The Direction of the SEC in the Wake of *National Ass'n of Private Fund Managers v. SEC*

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In *National Ass'n of Private Fund Managers v. SEC*[1] the U.S. Circuit Court of Appeals for the Fifth Circuit vacated an otherwise industry changing set of rules adopted by the Securities and Exchange Commission under the Investment Advisers Act of 1940[2] that would have governed private fund advisers' interaction with the private funds they advise and the investors in those private funds. That decision presents potentially far-reaching consequences for the efforts of the SEC to enact new regulations governing relationships between private investment funds and their investors. A dogged SEC, partly depending on the future direction of the agency, could, however, attempt to accomplish some of the same goals through the discretion that it has on exams of investment advisers and its ability to bring enforcement actions under pre-existing disclosure-based principles or under the SEC's interpretation of the fiduciary duty that investment advisers owe to client funds.

The SEC's Recent Court Setback

In August 2023, the SEC adopted its Private Fund Advisors Rule[3] ("*PFAR*"). PFAR, as adopted would have required, among other things, that private fund managers deliver quarterly statements to their investors in an SEC prescribed form, banned the practice of preferential redemption and information terms in certain circumstances, expanded fund audit requirements, added disclosure requirements for "side letter" terms, imposed limitations and requirements on expenses and imposed new valuation or fairness opinion requirements for general partner "secondary" transactions. Numerous industry groups promptly challenged the adoption of PFAR in the United States Court of Appeals for the Fifth Circuit. They argued that PFAR (i) exceeded the SEC's statutory authority, (ii) was adopted without compliance with notice-and-comment requirements, (iii) was otherwise arbitrary and capricious and (iv) was adopted in violation of the SEC's

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obligation to consider the rules' effects on efficiency, competition and capital formation.

On June 5, 2024 the Fifth Circuit vacated PFAR. The court did not rule on the notice and comment requirements, the alleged arbitrary and capricious elements or the alleged lack of consideration of PFAR's effects on efficiency, competition and capital formation. Rather, the court focused its analysis solely on the SEC's statutory authority and ruled that the SEC exceeded its statutory authority.

For its statutory authority, the SEC relied primarily on two sections of the Investment Advisers Act of 1940 (the "Advisers Act"):

- Section 206(4) which grants the grants the SEC the authority to adopt rules that "*define and prescribe* means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." In the Adopting Release, the SEC read that statutory authority as giving it the ability to adopt "prophylactic" rules against conduct that is not necessarily fraudulent.[4] (emphasis added).
- Section 211(h), which was added by Dodd-Frank,[5] provides the SEC the authority to "(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 interests, and compensation schemes for brokers, dealer, and investment advisers that the Commission deems contrary to the public interest and the protection of *investors*." (emphasis added).

The court ruled that the SEC's reliance on Section 206(4) was misplaced. Under the Section 206(4), the Court explained that in order to rely on such section the SEC must first "define" a practice, act or course of business that is "fraudulent, deceptive, manipulative" before the SEC could adopt "means reasonably necessary to prevent" such practice, act or course of business.[6] The court said by example that the failure to comply with fund governing documents or disagreements over discretionary violations is not "fraud."[7] The court further pointed out that the Investment Company Act of 1940[8] exempted private funds from the provisions of that Act that would otherwise limit the ability of private fund managers to negotiate agreements with investors regarding terms. The court held that the SEC could not use Section 206(4) to implement an internal governance structure for private funds, when Congress exempted them from the governance structures provided under the Investment Company Act, as such a use of Section 206(4) would be not be "reasonably designed" to accomplish the anti-fraud purpose of the statute.[9] The court then laid out a few principles related to "fraud" that may be important going forward, to the extent that *National Ass'n* is followed:

- The court stated that the SEC conflated a "lack of disclosure" with "fraud" or "deception" and that a failure to disclose cannot be deceptive without a duty to disclose.[10]
- The duty to disclose under the Advisers Act relates to the private fund as the client, not the investors in the fund.[11]

With respect to the SEC's alleged authority under Section 211(h), the court held that "investors" as used in Section 211(h) means "retail investors," not "private fund investors," relying upon the surrounding language in the Dodd-Frank that focused on retail investors.[12]

Implications for Current and Future SEC Rule Making

The most far-reaching statement in *National A*ss'*n* may be the suggestion that any potential fraud by a private fund adviser under Section 206(4) is something that is committed against the fund as the client of the private fund adviser, as opposed to something that is committed against the investors in the client fund. Although not cited, it echoes *Goldstein v. SEC*,[13] where the DC Circuit Court of Appeals held that in the private fund context an investment adviser's client is the fund itself and not the investors in the fund. The corresponding view of the court that fraud cannot occur under Section 206(4) without a duty to disclose has a compounding potential limitation on the SEC's ability to rely on Section 206(4) in future rule making.

Where does this measured reading of Section 206(4) leave the SEC in terms of its discretion to "define and prescribe" "fraudulent" when adopting new regulations? While the result is not entirely clear, to the extent that the SEC tries to use the "fraud" nexus in Section 206(4) for new rule making it would seem to have a couple of hurdles to overcome:

- If *National Ass'n* is followed by other courts, the SEC seemingly would need to focus its anti-fraud rule-making in the context of private funds on protecting a fund itself rather than investors in the fund. Consequently, it could be difficult for the SEC to adopt regulations under the Advisers Act requiring and governing disclosures to fund investors.
- Secondly, even if new regulation is focused on the protection of the fund itself, courts might not grant the SEC a broad brush to define "fraud." The court credibly constrains concepts of "fraud" to situations where a duty to disclose is

violated as opposed to a more expansive view focused on perceived conduct or the absence of voluntary disclosures.

