June 5, 2024

Fifth Circuit Vacates the SEC's Private Funds Rule

Fifth Circuit Holds that the SEC's 2023 Final Rule Regulating Investment Advisers to Private Funds Exceeded the SEC's Statutory Authority under the Advisers Act

SUMMARY

On June 5, 2024, the Fifth Circuit ruled in *National Association of Private Funds Managers, et al.* v. *Securities and Exchange Commission*, that the SEC exceeded its statutory authority under Sections 211(h) (codifying Section 913(h) of the Dodd-Frank Act) and 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") in adopting a 2023 final rule to enhance the regulation of private fund advisers (the "Private Funds Rule"), which imposed substantial new disclosure requirements and restricted a broad range of activities within the private funds industry. In a unanimous opinion of a three-judge panel, the Fifth Circuit vacated the Private Funds Rule in full. Importantly, in reaching its decision the Fifth Circuit held that the SEC's authority under Section 211(h) is limited to "retail customers" and that to promulgate rules under Section 206(4) the SEC is required to articulate a "rational connection" to fraud and explain how such rules are designed to prevent fraud.

For a more detailed summary of the Private Funds Rule, see our publication dated September 11, 2023.

BACKGROUND

The Private Funds industry, which includes, among others, hedge funds, private equity funds and venture capital funds, has grown substantially over the past 20 years. Prior to the passage of the Dodd-Frank Act, most private fund advisers were exempt from registration under the Advisers Act. However, the elimination of the "private adviser" exemption in 2010 subjected many private fund advisers to registration, including reporting and recordkeeping requirements under the Advisers Act. The Dodd-Frank Act also gave the SEC authority to promulgate new regulations for investment advisers.[1]

After a decade of overseeing, regulating and collecting data on private fund advisers, the SEC determined there was a need to enhance the regulation of such advisers in order to protect private fund investors and proposed new rules on February 9, 2022.[2] The SEC adopted the final Private Funds Rule on August 23, 2023 by a 3-2 vote, which moderated the proposed rule in response to hundreds of comment letters.[3] The final rule imposed several key changes on the regulation of private funds and their advisers.[4]

The National Association of Private Fund Managers, Alternative Investment Management Association, Ltd., American Investment Council, Loan Syndications and Trading Association, Managed Funds Association and National Venture Capital Association petitioned the Fifth Circuit to review the Private Funds Rule under the Administrative Procedure Act ("APA") on September 1, 2023, asserting that: "(1) the Commission exceeded its statutory authority, (2) the rule is not a logical outgrowth of the Proposed Rule, (3) the rule is arbitrary and capricious under the APA, and (4) the Commission failed to adequately consider the rule's impact on efficiency, competition, and capital formation."[5]

THE FIFTH CIRCUIT'S DECISION

The Fifth Circuit vacated the Private Funds Rule on the basis that the SEC exceeded its statutory authority under Sections 211(h) and 206(4) of the Advisers Act.[6]

Section 913(h) of the Dodd-Frank Act, as codified in Section 211(h) of the Advisers Act, expanded the SEC's authority to facilitate disclosure to investors by broker-dealers and investment advisers and examine and promulgate rules prohibiting or restricting sales practices, conflicts of interest and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors. The SEC argued that Congress's use of the term "investors" in Section 913(h), when Congress used "retail customers" elsewhere throughout Section 913, covered both retail investors and sophisticated private fund investors. The Fifth Circuit disagreed, reasoning that Section 913 of the Dodd-Frank Act pertains only to "retail customers" given that Title IX is focused on "retail customers," using the term at least 30 times.[7] Although Section 913(h) contains the word "investors," the court noted that "[i]t is unlikely that Congress meant to switch to 'investor' 'in the middle of a provision otherwise devoted' to retail investment."[8] The court noted that the heading of Section 913(h) "[o]ther matters" confirms this point. Thus, the court held that Section 913(h) applies only to "retail customers," and does not provide authority for the adoption of the Private Funds Rule.[9]

Further, the court held that the SEC exceeded its authority under Section 206(4), which authorizes 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.'"[10] Although the SEC stated that the Private Funds Rule was designed to prevent fraud, the court held that the SEC failed to articulate a "rational connection" or "close nexus" between fraud and any part of the Private Funds Rule.[11] Principally, the court took issue with the SEC's failure to adequately explain how the

