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ETF Ownership Limits—Trap for the Unwary Hedge Fund

In recent years, many hedge funds have significantly increased their holdings in exchange-traded funds (ETFs). Historically, hedge funds primarily acquired short positions in ETFs to hedge their long positions in a particular industry segment by obtaining short exposure to an entirely different industry segment. However, many hedge funds are now acquiring long positions in ETFs as part of their core investment strategies. Hedge funds and their managers should be aware that substantially increasing their long positions in ETFs could result in such hedge funds violating the ownership limit set forth in Section 12(d)(1)(A)(i) of the Investment Company Act of 1940 (the Investment Company Act). Although Section 12(d)(1)(A)'s limitations apply to investments in any registered investment company, including closed-end funds, the discussion below focuses on ETFs due to their popularity as a component of the investment strategies of hedge fund managers.

Current Regulations Affecting a Hedge Fund's Ability to Acquire Shares of an ETF

Under the Investment Company Act, private investment funds (e.g. hedge funds) are generally prohibited from acquiring more than 3% of an ETF's shares (the 3% Limit). In order to allow purchases of their shares in excess of the 3% Limit, many ETFs have sought exemptive relief from the Securities and Exchange Commission (the SEC). However, obtaining such exemptive relief generally requires satisfying a substantial number of conditions, which are similar to those that would apply to an investment company seeking relief to invest in unaffiliated traditional mutual funds, including a number of conditions designed to limit the influence that an acquiring fund may exercise over a particular ETF.

In response to complaints from the industry that many of the conditions for such exemptive relief are unnecessary and unduly burdensome, the SEC proposed new rules in March 2008 that would relax the 3% Limit as it applies to investments in ETFs. Specifically, proposed Rule 12d1-4 under the Investment

Company Act would allow investment companies to make investments in ETFs that exceed the 3% Limit, subject to the following conditions: (i) the acquiring fund does not exercise controlling influence over the ETF's management or policies, (ii) the acquiring fund may not redeem the shares acquired in reliance on the proposed rule, and must instead sell its shares in the secondary market, (iii) the ETF is not a fund of funds and (iv) in order to avoid duplicative or layered fees, the sales charges and service fees charged by the acquiring fund are subject to the Financial Industry Regulatory Authority's sales charge rule. Unfortunately, at this time, the SEC has not contemplated any further action regarding the proposed rule, so hedge fund managers will need to continue to comply with the 3% Limit.

Considerations for Hedge Funds that Invest in ETFs

We recommend that a manager of a hedge fund with a significant position in an ETF regularly determine whether its hedge fund is in compliance with the 3% Limit. In making this determination, the hedge fund manager should consider the following:

1. **Long Positions.** If a hedge fund holds a long position in a particular ETF and exceeds the 3% Limit, the hedge fund is in violation of Section 12(d)(1)(A)(i) unless exemptive relief was sought and obtained from the SEC. A hedge fund manager should implement policies and procedures to regularly monitor each of its hedge fund's long positions in ETFs, particularly if the hedge fund invests in niche ETFs with smaller asset levels.

2. **Short Positions.** Section 12(d)(1)(A)(i) does not specifically discuss whether short positions in ETFs are subject to the 3% Limit. As a general matter, the industry practice is to only subject long positions in ETFs to the 3% Limit. Although the SEC is aware that this issue regarding short positions in ETFs has not been formally addressed, the SEC has not indicated that the industry's approach is incorrect.

3. **Non-U.S. Funds.** Section 12(d)(1)(A)(i) applies to offshore hedge funds as well as U.S. domiciled hedge funds. Accordingly, if an offshore hedge fund has a long position in a particular ETF and exceeds the 3% Limit, the hedge fund is in violation of Section 12(d)(1)(A)(i) unless exemptive relief was sought and obtained from the SEC.

4. **Options on ETFs.** As Section 12(d)(1)(A)(i) only applies to holdings of "outstanding voting stock," holdings of options on ETFs would not be counted towards the 3% Limit. Derivatives that provide their holder with voting rights, however, would generally be considered "voting stock."

5. **Sub-Advisers.** An investment company must count all its holdings of an investment company's voting securities for the purposes of the 3% Limit. This is the case even if the investment company employs multiple sub-advisers. A fund manager that acts in the capacity as a sub-adviser to a fund would not typically be expected to monitor the 3% Limit. However, if the sub-adviser is aware that the hedge fund invests in ETFs or other registered investment companies, it would be prudent for such a sub-adviser to request that the fund adviser make a periodic representation to the sub-adviser that the 3% Limit has not been violated.

6. **Managed Accounts.** As a managed account is not an investment company, it would not be subject to the 3% Limit

7. **Aggregation of Funds.** The restrictions of Section 12(d)(1)(A) apply to the acquiring investment company and "any company or companies controlled by it." It is therefore necessary to aggregate the holdings of the acquiring investment company with any companies it controls when determining

whether the 3% Limit has been breached. It is not necessary to aggregate the holdings of funds merely because they share the same investment manager since these funds will generally not be able to exercise control over one another.

Other Limits of Section 12(d)(1)(A)

In addition to the 3% Limit, Section 12(d)(1)(A) contains restrictions on the percentage of a registered or unregistered investment company's assets that can be invested in a registered investment company. Specifically, Sections 12(d)(1)(A)(ii) and (iii) provided that an investment company may not invest more than 5% of its assets in a single registered investment company (the 5% Limit) or more than 10% of its assets in registered investment companies (the 10% Limit). As Sections 3(c)(1) and 3(c)(7) of the Investment Company Act (the exemptions relied upon by hedge funds to avoid registration as investment companies) indicate that companies relying on these exemptions will be considered investment companies for purposes of the 3% Limit but do not mention the 5% Limit or the 10% Limit, it has generally been assumed that only the 3% Limit applies to hedge funds. This assumption was placed in doubt by the March 2008 proposing release for Rule 12d1-4, which states in footnote 194 that "Both registered and unregistered funds are subject to these limits [i.e., the limits of Section 12(d)(1)(A)] with respect to their investments in a registered fund." The New York City Bar's Committee on Private Investment Funds requested clarification of this issue in a comment letter regarding the 2008 proposed rules but, as the rules were never adopted, no such clarification was ever issued by the SEC.

The SEC has indicated on an informal basis that only the 3% Limit would apply to hedge funds because Sections 3(c)(1) and 3(c)(7) provide that companies relying on these exemptions are only "investment companies" for the purposes of 12(d)(1)(A)(i). Hedge funds are not otherwise considered investment companies and would therefore not be subject to the 5% Limit and 10% Limit.

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