The court's limited reading of Section 211(h) could also restrict the SEC's ability to adopt regulations tied to fund investors independent of any fraud nexus. For example, both the SEC's current proposed regulation governing the use of predictive data[14] and the SEC's current proposed regulation addressing requirements for outsourcing to third parties[15] rely in part on authority that the SEC claims under Section 211(h).

Implications for SEC Enforcement

Where does this leave the SEC with enforcement activities under the Advisers Act? It may be important to recall that pre-PFAR securities regulation related to private investment funds was largely disclosure-based and important to note that disclosure-based principles still apply. Separate from more limited rule making under the Advisers Act, the SEC will continue to have an ability to bring enforcement actions against fund managers for any fraudulent statements made to fund investors in connection with the process of selling interests in funds, as the obligation to make complete disclosure rests on the Securities Act of 1933[16] and the Securities Exchange Act of 1934 rather than the Advisers Act.

An enforcement position of the SEC might be in the vernacular, "while the Advisers Act does not prohibit the action (since PFAR was vacated), the risks of doing that were not sufficiently disclosed in the sales process." For example, there could be a heightened focus on the granularity of disclosure regarding the preferential treatment that is granted to certain investors to the extent that such terms could potentially adversely impact other investors. To the extent that related risks were not disclosed to investors in connection with the sale of fund interests the SEC could argue that there was fraud against investors under the Securities Act of 1933 or the Securities Exchange Act of 1934,[17] putting aside any trimmed reading of fraud under the Advisers Act. It is possible that a similar disclosure-based approach could be taken by the SEC with respect to other tenets of PFAR that, among other things, addressed expenses, allocation of expenses and other forms of conduct that would have been prohibited. Any such enforcement actions could be outgrowth of enforcement actions that the SEC was already pursuing pre-PFAR but just possibly applied with more vigor.

In addition, the SEC may supplement its enforcement with its independent view separate from PFAR that fund managers have an unalterable fiduciary duty to their clients, as discussed below, which SEC believes should be defined as broadly as possible.

The Enduring Life of PFAR's "Dicta"

One of the greatest puzzles surrounds a rule that the SEC had initially proposed as part of PFAR regarding investment manager fiduciary duties. The proposed rule would have included a prohibition on seeking "reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful malfeasance, bad faith, negligence, or recklessness in providing services to the private fund." The SEC's stated rationale for not adopting that specific proposed rule was that it was unnecessary to adopt it because in its view the prohibition was already required by an investment adviser's independently existing fiduciary duties under the Advisers Act.[18]

Due to the SEC's statements regarding the scope of the fiduciary duty under the Advisers Act and "hedge clauses" purporting to waive duties under the Advisers Act only being an interpretation and not a rule, *National Ass'n* did not technically vacate the SEC's views. The SEC may continue to advance its views on fiduciary duty interpretation, coupled with its 2019 interpretive release broadly defining fiduciary duties, to possibly restrict through enforcement action the use of hedge clauses that attempt to limit a fund manager's fiduciary duties under the Advisers Act.

The SEC may find its ability to adopt new regulations limited to the extent that *National Ass'n* is followed. The interplay of the decision with SEC enforcement is uncertain but the SEC may seek to enforce some of the rationale underlying the Private Funds Rule through enforcement actions and exams that put heightened focus on disclosure used by fund managers in selling fund interests. Likewise, the long-standing position of the SEC that investment managers owe a fiduciary duty to the funds they manage is likely unaltered by *National Ass'n* and may remain as a focal point for future SEC enforcement.

NOTES:

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National Ass'n of Private Fund Managers v. SEC, Case No. 23-60471, Document 123-1.

[2]15 U.S.C.A. §§ 80b-1 et seq.

[3]Private Fund Advisors; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206 (Aug. 23, 2023) (to be codified at 17 C.F.R. Pt. 275) (the "Final Rule" or the "Adopting Release").

[4]Adopting Release at 29 (citing *U.S. v. O'Hagan*, 521 U.S. 642, 667, 673, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R.

Fed. 747 (1997)).

[5]Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub L. No. 111-203, 124 Stat. 1376 (2010).

[6]National Ass'n at 23.

[7]*Id*.

[8]15 U.S.C.A. §§ 80a-1 et seq.

[9]*Id*. at 24.

[10]*Id*. (citing *Regents of University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 386, Fed. Sec. L. Rep. (CCH) P 94173, 67 Fed. R. Serv. 3d 882 (5th Cir. 2007)).

[11]*Id*. (citing *S.E.C. v. Washington Inv. Network*, 475 F.3d 392, 404, Fed. Sec. L. Rep. (CCH) P 94152 (D.C. Cir. 2007).

[12]National Ass'n at 22.

[13]*Goldstein v. S.E.C.*, 451 F.3d 873, Fed. Sec. L. Rep. (CCH) P 93890 (D.C. Cir. 2006).

[14]Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Release Nos. 34-97990; IA-6353; File No. S7-12-23.

[15]Outsourcing by Investment Advisers, Release No. IA-6176; File No. S7-25-22.

[16]15 U.S.C.A. §§ 77a et seq.

[17]15 U.S.C.A. §§ 81a et seq.

[18]Final Rule at 258–60.

