Fifth Circuit Banishes SEC Private Fund Adviser Rules to a Galaxy PFAR, PFAR Away…

June 6, 2024

In a major win for the private funds industry, yesterday the U.S. Court of Appeals for the Fifth Circuit unanimously struck down the new rules adopted by the U.S. Securities and Exchange Commission (the "SEC") on August 23, 2023 applicable to investment advisers to private funds (the "Adopted Rules").[1]

Holding that "no part of [the Adopted Rules] can stand," the court sided with the six industry groups that brought the challenge (collectively, the "Petitioners") and fully vacated the Adopted Rules, including those that represented amendments to existing rules. The court's decision was based *solely* on the SEC's lack of authority to promulgate the Adopted Rules under the SEC's cited statutory authority of section 211(h) and section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act"). The court held that section 211(h) "has nothing to do with private funds" because it applies to "retail customers" only. The court also found that the Adopted Rules were not supported by the SEC's general antifraud authority under section 206(4) of the Advisers Act because the SEC had not articulated a "rational connection" between fraud and any part of the Adopted Rules. In a stinging rebuke to the SEC, the court described the rule's proffered antifraud basis as "pretextual." The court also concluded that section 206(4) does not authorize the SEC to require disclosure and reporting, because "where Congress wanted to provide for" the reporting and disclosure of certain information, "it did so explicitly."

The court considered other issues argued by the parties, but ultimately did not cite any of these grounds as a basis for its decision.[2]

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[1] See Release No. IA-6383 (the "Adopting Release"). The Adopted Rules included amendments to Rules 204-2 (the "Recordkeeping Rule") and 206(4)-7 (the "Annual Review Rule") and new Rules 206(4)-10 (the "Audit Rule"), 211(h)(1)-1, 211(h)(1)-2 (the "Quarterly Statement Rule"), 211(h)(2)-1 (the "Restricted Activities Rule"), 211(h)(2)-2 (the "Adviser-Led Secondaries Rule") and 211(h)(2)-3 (the "Preferential Treatment Rule").

[2] The court ruled against the SEC's arguments that venue was improper and that the Petitioners lacked standing. Given its holding that the SEC exceeded its authority, the court did not opine on the Petitioners' arguments that (i) the SEC failed to provide the public a meaningful opportunity to comment on the Adopted Rules, (ii) the Adopted Rules are arbitrary, capricious and otherwise unlawful and (iii) the SEC did not perform an adequate cost-benefit analysis.

The SEC has indicated that it is considering its next steps. It is unclear at this time whether the SEC will appeal the decision or abandon this rulemaking. While the full impact of the decision remains to be seen, the SEC's focus on private funds is likely to continue. Even if the SEC does not seek to appeal the decision or to re-propose a version of the Adopted Rules, the principles behind the Adopted Rules remain indicative of the SEC's views on many industry practices and potential areas of focus for Advisers Act exams and enforcement going forward. It is also unclear whether any of the court's conclusions will be read to apply to any existing Advisers Act rules or SEC interpretations.

Below we review several open questions arising from the decision, including the paths that the SEC may pursue to challenge the decision and to further its agenda with respect to the private funds industry and considerations for future negotiations with investors.

A. Potential Next Steps for the SEC in the Litigation Context

The Fifth Circuit panel was unanimous in its ruling, and is unlikely to entertain any request for rehearing. Although the SEC could petition the same panel or the Fifth Circuit in its entirety to hear the case *en banc*, the Fifth Circuit grants such *en banc* requests exceedingly rarely—in fewer than one percent of cases before the Circuit. The most likely path for further review is for the SEC to petition the U.S. Supreme Court for *certiorari*, which the SEC could do at any point within 90 days of the ruling regardless of whether it first seeks rehearing in the Fifth Circuit. There are significant cases regarding the scope of agency rulemaking authority already pending before the Court for which decisions have yet to be issued – including *SEC v. Jarkesy, et al.* and *Loper Bright Enterprises, et al. v. Raimondo, et al.*. Accordingly, we expect the SEC to wait until the current Supreme Court Term is complete and to file its petition toward the end of that 90-day period. The Court would likely decide whether to grant *certiorari* in the fall.

Because all but one of the Adopted Rules' compliance requirements have not come into effect,[3] it is virtually certain that neither the Fifth Circuit nor the Supreme Court will allow the Adopted Rules to become effective during the pendency of any further litigation. Absent any stay, the issuance of the Fifth Circuit's mandate on July 29, 2024 will vacate all of the Adopted Rules' requirements, including the requirement relating to written compliance reviews, which is currently in effect.

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[3] The only requirement in place as of the rule's effective date in November 2023 is Rule 206(4)-7(b), the written annual compliance review requirement. *See* our previous Debevoise Update, *Compliance Dates for New Private Fund Adviser Rules*. The remainder of the rules do not require compliance until September 14, 2024 or March 14, 2025.

B. Possible Re-Proposal

Given the Fifth Circuit's sweeping and decisive ruling on the SEC's lack of statutory authority with respect to the Adopted Rules, it is unclear whether the SEC would propose new rules that try to address the practices that the SEC identified as problematic in the Adopted Rules, just months before the September 30th end of its fiscal year and so close to the 2024 presidential election. Any reproposed rules would likely be significantly narrower given the court's conclusions regarding the SEC's statutory authority.

