CLIENT ALERT

Investment Advisers Receive Reprieve from Private Funds Rule

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Investment advisers for private funds were likely relieved to learn recently that the United States Court of Appeals for the Fifth Circuit invalidated five regulations and related amendments known as the Private Fund Adviser Rules (PFAR or the Rules). In August 2023, the SEC adopted the Rules in an effort to oversee the conduct of investment advisers to private funds. The Rules were adopted under Sections 206(4) and 211(h) of the Investment Advisers Act of 1940. Specifically, the primary Rules were:

1. **Rule 206(4)-10 (the Private Fund Audit Rule)**: This rule would have required registered private fund advisers to deliver audited financial statements to the investors of each private fund they manage within 120 days of each fiscal year-end.[1]

2. **Rule 211(h)(1)-2 (the Quarterly Statements Rule)**: This rule would have required registered private fund advisers to provide investors with quarterly statements that included performance statistics, fees and expenses paid by the private fund, the costs of investing in the private fund, and compensation and other amounts paid to the adviser.[2]

3. **Rule 211(h)(2)-2 (the Adviser-Led Secondaries Rule)**: This rule would have required registered private fund advisers to obtain a fairness or valuation opinion when offering investors the option to sell or convert their interests in a private fund to those in another vehicle managed by the adviser or its affiliates. Further, an adviser would have had to provide detailed disclosures to investors of any material business relationship the adviser had, within the prior two years, with the party providing the independent opinion.[3]

4. **Rule 211(h)(2)-1 (the Restricted Activities Rule)**: This rule would have restricted certain activities by private fund advisers, including charging specific fees and expenses to the fund without investor approval and borrowing or receiving extensions of credit from a private fund without investor approval.[4]

5. **Rule 211(h)(2)-3 (the Preferential Treatment Rule)**: This rule would have prohibited private fund advisers from providing preferential terms to certain investors if it would be detrimental to other investors, and required disclosure of any preferential treatment given to some investors to all other investors within the private fund.[5]

The Rules went into effect on November 13, 2023, with varying compliance dates beginning in September 2024. However, private fund advisers now have a bit of a respite after the Fifth Circuit's decision in *National Association of*

Private Fund Managers (NAPFM) v. SEC, No. 23-60471 (5th Cir. 2024). In *NAPFM,* the plaintiffs—a group of trade associations for private equity, venture capital, and other types of asset managers—asked the court to vacate the Rules. While the plaintiffs' argument set forth four bases for relief,[6] the Fifth Circuit relied on only one in deciding to vacate the Rules in their entirety.

On June 5, 2024, the Fifth Circuit vacated the Rules on the ground that the SEC exceeded its statutory authority.[7] According to the court, the central question was whether the Dodd-Frank Act conferred rulemaking authority upon the SEC to regulate private fund advisers and investors in private funds under Sections 211(h) and 206(4) of the Advisers Act.[8] The court concluded that "neither section grants the Commission such authority," emphasizing that the statutory language and legislative intent did not support the SEC's expansive regulatory reach over private funds.[9]

The court's analysis highlighted the fact that section 211(h) appears to allow the SEC to mandate clear disclosures and regulate certain practices for "any investment advisers," but the section primarily applies to "retail customers," not private fund investors.[10] In reaching this determination, the court considered the Investment Company Act (ICA), the sister statute to the Advisers Act. The ICA specifically exempts private funds from the ICA's prescriptive framework, allowing them greater freedom to negotiate fund agreements, including terms related to financial reports, advisory fees, and investor redemptions.[11] This exemption reflects Congress's intent to differentiate between publicly accessible investment vehicles and private funds that cater to sophisticated investors, thereby limiting federal regulation of private fund governance structures.[12] Furthermore, the court found the SEC's reliance on Section 913 of the Dodd-Frank Act was misplaced because it applies only to "retail customers" and not private fund investors.[13]

Additionally, the court critiqued the SEC's justification for the Rules under Section 206(4) of the Advisers Act, which is meant to prevent fraudulent, deceptive, or manipulative acts by investment advisers.[14] The court held that the SEC failed to establish a "rational connection" between the Rules and the prevention of fraud or deception, as required under Section 206(4).[15] The court also highlighted that a duty to disclose exists only between the investment adviser and the client (the fund itself), not the investors in the fund.[16] Consequently, a failure to disclose cannot be deceptive when there was no duty to disclose.[17]

