



SEC RULES OVERTURNED – WHAT DOES THIS MEAN FOR THE PRIVATE FUND BUSINESS GOING FORWARD?

In a significant legal development, several recent court rulings have struck down key regulations imposed by the U.S. Securities and Exchange Commission (SEC) on private funds, deeming them unconstitutional. In another case, the SEC’s practice of using in-house panels to decide enforcement cases was found to be unconstitutional. These decisions have profound implications for the financial industry, particularly for private equity, hedge funds, and other private investment vehicles.

Background on the Vacated SEC Rules

In 2023, the SEC had introduced new rules aimed at increasing transparency and accountability within the private funds sector (“Private Fund Advisers Rule”). These rules, amending the compliance rules for advisers (Rule 206(4)-7, *et. al.*) which were scheduled to take effect in 2024 and would have required fund managers to provide quarterly performance and fee reports, conduct annual audits, and eliminate preferential treatment for certain investors. The intention was to protect investors and ensure fair practices in an industry often criticized by some for its opacity.

Additionally, in another rulemaking early in 2024, in Exchange Act Rules 3a5-4 and 3a44-2 (the “Dealer Rule”), the SEC expanded the definition of a dealer, which would have required more firms, particularly those dealing in U.S. Treasuries, to formally register as dealers with the SEC and become members of the Financial Industry Regulatory Authority beginning in 2024. In particular, the Dealer Rule

would have applied to and required large hedge funds and proprietary trading vehicles that engaged in significant trading of treasuries “as a business” to comply with a raft of securities regulations and FINRA rules. This move was part of a broader effort to tighten oversight and enhance market stability.

Legal Challenges and Court Rulings

The rules faced immediate backlash from industry groups, including the National Association of Private Fund Managers and the Managed Funds Association, who argued that the regulations were overly burdensome and exceeded the SEC's authority. These groups contended that the rules would impose significant compliance costs and potentially stifle capital formation.

In a landmark decision, the Fifth Circuit Court of Appeals vacated the Private Fund Advisers Rule, ruling that the SEC lacked the authority to impose such regulations under the Investment Advisers Act of 1940. The court found that the SEC's rulemaking powers were limited to regulating the conduct of investment advisers vis a vis their customers (including private funds) but did not extend to regulate the conduct of private funds vis a vis their investors.

Similarly, a federal judge in Texas recently struck down the expanded Dealer Rule, siding with hedge funds and other financial firms that challenged the regulation. The judge ruled that the SEC had overstepped its regulatory boundaries, delivering a significant blow to the agency's efforts to broaden its oversight of the firms engaged in Treasury trading.

In an earlier decision, although not related to a new SEC rule specifically, on June 27, 2024, the U.S. Supreme Court ruled that the SEC can no longer use its in-house tribunals to decide cases involving civil penalties for securities fraud. This ruling, stemming from the case, *SEC v. Jarkesy* (144 S. Ct. 2117), not only marks a significant shift in how securities fraud cases will be handled moving forward by the SEC, but also reins in or eliminates the deference in interpretation of federal laws that courts have given to government agencies created by Congress to enforce federal regulations.

Implications for the Asset Management Industry

These rulings represent a major victory for many in the private funds industry, which had argued that the SEC's rules would disrupt their operations and increase costs.

The decisions underscore the ongoing tension between regulatory agencies and the financial sector over the scope and reach of regulatory oversight.

For the SEC, these setbacks highlight the challenges of implementing comprehensive reforms in a complex and highly influential industry, and rein in the agencies' tools for deciding civil cases by requiring that the cases be brought in federal courts. The agency may need to revisit its approach and consider alternative strategies to achieve its regulatory objectives without overstepping its legal authority.

Looking Ahead – Remain Vigilant!

The SEC may have several options moving forward, but the recent election of Donald J. Trump to his second non-consecutive term may likely keep the SEC from seeking to fight this trend. Even if they were inclined to ask higher courts to review the Private Fund Adviser Rule and Dealer Rule cases or seek to craft new rules under different legal theories, these processes are lengthy and uncertain, leaving the future of further regulation of the private fund industry in limbo. The SEC adopted technical amendments in early November to reflect the vacatur of the Private Fund Adviser Rules and amendments.

The recent court decisions serve as a reminder of the legal and practical limits of regulatory authority, and the ongoing debate over how best to protect investors while fostering a dynamic and competitive market involving private funds. As the financial industry continues to evolve, the balance between effective regulation and market freedom remains a contentious issue. It is likely that President Trump's pick for SEC Chair will likely espouse a "less is more" approach, like many of his other appointees to head other agencies.

While these developments mark significant limitations for the SEC's regulation of the private funds industry, private fund advisers continue to have significant compliance obligations under existing federal laws and regulations and firms should not take these recent developments as a sign that non-compliance will be overlooked, or that the SEC and FINRA do not lack authority to enforce the rules that already exist. The SEC and FINRA enforcement divisions are active and will remain so. Given a shifting regulatory environment, if you would like to discuss which regulatory requirements under the federal securities laws apply to your firm, please reach out to your Macaluso LLP contact.

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