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Fifth Circuit Vacates SEC Private Fund Adviser Rules

By: C. Dirk Peterson
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Yesterday, the private fund industry was victorious in its challenge to a package of private-fund adviser rules adopted in August 2023 by the Securities and Exchange Commission ("SEC" or "Commission") [*see National Association of Private Fund Managers et. al vs. SEC* (No. 23-60471) (Fifth Cir. June 5, 2024)]. The rules, grounded in the SEC's purported authority under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") and under general antifraud, unsuccessfully sought to prohibit, restrict, and regulate governance and operational aspects of private investment funds. As of today, the SEC has not publicly indicated if it will appeal the decision.

The petition was one of two lawsuits brought by the private fund industry against the Gensler Commission's exercise of authority to regulate hedge funds, private equity funds, real estate funds, venture capital funds, and collateralized debt obligation funds, colloquially known as private investment funds. The other petition, which is currently pending before the Fifth Circuit Court of Appeals, challenges the Commission's authority to regulate as dealers certain private investment funds, among others, under a novel definition of a "regular dealer business." That challenge is currently awaiting the SEC's response to the petitioner's Motion for Summary Judgment due June 11, 2024.

In the opinion published yesterday, a three-judge panel of the Fifth Circuit vacated the following rules newly codified under the Investment Advisers Act of 1940, as amended ("Advisers Act"): 17 CFR §§275.211(h)(1)-1 (Definitions); 275.211(h)(1)-2 (Quarterly Statements); 275.211(h)(2)-1 (Restricted Activities); 275.211(h)(2)-2 (Adviser-Led Secondary Market Transactions); 275.211(h)(2)-3 (Preferential Treatment); and 275.206(4)-10 (Annual Private Investment Fund Audit).[1] In addition to those newly codified rules, the Court also vacated amendments to existing rules under the Advisers Act that the SEC adopted at the same time. These amendments would have required an annual compliance review of all investment advisers (17 CFR §275.206(4)-7) and required the maintenance of related books and records relevant to the private-fund adviser rulemaking package (17 CFR §275.204-2). The Fifth Circuit referred to the entirety of the rulemaking, including the amended rules, as the "Final Rule" and held that the SEC had exceeded its statutory authority when adopting the rule package.

According to the Court, the petitioners had standing to sue because they represented private investment funds and their advisers, the industry sector impacted by the Final Rule. It also held that the venue was valid because at least one of the petitioners was headquartered within the circuit (Fort Worth, TX).

[1] As a practical matter, most (if not all) private investment funds are subject to annual audits by virtue of their operating agreements and/or the Advisers Act custody rule.

After the court addressed challenges to the petitioners' standing and choice of venue, the Fifth Circuit addressed claims of the Commission's statutory authority and, because the Court vacated the Final Rule on statutory grounds, it declined to address the petitioner's claims of arbitrary and capricious rulemaking in violation of the Administrative Procedure Act and of the failure of the Commission to adequately consider the Final Rule's economic impacts.

The Court took a contextual approach in addressing the Commission's statutory authority, reviewing the Congressional intent to exclude private investment funds from the detailed governance and operational regulations of the Investment Company Act of 1940 and the construction of Dodd-Frank and its express grants of rulemaking authority.

The Court's approach can be encapsulated, as follows: Congress intended private investment funds, because they are non-public and available solely to sophisticated investors, to be relieved of the detailed governance obligations and operational restrictions applicable to public-facing funds that are widely available to retail customers. Thus, the SEC should not impermissibly frustrate Congressional intent by imposing governance obligations and operational restrictions on private investment funds indirectly through the funds' advisers in an irrational and poorly defined connection to the Advisers Act's general antifraud authority – i.e., authority under Section 206(4).

Moreover, the construction of Dodd-Frank itself does not support the Final Rule because the section relied on by the SEC – Section 913 of Title IX of Dodd Frank – regulates client relationships for the protection of "retail customers," not investors in private investment funds, and includes an express prohibition against the SEC ascribing "retail customer" status to an investor in a private investment fund subject to an investment management agreement. In other words, the SEC impermissibly extended its statutory authority to the private fund sector by extrapolating rulemaking authority intended for "retail customers" to regulate "other matters" involving "sales practices, conflicts of interest, and compensation schemes" of investment advisers "that the Commission deems contrary to the public interest and the protection of investors."

According to the Court, where Congress granted specific authority to the SEC to regulate private investment funds, it did so in Title IV of Dodd-Frank, not in a catch-all provision of an entirely separate section of Dodd-Frank that overwhelmingly addressed the protection of "retail customers." Hence, the Court invalidated the entire rulemaking package impacting private investment funds.

CONTACT INFORMATION

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