Client Update Memo[1]

From: Capitol Asset Strategies

Re: Analysis of the Fifth Circuit Vacating the SEC's Private Fund Adviser Rule

Date: June 2024

Background: On June 5, 2024, the U.S. Appellate Court for the Fifth Circuit vacated the SEC's controversial Private Fund Adviser Rule ("PFAR")in *National Association of Private Fund Managers v. SEC*.[2] The court held the full rule needed to be vacated because the SEC lacked statutory authority to make the rule.

This decision has many significant implications not only for investment advisers to private funds, and their limited partner investors, but also perhaps more generally to other regulated entities at the SEC based on the broad way the court vacated the SEC's Rule. This memo will review: (1) the big picture takeaways from the Fifth Circuit's decision for Private Fund Advisers (General Partners); (2) the impact of the decision for limited partner investors in private funds, (3) implications from the decision that could limit the ability of the SEC's rulemaking reach on other active regulatory topics and, (4) unresolved questions.

1) "Big Picture" Takeaways from the Fifth Circuit's Decision; Impact on Private Fund Advisers (General Partners)

- **The Court Invalidated the PFAR in its Entirety; Appealing the Fifth Circuit's Decision is Unlikely to Revive the Rule for the SEC, and Pursuing Regulatory Changes Similar to the PFAR in the Future Would Require New Legislative Action:** The Fifth Circuit decision **decisively rebuffed the SEC on statutory authority grounds**, finding the agency could not rely on either Section 206(4) or Section 211(h) of the Investment Advisers Act of 1940 to impose the PFAR on private fund advisers.

- **The Fifth Circuit's Decision Will Have Limiting Repercussions for SEC Authority in the Private Funds Space and Beyond:** The impact of this case on the world of private funds

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[1] This publication provides summary information only and is not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to matters discussed herein. If you or your firm would like to discuss this topic further with our team, please contact our team at info@capitolassetstrategies.com.

[2] *National Association of Private Fund Managers v. SEC*, Full Docket, Court Listener, *available at:* https://www.courtlistener.com/docket/67756185/na-of-private-fund-managers-v-sec/

regulation is significant and the impact on SEC regulated entities even outside of the private funds' world may be important and long-lasting. This is evidenced by the following elements of the decision:

- **The SEC Will Be Unable in to Use Dodd-Frank Granted Authorities in Section 211(h) to Justify Rules in the Private Fund Adviser Space:** Section 211(h) of the Investment Advisers Act is not a valid means for the SEC to ban or restrict activities by registered investment advisers or exempt reporting advisers while advising their private fund clients (i.e., their funds). In the Fifth Circuit's words, Section 211(h) "has nothing to do with private funds." Section 211(h) can only be used to justify new rules for retail investor products and retail facing activities. This clarification of statutory authority could impact several of the SEC's other proposed rules, including (a) cyber risk management for investment advisers; (b) the predictive data analytics rule; and (c) the outsourcing rule (although other statutory authorities may be available to justify this proposal).

  As emphasized in the Fifth Circuit's opinion, Dodd-Frank did not significantly expand the SEC's rulemaking authority with regard to private fund advisers with Section 211(h). The Court recognized that Congress has historically drawn a sharp line between private funds, which are subject to limited federal regulation, and funds that serve retail customers, which are subject to extensive regulation under the Investment Company Act of 1940. As stated by the Fifth Circuit, "Congress clearly chose *not* to impose the same prescriptive framework on private funds" that it did on retail funds, and the passage of the Dodd-Frank Act in 2010 did not fundamentally alter this framework. The new registration requirements for most private fund advisers imposed by Title IV of the "Dodd-Frank Act only stepped towards regulating the relationship between the advisers and the private funds they advise," and did not otherwise overhaul the regulatory framework for private funds first set out by Congress in 1940."

- **Reaffirmation of Fiduciary Duties Being Owed to the Fund as a Whole, Not to Individual Investors in the Fund, Continuing Limitations on Private Right of Action Under the Advisers Act:** The case further reminds the SEC and market participants that the fiduciary duty of an investment adviser is, and has always been, to the client. As the Fifth Circuit states, "The duty [to disclose material facts and conflicts of interest] extends to the client alone, which is the fund, not the investors in the fund." Over the past 20 years, the SEC has tried to extend disclosure requirements to investors, by adopting certain rules under the authority granted under the Section 206(4) Anti-Fraud Rule of the Advisers Act. Removal of this authority option will limit the SEC's ability to transpose retail investor style protection activities in the private funds space, as it has tried to do increasingly since the passage of the Dodd-Frank Act in 2010.

