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INVESTMENT MANAGEMENT SERVICES

ETF Hedge Fund Registration Primer

One question that often confronts emerging investment managers is whether a private hedge fund that invests primarily in exchange-traded funds ("ETFs") must register with the SEC. Although ETFs themselves are registered investment companies under the Investment Company Act of 1940, a private fund investing in ETFs is subject to a different regulatory framework. The registration analysis depends not on the securities being purchased, but on the structure of the fund, the manner in which interests are offered, the characteristics of the investors, and whether the investment adviser qualifies for an exemption under the Investment Advisers Act of 1940. This primer provides a high-level overview of the registration requirements that generally apply to managers forming a private ETF hedge fund.

Can private hedge funds invest exclusively in ETFs without registering as an investment company?

Yes. Although ETFs are themselves registered investment companies, a private hedge fund investing exclusively in ETFs generally does not become a registered investment company merely because of the assets it holds. Instead, most hedge funds rely on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940. Section 3(c)(1) generally applies to funds with no more than 100 beneficial owners that do not publicly offer their securities, while Section 3(c)(7) applies to funds whose investors are exclusively qualified purchasers and that likewise avoid a public offering. As long as the fund satisfies one of these statutory exclusions, it may remain an unregistered private investment company despite investing solely in publicly traded ETFs.

How are interests in the hedge fund typically offered?

Private hedge funds generally raise capital through a private placement rather than a public offering. Most managers rely on Rule 506(b) or Rule 506(c) of Regulation D under the Securities Act of 1933. Rule 506(b) permits offerings without general solicitation, while Rule 506(c) allows general solicitation provided that every investor is an accredited investor whose status has been verified by the issuer. Regardless of the exemption selected, the fund will typically file a Form D with the SEC after the first sale of securities and comply with applicable state notice filing requirements.

Does the investment adviser have to register with the SEC?

Not necessarily. Registration of the investment adviser is governed separately under the Investment Advisers Act of 1940. Many first-time hedge fund managers qualify for the private fund adviser exemption under Section 203(m), which generally exempts advisers that advise only private funds and maintain less than $150 million in regulatory assets under management in the United States. Advisers relying on this exemption typically become Exempt Reporting Advisers ("ERAs"), meaning they file limited portions of Form ADV but are not fully registered investment advisers. Once the adviser exceeds the applicable regulatory thresholds or otherwise becomes eligible for SEC registration, full registration under the Advisers Act generally becomes required unless another exemption applies.

Does investing only in ETFs change the registration analysis?

Generally, it does not. The federal securities laws focus primarily on the structure of the fund and the activities of the investment adviser rather than the particular securities held in the portfolio. Whether a hedge fund invests in individual stocks, bonds, ETFs, or other publicly traded securities, the same statutory exemptions generally govern whether the fund must register under the Investment Company Act and whether the adviser must register under the Advisers Act. Nevertheless, managers should ensure that their offering documents accurately disclose the fund's ETF-focused investment strategy, including any anticipated use of leverage, derivatives, concentrated sector allocations, or other investment risks associated with exchange-traded funds.

What obligations arise if the adviser registers with the SEC?

Registration as an investment adviser carries substantial compliance obligations. A registered investment adviser must adopt written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, designate a Chief Compliance Officer, maintain extensive books and records, comply with the SEC's Marketing Rule and Code of Ethics requirements, and submit annual amendments to Form ADV. Depending on the size and structure of the adviser, additional reporting obligations, including Form PF, may also apply. Registered advisers should also expect periodic SEC examinations and ongoing oversight of their compliance program.

What other regulatory issues should new ETF hedge fund managers consider?

Beyond registration, managers should carefully consider the structure of their offering documents, subscription materials, and investor qualification procedures. Most private funds adopt comprehensive anti-money laundering and know-your-customer procedures, obtain appropriate investor representations regarding accredited investor or qualified purchaser status, and prepare detailed disclosures addressing investment risks, fees, conflicts of interest, and valuation policies. If the fund anticipates using leverage, options, futures, or other derivatives in conjunction with its ETF strategy, those practices should likewise be clearly described in the governing documents to ensure that investors receive full and fair disclosure.

Should a new ETF hedge fund manager register immediately?

For many emerging managers, immediate SEC registration is unnecessary. A newly formed adviser that manages only private funds and remains below the applicable assets-under-management threshold can often operate as an Exempt Reporting Adviser while developing its business. As assets under management increase or institutional investors begin requiring registration as a condition to investment, full SEC registration may become advantageous or mandatory. Ultimately, the decision depends on the manager's anticipated fundraising strategy, projected growth, investor base, and long-term business objectives.

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