

What next for SEC after Court of Appeals rules against PFA rule

The New Orleans-based 5th U.S. Circuit Court of Appeals has struck down the Securities Exchange Commission's Private Fund Advisers ('PFA') rule, saying the SEC had exceeded its authority by adopting the rule back in August 2023.

The case, which was brought to appeal in August 2023 by six groups of private equity and hedge fund managers including AIMA and MFA, was heard by the Court of Appeal on 5 June 2024. The three-judge panel agreed unanimously that the SEC had "exceeded its statutory authority" and ruled that "no part of [the PFA rule] can stand".

The rule had been designed to offer investors greater transparency on their investments, with managers required to introduce quarterly reporting, fee reports and annual audits. Those who brought the suit to Court argued it would make compliance with the requirements burdensome, erode profits and raise costs.

Industry responses

The industry groups behind the complaint applauded the Court's decision. "Today's ruling is a significant victory for markets, fund managers, and investors, including pensions, foundations, and endowments," Bryan Corbett, president and CEO of the Managed Funds Association (MFA) said - the MFA is the trade association representing asset managers including hedge funds. "The court affirmed that the SEC cannot expand its authority beyond what Congress intended."

However, financial reform groups were disappointed by the decision to vacate the rule, which they said would provide investors with key protections and transparency.

Stephen Hall, legal director and security specialist at Better Markets, called the decision, "a terrible setback on many levels." First and foremost, it will deprive investors in private funds — including everyday Americans with pension funds — of the protections the rule would have provided against unfair and opaque practices," Hall said.

Institutional Limited Partners Association (ILPA) CEO Jennifer Choi delivered the following statement. “ILPA has viewed the Private Fund Advisers rules as effectively addressing three primary factors that pose actual and meaningful risks to private equity investors: lack of transparency, conflicts of interest, and the lack of effective internal governance mechanisms to protect the capital managed by private funds - which is provided in large part by hardworking public employees, like teachers, firefighters, and police officers.”

The statement continued, noting that with the ruling and that in “the absence of minimum mandated standards, private funds will be under no obligation to provide critical information related to the fees and expenses charged to fund investors and meaningful performance information, leaving LPs to negotiate for terms that should be common sense. We are also disappointed that the 5th Circuit did not acknowledge the SEC’s longstanding authority to protect private market investors.”

The judgement and the SEC’s options

In its written judgement, the Court of Appeals asserted that Section 211(h) of the Investment Advisers Act applies to “retail customers”— a term that “has nothing to do with private funds” — and that the SEC “exceeded its statutory authority in relying on that section to adopt the Final Rule”. The 5th Circuit also stated that the PFA rule lacked a “close nexus” to the statutory anti-fraud aims of Section 206(4).

The Court of Appeals have ruled that the SEC cannot expand its authority beyond what congress intended, although its judgement did not rule on the merits of the proposed rule changes itself.

The SEC is yet to respond to the ruling. Among the SEC’s options is to call for the matter to be heard before the full bench of the 5th Circuit Court of Appeals or get the U.S. Solicitor General to make a request for the decision to be reviewed by the U.S. Supreme Court.

If the SEC decides on the appeal route it will take time. In the meantime, the SEC can make use of its well-established statutory levers to deliver on the objectives it had tried to legislate in the PFA rule. The SEC may increase oversight focus on investment managers’ disclosure practices with respect to expenses, expense allocations, preferential treatment, and potential conflicts. It could also be the

case that the demands of investors may mean that even without the new rule in place, investment managers will embrace some of the standards that were initially recommended.

What does the PFA rule include?

The PFA consisted of 7 elements:

- Quarterly Statement Rule
- Private Fund Audit Rule
- Preferential Treatment Rule
- Advisor-Led Secondaries Rule
- Restricted Activities Rule
- Books and Records Rule Amendments
- Compliance Rule Amendments

The rules would have required fund managers to issue quarterly performance and fee reports, perform annual audits, and stop giving some investors preferential treatment over redemptions and preferential information about portfolio holdings. The intent of the rule changes was to increase transparency in favor of investors, particularly as the industry begins to open up to retail-style investors.

While this decision has been welcomed by a number of bodies representing the Investment Manager community, the counter argument to today's decision is that it has put investors at a disadvantage. It prevents investors from accessing important information about fees and expenses charged to investors, as well as receiving access to further performance information. A number of the measures that were included within the PFA rule, would have brought the U.S. in line with some of the measures passed in Europe through the Alternative Investment Fund Managers' Directive, or AIFMD.

Aztec's support

Whatever your reflections on this ruling and whether it will change preparations you may have been making to comply with the PFA Rule, we are ready to support you in your approach and we are able to help you set up your plan and implement it.

To discuss any of the issues raised in this article please contact [Ore Adegbotolu](#) or [Scott Kraemer](#).