- **The Decision Curtails Further Expansion of the SEC's Authorities under the Anti-Fraud Provisions in Section 206(4) of the Advisers Act:** The SEC's ability to rely on the general Anti-Fraud Rule (206(4)) as a catch-all fount of regulatory authority will be curtailed. As the Fifth Circuit correctly recognized, the Anti-Fraud Rule does not provide limitless prophylactic authority to justify any regulation that the SEC wants to advance. In assessing the SEC's reliance on Section 206(4), the Fifth Circuit concluded that the Rule's "'anti-fraud' measure is pretextual," and that the SEC did not show how the Rule's reporting and disclosure provisions were rationally connected to preventing fraud. The link was too tenuous. The Court held that the SEC had "fail[ed] to explain how the Final Rule would prevent fraud"—as a result, its "vague assertions" regarding observations of fraudulent adviser misconduct "fall short of the definitional specificity that Congress has required." The Court also noted that the SEC had observed misconduct by only "about 0.05% of [private fund] advisers."

  The Fifth Circuit held that Section 206(4) requires the SEC to "define" a fraudulent act or practice before the SEC can issue rules designed to prevent that fraudulent act or practice and that SEC had largely failed to do so here. This statement by the Court may set a higher standard for remaking in reliance on Section 206(4), with implications for several pending proposed rules and potentially for existing final rules. Agreeing with Petitioners in the case, the Court observed that the internal governance structures of private funds have long been dictated not by federal regulation, but instead by contractual negotiation among sophisticated parties, and the SEC could not issue rules "under the guise" of its "anti-fraud" provision to modify the governance structure of private funds.

  Likewise, the Court also found that requirements within the PFAR that mandated "disclosure" to investors were not necessarily designed to prevent fraud. Per the Court, absent a duty to disclose there can be no fraud, and the private fund adviser's disclosure duty under the Advisers Act is to the fund itself, and not investors in the fund. Accordingly, the SEC will likely have to become much more cautious in relying on the Anti-Fraud Rule to justify new regulations that are not directly related to actual fraudulent activity.

- **The Decision May Impact Interpretation of Current SEC Rules and Embolden Private Fund Advisers to Challenge Aggressive SEC Examination or Enforcement Practices:** The Fifth Circuit's opinion states that, "... complying with the "fund's governing agreements' is not fraud, nor is disagreement over 'discretionary violations." This part of the court's opinion calls into question whether enforcement actions and cases based on an "alleged" failure to comply with a fund's governing agreements will continue to be brought and whether SEC examinations will be able to cite anti-fraud provisions. While the Court's decision may force the SEC to become more cautious in challenging activities undertaken by advisers to private funds, conversely advisers could become more aggressive in response to unreasonable enforcement actions. With that said, it is also important to remember that this case did not roll back registration requirements enacted in Title IV of the Dodd Frank Act and compliance programs will likely remain largely unchanged although fortunately for investment advisers they will not have to address a whole new swath of regulatory challenges that the PFAR would have created had it been upheld.

2) Impacts of the Decision for Limited Partner (LP) Investors in Private Funds

The Institutional Limited Partners Association (ILPA) was initially a significant driving force for policy changes at the SEC, which resulted in the PFAR. This interest was somewhat aligned with progressive groups and labor unions, and their allies in the SEC's current leadership who wished to impose more regulatory requirements on the private fund industry, with a goal to address the alleged challenges of some institutional LPs in the private fund markets, including pensions of unionized workers.

- **LP Views on the PFAR & Impact on the Fifth Circuit Challenge:** ILPA and many institutional LPs focused their initial reform efforts on 3 main areas to: (1) address the contracting away of state-level fiduciary duties, (2) require indemnification for SEC violations, and (3) obtain greater fee and performance reporting. The second and third of these provisions were included in the final PFAR, along with many other provisions. Several of the additional provisions included in the PFAR were divisive and created concern among larger LPs, particularly the preferential treatment rules, regarding their ability to secure specific provisions and benefits for their beneficiaries. There were and are also, generally, divisions among LPs regarding the value vs. cost of additional SEC regulatory requirements, which are often passed along to LPs as a fund expense. Finally, there are different viewpoints from legal and investment staff at LPs, with the legal staff focused on negotiating terms with fund counsel, and investment staff focused on accessing fund allocation, and potentially less focused on terms addressing downside risk.

