



## LAUNCHING A HEDGE FUND? Is Investment Adviser Registration Required?

### **Background**

In a post Dodd-Frank world, compliance is king. For the founder of a new hedge fund, compliance with the new Investment Advisers Act (the “Advisers Act”) registration regime is a critical initial step. If registration is required, investment advisory services may not be provided until SEC or state registration is obtained.

Title IV of Dodd-Frank eliminated the “private adviser exemption” which allowed any investment advisor with fewer less than 15 clients who did not hold itself out to the public to avoid registration. For purposes of the numerical limit, each fund was considered one client so most hedge fund were exempt from the registration and the compliance and disclosure obligations of the Advisers Act. Title IV changed the regulatory landscape by basing registration not on the number of clients but on regulatory assets under management (“RAUM”), thereby shifting regulatory authority over smaller managers to the states and regulating larger managers outright. This memorandum outlines which advisers must, may, or are prohibited from SEC registration.

### **Am I an Investment Adviser?**

The registration obligations apply to “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues of promulgates analysis or reports concerning

securities.”<sup>1</sup> Most hedge and private equity fund managers provide advice with respect to securities but if such manager advises solely about matters other than securities (such as advice regarding real estate, precious metals, or off-exchange retail forex for example) it would not be subject to the Advisers Act (although maybe subject to registration with the CFTC in the case of futures or forex managers).

### **How do I determine RAUM for SEC registration eligibility, exemption or prohibition?**

The first step in determining whether you must register with the SEC or a state regulator is to calculate your regulatory assets under management (“RAUM”). Advisers must calculate the value of their securities portfolios with respect to those provides “continuous and regular supervisory or management services”, including: (i) proprietary assets; (ii) assets managed without receiving compensation; (iii) assets of foreign clients; and (iv) uncalled capital commitments. A hedge fund manager typically provides continuous and regular supervisory or management services to its clients.

RAUM must be calculated on a gross basis, thus an Adviser is not permitted to subtract any outstanding debt (including leverage) and other accrued but unpaid

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<sup>1</sup> The following are exempted from the definition of an investment adviser: banks or BHCs; lawyers, accountants, engineers or teachers; certain broker-dealers, advisers whose advice or analysis relates to certain U.S. government related securities; nationally recognized statistical rating agencies; and family offices.

liabilities relating to the account. Finally, all assets must be valued at their market value or fair value where market value is unavailable. Advisers that calculate fair value in accordance with GAAP (or another international accounting standard) must use that same basis for determining RAUM.

Thus, for a private fund (i.e. a 3(c)(1) or 3(c)(7) fund), *all* of the fund's assets are considered securities. The actual composition of the portfolio is irrelevant. For a managed account fund or non-private funds (including propriety accounts), a securities portfolio includes at least 50% of the total value of which consists of securities.

Advisers are required to calculate the amount of threshold for SEC registration. After reaching the threshold, you will then generally have a 90-day grace period to register with the SEC (unless you are otherwise exempt from registration).

#### **When am I required to register with the SEC as an investment adviser?**

(1) you have RAUM of \$150 million or more;

(2) some of your clients are *not* hedge funds or private equity funds, *and* you have RAUM of \$100 million or more; or

(3) some of your clients are not hedge funds or private equity funds, you have RAUM of \$25 million or more *and* your principal office and place of business is in a state where either:

(A) you are not required to register with the state securities regulator as an investment adviser; or

(B) you are required to register with, *but* you are not subject to examination as an investment adviser by, the state securities regulator (note that currently the only states where you are not subject to examination are New York and Wyoming); or

(4) you act as an adviser to a registered investment company or a business

development company, or you hold yourself out to the public in the United States as an investment adviser.

