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Fifth Circuit Reviews Private Fund Advisers Rule

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A "private fund" is an investment vehicle that is not required to be registered or regulated as an investment company under the Investment Company Act of 1940 (the ICA). Private funds are typically accessible only to accredited investors or qualified purchasers and operate under the guidance of investment advisers or affiliated entities who act as general partners for the fund. Over the last decade, the role of private funds and their advisers in investment markets has significantly expanded. Privately managed assets have grown from $9.8 trillion in 2012 to $26.6 trillion in 2022. Though traditionally aimed at large qualified institutions and high-net-worth individuals, a broader demographic, including smaller public pension funds, now has exposure to private funds.

Before the Private Fund Advisers Rule (or Rule) was passed, private funds had minimal ongoing disclosure and compliance obligations. In contrast, funds required to register under the ICA are subject to significant regulatory oversight and reporting requirements. These "registered funds" are designed to offer more investor protections, including limitations on leverage, diversification requirements, and ongoing disclosure obligations. Unlike private funds, ICA-covered funds are generally available to retail investors and include mutual funds, exchange-traded funds, and closed-end funds.

The Securities and Exchange Commission (the SEC or Commission) claims that, despite its efforts to regulate private fund advisers through examinations and enforcement, some common advisers' practices pose risks to investors. In response to these perceived threats, on August 23, 2023, the SEC adopted the Private Fund Advisers Rule in a 3-2 vote. The Rule significantly expands the agency's oversight of private fund advisers under the Investment Advisers Act of 1940 (the Advisers Act), imposes new mandatory reporting requirements on advisers, and curtails many previously accepted practices. According to the SEC, the Rule aims to enhance transparency around private fund adviser compensation, fund performance, preferential treatment accorded to investors with substantial bargaining power, sales practices, and conflicts of interest through five key regulatory frameworks.

Oral Argument Before the Fifth Circuit

On September 1, 2023, the National Association of Private Fund Managers, Managed Funds Association and other industry groups (collectively, Petitioners) filed a petition for review with the United States Court of Appeals for the Fifth Circuit challenging the Rule.[1] Oral argument took place on February 5, 2024, and highlighted the parties' fundamental disagreement over whether the SEC complied with its statutory obligations when it adopted the Rule. Petitioners argued for full vacatur on three principal grounds. First, they claimed the Rule's alleged statutory authority–Sections 211(h) and 206(4) of the Advisers Act–does not apply to private fund investors. Section 211(h), entitled "Other Matters," was added to the Advisers Act by Section 913[2] of the 2010 Dodd-Frank Act, and provides:

> 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***. (emphasis added.)

[1] *See Nat'l Assoc. of Private Fund Managers v. S.E.C.*, No. 23-60471 (5th Cir. 2023).
[2] Titled "Study and rulemaking regarding obligations of brokers, dealers, and investment advisers."

Petitioners criticized the SEC's attempt to regulate private fund advisers through what they called a "misplaced mousehole" in Section 211(h). Petitioners argued that because Section 913 of the Dodd-Frank Act added provisions aimed at "retail customers" to the Advisers Act, Section 211(h) also applies solely to retail customers (who do not invest in private funds). They also asserted that if Congress wanted Section 211(h) to cover private fund advisers, it would have added this provision through Title IV of the Dodd-Frank Act, which deals with such advisers, rather than through Title IX. Additionally, they highlighted the SEC's inconsistency in claiming new powers under Section 211(h) while also relying for the same authority on Section 206(4), a general anti-fraud provision of the Advisers Act that long predates Congress's expansion of registration requirements to private fund advisers.

Second, Petitioners argued that the Rule is a solution in search of a problem, citing the private market's growth and falling advisory fees as evidence of its health and competitiveness. Third, they claimed the SEC failed to adequately assess the Rule's effect on competition and capital formation, which led to the imposition of counterproductive, "one size fits all" regulatory solutions that would hamper the ability of smaller advisers to compete and actually harm many of the investors the SEC purported to protect.

The Fifth Circuit Panel primarily questioned Petitioners' call for complete vacatur, noting their briefs did not contest the Audit or Adviser-Led Secondary components of the Rule. Petitioners countered that the Rule should be voided entirely on grounds that it lacks statutory authority.

