# Appeals Court Determines to Vacate Private Fund Advisers Rule

June 6, 2024

On June 5, 2024, the United States Court of Appeals for the Fifth Circuit (the "*Court*") determined to vacate rules recently adopted by the Securities and Exchange Commission (the *"Commission"*) regulating the conduct of investment advisers to private investment funds (the *"Private Fund Advisers Rule"*).

The Court held that the adoption of the Private Fund Advisers Rule exceeded the statutory authority provided to the Commission by the provisions of the Investment Advisers Act of 1940 (the "*Advisers Act"*) on which the Commission relied for its rulemaking – Sections 206(4) and 211(h). The Private Fund Advisers Rule, among other things, required advisers to private funds to provide additional disclosures to investors in such funds and imposed new requirements related to fund audits, performance reporting, books and records, and adviser-led secondary transactions. Additionally, the Private Fund Advisers Rule restricted certain types of preferential treatment to investors and required most private funds to produce quarterly fee and performance reports. The proposal and eventual adoption of the Private Fund Advisers Rule faced strong and mixed reactions from both fund managers and private fund investors.

In the Adopting Release for the Private Fund Advisers Rule, the Commission explained that it had authority under Section 206(4) of the Advisers Act to adopt rules "reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." Further, the Commission stated that Congress expanded the Commission's oversight responsibility for private fund advisers in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the *"Dodd-Frank Act"*).

Specifically, the Commission cited the Dodd-Frank Act's enactment of Section 211(h) of the Advisers Act, which provides that the Commission is authorized to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with…investment advisers" and "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 Commission interpreted the word "investors" in Section 211(h) to mean *all* investors, including private fund investors.

The "crux" of the argument of the parties that challenged the Private Fund Advisers Rule (the *"Petitioners"*), as described by the Court, is that Congress drew a "sharp line" between private funds and funds that serve retail customers. In the Petitioners' view, the Dodd-Frank Act provided for only limited and specific regulation of private fund advisers within the context of the adviser's duties as an investment adviser, and therefore did not reach to regulation of the relationship between the adviser and a private fund's investors or to the internal governance of private funds.

In analyzing the authority granted to the Commission by Section 211(h), the Court acknowledged that the word "investors" is used in Section 211(h) but ultimately determined that Section 211(h) applies only to "retail customers" – the specific group of investors to which the other provisions of Section 211 apply. The Court agreed with the Petitioners that the Dodd-Frank Act only "stepped towards regulating the relationship between the advisers and the private funds they advise" and did not intend to address or alter the "market-driven relationship between a private fund adviser, the fund, and outside investors" stating that Section 211 has "nothing to do with private funds." Therefore, the Commission could not rely on Section 211(h) to enact rules regulating the conduct of private fund advisers with respect to private fund investors.

With respect to the Commission's reliance on Section 206(4) and its position that it had authority under that Section to regulate acts that are "not themselves fraudulent" if the restriction is "reasonably designed to prevent" fraud or deception, the Court found that the Private Fund Advisers Rule's anti-fraud measures were "pretextual," agreeing with the Petitioners that the Commission failed to articulate a "rational connection" between fraud and any part of the Private Fund Advisers Rule. The Court also agreed with the Petitioners that the Private Fund Advisers Rule does not "fit within the statutory design" because Congress intentionally exempted private funds from federal regulation of their internal governance structure by exempting them from registration under the Investment Company Act of 1940. Instead, according to the Court, Congress intended to permit "private funds to freely negotiate fund agreements concerning investor access to periodic financial reports…investor input on advisory fees chargeable to the fund…and terms – including redemption terms – available to particular investors."

The Court's judgment, which is issued alongside the decision articulating its reasoning, declares that the Private Fund Advisers Rule shall be vacated and makes that order effective after the time to file any procedural motions seeking a rehearing, an en banc review, or a stay of the judgment has expired. Once such period expires, assuming no such motions are filed, the Private Fund Advisers Rule shall have no further legal effect. The Commission has not yet made its intention for further action in this case known.

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