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SEC's Private Fund Adviser Rules Struck Down (But Still Matter): What Registered and Exempt Private Fund Advisers Need to Know

Executive Summary

On June 5, 2024, the Fifth Circuit U.S. Court of Appeals (the Fifth Circuit) issued a unanimous decision[i] vacating the U.S. Securities and Exchange Commission's (SEC) Private Fund Adviser Rules[ii] (the Private Fund Rules). This ruling not only invalidates the SEC's recent regulatory efforts but also sets a significant precedent for the scope of the SEC's authority under the Investment Advisers Act of 1940 (the Advisers Act). This article provides a summary of the SEC's Private Fund Rules, an analysis of the Fifth Circuit's decision, and a discussion of the broader implications for the regulation of private fund[iii] advisers, including venture capital funds advisers (VC Fund Advisers) and other exempt reporting advisers[iv] (ERAs).

While the Fifth Circuit's decision is a significant development, it does not negate the influence of the Private Fund Rules. These rules will continue to shape future examination and enforcement activities, as well as private fund adviser and institutional investor relationships, and industry best practices. As a result, private fund advisers, whether registered or not, should assess whether to adjust their compliance and disclosure practices to be more in line with the Private Fund Rules, the Fifth Circuit's decision, and SEC and investor expectations around investor transparency, parity and fairness.

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Background of the SEC's Private Fund Rules

On August 23, 2023, in response to ongoing concerns about various practices of private fund advisers, the SEC adopted the Private Fund Rules to exercise greater oversight over how private fund advisers, including VC Fund Advisers and other ERAs, conduct their business. These rules address potential conflicts of interest, lack of transparency, and compensation practices that the SEC believes could be detrimental to investors.

Some of the new Private Fund Rules the SEC adopted imposed specific obligations only on SEC-registered private fund advisers (RIAs), while others applied to all private fund advisers, including VC Fund Advisers and ERAs. Both categories are discussed below.

A. *Rules Applicable to RIAs only*

- **Quarterly Statements Rule**[v]: Required RIAs to provide detailed quarterly statements to private fund investors, including information on funds fees, expenses, performance, and compensation paid by portfolio companies to the adviser or its related persons.
- **Private Fund Audit Rule**[vi]: Required RIAs to conduct an annual audit of each private fund they advise (other than securitized asset funds), performed by an independent public accountant.
- **Adviser-Led Secondaries Rule**[vii]: Required RIAs to obtain either a fairness or valuation opinion in connection with any adviser-led secondary transaction and disclose any material business connections with the entity providing the opinion.

B. *Rules Applicable to All Private Fund Advisers*

- **Restricted Activities Rule**[viii]: Targets private fund practices that the SEC considers harmful to investors due to potential conflicts of interest and compensation schemes that could disadvantage them:
  - **Adviser Investigation Expenses**: Prohibited all advisers from using private fund assets to cover fees and expenses associated with a governmental investigation of the adviser without prior written consent of the fund's investors. If the investigation results in sanctions, this prohibition would have been absolute.
  - **Adviser Compliance Costs**: Prevented all advisers from allocating regulatory, examination, or compliance fees of the adviser to the fund, unless such fees and expenses were disclosed to investors within 45 days after the quarter-end in which such charges occur.
  - **Clawback**[ix] **Adjustments**: Prohibited all advisers from reducing their carried interest clawback by the amount of the adviser's taxes (actual, potential, or hypothetical), unless the pre-tax and post-tax amounts were disclosed to investors within 45 days after the quarter-end in which such clawback occurs.

- **Non-Pro Rata Allocation of Portfolio Costs**: Required all advisers to provide advance written notice and justification for non-pro rata charges related to shared portfolio investments, unless the adviser provided advance written notice of the non-pro rata charge with a description of how it is fair and equitable.

- **Borrowing from Private Funds**: Prohibited all advisers from borrowing money, securities, or other fund assets or receiving a loan or extension of credit from a private fund without adequate disclosure and written consent.

- **Preferential Treatment Rule**[x]: Addresses concerns about side letters and other preferential treatment arrangements that may benefit some investors at the expense of others. This rule restricted all private fund advisers, regardless of registration status, from, directly or indirectly, granting:

  - **Preferential Redemption Rights**: Prohibited preferential redemption or liquidity rights to private fund investors that the adviser "reasonably expects" to have a "material, negative effect" on other fund investors, unless the redemption rights were required by applicable law or these rights were offered "without qualification" to all existing and future investors. (This restriction generally would not have applied to illiquid[xi]/closed-end private funds, like venture capital funds, as they do not permit redemptions in the ordinary course.)

