Planning a Hedge Fund Launch? SEC Registration Thresholds for Start-Up Managers

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A critical gating question for the founder of a new hedge fund manager is whether the firm will be required to register with the SEC as an investment adviser under the Investment Advisers Act of 1940 (the “Advisers Act”). If a new manager is required to register at the outset of its operations, client advisory work may not begin until the registration process is complete.

This memorandum provides an overview of the law and regulations relevant to whether a new hedge fund manager must register with the SEC under the Advisers Act. It addresses the general situation of an adviser1 that has its principal office and place of business in the United States and has clients consisting of one or more “private funds,” i.e., pooled investment vehicles excluded from investment company status under §3(c)(1) or §3(c)(7) of the Investment Company Act of 1940.2 This prototypical adviser is either in its initial asset-gathering phase, or already has a modest amount of assets under management and expects to grow further through additional fund-raising and/or portfolio appreciation.3

THE BIG PICTURE: MANY NEW HEDGE FUND MANAGERS WILL NEED TO REGISTER WITH THE SEC

The likelihood that a new hedge fund adviser will have to register with the SEC — either in conjunction with the firm’s formation or relatively soon thereafter — is greater today than it was before July 2011. That is when the new Advisers Act registration regime ushered in by the Dodd-Frank Act took effect.4

The heightened odds of required SEC registration result from the interplay of three aspects of Dodd-Frank. First and most dramatically, Dodd-Frank repealed the sweeping registration exemption previously available to hedge fund (and other) managers under the Advisers Act.5 That provision had generally exempted from SEC registration any investment adviser that during the previous 12 months had fewer than

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1 In referring to a hedge fund management firm, we use the terms “manager” and “adviser” interchangeably.
2 See Advisers Act §202(a)(29). A so-called “3(c)(1) fund” is a fund the securities of which are beneficially owned by less than 100 persons and that is not making and does not propose to make a public offering of its securities. A so-called “3(c)(7) fund” is a fund all the securities of which are owned by “qualified purchasers” and that is not making and does not propose to make a public offering of its securities. See Investment Company Act §§3(c)(1) and 3(c)(7). A “qualified purchaser” includes, among other possibilities, any natural person who owns at least $5 million in investments and any entity that owns and invests on a discretionary basis for its own account or the account of other qualified purchasers at least $25 million in investments. See Investment Company Act §2(a)(51).
3 The founder of a new adviser of course should consult with counsel about the firm’s particular circumstances and potential registration obligations.
4 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). The new investment adviser registration provisions introduced by Dodd-Frank are found in Title IV of the statute, comprising the Private Fund Investment Advisers Registration Act of 2010.
5 Former §203(b)(3) of the Advisers Act.
15 clients and did not hold itself out to the public as an investment adviser. As a result, most hedge fund advisers that had fewer than 15 funds or other accounts under management, regardless of total asset value, did not need to undertake SEC registration.\(^6\) Dodd-Frank’s repeal of this traditional Advisers Act exemption means a hedge fund adviser no longer may decline to register on the basis that it has a limited number of clients.

Second, Dodd-Frank introduced into the Advisers Act a $100 million assets-under-management threshold above which advisers are now presumptively required to register with the SEC. A new hedge fund adviser might reach this threshold early in its life, perhaps even as a result of its initial fund marketing effort at the time of formation.

Finally, while Dodd-Frank added to the Advisers Act a new registration exemption for advisers that have only “private fund” clients — which may be the case for many hedge fund managers — the exemption has a $150 million assets-under-management ceiling.\(^7\)

**ASSETS UNDER MANAGEMENT ARE CENTRAL TO WHETHER SEC REGISTRATION IS REQUIRED**

The Advisers Act as modified by Dodd-Frank features an assets-driven framework for answering the “Do we have to register?” question. This framework is based on the concept of “regulatory assets under management,” or RAUM.

**Regulatory Assets Under Management**

An adviser’s RAUM consists of the value of the

“securities portfolios” with respect to which the adviser provides “continuous and regular supervisory or management services.”\(^8\) The typical hedge fund adviser is providing continuous and regular supervisory or management services to its clients. The question, therefore, is what is meant by “securities portfolios.”

