of hours of additional employee time.[1]

Absent this ruling, which has national effect, the Rules were scheduled to take effect on (i) September 14, 2024 for large private fund advisers, and (ii) on March 14, 2025 for all other private fund advisers.

Background

On August 23, 2023, the SEC adopted (via a 3-2 vote) new Rules that were initially proposed in early 2022. The SEC intended the Rules to enhance adviser transparency and investor protections by:

- mandating disclosure or investor consent with respect to certain restricted activities, including conflicts of interest and compensation schemes (the "Restricted Activities Rule");
- prohibiting or restricting private fund advisers from providing investors with preferential treatment regarding redemptions and information rights, if such treatment would have a material, negative effect on other investors, or material economic terms, subject to certain exceptions and disclosure requirements (the "Preferential Treatment Rule");
- adding third-party fairness opinion or valuation requirements for adviser-led secondary transactions (the "Adviser-Led Secondaries Rule");
- mandating the audit of private fund financial statements to, among other things, serve as a check against misappropriation of assets and calculation of adviser fees (the "Audit Rule"); and
- requiring standardized quarterly statements detailing certain information regarding fund (a long-sought transparency effort sponsored by the Institutional Limited Partners Association).

Following the adoption of the Private Fund Adviser Rules, various industry groups representing private fund advisers challenged the regulations, arguing that they "would fundamentally change the way private funds are regulated in America."[2]

Ruling

In defending the regulations, the SEC relied on authority granted by the Investment Advisers Act of 1940 (the "Advisers Act") and the Dodd-Frank Act. While the Advisers Act did not provide the SEC with the explicit authority to regulate these kinds of disclosure requirements for private investors, the SEC argued that the Dodd-Frank Act gave them the implicit authority to do so.[3]

The SEC argued that section 913 of the Dodd-Frank Act, which required the SEC to conduct a study on regulatory gaps in the protection of retail customers and then issue new regulations to facilitate disclosure to investors granted them the authority to regulate disclosure requirements for both public and private companies.[4] The SEC's position was that the statute's grant of authority for the SEC to regulate on behalf of "investors" applied to all investors, including investors in private funds.

The Court rejected the SEC's arguments, holding that section 913 did not grant the SEC the statutory authority to impose these obligations on private funds. First, the Court held that the simultaneous passage of the Investment Company Act of 1940 (containing disclosure requirements for publicly traded investment companies) and the Advisers Act made it clear that Congress intended to distinguish between the disclosure requirements of public investment companies and private funds.[5] In addition, the Court focused on the fact that the Advisers Act regulates the relationship between investment advisers and their clients, and that in the private fund context the private fund itself, and not the underlying investors, is the clients of the investment adviser. The Court found that the Dodd-Frank Act was intended to regulate only the relationship between the investment adviser and the private fund, while the Investment Company Act would address the relationship between investment advisers, public investment funds, and the investors in public investment funds. Based on these findings the Court determined that the SEC's regulation was "in excess of statutory jurisdiction" under the Administrative Procedure Act vacated the regulations.[6]

The SEC does not have an automatic right of appeal in this case.[7] As of the date of this FUNDamentals publication the SEC has not commented on whether it intends to seek further review of the order to vacate, whether through an *en banc* rehearing by the full Fifth Circuit or a petition to the Supreme Court. Regardless of the SEC's decision, this ruling means that private fund advisers will not be required to comply with the new Rules at this time and will not incur the expense and burden to comply with the Rules.

The plaintiffs in this case, the National Association of Private Fund Managers and other trade associations, likely selected the Fifth Circuit due to its demonstrated animus against the SEC.

Conclusion

As we have in the past, we will continue to monitor these issues and will provide future client updates. This QuickStudy is for guidance only and is not intended to be a substitute for specific legal advice.

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[1] National Association of Private Fund Managers v. SEC, No. 23-60471 (5th Cir. 2024) at 13-14.

[2] *Id*, at 14.

[3] *Id*, at 16-17.

[4] *Id*, at 20; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 123 Stat. 1376, 1824-1829 (2010).

[5] *Id*, at 19.

[6] *Id*, at 25; Administrative Procedure Act, , Pub. L. No. 79-404, § 706, 60 Stat. 237 (1946)

[7] The SEC may appeal the Court decision by request to the Fifth Circuit to re-hear the case en banc or by appeal to the U.S. Supreme Court. The SEC may also re-propose certain portions of the Rules.

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