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Securities Alert

June 25, 2024

Fifth Circuit Vacates Private Funds Advisers Rules

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The Final Rules will not become effective on the planned initial compliance date and seem unlikely to either be appealed or reconstituted in the near future.

What's the impact?

- The ruling emphasized the difference between retail investors and private funds investors, and could potentially limit the SEC's ability to regulate the private funds industry.
- This challenge could embolden other challenges to proposed SEC rules that are based on the same or similar regulatory authority.
- Nonetheless, the principles behind the Rule may survive as the basis for SEC examinations and enforcement proceedings, and through adoption as commercial terms by investors.

On June 5, 2024, the US Fifth Circuit Court of Appeals (the 5th Circuit) vacated the Private Funds Advisers Rules (the Final Rules) adopted by the Securities and Exchange Commission (the SEC).

What was the 5th Circuit's decision?

The 5th Circuit held that the SEC exceeded its statutory authority in adopting the Final Rules based on Section 211(h) and Section 206(4) of the Investment Advisers Act of 1940 (the Advisers Act).

The 5th Circuit emphasized that statutory interpretation starts with the "ordinary meaning" of the text. Therefore, the courts should interpret the text consistent with their ordinary meaning at the time Congress enacted the statute unless the context suggests otherwise.

Section 211(h) of the Advisers Act, as amended, states that "[t]he Commission shall—

> (1) facilitate the provision of simple and clear disclosures to **investors** regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and
>
> (2) 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 Commission deems contrary to the public interest and the protection of **investors**."

The 5th Circuit ruled that Congress intended Section 211(h) for retail investors, not persons investing in private funds, since it was enacted during the 2007–2008 financial crises—a period of renewed interest in consumer protection—and Congress, "clearly chose not to impose the same [rules] on private funds" as it did for registered investment companies.

Section 206(4) of the Advisers Act, as amended, states that "[i]t shall be unlawful for any investment advisor by use of the mails or any means of instrumentality of interstate commerce, directly or indirectly— … (4) to engage in any act, practice, or course of business which is **fraudulent, deceptive, or manipulative**. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

The 5th Circuit rejected the SEC's argument that it had authority based on the anti-fraud provisions of Section 206(4) because the SEC failed to establish a "rational connection" and the Final Rules lacked a "close nexus" to those provisions. The 5th Circuit noted that a "lack of disclosure" is not "fraud" or "deception" and "the duty [of the advisers] extends to the client alone, which is the fund, not the investors in the fund."

Was this a surprising decision?

While, the 5th Circuit ruling was a surprising decision, perhaps it should have been anticipated. Historically, there has been a bright line between registered investment companies, such as mutual funds, and private funds, such as private equity funds. In respect of registered investment companies, Congress enacted specific, proscriptive rules that imposed specific requirements on what a registered investment company could and could not do. The 5th Circuit emphasized (1) the Investment Company Act "places significant restrictions on the types of transactions registered investment companies may undertake," and has additional measures to protect investors, and (2) Congress specifically exempted private funds from these rules through the enactment of Section 3(c)(1) and 3(c)(7) of the Investment Company Act.

In addition, the 5th Circuit clarified that the Dodd-Frank Act focused on regulating the relationship between the advisers and the private funds they advise. Private funds themselves were governed only by the more amorphous prohibition from engaging in "fraudulent, deceptive[,] or manipulative" practices.[1] The SEC has historically relied on that language to rule through administrative enforcement actions and penalize conduct that the SEC deemed improper. Otherwise, private funds have historically enjoyed tremendous freedom under the notion that sophisticated investors in private funds can protect their own interests and do not need the SEC to "watch their back."

However, this environment has been recently eroded by the SEC's 2021 marketing rules that impose specific requirements related to advertisements made by investment advisers for purposes of soliciting investors. These rules were founded on the principles of prohibiting "fraudulent, deceptive[,] or manipulative" practices. Rather than using the avenue of piecemeal rules through the SEC enforcement actions, the SEC promulgated these specific marketing rules to achieve this purpose, similar to the apparatus used for registered investment companies. This was a departure from the prior environment where investment advisers had tremendous freedom to operate.

After the marketing rules, the SEC promulgated the new private fund rules where the SEC delved even deeper into specifying what an investment adviser could and could not do, and imposed specific obligations on private funds. The question that came to mind for players in this field was whether this was just the beginning and whether additional rules would follow once the door to pandora's box was opened. In the end, the 5th Circuit concluded that the SEC went too far in the Final Rules. The 5th Circuit refused to allow the SEC to govern the internal operations of private funds under the "guise of section 206(4)," which prohibits "fraudulent, deceptive[,] or manipulative" practices. The 5th Circuit chose to formalize a demarcation that Congress arguably

[1] 15 U.S.C. § 80b-6(4).

made between registered investment companies and private funds, and concluded that the SEC exceeded its authority in promulgating the Final Rules.

What are the possible next steps for the SEC?

The SEC may decide to challenge the ruling by filing a petition for certiorari with the United States Supreme Court. But there is no guarantee that the Supreme Court will take the case. Whatever the SEC decides to do, the Final Rules will be put on hold for now and won't become effective on the planned initial compliance date.

The 5th Circuit's decision could potentially limit the SEC's ability to regulate the private funds industry. The ruling emphasized the difference between retail investors and private funds investors. This could be a constraint in the future if the SEC wants to promulgate similar rules or bring enforcement actions to regulate the private funds industry. In addition, this successful challenge may embolden other challenges to proposed SEC rules—the Cybersecurity Rule, Safeguarding Rule, and the Predictive Data Analytics Rule—that are based on the same or similar regulatory authority.

Even though the 5th Circuit vacated the SEC's Final Rules, the SEC may find other ways to achieve the objectives here, such as examinations and enforcements. It is no secret now that the SEC's attention will be on the issues discussed in the Final Rules. The SEC will likely put more focus on private fund managers' practices such as disclosure and internal policies and procedures related to preferential treatment of certain investors, fees, and expenses. Private fund managers are still recommended to consider the adequacy of arrangements in this regard.

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