What constitutes a securities portfolio depends on the type of client. For a client that is a private fund (i.e., a 3(c)(1) or 3(c)(7) fund), all of the fund’s assets are deemed to be securities.\(^9\) So, the entire portfolio of a hedge fund normally will be a securities portfolio, no matter its actual composition. For managed account clients, or clients that otherwise are not private funds (including any proprietary account run by the manager), a securities portfolio generally means a portfolio at least 50% of the total value of which consists of securities.\(^10\)

Once a client portfolio has been identified as a securities portfolio, its entire value counts toward the adviser’s RAUM. For RAUM purposes, each securities portfolio must be valued at market value; if market value is not available, fair value may be used instead.\(^11\) The adviser must calculate RAUM on a gross basis — that is, the adviser cannot deduct any outstanding indebtedness or other accrued but unpaid liabilities (including accrued fees or expenses) relating to an account. For example, borrowings to provide trading leverage for a fund would not be deducted from the RAUM attributable to that fund.

**Advisers with RAUM of < $25 million or ≥ $100 million**

The situation of a hedge fund adviser with less than $25 million of RAUM is simple: it may **not** register with

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\(^6\) In general, a hedge fund adviser counts as a “client” each fund it advises, rather than the individual investors in those funds. See Rule 203(b)(3) under the Advisers Act as in effect prior to July 21, 2011; and see Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006), cited in SEC Release No. IA-3060 (Jul. 26, 2010) at n.192.

\(^7\) We discuss this so-called “Private Fund Adviser Exemption” in detail below.

\(^8\) See Instruction 5.b to Form ADV Part 1A.

\(^9\) Id. A private fund’s “assets” include any uncalled capital commitments. This point is more likely to be relevant for a private equity fund than for a typical hedge fund.

\(^10\) Id. The adviser may, but is not required to, treat cash and cash equivalents as securities.

\(^11\) A manager that does not use GAAP or another international accounting standard may rely on another process it uses for calculating fair value, as long as it uses that other process consistently and in good faith.
the SEC.\(^\text{12}\) The situation of a hedge fund adviser with RAUM of $100 million or more is almost as simple: it generally must register with the SEC. The exception to this rule is an adviser with RAUM between $100 million and $150 million that qualifies for the Private Fund Adviser Exemption discussed below.

### “Mid-Sized Advisers”

Dodd-Frank establishes under the Advisers Act a new class of “mid-sized advisers.”\(^\text{13}\) These are advisers with RAUM of at least $25 million but less than $100 million. The applicability of SEC registration requirements to mid-sized advisers is more complex.

#### Mid-Sized Advisers: General Prohibition on SEC Registration

The presumptive rule is that a mid-sized adviser is prohibited from registering with the SEC.\(^\text{14}\) In the general case, therefore, any registration obligation a mid-sized adviser might face would be at the state rather than the SEC level.

#### Mid-Sized Advisers: SEC Registration Despite the General Prohibition

The bar on mid-sized advisers registering with the SEC is not absolute. A mid-sized adviser is required to register with the SEC (absent an available exemption such as the Private Fund Adviser Exemption discussed below) if the adviser’s home state insufficiently regulates it. In addition, a mid-sized adviser may choose SEC registration if the adviser otherwise would be burdened with multiple state registrations.

#### Adviser Insufficiently Regulated by Home State: The prohibition on SEC registration for mid-sized advisers flips to a federal registration requirement if either:

- the mid-sized adviser is “not required to be registered as an investment adviser with the securities commissioner (or any agency or office performing like functions) of the state in which [the adviser] maintains its principal office and place of business;” or
- even if the mid-sized adviser is required to be registered by its home state securities regulator, that state regulator does not “subject [the adviser] to examination as an investment adviser.”\(^\text{15}\)

A mid-sized adviser whose home state law exempts or excludes it from registration is viewed as “not required to be registered” by that state.\(^\text{16}\) Such a manager therefore must register with the SEC unless it can claim a federal exemption such as the Private Fund Adviser Exemption discussed below.

As for whether a mid-sized adviser is “subject to examination” by its home state securities regulator, the SEC maintains a list of states that are deemed not to conduct examinations. The founder of a new manager may be surprised to learn that the current list includes New York.\(^\text{17}\) This means that a hedge fund adviser with its principal office and place of business in New York and RAUM between $25 million and $100 million must register with the SEC unless a federal exemption such as the Private Fund Adviser Exemption is available.