  In sum, however, ILPA and various progressive groups pushed the SEC to impose as a matter of law particular contractual preferences of some LPs on all sophisticated investors (both GPs and LPs) in private funds and remove such topics from the realm of flexible contractual negotiations (e.g., limits on preferential treatment, substantial restrictions or prohibitions on certain activities, disclosure of even more information than the voluminous information that funds already provide to their investors on a quarterly basis as if such funds were registered investment companies).

The lack of unity among the LP community, however, including different views and approaches to the preferential treatment rules based on size, and being unclear about what the rules would mean for them, prevented a wholehearted, vigorous support for the PFAR. Even if such unity in views on the rule were achieved, it is unclear whether this would have made any difference to the Fifth Circuit or would have prevented the petitioners from challenging the rule.

The result in this case establishes that the effort to impose certain contractual preferences via government regulation has failed, but this does not mean that LPs will be powerless in fund terms negotiations going forward. Fund negotiations in the marketplace between GPs and LPs will continue as they have, with varying levels of leverage for both sides in negotiations.

- **LP Fund Terms Negotiations & The PFAR's Demise:** The PFAR's advocates sought the rulemaking to address certain "structural imbalances" they believed existed in the private fund marketplace and set certain standards on transparency and governance for private fund advisers. The idea was to have government require targeted contractual preferences of some LPs in private funds as a matter of law and remove such topics from the realm of flexible contractual negotiations. The PFAR went further than many LPs expected in this effort. In particular, the SEC tried to change market dynamics to assist smaller LPs through the preferential treatment rules, which was an attempt to require the negotiation power of large LPs to improve terms for all LPs in the fund, rather than being diluted in the side letter or strategic partnership of a large LP.

  The demise of the PFAR is a mixed bag for LPs. There are several benefits to LPs. These include:

  1. Significantly reduced short-term uncertainty in fund terms negotiations, particularly for larger LPs that are receiving bespoke reporting, co-investment rights, and reduced fees through side letter negotiations or strategic partnership arrangements with particular GPs.

  2. Reduced potential indirect legal or compliance costs (as well as additional and unnecessary voluminous paper disclosures) that LPs would indirectly pay for as a fund expense and may not receive value from, depending on the specific LP.

3. Larger LPs may receive continued better negotiation outcomes in side letters as GPs will not have to disclose or share those with other, smaller LPs in funds (although many of these provisions are often disclosed in existing most favored nation ("MFN") processes)

4. Removes a friction point for LPs with GPs given the general hostility to the PFAR changes in the GP community.

However, there are also potential downsides for LPs. These include:

1. Many key reforms that LPs sought, particularly the requirement of mandatory fee and performance reporting, and state fiduciary duty retention will remain subject to negotiation with GPs, leaving the industry to the status quo state of fund negotiations. This potential "loss" is mitigated by the fact that LPs already receive bespoke reporting from the GPs of their funds that are tailored to specific LP needs.

2. Without the PFAR, some smaller LPs may not have the negotiation leverage to access the fee/performance reporting that the PFAR would have mandated.

3. Many of the restricted activities in the PFAR (such as clawbacks net of taxes) sought to displace industry standards that LPs did not like, and without the PFAR these items will likely continue to be market terms.

The PFAR would have forced the industry around a common, robust (many would say excessive) standard of fee and expense reporting. Momentum towards a common reporting template that advisers—particularly GPs of illiquid funds—could use to satisfy the Quarterly Statements Rule had been building as the PFAR compliance dates drew nearer, with ILPA convening working groups to gather input from institutional investors, private fund advisers, and other stakeholders. Having seen the details of the Quarterly Statement Rule and having considered the possibility of receiving more standardized reporting across funds, investors may now try to push sponsors towards providing some of these items, in addition to the current ILPA Fee Template.

ILPA has temporarily paused these efforts, but it will continue its "work on the next evolution of ILPA reporting templates" going forward.[3] These templates will continue to be subject to the market power of LPs in individual commercial negotiations, rather

[3] See https://ilpa.org/quarterly-reporting-standards/.

than creating a common standard for all LPs that is required to be delivered as a matter of law. The new annual mandatory fee reporting provisions in the EU under AIFMD II (Article 23), however, could provide a regulatory vehicle for multinational GPs who want to provide a common standard to all LPs.

