WINSTON & STRAWN LLP

BLOG

Form ADV Registration Considerations; Form ADV and Form PF Reporting Considerations (Part II)

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In our previous post, we discussed whether a **non-private fund** account (*e.g.*, a "managed account") that holds crypto assets should be included in an SEC-registered investment adviser's RAUM by virtue of being a "securities portfolio," that is, an account at least 50% of the total value of which consists of securities and cash and cash equivalents (and over which the adviser provides continuous and regular supervisory or management services) (the 50% Test).

In this post, we will discuss how an SEC-registered investment adviser should treat the assets in a "private fund" managed by such investment adviser for purposes of calculating the adviser's RAUM. A "private fund" is a fund that would be an investment company as defined in Section 3 of the Investment Company Act (ICA) but for the exclusion from that definition provided by Section 3(c)(1)[1] or 3(c)(7)[2] of the ICA.

Background

Under Section 3(a) of the ICA, an investment fund will be considered an "investment company," and must register as such under the ICA (unless an exclusion from the definition of "investment company"—such as that provided by Section 3(c)(1) or Section 3(c)(7) of the ICA—or an exemption from registration, is available), if the investment fund:

- is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; or
- is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire "investment securities"[3] having a value exceeding 40 per centum of the value of such fund's total assets (exclusive of Government securities (as defined in the ICA) and cash items) on an unconsolidated basis.

Under Item 5.b.(1) to the Instructions to Part 1A of Form ADV, **an adviser must treat all of the assets of a "private fund"**—that is, any fund that would be an investment company as defined in Section 3 of the ICA but for Section 3(c)(1) or 3(c)(7) of the ICA—**as a "securities portfolio," regardless of the nature of such assets.**

Thus, “private funds” managed by an adviser are not subject to the 50% Test for purposes of determining whether they are “securities portfolios” – they automatically qualify as “securities portfolios,” and their entire value is therefore included in the adviser’s RAUM.

When Is a Private Fund a Private Fund?

But what if an adviser to an investment fund operates the fund in a manner that complies with Section 3(c)(1) or Section 3(c)(7) of the ICA precisely because the adviser, in light of the current regulatory uncertainties regarding the nature of crypto assets, doesn’t want to get into the messy business (see When Is a Crypto Asset a “Security,” and Why Does That Matter? (Part I)) of determining which of the fund’s asset are “securities” and which are not?

That is, the adviser to a crypto asset fund might say: I am going to invest the fund’s assets in all types of crypto assets that I find to be good investment opportunities, without regard to whether they are “securities,” but I don’t want to inadvertently trigger the requirement to register the fund under the ICA, so I will “pre-emptively” design the fund to operate in accordance with Section 3(c)(1) or Section 3(c)(7).

This is a legitimate approach. The SEC recently settled an enforcement action against the manager of a crypto fund in a situation where more than 40% of the fund’s portfolio consisted of crypto assets that the SEC found to be securities but the fund was not structured to rely on Section 3(c)(1) or Section 3(c)(7). *See In the Matter of Crypto Asset Management, LP and Timothy Enneking*, Investment Company Act (ICA) Release No. 33222 (Sept. 11, 2018).

But what if, at any given point in time, the bulk of the fund’s assets consist of crypto assets that are not securities, such that, at that given point in time, the fund has no need to rely on Section 3(c)(1) or Section 3(c)(7)?

In that case, is the fund a “private fund” at that time, such that all of its assets should be included in the adviser’s RAUM?

Or should the fund be treated like an ordinary account that is subject to the 50% test—which effectively means that the adviser will, contrary to its desire, need to engage in the messy business of determining which of the fund’s assets are “securities” and which are not?

After all, it is arguable that, at the relevant time, the fund is not an investment company **but for** Section 3(c)(1) or 3(c)(7), but is simply not an investment company at all.

There is are no clear answers to these questions at this time.

Nonetheless, one would think that, from an enforcement perspective, the SEC would not initiate an enforcement action against an adviser who:

- in good faith structures a fund to rely on Section 3(c)(1) or 3(c)(7) because the adviser is not sure what the composition of the assets of the fund will be at any particular point in time (that is, the adviser legitimately fears that the fund could “tip” from time to time from being an investment company to not being an investment company, and vice versa, because of changes in the nature of its assets from time to time); and
- includes all of the assets of such fund in its RAUM, regardless of the nature of such assets at any given point in time.

Only time will tell.

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[1]Briefly, Section 3(c)(1) excepts from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons (250 persons in the case of certain qualifying venture capital funds), exclusive of “knowledgeable employees” as defined in Rule 3c-5 under the ICA) and that is not making and does not at that time propose to make a public offering of such securities.

[2]Briefly, Section 3(c)(7) excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" (as defined in Section 2(a)(51) of the ICA and the rules and regulations thereunder) or "knowledgeable employees" (as defined in Rule 3c-5 under the ICA) and that is not making and does not at that time propose to make a public offering of such securities.

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[3]Under Section 3(a)(2), an "investment security" is any security, with certain exceptions not relevant to this discussion.

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