#### Adviser Subject to Registration in 15 or More States

A mid-sized adviser that is registered and examined by its home state (and thus normally could not register with the SEC) may opt into SEC registration if it otherwise would be required to register as an investment adviser in 15 or more states.\(^\text{18}\)

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12 Advisers Act §203A(a)(1). This provision actually states that any adviser — even one with AUM below $25 million — must register with the SEC if it is not “regulated or required to be regulated as an investment adviser” in the state in which it has its principal office and place of business. It thus might seem that a small adviser exempt from registration under applicable state law must register with the SEC. That is not the case, however. Rule 203A-1 interprets “regulated or required to be regulated” to mean simply that a state has enacted an investment adviser statute, regardless whether any particular adviser is required to be registered thereunder. Consequently, if an adviser has less than $25 million of RAUM and is located in a state with an investment adviser statute (Wyoming is the only state without one), the adviser may not register with the SEC.

13 Advisers Act §203A(a)(2).


16 See Instruction 2.b to Form ADV Part 1A.

17 The list of non-examining states is available at [http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm](http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm). Wyoming is the only state listed besides New York.

Mid-Sized Advisers: RAUM Buffer
The SEC has established an RAUM buffer zone for mid-sized advisers. Notwithstanding the $100 million RAUM threshold beyond which SEC registration is generally mandated, a mid-sized adviser not currently registered with the SEC is required to register only when its RAUM equals or exceeds $110 million. Similarly, an adviser that has registered with the SEC because its RAUM equals or exceeds $100 million is required to de-register only if its RAUM falls below $90 million.20

TIMING CONSIDERATIONS IF SEC REGISTRATION IS REQUIRED
If a new hedge fund adviser concludes that it must register under the Advisers Act, how quickly does it need to act? The precise answer will hinge on when the adviser plans to close on subscriptions from investors and sign an investment management agreement with its client(s). Generally speaking, though, prompt action is necessary.

An adviser subject to SEC registration effectively may not enter into an advisory contract with a client fund and commence investment advisory operations until it has registered. Therefore, if a new adviser anticipates registration, it must ensure that the registration process is complete before its client advisory activities begin. Form ADV, which is the SEC’s investment adviser registration form, accommodates registration by a newly-formed adviser that expects to be eligible for registration within the next 120 days. An adviser should budget 45 days from submission of its Form ADV to the receipt of the SEC’s acknowledgment of registration.20

THE PRIVATE FUND ADVISER EXEMPTION FROM SEC REGISTRATION
A hedge fund manager presumptively required to register with the SEC as described above21 may avoid SEC registration if it qualifies for the so-called “Private Fund Adviser Exemption” created under Dodd-Frank.22 We discuss below this exemption’s application to a manager with its principal office and place of business in the United States.23

Requirements for the Exemption: Only Private Fund Clients and RAUM Below $150 million
To be eligible for the Private Fund Adviser Exemption, a manager must:

• act solely as an investment adviser to one or more “qualifying private funds,” meaning one or more 3(c)(1) and/or 3(c)(7) funds; and
• have less than $150 million of total RAUM attributable to those funds.

An adviser is eligible to rely on the Private Fund Adviser Exemption only if its clients are exclusively 3(c)(1) and/or
The Private Fund Adviser Exemption Entails SEC Reporting Obligations

Although a hedge fund manager claiming the Private Fund Adviser Exemption does not register with the SEC, it has public SEC disclosure obligations. This disclosure is made on Part 1A of Form ADV. The Form ADV contains basic information about the adviser’s owners and affiliates, certain business activities that may give rise to conflicts of interest with clients, information about the private funds the adviser manages, and disciplinary information about the firm and its employees.26

A manager must file its Form ADV with the SEC within 60 days of relying on the Private Fund Adviser Exemption and must file an annual updating amendment within 90 days of its fiscal year-end. Among other matters, the year-end update must confirm the manager’s continued eligibility for the Private Fund Adviser Exemption, including confirmation that RAUM remains below $150 million. The manager also may need to file interim amendments to its Form ADV upon the occurrence of specified events.

