

FUND FINANCE FRIDAY

Fifth Circuit Strikes Down the Private Fund Adviser Rules

June 7, 2024



By Leah Edelboim
Partner | Fund Finance

This week, the U.S. Court of Appeals for the Fifth Circuit vacated the private fund advisor rules (the “Final Rule”) adopted by the United States Securities Exchange Commission (the “SEC”). The Final Rule imposed significant regulatory requirements on advisor to private equity funds, hedge funds, and other private funds. It represented a significant expansion of the SEC’s power to regulate private fund advisor and investors and, according to the decision, compliance with the Final Rule would cost the private funds market \$5.4 billion and require millions of hours of employee time.

The Court vacated the Final Rule in its entirety. In a unanimous decision with Judge Kurt Englehardt writing for the three-judge panel, the Court concluded that, in enacting these rules, “The Commission has exceeded its statutory authority. No part of it can stand.”

The Court’s decision emphasizes that, if reform such as this is going to be implemented by an organization like the SEC, which is part of the executive branch, it needs to be done within the bounds of the laws that give such organization the power to regulate. The SEC was established pursuant to the Securities Exchange Act of 1934 and is led by a five-member Commission. The Commissioners are appointed by the President, not elected, and are confirmed by the Senate. The President also decides which of the five Commissioners will be the SEC Chairman.

The Final Rule was comprised of a number of separate rules intended to govern the \$26 trillion private funds market, including:

- Preferential Treatment Rule – a rule that limited the ability of fund sponsors to grant certain investors better terms than other investors, such as more favorable redemption terms, greater access to information, or just better or different treatment - fund finance industry participants understand from side letter diligence that the granting of preferential terms can be an important element of the investing relationship particular investors have with a fund.
- Restricted Activities Rule – a rule that placed restrictions on the charging of certain fees or expenses, and disclosures regarding the same.

- Quarterly Statement Rule – a rule that required that private funds advisors provide their investors with detailed quarterly reporting which would include fund performance as well as expense reports. This rule was particularly relevant to subscription lending, as it required funds to disclose unlevered returns without the impact of fund-level subscription facilities. The SEC has expressed concerns that levered returns don't provide a complete picture of fund performance.
- Advisor-led Secondaries – a rule that required advisors to obtain and distribute to investors an independent fairness or valuation legal opinion in connection with certain types of transactions.

The plaintiffs in the case who challenged the Final Rule included the National Association of Private Fund Managers, the Alternative Investment Management Association, the American Investment Counsel, the Loan Syndications and Trading Association, the Managed Fund Association and the National Venture Capital Association. They have been some of the loudest voices opposing these regulatory measures since they were initially proposed by the SEC in February 2022.

As further background, on August 23, 2023, the SEC's five Commissioners voted three to two to adopt the Final Rule. In promulgating the Final Rule, the SEC relied on certain anti-fraud rulemaking authority under the Investment Advisers Act of 1940, as well as the Dodd-Frank Act. The SEC adopted the Final Rule despite the questions raised by some experts and commentators as to whether it had the statutory authority to do so.

Just a week later, on September 1, 2023 the plaintiffs in this action filed a petition with the Fifth Circuit Court of Appeals seeking review of the Final Rule under the Administrative Procedure Act (the "APA") claiming that, among other things, the SEC did not have the authority to institute such significant regulation that "would fundamentally change the way private funds are regulated in America." The APA sets forth a high standard for overturning a decision by a regulatory authority like the SEC whereby a court must uphold a decision unless it is in "excess of statutory jurisdiction, authority, or limitations" or "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

The Court considered the powers that the relevant laws give the SEC to regulate funds and investment activities and determined that the SEC exceeded the power it has under the relevant laws when it adopted the Final Rule. Under the APA, the Court found it to be against the law and vacated it – meaning, set it aside.

As a bit of a kicker the Court found the SEC's position that the Final Rule is to prevent fraud as "pretextual" and that the SEC had failed to articulate a "rational connection" between fraud and any part of the Final Rule.

We will continue to monitor this case for any further developments and will post any updates here in *Fund Finance Friday*. The SEC has not indicated what it is going to do next, if anything. Of course it could abandon these efforts completely. If the SEC decides to appeal, it could request a hearing *en banc* by the full Fifth Circuit or it could attempt to appeal to the Supreme Court.

The takeaways for fund managers are that if the Fifth Circuit's decision vacating the Final Rule is not set aside by the full Fifth Circuit Court of Appeals or if the Supreme Court does not overrule this decision (or if it declines to hear it all together – it only hears about a hundred out of thousands of cases that petition to be heard), then the Final Rule will never take effect.