Simpson Thacher

Regulatory and Enforcement Alert

The Fifth Circuit Vacates the SEC's Private Fund Adviser Rules

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Yesterday, a panel of three judges on the Fifth Circuit Court of Appeals issued its opinion in a 3-0 decision to vacate the entirety of the SEC's Private Fund Adviser Rules ("PFAR" or the "Rules") on the grounds that the SEC lacked statutory authority to adopt the Rules. The Fifth Circuit's decision amounts to a complete victory for the various trade associations that challenged the legality of the Rules. It is not yet clear whether the SEC will request further rehearing by the Fifth Circuit or appeal the decision to the Supreme Court, and the SEC has a mixed record on appealing decisions vacating its prior rulemakings.

As a reminder, the trade associations claimed four potential grounds for the Fifth Circuit to possibly vacate the Rules: (1) the SEC exceeded its statutory authority, (2) the final Rules were not a logical outgrowth of the SEC's proposed rulemaking, (3) the final Rules adopted were arbitrary and capricious and (4) the SEC failed to adequately consider the Rules' impact in adopting them (*i.e.*, the SEC failed to conduct an adequate economic analysis). Generally, federal courts must uphold SEC rulemaking unless the rulemaking exceeded the SEC's statutory authority or was arbitrary, capricious, an abuse of discretion or otherwise unlawful, and the courts must generally defer to SEC factual assertions as conclusive.

The opinion rejected the SEC's argument that it has the ability to regulate private funds under Section 211(h) of the Advisers Act (which was promulgated under the Dodd–Frank Act) and the opinion also vacated those portions of the Rules promulgated under Section 206(4) (which the SEC has regularly used for other Advisers Act rulemakings, including the SEC's marketing rule and compliance program rule) as lacking a sufficient nexus to identified fraud.[1]

In particular, the court found unpersuasive the SEC's arguments that provisions of 211(h), which in certain cases refer to "investors," were intended to regulate interactions between private fund advisers and their limited partners and affirmed that Congress, in adopting Dodd-Frank, intended to preserve the different regulatory treatment of private fund advisers and their relationships with their client funds. Heeding the arguments of petitioners, the court affirmed the circumscribed scope of Advisers Act regulation (in contrast to the more

[1] Section 206(4), as amended, authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative" regarding "any investment adviser."
Section 211, as amended, authorizes the SEC "to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in [the Advisers Act]."

prescriptive approach to regulating funds under the Investment Company Act), in particular citing the sophistication of private fund investors.

As noted above, the court also rejected the SEC's arguments that the entire rulemaking was supported by Section 206(4) authority, finding that the SEC's "anti-fraud" rationale for adopting the Rules was "pre-textual" and that the SEC did not articulate "a rational connection" between fraud (which the SEC can adopt rules designed to prevent under Section 206(4)) and the final adopted Rules. Agreeing with petitioners, the Fifth Circuit said the SEC failed to explain how the Rules would prevent fraud and that Section 206(4) requires the SEC to also "define" a practice as fraudulent in order to prevent it, finding that the SEC's "vague assertions" fell short of this requisite definitional specificity. (In particular, the court noted that the SEC has observed misconduct by only 0.05% of advisers, most of which were settled actions.) The court also challenged the SEC's ability to adopt the "disclosure and reporting" requirements of the Rules under 206(4) authority. In all, the court found that the Rules were insufficiently "reasonably designed" to prevent fraud or deception against an adviser's clients (*i.e.*, their funds) under Section 206(4). In issuing its decision, the court reasoned that "[b]y Congressional design, private funds are exempt from federal regulation of their internal 'governance structure'" (unlike funds regulated under the Investment Company Act), and that the SEC cannot "promulgate rules under the guise of Section 206(4) that [affect] this internal governance structure."

Because the Rules were vacated on statutory authority grounds, other arguments made by the petitioners were not considered (and the court also dismissed the SEC's invalid standing and improper forum arguments).

As of this writing, the SEC has not yet reacted publicly to the decision and it remains to be seen what action they will take in response, including whether to seek further review. Although the Rules have been vacated by the court's ruling, the SEC could theoretically seek a stay of the decision pending further appeal, which would allow the Rules to take effect on their respective compliance dates pending the outcome of the appeal. It is not clear that the SEC would be successful in pursuing such a stay or that the SEC would even request one.

While the court's decision with respect to the SEC's 211(h) authority may not be all that surprising to those that have been watching the case, the court's skeptical view of the SEC's arguments under 206(4) coupled with the SEC's historical reliance on 206(4) and its ambitious rulemaking agenda—which in numerous instances relies on that authority[2]—may give the SEC extra incentive to consider appealing this decision further. Alternatively, the SEC might attempt to rely on the court's specific finding regarding a lack of a "close nexus" in this particular case to determine that the SEC's authority under 206(4) has not been limited in a way that would materially curtail future rulemakings or call into question prior or currently pending rulemakings.

Regardless of whether the SEC chooses to further pursue saving PFAR in the courts, the SEC may use its examination and enforcement powers under the existing Advisers Act framework to pursue some of the concerns

[2] Notably, portions of the SEC's proposed Predicative Data Analytics Rules also rely on Section 211(h) for authority.

(and alleged abuses) it sought to address in the Rules and which it detailed at length in the proposing and adopting releases for the Rules.

We will continue to monitor any further developments, but we expect that most firms will likely hold off on taking any further significant steps to prepare for compliance with the Rules now that they have been vacated.

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