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New Developments on the Scope of the Registered Investment Adviser Exemption under Section 16 of Exchange Act

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Hedge funds and other private investment funds can take advantage of the exemption for registered investment advisers (RIAs) under Exchange Act Rule 16a-1(a)(1)(v), the "RIA Exemption." While the exemption can be helpful, it can be tricky in practice due to open questions as to its scope, when the adviser has relationships with the advised fund beyond the adviser-advisee relationship. In our alert, we analyze two scenarios in which the RIA Exemption may be undermined.

A recent case also reminds us that the RIA Exemption may also be undermined if the underlying investment is not passive.

RIA Exemption Undermined by Economic Interest in the Advised Funds

Perhaps the most prominent question about the scope of the exemption is whether it is available where the adviser has an interest in the advised fund. The exemption is clearly available where, for example, the advised fund is a third party that has no relationship with the adviser other than the advisory agreement. However, its availability is less clear if the adviser has an ownership or control interest in the advised fund or in its general partner. An ownership interest can take the form of a GP, LP, or membership interest. A control interest normally involves a controlling interest in the advisee's general partner. The reason why such additional relationships can cast doubt on the availability of the exemption is a requirement in the rule that the shares be "held for the benefit of third parties . . . in the ordinary course of business." If the investment adviser maintains an ownership interest in the advised entity, one could argue that the shares that it holds are not strictly "held for the benefit of third parties," as the shares are held also for the benefit of the adviser itself. Some cases and secondary authorities have provided support for such a reading. Some funds have accordingly taken a conservative position when relying on the exemption, to assume it is not available if an adviser held a LP or GP interest in the advised fund, even without a controlling stake, unless the interest was trivial in size and compelled by tax or regulatory considerations.

A recent court decision suggests that an ownership interest in an advised entity may not undermine the RIA exemption. In *Greenfield v. Criterion Capital*, 2017 WL 2720208 (N.D. Ca. June 23, 2017), the adviser had a management agreement with the advised master funds. Either the adviser or one or more of its members also had an economic interest of between 2% and 12% in the advised funds. Neither the adviser nor its members served as the general partner (or as a director of the general partner) of the advised funds; the general partners were corporations with independent boards. The adviser, however, did serve as the general partner of the feeder funds. The court held that the adviser's ownership interest in the master funds did not undermine the exemption, holding that the exemption does not require that interests in the advised funds are held "solely" by third parties.

But this issue remains very much open. In another decision that came down before Criterion Capital, a court in the Southern District of New York took a seemingly opposite position. In *Greenfield v. Cadian Capital Management*, 213 F. Supp. 3d 509 (S.D.N.Y. 2016), the adviser had a direct investment of between 3 and 11 percent in the underlying funds. Based on its ownership, on a motion to dismiss, the court concluded that the plaintiff adequately pleaded that the adviser may not hold the issuer's securities "for the benefit of third parties."

Even if the exemption is available, bear in mind that the adviser could be deemed to be part of a Section 13(d) "group" that has beneficial ownership of the advised fund's shares. Individuals who are "control persons" of the advised fund or its general partner may also seek to utilize the exemption under Rule 16a-1(a)(1)(vii), which exempts "[a] parent holding company or control person, provided the aggregate amount held directly by the parent or control person, and directly and indirectly by their subsidiaries or affiliates that are not [exempt] persons . . . , does not exceed one percent of the securities of the subject class."

RIA Exemption Undermined by Non-Passive Status

Another recent case serves as a reminder of an often-overlooked condition of the RIA Exemption: The requirement under Rule 16a-1(a)(1)(v) that "such shares are acquired . . . without the purpose or effect of changing or influencing control of the issuer . . . .". Even after legitimately claiming the exemption, an adviser's interaction with the issuer could cause it to become disqualified.

In another decision in the Northern District of California, the court determined that an issue of fact existed precluding a motion to dismiss based on application of the exemption where the adviser, after the relevant time period, later became an "activist" relative to the company, and switched from being a filer on Schedule 13G to Schedule 13D. See *Sand v. Biotechnology Value Fund, L.P.*, 2017 WL 3142110 (N.D. Ca. July 25, 2017).

Related Professionals

- **Frank Zarb**
  Partner

- **Christopher M. Wells**