Once registered with the SEC, advisers are subject to the full scope of the Advisers Act. This includes:

- (i) Filing current disclosures on Form ADV;
- (ii) Record keeping requirements;
- (iii) Examinations by the SEC's Office of Compliance Inspections and Examinations;
- (iv) Establishing, maintaining, and implementing a code of ethics;
- (v) Custody requirements;
- (vi) Complying with advertising rules; and
- (vii) Restrictions on performance fees.

#### **When am I exempted from SEC Registration?**

Advisers that would otherwise be required to register with the SEC may qualify under the following new exemptions. The following outline certain new exemptions.

#### **(1) Private Fund Adviser and RAUM below \$150 million**

This exemption applies to any adviser with its principal office and place of business in the U.S. that **solely** advises:

- (i) "qualifying private funds"; and
- (ii) the total RAUM attributable to those funds is *less* than \$150 million

#### **Qualifying Private Funds:**

The term includes funds that rely on any of the exemptions under Section 3 of the Investment Company Act, including Section 3(c)(1), Section 3(c)(7), Section 3(c)(5)(C). Thus, you may only rely on this exemption if you *all* your U.S. person clients are hedge funds and private equity funds, without regard to the type of non-U.S. clients. A single client that is not a

“qualifying private fund”, such as a managed account, eliminates the availability of this exemption.

#### Single-Investor Private Funds:

The SEC has not determined whether a hedge fund with a single investor is considered a qualifying private fund or managed fund. However, it did outline two situations when a single-investor fund has constituted a qualifying private fund: a fund seeking to raise capital from multiple investors but has only a single investor for an initial period of time, and a fund in which all but one the investors have redeemed their interests.

#### Affiliated Advisers:

The SEC typically will view as a single firm two affiliated advisers that are separately organized but operationally unified. To be considered separated entities for purposes of this exemption, the two firms must be carrying on discernibly independent advisory businesses.

#### Application to Non-US Advisers:

This exemption also applies to advisers with principal offices and places of business *outside* the U.S. if the adviser:

- (i) has no clients that are U.S. persons except for one or more qualifying funds; and
- (ii) RAUM at the place of business in the U.S. solely attributable to private fund assets has a value less than \$150 million.

#### Maintaining the Private Fund Exemption:

Changes in RAUM *between* the filing of each annual Form ADV updating amendment do not affect qualification for the exemption as long as the RAUM reported returns to below \$150 million. If you lose edibility solely because of RAUM equaling or surpassing \$150 million as reported on the annual Form ADV updates,

you have a 90-day grace period from that update to file with the SEC a full Form ADV. However, there is no grace period when you rely on the exemption but now plan to accept non-qualifying private funds. You must become SEC-registered before advising new clients.

#### Exempt Reporting Advisers:

Advisers relying on the Private Funds exemptions are not required to register with the SEC, but remain subject to modified reporting obligations of the Exempt Reporting Adviser. This includes disclosure on Part 1A of Form ADV and the possibility of SEC examination.

#### **(2) Advisers to Only Venture Capital Funds**

All U.S. and non-U.S. fund managers that advise solely venture capital funds, irrespective of size or number of funds, are exempt. A venture capital fund under this exemption is defined as any private fund that:

- (i) represents to investors and potential investors that it pursues a venture capital strategy;
- (ii) does not surpass the 20% basket for “non-qualifying investment”;
- (iii) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the private fund’s capital contributions, which borrowing, indebtedness, guarantee or leverage is on short term basis, for a nonrenewable period of less than 120 days;
- (iv) does not offer its investors redemption or similar liquidity rights, except in extraordinary circumstances such a withdrawal; and
- (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company.

#### Exempt Reporting Advisers:

Like advisers relying on the Private Funds exemption, advisers relying on the venture capital exemption remain subject to modified reporting obligations.

### (3) Foreign Private Adviser

A “**foreign private adviser**” includes an investment adviser that:

- (i) has no place of business in the U.S.;
- (ii) has, in total, fewer than 15 clients and fund investors in the U.S.;
- (iii) has less than \$25 million in RAUM from clients and fund investors in the U.S.;
- (iv) does not hold itself out to the public in the U.S. as an investment adviser; and
- (v) does not act as an investment adviser to a registered investment company or a business development company.