While there is a mixed bag of results from the demise of PFAR from an LP perspective, commercial dynamics have shifted significantly since the rule was proposed in early 2022. LPs are no longer operating in a zero-interest rate environment as they were in the 2010s, where allocations to alternatives continued to grow to meet their return thresholds. The rise in interest rates has resulted in a more difficult fundraising environment for many GPs, due to the lack of fund distributions and other factors. While allocators have not significantly shifted allocations away from the asset class due to the need to maintain their pacing, the rising rates could make other investment products more attractive relative to the risk and cost of private funds. In sum, the market appears to have moved in a more LP-friendly direction recently, which could help LPs achieve some of their desired provisions more easily in flexible fund terms negotiations.

3) Next Steps and Implications of the Case beyond the PFAR

- **The "$5.4 Billion Dollar" Question[4] – Will the SEC Appeal?** The SEC has 45 days after the decision (i.e., until July 22, 2024 because July 20, 2024 is a Saturday), to appeal the Fifth Circuit's decision via a petition to the full Fifth Circuit to re-hear the case en banc. The SEC has a slightly longer time window of within 90 days from the decision (i.e., Tuesday, September 3, 2024) to petition the U.S. Supreme Court via a writ of certiorari to review the Fifth Circuit's decision. SEC Chair Gensler recently testified in Congress that the SEC is still considering its options, but an appeal by the SEC seems unlikely because the SEC's two appeal options from the unanimous three judge panel decision face long odds.

  The full Fifth Circuit is likely to be as skeptical of the SEC's claims of regulatory authority to advance the rule as was the three-judge panel that decided the case. The Fifth Circuit's Internal Operating Procedures caution that "a petition for rehearing en *banc* is an extraordinary procedure that is intended to bring to the attention of the entire court an error of exceptional public importance or an opinion that directly conflicts with prior Supreme Court, Fifth Circuit or state law precedent…" Similarly, the U.S. Supreme Court over the past decade has demonstrated a heightened skepticism about the ability or regulators, including the SEC, to utilize stale or

[4] As the Fifth Circuit recognized in its opinion, by the SEC's own calculation, implementing the PFAR would have cost private fund advisers at least $5.4 billion and millions of employee hours going forward. The real numbers are probably even larger.

ambiguous authority to expand regulatory control over economic actors. See, e.g., the line of "Major Questions Doctrine" cases that have reversed regulatory actions when Congress has not expressly granted the regulator clear authority to do so (*See, e.g., West Virginia v. EPA*). The Supreme Court has also delivered several decisions that limit the SEC's authority, i.e., *Kokesh v. SEC* (A disgorgement order in an SEC enforcement action is a "penalty" and therefore subject to the applicable 5-year statute of limitations under 28 U.S.C. §2462).[5]

Additional losses on appeal for the SEC in this case would only serve to reinforce the status and prominence of the Fifth Circuit's decision, putting an exclamation point on activities that the SEC may not do. It may also jeopardize other areas of SEC authority beyond private funds.

- **Potential Impacts on SEC's Rulemaking and Existing Rules:** The Fifth Circuit's opinion could have significant implications on the SEC's other rulemaking initiatives under the Advisers Act. For the past couple of years in particular, SEC leadership has signaled it wants to increase regulations on the private funds industry and that desire is unlikely to change, at least in the near term. At the same time, the Fifth Circuit has now taken a strong position that curtails SEC's statutory authority in this space. Going forward, the Fifth Circuit's opinion may pose significant challenges for the SEC to regulate private fund advisers absent a clearer rationale for how proposed rules are designed to prevent potential fraud or fit within the existing statutory framework governing private fund advisers. New proposed rules would also require a more substantial evidentiary showing as part of the administrative rulemaking process. In addition, the Fifth Circuit's narrow interpretation of Section 206(4) may impact even existing SEC rules that rely on this antifraud provision to regulate the activities of private fund advisers. It is important to remember, however, that while the Fifth Circuit has adopted a narrow view of the SEC's statutory authority, it is possible that other circuit courts would not follow the Fifth Circuit's decision in any future challenges to other regulations.

