



STATE OF WASHINGTON
DEPARTMENT OF FINANCIAL INSTITUTIONS
SECURITIES DIVISION

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Notice to Hedge Fund Managers

Regarding the Use of Partnership and LLC Agreements to Satisfy the Written Investment Advisory Contract Requirement

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Investment advisory contracts are required to be in writing and contain certain provisions. Hedge fund managers who rely on a fund's organizational document, such as a partnership or limited liability company ("LLC") agreement, to satisfy the written advisory contract requirement should be aware that careful drafting is necessary to ensure a partnership or LLC agreement satisfies the written investment advisory contract requirements and does not conflict with state or federal securities laws.

A hedge fund manager who employs a partnership or LLC agreement as an advisory contract should also be aware that the Division will closely review the agreement due to the special issues involved. The hedge fund manager should be prepared to amend the agreement following our review as necessary to comply with the written investment advisory contract requirements. A hedge fund manager who desires to use a partnership or LLC agreement to satisfy the written advisory contract requirement is encouraged to consult with an attorney.

The following are a sampling of the issues that may arise from the use of a fund's organizational document to fulfill the written investment advisory contract requirement. There are other issues that are not addressed here.

- **The fiduciary duties of an investment adviser may not be modified.** Investment advisers are fiduciaries and have "a duty to act primarily for the benefit of [their] clients." WAC 460-24A-220. The standard of care imposed on a fiduciary are generally higher than those owed to partners in a partnership or members in a limited liability company. *See* RCW 25.05.165 (general standards of partner's conduct); RCW 25.15.155(1) (liability of managers and members in a LLC). Because the duty of care owed to partners or members under default provisions of state law is lower than the fiduciary duty of an investment adviser, a hedge fund manager that wishes to satisfy the written investment advisory contract requirement with the fund's organizational document should include an express provision in the document stating the fiduciary duty owed to investors in the fund.
- **The investment advisory contract must contain certain terms.** An investment advisory contract is required to include "the services to be provided, the term of the

contract, the advisory fee, the formula for computing the fee, [and] the amount of prepaid fee to be returned in the event of contract termination or nonperformance.” *See* WAC 460-24A-220(16). These are terms that are not ordinarily included in a partnership or LLC agreement. A hedge fund manager that uses a partnership or LLC agreement to satisfy the written investment advisory contract must ensure the agreement includes these terms.

- **Hedge fund managers may not exercise discretion without client authorization.** The written investment advisory contract must specify whether or not the client grants the investment adviser discretion. *See* WAC 460-24A-220(16). If a hedge fund manager chooses to use a partnership or LLC agreement as an investment advisory contract, the manager must ensure the agreement satisfies this requirement.
- **Hedge fund managers may not assign their contractual obligations without client consent.** The written investment advisory contract must specify that the investment adviser may not assign its obligations under the contract without client consent. *See* WAC 460-24A-220(16). However, default provisions under state law may allow partners or members to dissociate and/or transfer their interests without the consent of the other owners. *See* RCW 25.05.230 (partner’s power to dissociate); .210 (transfer of partner’s transferable interest); RCW 25.10.320 (power of general and limited partners to withdraw from limited partnership); .330 (assignability of limited partnership interest); RCW 25.15.180 (resignation of manager of LLC); .250 (assignment of interests in LLCs). As such, a hedge fund manager that wishes to use a partnership or LLC agreement to satisfy the written investment advisory contract requirement must ensure that it specifies that the investment adviser may not assign its obligations under the contract without client consent.
- **Loan transactions with clients are generally prohibited.** Investment advisers are generally prohibited from entering into loan transactions with clients. *See* WAC 460-24A-220(6)-(7). However, partners and members of LLCs are generally permitted to enter into business transactions with the partnership or LLC. *See, e.g.,* RCW 25.15.035 (business transactions of member or manager with the LLC). Because these default provisions would permit loan transactions with clients, the hedge fund manager should ensure that the investment advisory contract prohibits them in accordance with WAC 460-24A-220(6)-(7).
- **Hedge clauses are prohibited in investment advisory contracts.** An advisory contract may not provide that a customer waives compliance with state or federal securities laws or that a customer waives any rights under these laws (so called “hedge clauses”). *See* WAC 460-24A-220(19). Partnership and LLC agreements often limit the liability of partners and members to other partners and members or otherwise provide for indemnification. *See, e.g.,* RCW 25.15.040(1)(a) (limitation of liability and indemnification in LLC agreements). However, a broadly drafted limitation on liability or indemnification provision may constitute an impermissible hedge clause. A hedge fund manager that wishes to use a partnership or LLC agreement to satisfy the written investment advisory contract requirement must ensure that any limitations on liability or

indemnification provisions included in the agreement do not violate the prohibition on hedge clauses.

- **Amendments to the terms of the investment advisory contract may require amendment of the partnership or LLC agreement.** Depending on the terms of the partnership or LLC agreement, amendments of the investment advisory contract terms may require amendment of the partnership or LLC agreement itself when the organizational document is used to satisfy the written investment advisory contract requirement. Hedge fund managers should take this into consideration if they are considering using a partnership or LLC agreement to satisfy the written investment advisory contract requirement.
- **Amendment of investment advisory contract terms might require a filing with the Secretary of State.** Hedge fund managers that are considering using a partnership or LLC agreement as an investment advisory contract should be aware that changes to the terms of the contract may require a filing with the Secretary of State's office. *See, e.g.*, RCW 25.10.090(2) (amendments to certificate of limited partnership).

If you have any questions about this notice please contact Faith Anderson by telephone at (360) 725-7825 or by e-mail at fanderson@dfi.wa.gov.