Private Funds Rule would prevent fraud, reading Section 206(4) to require the SEC to "define" a fraudulent or manipulative act, practice or course of business before it can adopt rules proscribing such act, practice, or course of business.[12] The court further stated that Section 206(4) does not authorize the SEC to require disclosure or reporting.[13] The court reasoned that while other sections of the Advisers Act explicitly provide for reporting and disclosure, Section 206(4) does not. The court also concluded that the Private Funds Rule does not fit within the statutory design, citing the exemption for private funds in the Investment Company Act, the "sister statute" to the Advisers Act.[14] Finally, the court rejected the SEC's argument that a failure to disclose fell under the behavior that could be proscribed under Section 206(4), noting that "lack of disclosure" should not be conflated with fraud or deception and a "failure to disclose 'cannot be deceptive' without a 'duty to disclose.'"[15]

IMPLICATIONS

The Private Funds Rule imposed substantial new disclosure and other requirements on private fund advisers and restricted certain common market practices in the private funds industry. A spokesperson for the SEC stated that it is reviewing the decision and determining its next steps. Aside from vacating the onerous and prescriptive requirements that would have been imposed on the private fund industry, the Fifth Circuit's decision has the following key implications:

- The decision limits the SEC's authority under Section 211(h) to promulgate rules pertaining to retail customers.
- The decision restricts the SEC's authority to promulgate rules prescribing fraudulent and manipulative behavior under Section 206(4). The SEC will now need to "define" a fraudulent, deceptive or manipulative act or practice before it is authorized to adopt rules "reasonably designed to prevent" such act or practice.[16] Further, the opinion notes that Section 206(4) does not authorize the SEC to require disclosure or reporting, limiting the tools at the SEC's disposal to address the activities of investment advisers. The court noted that the SEC conflated a "lack of disclosure with fraud or deception" and that "a failure to disclose 'cannot be deceptive' without a 'duty to disclose.'"[17]
- The court's narrow interpretations of Sections 206(4) and 211(h) could provide grounds for industry participants to challenge a number of the SEC's proposed rules, if finalized as proposed, that rely on these provisions of the Advisers Act, such as the proposed predictive data analytics, cybersecurity and outsourcing rules. Many of the SEC's existing rules also rely on Section 206(4) rulemaking authority, including the investment adviser marketing rules and the investment adviser compliance rule.
- The language interpreted by the Fifth Circuit is present in the Exchange Act of 1934, including in Sections 9(j), 14(e), and 15(c)(2)(D), and thus the Fifth Circuit's decision implicates the SEC's rulemaking authority under those provisions.
- Finally, given that the Fifth Circuit defined the Private Funds Rule as the adopting release, the fiduciary duty guidance in the adopting release is also likely vacated.[18]

* * *

Copyright © Sullivan & Cromwell LLP 2024

ENDNOTES

1 See Dodd-Frank Act, § 404, 124 Stat. at 1571-72; see also 15 U.S.C. § 80b-4(b); *National Association. of Private Fund Managers, et. al.* v. *the Securities and Exchange Commission*, No. 23-60471, at 4-5 (hereinafter, the "Opinion").

2 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022). See also SEC Fact Sheet: Private Fund Proposed Reforms (Feb. 9, 2022), *available at* https://www.sec.gov/files/ia-5955-fact-sheet.pdf.

3 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-6383 (Aug. 23, 2023). See also SEC Fact Sheet: Private Fund Adviser Reforms: Final Rules (Aug. 23, 2023), *available at* https://www.sec.gov/files/ia-6383-fact-sheet.pdf.

4 Private Funds Rule at 63388-89; Opinion at 11-12.

5 Opinion at 14-15.

6 *Id*. at 16-17.

7 *Id.* at 21.

8 *Id.* at 21-22 (citing *Schreiber* v. *Burlington N., Inc.*, 472 U.S. 1, 12 (1985)).

9 *Id.* at 20-22.

10 *Id*. at 22 (citing 15 U.S.C. § 80b-6(4)).

11 *Id*. at 22-23.

12 *Id*. at 21-22.

13 *Id.* at 24.

14 *Id*.

15 *Id.* (citing *Regents of Univ. of Cal.* v. *Credit Suisse First Bos.*, 482 F.3d 372, 386 (5th Cir. 2007)).

16 *Id*. at 22-23.

17 *Id.* at 24.

18 See our publication on the Private Funds Rule, dated September 11, 2023, for a discussion of the release's fiduciary duty guidance, pages 7-8.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.