- **Impacts on Exams and Enforcement, Certain Types of Cases to Decline:** The Fifth Circuit's decision challenges the validity of the primary legal theories behind many types of SEC private equity enforcement actions. Enforcement cases where the legal theories rely on formation document noncompliance will significantly slow. Likewise, exams focused on these issues may grind to a halt. More broadly, matters relying on

[5] After *Kokesh*, the National Defense Authorization Act of 2020 expanded the statute of limitations at issue in the case from 5 years to 10 years if the disgorgement claim involves conduct that violates certain antifraud provisions, namely: (1) Section 10(b) of the Exchange Act, (2) Section 17(a)(1) of the Securities Act, (3) Section 206(1) of the Advisers Act, or (4) "any other provision of the securities laws for which scienter must be established." The five-year statute of limitations for civil penalties remains the same.

Rule 206(4)-8 or other disclosure-based rules promulgated under 206(4) may similarly slow or be suspended.

Private fund firms under investigation for improper investor disclosures, noncompliance with fund documents or other 206(4) rules, including the pay-to-play rule, many now refuse to settle with the SEC and the SEC may not be willing to take the litigation risk. Accordingly, we will likely see less private fund SEC enforcement actions in the near future.

- **Private Fund Adviser Compliance Regimes to Remain Intact and Important:** As discussed above, while the Fifth Circuit's opinion invalidates the PFAR in its entirety and throws some components of private fund adviser regulation into question, private fund managers' approach to pre-PFAR compliance is unlikely to change substantially. The decision has not invalidated the SEC rules that pre-existed the PFAR (although the decision could lead to challenges to other rules by private fund advisers based on the reasoning of this case). Furthermore, many LPs expect a robust compliance regime, and will continue to press the SEC to continue to make private fund adviser oversight an examination priority.

- **Impacts on Fund Terms Negotiations with LPs:** While the demise of the PFAR will remove specific requirements in the side letter provisions, LPs may use their current market position to continue to push for some provisions that would have been required under the PFAR, including reporting on an updated ILPA fee template. Private fund advisers who already are providing the template or expect they will have to provide it to their LPs should consider participating and commenting in the ILPA review process to ensure that updates to template reporting are manageable for their firm and pose as minimum a burden as possible.

- **Further Judicially Imposed Restrictions on the SEC's Regulatory Authority Ahead?** It is important to keep in mind that the Fifth Circuit's recent decision may not be the last major case this year to curtail SEC's regulatory authority over private fund advisers and other registrants. Two sets of cases to be decided in the U.S. Supreme Court soon could be particularly impactful.

  First, in *Loper Bright Enterprises v. Raimondo* and *Relentless Inc. v. Department of Commerce* (i.e., the "*Chevron* reversal cases") the Supreme Court will likely reverse or at least substantially revise the so called *"Chevron* Doctrine," which since the *Chevron* case was decided in the mid-1980s has given tremendous (many would say excessive and unwarranted) discretion to regulatory agencies to interpret the meaning of ambiguous statutory provisions under their jurisdiction and grant the agency's interpretation of those provisions judicial deference.

Second, in *Jarkesy v. SEC* there is a distinct possibly that the Supreme Court will invalidate the SEC's Administrative Law Judges system. The *Jarkesy* case taken together with the probable *Chevron* reversal cases, could have a major impact not only on how far the SEC is willing to wander away from its actual authority when proposing new rules but also how aggressive they will be in enforcement actions. While each of these cases have distinct fact patterns from those before the Fifth Circuit in the PFAR case, the judicial approach that will decide each case will likely be similar and the *Chevron* reversal cases could further restrict the ability of the SEC to prevail if it chose to appeal the Fifth Circuit case. If the *Chevron* reversal cases and *Jarksey* come out as we expect, there should also be less of an ability for the SEC to dictate the outcome of enforcement actions through pressure tactics, etc., that would not survive in court.

Finally, it is important to keep in mind that no matter how the Supreme Court resolves the *Chevron* reversal cases and *Jarkesy*, many parties in litigation with the SEC over other rules are likely to turn to the Fifth Circuit's decisions to invalidate the PFAR as persuasive in their arguments to invalidate other controversial rules, including the SEC's climate disclosure rule for public issuers.

Contact Us: For help your firm needs on regulatory or policy challenges, including interpretation of what the invalidation of the PFAR means for your organization, please feel free to reach out to discuss further at info@capitolassetstrategies.com.

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