The SEC argued that Sections 211(h) and 206(4) each independently provide the Commission ample authority to regulate private fund advisers, grounding its argument in the text of the relevant statutes. The SEC highlighted some institutional investors' demands for increased transparency on fees and performance, exemplified by investors like the Louisiana Municipal Police Employees Retirement System. Despite private fund investors' general sophistication, the Commission argued that oversight is necessary to level the playing field, guarantee investors' access to vital information, and ensure that some investors do not lag behind others in obtaining preferential rights to performance data and redemption because of a lack of transparency and disparities in bargaining power. The SEC also asserted that its economic analysis supporting the Rule is comprehensive and incorporates quantitative data where possible. According to the Commission, qualitative and predictive decision-making are not prohibited when it is developing and promulgating generally applicable regulations for the capital markets in accord with its statutory mandates.

The Fifth Circuit Panel was particularly skeptical of the claim that Section 211(h) granted the authority the Commission sought to exercise, prompting one judge to ask: "Why would Congress waste its time with Title IV if in the end they were going to say, well, there's this 'Other Matters' provision" in Title IX which lets "the camel's nose in the tent?" The Commission stressed that Section 211(h) uses the term "investors" and not "retail customers," meaning Congress intended this provision to apply to all investors.

Industry Implications

This case could shape the future of the private funds industry and the SEC's regulatory authority. The Rule blurs the historical distinction between the treatment of registered funds and private funds. Private funds are specifically exempt from the framework of the ICA. Private fund advisers are governed by the more permissive Advisers Act, which Petitioners argue reflects a policy choice to stay out of the relationship between private fund advisers and the investors in those funds. The Fifth Circuit's decision, therefore, has significant industry implications. If the Court finds that the contested portion of the Dodd-Frank Act applies to private fund advisers, it could open the proverbial floodgates for additional SEC regulation. On the other hand, the Fifth Circuit could deliver a mixed decision, including a possible remand to the agency for further work on the Rule that would increase regulatory uncertainty for the foreseeable future.

The new rules provide tangible benefits for some private fund investors, particularly those that are smaller and lack the bargaining power of the behemoths (like the Abu Dhabi Investment Authority). Indeed, several investor groups, including a group of public pension funds, submitted arguments as amicus curiae in support of the SEC. They believe that the new rules include better, necessary protections for investors to address this bargaining power discrepancy. These investors argued that there is a substantial information asymmetry between the fund adviser and investors, in favor of the adviser, and that advisers have increasingly been using this advantage to draft initial LPAs–which form the baseline for any negotiations–that are highly favorable to the adviser. Investors and advisers typically embark on a years-long business relationship with tied-up capital and the cost to exit, if even possible, is high. Furthermore, even sophisticated investors can have difficulty monitoring the adviser for mismanagement of funds. In the view of some private fund investors, the Rule thus addresses a real need and serves the core purpose of the securities laws: ensuring that investors can make informed decisions.

On the other hand, private fund advisers (and some investors whose freedom of action is constrained under the Rule) believe that the purported benefits of the rule are entirely speculative, and the costs of compliance will run into the billions. It is precisely because Congress and the SEC have traditionally taken a "hands-off" approach that the private funds industry has flourished into a multi-trillion-dollar sector of the economy. Under this regime, parties enjoyed the freedom to create and negotiate contracts that worked for their unique circumstances. The Rule, from this perspective, threatens some of the very practices that have made the industry successful. The Rule's disclosure requirements, particularly as they concern the adviser's related parties, are onerous, and will result in countless hours of work and substantial compliance costs that would ultimately be passed on to investors. Effectively disallowing preferential treatment (which Petitioners argue is what the Rule effectively does) can hamper fundraising and capital formation by eliminating negotiation of terms between seed investors and advisers. Furthermore, the Rule does not stand alone, and the cumulative effects of the many new regulations proposed or already adopted by the SEC matter. The SEC under its current leadership has been a prolific, robust and (at times) controversial regulator. Indeed, the Securities Industry and Financial Markets Association notes the SEC anticipates proposing at least 14 more rules, which may impose upon private fund advisers "staggering aggregate costs and unprecedented operations and other practical challenges." Regardless of how the case ultimately turns out, the Fifth Circuit's decision will undoubtedly shed some light on whether the SEC has been "turning square corners" with the public as it seeks to reform the capital markets, or whether it has exceeded the bounds of the authority Congress bestowed upon it to police those markets.

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