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PFAR Oral Arguments Summary

On February 5, 2024, at around 2 pm EST, oral arguments took place in New Orleans at the U.S. Court of Appeals for the Fifth Circuit in the case of NAPFM, et. al. v. SEC, the case in which AIMA and other industry petitioners have challenged the SEC's Private Fund Adviser Rule ("PFAR"). The panel of judges hearing the case includes Judges Leslie Southwick, Kurt Engelhardt, and Cory Wilson. Below is a brief summary of the arguments presented to the Court. A recording of the full session can be accessed under Docket No. 23-60471 using this link:

https://www.ca5.uscourts.gov/oral-argument-information/oral-argument-recordings.

Petitioners' Argument

Eugene Scalia, a partner at Gibson Dunn, as counsel for AIMA and other petitioners, opened by arguing that PFAR is a brazen attempt at exercising plenary regulatory authority over private funds. Scalia noted that Congress had purposely exempted private funds from the Investment Company Act of 1940 ("ICA"), a statute whose purpose is to protect retail investors, given the required level of investor sophistication for investments in private funds. He argued that the SEC is attempting to use a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") as a back door to bypass the ICA's private fund exemption.

Scalia gave several reasons for full vacatur including lack of statutory authority, failure to establish a need for the regulation, and failure to determine whether the rule will promote competition and capital formation. Scalia noted that the Chamber of Commerce won their recent lawsuit against the SEC on grounds that there was a failure to establish a need for such regulation (i.e., it was "arbitrary and capricious"). Additionally, Scalia noted that the areas of focus were the worst parts of the rule but that the petitioners' position has always been for full vacatur of the rule.

In response to a question about the "Other Matters" provision, Scalia explained that Title IV of Dodd-Frank is where Congress established the regulation of private funds. Scalia also confirmed private funds were not mentioned elsewhere in Dodd-Frank and argued that this is what makes the SEC's argument weak. Scalia pointed out that the rulemaking authority SEC is claiming was set forth by

Congress in a subsection of Dodd-Frank dedicated to retail investors, far away in the statute from the rest of the provisions of Dodd-Frank applicable to private fund advisers. Scalia highlighted that Title IV of Dodd-Frank does not give the SEC the regulatory authority to compel private fund advisers to give materials to fund investors, such as descriptions of side letters, in contrast all it states is that the adviser must maintain these as required records subject to SEC inspection.

Regarding economic analysis, Scalia explained that the argument is not specifically about the SEC failing to do quantitative analysis but that it also failed to do qualitative analysis. Scalia pointed out that even the SEC admits that this rule would negatively impact small firms and cause some to go out of business. Scalia also highlighted the questionable legal grounds the SEC is relying on when trying to regulate private funds under the pretext that they are simply regulating the advisers. Finally, Scalia also argued that the whole case underscores the issue of the SEC's rulemaking process.

In response to a question from the panel about logical outgrowth, Scalia reiterated his criticism of the lack of statutory authority but acknowledged that if the Court found the only flaw to be the notice and comment, it may be sufficient to vacate only relevant provisions rather than the whole rule.

The panel said it would be difficult to vacate portions of the rule that have not been directly challenged or fully detailed, but Scalia replied that the whole rule is being challenged on the three provisions he outlined in his brief.

<u>Respondent's Argument</u>

Jeffrey Berger, as counsel for the SEC, opened by tying private funds to pensions impacting teachers, firefighters, and many Americans. Berger argued that sections 211(h) and 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") both provide sufficient authority. However, the panel criticized this argument, as section 211(h) derives from a retail investor provision in Dodd-Frank and noted that Congress has established a dichotomy between the regulation of private versus retail investors.

The panel asked why Congress would waste their time with Title IV if they were going to address private funds in another subsection. The panel also pushed Berger on the use of "subchapter" asking for further information on what the "subchapter" is referring to and whether it goes back all the way to Title IV of Dodd-Frank. Berger argued the "subchapter" is referring to the entire Advisers Act. Berger noted that all the provisions of section 913 of Dodd-Frank where the term "retail customers" appear are codified in the Securities Exchange Act of 1934 rather than the Advisers Act.

The panel asked about section 206(4), noting that it was intended to prevent fraud. Berger referenced the Supreme Court's ruling in *United States v. O'Hagan* (1997) in support of the SEC's position. Berger explained that even if section 211(h) of the Advisers Act is not ruled in the SEC's favor, the SEC still had the authority vested in section 206(4) of the Advisers Act to support adopting PFAR.

The panel asked whether there was a case analogous to this regarding the thin number of examples to justify a major ruling. Berger referenced the pay to play rule and pointed to *Wagner, et al. v. FEC* (2015).

The panel questioned whether the examples referenced in the PFAR adopting release were settlements. Berger said they were all settlements but claimed this was a "market failure" of disclosure as referenced in numerous amicus briefs by pension funds participating in private funds.

The panel pushed back on Berger's use of the term "market failure" arguing that private funds have clearly been a "market success." The panel also noted the fiduciary relationship was only between private funds and private fund advisers.

The panel asked Berger what the SEC's best argument was for upholding the rule. Berger said to put oneself in the shoes of a small pension fund. Berger's time concluded.

Petitioners' Rebuttal

Scalia criticized the SEC using settlements as justification for this rule. Regarding plenary regulatory authority, Scalia clarified that his point was not that the SEC is fully using plenary regulatory authority but that it is claiming to have it. Regarding the structure of Dodd-Frank, Scalia pointed out that "Other Matters" was not intended to be a trapdoor. Scalia noted that the SEC itself has used the term "investor" in place of "customer" in other contexts to denote a person who has not yet become a customer. Scalia emphasized that the language in section 211(h) of the Advisers Act is regarding an advisory relationship but there is no advisory relationship between a private fund adviser and an investor. Scalia pointed out that section 206(4) of the Advisers Act has existed since 1960, but the SEC is now using it for this broad scope of authority. Lastly, Scalia reiterated concerns with the SEC's compliance with the Administrative Procedure Act in this rulemaking.

Next Steps

The Court will now deliberate. A decision could be handed down by the end of April, however, timing is in the full discretion of the Court. If the decision results in PFAR being vacated in full or in part, the SEC can pursue an appeal.

We think the arguments made on behalf of the petitioners were strong and well presented. Our counsel powerfully challenged all of the SEC positions. The panel of judges appeared to be very well-versed in the details of the case and asked all the pertinent questions of both sides. External commentators on the hearing have so far largely expressed a view that the SEC case is weaker.