  - **Preferential Information Rights**: Prevented preferential disclosure of portfolio holdings and exposure information to any investor if doing so would have a material, negative effect on other investors in the private fund, unless the adviser provided this information to all other existing investors at the same time or substantially the same time.

  - **Preferential Terms**: Prevented preferential terms to any private fund investor, unless material economic terms—including those related to the cost of investing, liquidity rights, fee breaks, and co-investment rights—were disclosed prior to an investor's investment in the fund and other terms were disclosed after their investment.

The Preferential Treatment Rule was arguably the most contentious rule for many private fund advisers, particularly emerging VC Advisers, as it would have significantly limited their ability to offer different economic or information terms to select investors on a confidential basis.

Petition Against the Final Rule

On September 1, 2023, a coalition of private fund industry trade groups (collectively, the Petitioners[xii]) challenged the Private Fund Rules. They argued that the SEC exceeded its statutory rulemaking authority to issue the rules under both Section 211(h) and Section 206(4) of the Advisers Act.

The Fifth Circuit's Decision

The Fifth Circuit agreed with the Petitioners, ruling that the SEC exceeded its statutory authority in promulgating the Private Fund Rules under both referenced sections of the Advisers Act.

A. Lack of Authority Under Section 211(h)[xiii]

The Fifth Circuit's analysis focused on the statutory interpretation of Section 211(h) of the Advisers Act, which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The court noted that Title IX of Dodd-Frank, which includes Section 211(h), pertains to the protection of "retail customers," not private fund investors. The Fifth Circuit concluded that Section 211(h) "has nothing to do with private funds," was intended to apply solely to retail customers, and that Congress "clearly chose not to impose the same [restrictions] on private funds."

The Fifth Circuit therefore invalidated the SEC's reliance on this section for the Private Fund Rules.

B. Lack of Authority Under Section 206(4)[xiv]

Section 206(4) of the Advisers Act grants the SEC the authority to adopt regulations to prevent fraudulent, deceptive, or manipulative business practices. The Fifth Circuit's ruling highlighted several key points in this regard:

- **Rational Connection to Fraud**: While Section 206(4) does confer the SEC with authority to prevent fraud or deception, the SEC failed to establish a rational connection between fraud and any part of the Private Fund Rules. The court emphasized that the SEC must define the fraudulent act it seeks to prevent before prescribing regulatory means to address it, which the SEC did not do. Indeed, the court even described the SEC's anti-fraud rational for the Private Fund Rules as "pretextual."

- **Disclosure and Reporting Obligations**: The court ruled that Section 206(4) does not authorize the SEC to impose any disclosure and reporting obligations. The court contrasted this with other sections of the Advisers Act that explicitly provide for reporting and disclosure, noting the conspicuous absence of such provisions in Section 206(4).

- **Lack of "Close Nexus with Statutory Aims"**: The court criticized the SEC for conflating a lack of disclosure with fraud or deception in the Private Fund Rules, arguing that a failure to disclose cannot be deceptive without a pre-existing duty to disclose. This duty, according to the court, extends only to the client (*i.e.,* the fund) and not the investors in the fund.

In light of the above, the Fifth Circuit held that Section 206(4) also did not confer the SEC with the necessary authority to adopt the Private Fund Rules, finding "no part of it can stand" and vacating the rules in their entirety.

With the Private Fund Rules vacated, the SEC has several options, including abandoning the Private Fund Rules, seeking *en banc* review within 45 days with the full Fifth Circuit, or appealing the Fifth Circuit's decision to the U.S. Supreme Court within 90 days. Given the time required for the Supreme Court to consider and act (or not) on any petition by the SEC for review, the decision will not be final for at least several months, and possibly well into 2025.

What's Next for Private Fund Advisers?

The immediate effect of the Fifth Circuit's decision is that all private fund advisers, whether registered or exempt from registration, are no longer required to comply with the Private Fund Rules, and can avoid the rules' burdensome and expensive reporting and compliance obligations[xv].

At least for now, private fund advisers can put on hold their efforts to come into compliance with the Private Fund Rules in advance of the fast-approaching September 14, 2024 compliance deadline.

Despite their invalidation, however, the Private Fund Rules remain relevant for several reasons:

- **Guidance for Compliance Practices**: The Private Fund Rules reflect the SEC's evolving views on investor transparency, parity, and fairness, and can serve as a blueprint for best practices in the private fund industry. Advisers may voluntarily adopt aspects of the Private Fund Rules to align their compliance practices with SEC expectations, to the extent consistent with their fund agreements and fiduciary obligations.