You must fulfill **all** of the aforementioned criteria in order to be eligible for this exemption.

### Additional Exemptions

There are several other exemptions and exclusions that are not commonly available for hedge fund or private equity fund managers, such as exclusion for family offices, intrastate advisers, and advisers only to small business investment companies.

### When am I prohibited from SEC Registration?

SEC registration is prohibited if you are:

#### (1) Small Adviser

If you have **less than \$25 million** in regulatory assets under management, you are **prohibited** from registering with the SEC and must register with state regulators, unless an exemption applies.

#### (2) Mid-Sized Adviser

If you have **between \$25 million and \$100 million of regulatory assets** under management **and**: (i) you are required to be registered as an investment adviser in the state in which you maintain your principal office and place of business; **and** (ii) if registered, you would be subject to examination as an investment adviser by the applicable state securities commissioner, you will not be permitted to register with the SEC, unless you are required to register with 15 or more states. In this case, a mid-sized adviser that is registered and examined by its home state may opt in SEC registration.

Currently, the only states that do not meet these requirements are **New York and Wyoming**. Accordingly, if you have between \$25 million and \$100 million of regulatory assets under management and maintain your principal office and place of business in New York or Wyoming, you **must register with the SEC** (unless another exemption is available).

#### Mid-Sized Adviser “Buffer”

In order to prevent consecutive registration, deregistration and re-registration, the SEC created a buffer zone to allow for small movements of RAUM caused by movements in the market or departure of clients. Accordingly, a mid-sized adviser not currently registered with the SEC is **required** to register *only* when its RAUM *equals or exceeds* \$100 million. An adviser that is registered with the SEC is only required to de-register if its RAUM falls below 90 million.

### May I still register with the SEC if I am not required to?

The presumptive rule is that investment advisers must register with the SEC or one or more states and **may not choose** with whom they can register, subject to certain exceptions. However, you **may** register with the SEC if you are *exempt* from

SEC registration (*unless you are prohibited* from registering) because:

- (i) you advise solely hedge funds and/or private equity funds (“Private Fund Adviser”) and have RAUM less than \$150 million;
- (ii) you advise solely venture capital funds; or
- (iii) are a “foreign private adviser”.

### **State Law Considerations**

It is critical to also consider applicable state adviser registration and reporting laws and regulations. For SEC registered advisers, a state may not require registration. However, the adviser may be required to make notice filing in any state in which it has a place of business of clients. Furthermore, the state authorizes do have a right to inspect you for alleged violations of state anti-fraud law. For advisors not registered with the SEC, state registration and/or notice filings may be required with one or more state securities regulators. A review of state statutes and regulations is necessary to determine compliance.



## INVESTMENT ADVISER REGISTRATION TABLE U.S. HEDGE FUND MANAGERS

Location of Manager's Principal Place of Business	Type of Clients	Regulatory Assets Under Management (RAUM)	Registration Requirements
Any State	Solely 3(c)(1) or 3(c)(7) funds (e.g. private funds)	Less than \$150m	Private Fund Adviser exemption available. No SEC registration required. State registration or notice filing may be required. Exempt Reporting Adviser filing required with SEC over \$150m (\$25m in NY and WY)
Any State	Solely 3(c)(1) or 3(c)(7) funds (e.g. private funds)	More than \$150m	SEC registration required. State notice filing may be required.
Any State other than NY or WY	Clients include one or more non-private funds (separately managed accounts)	Between \$25m and \$100m	If state registration not required
Any State other than NY or WY	Clients include one or more non-private funds (separately managed accounts)	More than \$100m	Registration is permitted above \$100m and required at \$110m of RAUM.
NY	Clients include one or more non-private funds (separately managed accounts)	More than \$25m	SEC registration is required.