C. Implications for Examinations and Enforcement

The Fifth Circuit's decision deprives the Divisions of Examinations ("Exams") and Enforcement ("Enforcement") of a significant new arsenal to pursue private fund advisers, and the SEC will not be able to unilaterally impose substantive new conduct, audit, reporting, and disclosure requirements on private fund advisers through examination or enforcement.

Nonetheless, the SEC will likely continue to deploy the existing provisions of the Advisers Act through examination and enforcement to advance the same themes of investor transparency, parity, and fairness that formed the basis of the Adopted Rules. Existing Exams pronouncements and recent Enforcement matters demonstrate the SEC's determination to pursue private fund advisers aggressively under the existing Advisers Act framework. For instance, Exams stated in its 2024 Priorities that it "will continue to focus on advisers to private funds" and prioritize multiple evergreen areas of concern. The elimination of the Adopted Rules may prompt Exams and Enforcement to redouble their efforts to scrutinize private fund advisers for alleged violations of existing provisions of the federal securities laws.

As a result, in future exams the SEC could increase its focus on practices such as: charging certain regulatory and compliance expenses to a fund; non-*pro rata* allocations of expenses associated with an investment shared among fund clients; perceived unfair side letter arrangements; compliance with constituent document requirements relating to reporting; and conflicts arising out of adviser-led secondaries transactions without third-party checks of the underlying asset valuation.

Similarly, Enforcement has pursued private fund advisers for alleged violations of the antifraud provisions of the Advisers Act involving the disclosures of fees, expenses, valuation, and conflicts. Such cases hinge on the SEC's view that private fund investors need sufficient disclosure of material facts about their investments—one of the chief

animating purposes of the Adopted Rules. The SEC will now have to vindicate this principle through the continued pursuit of cases involving alleged misstatements and omissions in existing disclosures provided to investors. While the outcome of the presidential election will determine the intensity of future asset management enforcement, the SEC is nonetheless expected to continue its investigation of additional longstanding Advisers Act priority areas, such as the Custody Rule, the Marketing Rule, the Dodd-Frank whistleblower provisions, and recordkeeping.

D. Important Remaining Questions

Private Fund Adviser Rules Proposed but Not Adopted

While the decision vacates the Adopted Rules themselves, commentary from the SEC in the Adopting Release regarding adviser liability is still indicative of the SEC's focus on indemnification and a posture that potentially opposes standard market practice. Although the SEC dropped the language in the proposal that would have expressly prohibited limitations of liability for simple negligence, the Adopting Release explicitly confirmed the SEC's position that advisers cannot waive their fiduciary duty or seek reimbursement for breaches of such duty and, importantly, its view that a breach of fiduciary duty may arise from conduct constituting mere negligence. The vacatur of the Adopted Rules does not necessarily change the SEC's position on the standard of conduct for investment advisers. An adviser that has not done so already should review with counsel the savings provisions of its indemnification and exculpation provisions.[4]

Likewise, although the Adopted Rules did not, as proposed, include a prohibition on fees for unperformed services, the SEC made clear in the Adopting Release that it views such fees as contrary to an adviser's fiduciary duty, even where there is disclosure and investor consent. The vacatur of the Adopted Rules does not necessarily change the SEC's position on charging fees for services not performed or not reasonably expected to be performed. Advisers should review any accelerated monitoring or similar fees through this lens.[5]

Impact on Investor Negotiations

The court's decision does not prevent shifts in market practice based on contractual negotiations between private fund advisers and investors. As has historically been the case, advisers and investors will continue to discuss what terms are appropriate for a particular fund based on the unique characteristics of that fund, adviser and anticipated investor base. It is yet to be seen whether any of the content of the Adopted Rules will

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[4] Adopting Release at 253-257.

[5] Adopting Release at 248-253.

surface as investor requests in negotiations of fund terms despite the fact that the Adopted Rules themselves have been vacated.

Future Rulemaking

The decision also has potential implications for other proposed rulemakings relating to private fund advisers that rely at least in part on section 211(h) of the Advisers Act, given that the court held that section 211(h) applies to "retail customers" only and that the SEC exceeded its statutory authority in attempting to apply that section to the regulation of private fund advisers. The authority for pending proposals relating to investment advisers with respect to outsourcing, cybersecurity risk management, and the use of predictive data analytics, each of which rely in part on section 211(h), are all in question with respect to private funds as a result of the decision.

E. Where Do We Go From Here?

Private fund advisers should be prepared to address investor requests that reflect certain principles within the Adopted Rules. However, we think it is appropriate for private fund advisers to put on hold comprehensive efforts to comply with the substance of the Adopted Rules, pending developments in the appeals process or other SEC rulemaking.

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Please do not hesitate to contact us with any questions.

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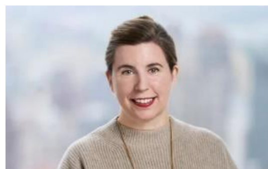

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