- **Regulation by Enforcement**: In response to the ruling, the SEC may shift its approach to regulation by leveraging its examination and enforcement authority to target fraudulent activities, or those that otherwise violate private fund investors' interests. This could involve more frequent and intensive examination sweeps and increased referrals to the Division of Enforcement. While advisers may successfully challenge these actions, the associated costs and reputational risks could deter non-compliant practices.

- **Industry Standards and Investor Expectations:** The principles underlying the Private Fund Rules could influence industry standards and self-regulatory initiatives. Private fund advisers may adopt similar practices to those outlined in the rules to meet investor expectations and mitigate regulatory risks.

Key Takeaways

The Fifth Circuit's decision to vacate the SEC's Private Fund Rules represents a significant victory for the private fund industry, reinforcing the need for regulatory agencies to operate within the bounds of their statutory authority. While the immediate impact is the invalidation of the Private Fund Rules, the decision's broader implications for SEC rulemaking and enforcement cannot be understated. The ruling may spur challenges to other SEC regulations,[xvi] encourage a shift toward regulation by enforcement, and potentially lead to legislative changes to clarify the SEC's authority.

Moreover, the Private Fund Rules, despite being tossed out, continue to hold relevance for private fund advisers as a guideline for best practices and a potential benchmark for future regulatory and legislative

developments. Advisers should stay abreast of ongoing regulatory changes, assess their compliance practices in light of investor expectations and industry standards, and be ready to adapt to new regulatory requirements that may emerge in this ever-evolving landscape.

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[i] *National Association of Private Fund Managers v. SEC*, 5th Cir. No. 23-60471, available here.

[ii] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 6383 (Aug. 23, 2023), 88 Fed. Reg. 63206 (Sept. 14, 2023) (the "Adopting Release"), available here.

[iii] Under the Advisers Act, a "private fund" is any issuer that would be an "investment company", as defined in Section 3 of the Investment Company Act of 1940, but for Sections 3(c)(1) or 3(c)(7) thereof.

[iv] An ERA is generally exempt from registration under either Section 203(l) of the Advisers Act (VC Fund Advisers) or Section 203(m) of the Advisers Act (private fund advisers with less than $150 million in assets under management).

[v] Rule 211(h)(1)-2.

[vi] Rule 206(4)-10.

[vii] Rule 211(h)(2)-2.

[viii] Rule 211(h)(2)-1.

[ix] The Private Fund Rules define "adviser clawback" as "any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements." In turn, "performance-based compensation" is defined as any allocations, payments or distributions of capital based on the private fund's (or its portfolio investments') capital gains, capital appreciation and/or other profit.

[x] Rule 211(h)(2)-3.

[xi] The Private Fund Rules define an "illiquid fund" as a private fund that (i) is not required to redeem interests upon an investor's request, and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund.

[xii] The Petitioners included the National Association of Private Fund Managers, Alternative Investment Management Association, Ltd., American Investment Council, Loan Syndications and Trading Association, Managed Funds Association, and National Venture Capital Association.

[xiii] Section 211(h) of the Advisers Act provides that "The 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."

[xiv] Section 206(4) of the Advisers Act provides that "It shall be unlawful to any investment adviser, by use of the mails or any means or 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."

[xv] As noted by the Fifth Circuit, the SEC estimated that compliance with the Private Fund Rules would have cost the private funds industry $5.4 billion and millions of hours of employee time.

[xvi] The SEC has proposed several rules which also rely on Section 211(h) or Section 206(4) for its statutory authority, including proposed rules regarding predictive data analytics and outsourcing by investment advisers, and its proposed "Safeguarding Rule" that would amend the Custody Rule (Rule 206(4)-2). These rules may face potential challenges based on the precedent established by the Fifth Circuit.

See Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Exchange Act Release No. 34-97990 (July 26, 2023), 88 Fed. Reg. 53960 (Aug. 9, 2023) (available here); Outsourcing by Investment Advisers, Advisers Act Release No. 6176 (Oct. 26, 2022), 87 Fed. Reg. 68816 (Nov. 16, 2022) (available here); and Safeguarding Advisory Client Assets, Advisers Act Release No. 6240 (Feb. 15, 2023), 88 Fed. Reg. 14672 (Mar. 9, 2023) (available here).

The Fifth Circuit's decision may also call into question prior SEC rulemakings which rely on Section 206(4), including, most notably, the Marketing Rule (Rule 206(4)-1) (available here) and the pooled investment vehicle antifraud rule (Rule 206(4)-8) (available here).