Client Alert | June 7, 2024

Private Fund Advisers Rule Struck Down by Fifth Circuit Court of Appeals

In August 2023, the U.S. Securities and Exchange Commission (the "SEC") passed a final rule known as the "Private Fund Advisers Rule" (the "Rule"), which would have substantially changed the manner in which both registered investment advisers and exempt reporting advisers conducted their private fund businesses. On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit struck down the Rule in its entirety on the grounds that the passage of the Rule exceeded the SEC's authority.

The Rule was initially proposed in February 2022 and was viewed as controversial by the industry, resulting in hundreds of comment letters to the SEC as well as numerous meetings with SEC officials prior to the Rule's finalization. While the SEC eliminated from the final Rule some of the more controversial elements from the proposed rule, many aspects of the final Rule were considered unclear and burdensome to the private fund industry.

Several industry groups brought an action against the SEC in the Fifth Circuit shortly after the Rule was passed, arguing that the SEC did not have authority under existing anti-fraud rulemaking authority or under Dodd-Frank, which were the two statutory provisions that the SEC relied upon for its authority to pass the Rule. The SEC had based its authority upon (i) Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act"), which permits the SEC to pass rules and regulations reasonably designed to prevent acts, practices, and courses of business that are fraudulent, deceptive, or manipulative, as well as (ii) Section 211(h) of the Advisers Act (an amendment to the Advisers Act as part of Dodd-Frank), which authorizes the SEC to "promulgate rules prohibiting or restricting certain sales practices, conflict of interest, and compensation schemes for brokers, dealers and investment advisers that the Commission deems contrary to the public interest and the *protection of investors*."

With respect to the anti-fraud rulemaking authority, the industry groups argued that the SEC failed to define the fraudulent acts or practices that the Rule was designed to prevent, and that the Rule was not reasonably designed to prevent any specific fraudulent acts. With respect to the authority under Section 211(h), the industry groups argued that such authority was intended to protect retail investors and *not* investors in private funds, since such interests in private funds are only offered to sophisticated investors and were intended under the Investment Company Act of 1940 to be treated differently than other investment products. The Fifth Circuit agreed with the industry groups' arguments and struck down the entire Rule on that basis, without the need to specifically analyze any single portion of the rule.

It is worth noting that the SEC already has broad authority under existing anti-fraud rules to take action against some of the behaviors that the Rule was intended to curb. For example, the SEC has frequently and publicly criticized the preferential treatment of certain investors with respect to liquidity and transparency. While the Rule would have outright prohibited such preferential treatment without offering the same treatment to all investors, the SEC may still raise issues with offering preferential liquidity or transparency, including through deficiency letters in the SEC's examination program or even through enforcement actions, to the extent the conduct results in harm to investors. Similarly, the SEC may continue to view other behaviors that the Rule was designed to prevent, such as charging the costs of regulatory investigations to private funds, as inconsistent with investment advisers' fiduciary duties.

It is unclear what the SEC's next step will be, including whether the SEC will attempt to appeal the decision. Given the current composition of the Supreme Court, it seems unlikely that such an appeal would be successful.

The ultimate takeaway is that this decision is a tremendous win for the private fund industry. The current SEC has aggressively pursued new rulemaking that would affect the industry, with several other proposed rules awaiting finalization, including a rule that would require prescriptive due diligence on any service providers to whom certain "covered functions" are outsourced, rules regarding the use of predictive data analytics, as well as amendments to the well-known Custody Rule. The Rule included the most significant changes that were sought by the SEC, and it remains to be seen how this consequential defeat will influence the SEC in moving forward with existing proposals, given the potential for an adverse result in court.

Key Contacts

If you require any additional information regarding this decision, or other issues impacting private funds, please feel free to contact any of the attorneys listed below.

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