This decision ultimately invalidated the Rules, reaffirmed the statutory limitations on the SEC's authority, and preserved the freedom of negotiation between private fund advisers and their investors. Although the decision was not entirely surprising, we anticipate the SEC will appeal, either through (A) a request for further review with the full panel of the Fifth Circuit or (B) a request for review by the Supreme Court. If the SEC chooses Option A, it has 45 days to file an en banc petition for rehearing by the full Fifth Circuit. After that, depending on what the Fifth Circuit does, the SEC could further appeal to the U.S. Supreme Court. If the SEC chooses Option B—jumping straight to the Supreme Court—it has 90 days to file a writ of certiorari. The SEC has several interests to weigh in making this determination. Among them:

- The new Rules were clearly important to the SEC's program, given that the SEC described them as regulations to "address certain practices that impose significant risks and harms on investors and private funds … by increasing visibility into certain practices, establishing requirements to address practices that have the potential to lead to investor harm, and prohibiting or restricting adviser activity that is contrary to the public interest and protection of investors."[18] As such, the government is likely to seriously consider appealing directly to the Supreme Court instead of first proceeding with the en banc petition.
- Weighing in favor of that approach is the concern that the SEC would not want to be seen as capitulating to the Fifth Circuit's recent assault on its regulations. *See, e.g.*, *Chamber of Com. of the USA v. SEC*, No. 23-60255 (5th Cir. 2023), *vacated*; *Jarkesy v. SEC*, 20-61007 (5th Cir. 2022), *vacated*. Proceeding within the Fifth Circuit is obviously not without its risks right now.
- On the other hand, it is possible that the Supreme Court will be just as hostile to the SEC's rules as the Fifth Circuit, and a loss at the Supreme Court would be viewed as more of a final loss than one at the Fifth Circuit.

Alternatively, there is the possibility of an Option C, where the SEC chooses not to appeal at all. Leaning in favor of forgoing the appeal, the SEC has other battles to fight right now, and may decide that its pursuit of PFAR is less of a priority, or that it can address some of the issues the Rules were designed to address through enforcement and examination. The SEC may also see the Fifth Circuit's opinion as a road map to try again, so we will be looking out for new rulemaking from the SEC designed to avoid some of the flaws the Fifth Circuit identified.

The SEC has a little time to decide its next move, and if it appeals, the process will likely take months, which means that even if the SEC were to ultimately prevail, private fund advisers are likely safe in assuming that they can pause on efforts to come into compliance in advance of the upcoming compliance dates. We will continue to monitor and will provide updates as they come. For now, the decision means that private funds will only have to navigate the current regulations—so they can take a bit of a summer break!

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[1] SEC, Private Fund Adviser Reforms: Final Rules (Fact Sheet) (Nov. 23, 2023).

[2] *Id.*

[3] *Nat'l Ass'n of Priv. Fund Managers v. SEC*, No. 23-60471, at 13 (5th Cir. June 5, 2024).

[4] SEC, Private Fund Adviser Reforms: Final Rules (Fact Sheet) (Nov. 23, 2023).

[5] *Id.*

[6] *First*, the SEC exceeded its statutory authority when it enacted these Rules under Sections 211(h) and 206(4) of the Advisers Act; *second*, the SEC failed to provide the public with a meaningful opportunity to comment on the Rules; *third*, the Rules were "arbitrary, capricious, and otherwise unlawful" because they lacked a factual basis and imposed unnecessary and unduly burdensome provisions; and *fourth*, the SEC failed to consider whether the Rules would "promote efficiency, competition, and capital formation." Brief for Appellants at 22–24, *Nat'l Ass'n of Priv. Fund Managers*, No. 23-60471.

[7] *Nat'l Ass'n of Priv. Fund Managers*, No. 23-60471, at 15.

[8] *Id.* at 17.

[9] *Id.* at 18.

[10] *Id.* at 22.

[11] *Id.* at 20.

[12] *Id.* at 19-20.

[13] *Id.* at 21.

[14] *Id.* at 22.

[15] *Id.* at 23.

[16] *Id.* at 24.

[17] *Id.*

[18] SEC, Private Fund Adviser Reforms: Final Rules (Fact Sheet) (Nov. 23, 2023).

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