Maintaining the Private Fund Adviser Exemption

Fluctuations in RAUM between the filing of each annual Form ADV updating amendment do not affect the availability of the Private Fund Adviser Exemption. That is, an adviser may continue to rely on the exemption if its RAUM exceeds $150 million during the course of the year, as long as the RAUM reported in the annual Form ADV updating amendment is back below $150 million.27

If an adviser loses eligibility for the Private Fund Adviser Exemption solely due to RAUM equaling or exceeding $150 million as reported on the adviser’s annual Form ADV update, the adviser has a 90-day grace period from that update to file with the SEC a full Form ADV.
applying for registration. By contrast, there is no grace period for an adviser that has been relying on the Private Fund Adviser Exemption but now plans to accept clients that are not qualifying private funds (e.g., managed account clients); the adviser must become SEC-registered before beginning to advise the new clients.28

WHAT ABOUT STATE LAW?
Our prototypical hedge fund manager also needs to consider applicable state adviser registration and reporting laws and regulations.

SEC-Registered Advisers
No state may require registration by an adviser that is currently registered with the SEC.29 It is possible, however, that an SEC-registered adviser may be required to make notice filings in one or more states in which it has a place of business or clients. The adviser should review the relevant state investment adviser statutes and regulations to determine whether it may have a notice filing obligation.30 In addition, it is important to recognize that while a state may not require registration by an SEC-registered adviser, state authorities do have the right to inspect the adviser for alleged violations of state anti-fraud laws.31

Non-SEC-Registered Advisers
A hedge fund manager not registered with the SEC may be required to register with and/or submit notice filings to one or more state securities regulators. The adviser should consult the investment adviser statutes of the states in which it has a place of business or clients to investigate whether this may be the case. In particular, a manager relying on the Private Fund Adviser Exemption should be aware that using this federal exemption does not affect whether the manager has state registration or notice obligations.

On the following page, Annex A summarizes the registration analysis discussed in this memorandum.

QUESTIONS
Richards Kibbe & Orbe LLP provides counsel to many of the largest U.S. hedge fund managers. We are experienced in guiding new and growing advisers through the SEC registration analysis. If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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# Registration Analysis For U.S. Hedge Fund Managers

<table>
<thead>
<tr>
<th>Location of Manager’s Principal Office and Place of Business</th>
<th>Type of Clients</th>
<th>RAUM</th>
<th>Registration Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any state</td>
<td>Exclusively private funds (i.e., 3(c)(1) and/or 3(c)(7) funds)</td>
<td>&lt; $150 million</td>
<td>Manager may claim Private Fund Adviser Exemption from SEC registration. (Form ADV Part 1A must be filed if exemption claimed.) State registration or notice filings may be required; consult applicable state law.</td>
</tr>
<tr>
<td>Any state</td>
<td>Exclusively private funds (i.e., 3(c)(1) and/or 3(c)(7) funds)</td>
<td>≥ $150 million</td>
<td>SEC registration is required. State notice filings may be required; consult applicable state law.</td>
</tr>
<tr>
<td>Any state except NY or WY</td>
<td>Clients include one or more non-private fund clients (e.g., one or more managed accounts)</td>
<td>≥ $25 million and &lt; $100 million</td>
<td>State registration or notice filings may be required; consult applicable state law. If state registration is not required, SEC registration is required.</td>
</tr>
<tr>
<td>Any state except NY or WY</td>
<td>Clients include one or more non-private fund clients (e.g., one or more managed accounts)</td>
<td>≥ $100 million</td>
<td>SEC registration is permitted up to $110 million of RAUM. SEC registration is required at or above $110 million of RAUM. State notice filings may be required; consult applicable state law.</td>
</tr>
<tr>
<td>NY</td>
<td>Clients include one or more non-private fund clients (e.g., one or more managed accounts)</td>
<td>≥ $25 million</td>
<td>SEC registration is required. State notice filings may be required; consult applicable state law.</td>
</tr>
<tr>
<td>WY</td>
<td>Clients include one or more non-private fund clients (e.g., one or more managed accounts)</td>
<td>&gt; $0</td>
<td>SEC registration is required. State notice filings may be required; consult applicable state law.</td>
</tr>
</tbody>
</table>