

Legal Steps to Establish a Hedge Fund in the U.S.

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KEY TAKEAWAYS

- Setting up a hedge fund in the U.S. involves forming a business entity for both the fund and the investment manager.
- Register the hedge fund with the SEC and become a Registered Investment Adviser to comply with regulations.
- Hiring a qualified hedge fund attorney is crucial to navigate regulatory hurdles and to establish legitimacy.
- Marketing to accredited investors is permitted under the JOBS Act, which allows greater flexibility in fundraising.
- Choosing your state of incorporation wisely can provide legal and financial advantages; Delaware is a popular choice.

The United States offers one of the best business environments in the world to start a hedge fund, which is a private investment entity that uses various strategies to generate returns for its investors. Indeed, the industry is given generous tax breaks and has grown to over a trillion dollars in assets under management (AUM) as of 2020. Given the growth and popularity of the hedge fund industry, here are the general steps for establishing a U.S.-based hedge fund that checks off all of the regulatory boxes.

Understanding Hedge Funds

The term hedge fund refers to any type of private investment company that is operating under certain exemptions from registration requirements under the Securities Act of 1933 and the Investment Company Act of 1940.¹ (Ironically, hedge funds may use investment strategies that have nothing to do with hedging.) Given these exemptions, it is much easier to start a hedge fund firm than a firm that manages more highly regulated investment options such as mutual funds.² The relaxed restrictions for hedge funds have helped bolster the growth of the hedge fund industry.

Filing Articles of Incorporation for Your Hedge Fund

In order to start a hedge fund in the United States, two business entities typically need to be formed. The first entity is created for the hedge fund itself and the second entity is created for the hedge fund's investment manager. The hedge fund is typically set up as either a limited partnership (LP) or limited liability corporation (LLC). In comparison, a general investment manager can set up any type of business structure that meets the needs of the investment manager. In most cases, hedge funds are formed as limited partnerships, in which the investment advisor or adviser acts as the primary partner, and an incorporated group of investors acts as the secondary partner.

Contact the secretary of state in the state where you plan to incorporate your firm for guidance about hedge fund business structures. Regardless of the physical location of the firm, many hedge funds incorporate in Delaware because of its business-friendly laws. However, other states have introduced business-friendly provisions to help make their states more competitive with Delaware.³ Choose your best state for incorporation.

Once the proper business structure has been determined for the hedge fund firm, name the fund and begin using the name to complete the necessary legal paperwork. In addition, the new firm will need to apply for a Federal Employer Identification Number (FEIN) with the Internal Revenue Service. An FEIN number can be obtained for free by applying online through the IRS website, or by filling out IRS Form SS-4.⁴ With this information, complete the state articles of incorporation. In the United States, companies can be formed in a very short period of time and with a minimal amount of money.

Drafting Corporate Bylaws for Your Hedge Fund

In today's more regulated hedge fund environment, representatives for the new hedge fund firm will likely want to complete a host of documents in order to move forward with incorporation, register with the U.S. Securities and Exchange Commission (SEC), and register with the regulatory bodies in the state of incorporation.

The level of documentation and regulatory compliance will depend upon the type of hedge fund strategy the firm plans to use. At a minimum, the hedge fund firm's bylaws should include a mission statement, a compliance manual, an ethical code of conduct, a manual for supervisory procedures, and an advisor portfolio management agreement.

Registering as an Investment Adviser

In order to establish a legal partnership, the company must register as an investment adviser. Do this by going to the Investment Adviser Registration Depository (IARD) website. This process is free and can be completed over the Internet.⁵

A Registered Investment Adviser (RIA) is a firm that advises high-net-worth individuals on investments and manages their portfolios.⁶ RIAs have a fiduciary duty to their clients, which means they have a fundamental obligation to provide investment advice that always acts in their client's best interests.

Getting Hedge Fund Representatives Registered as Investment Advisers

If the hedge fund is going to operate as a going concern, some of its representatives will likely need to register as an investment advisor or adviser with the U.S. Securities and Exchange Commission. Representatives can register as the investment advisor by visiting the IARD website. Representatives can also check with the secretary of state in the state of incorporation for more information.

In order to register as an investment advisor, the representatives will need to take the Financial Industry Regulatory Authority (FINRA) Series 65 regulatory exam, which will test the representatives' knowledge of securities laws and practices, as well as their understanding of ethics. After passing the exam, the representatives will be licensed investment advisers with the state. The fee to take the FINRA Series 65 exam is relatively inexpensive.

SEC Registration for Hedge Fund Offerings

The hedge fund will also need to register the offering of the limited partnership with the SEC. Whereas corporations offer stock and LLCs offer memberships, limited partnerships offer interests. To register the hedge fund with the SEC, complete SEC Form D in each state in which the hedge fund will be offered.

This offering will name the key partners in the firm, as well as identify large investors and the fund's primary investment strategy and investment approach.

Navigating Consumer Protection Compliance

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, hedge fund managers are subject to registration and reporting requirements. However, if the manager has less than \$25 million dollars in assets under management, the manager is not eligible for SEC registration and must look to the laws of the adviser's home state to determine registration and licensing requirements.

Advisers registered in their home state can avoid SEC registration until they reach \$100 million dollars in assets under management.⁸ Once they reach this level, hedge fund managers will need to complete Form ADV, which 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.

If the manager registers with the SEC as an investment adviser, the representative will need to complete SEC Form PF if the hedge fund has at least \$150 million dollars in private fund assets under management. SEC Form PF is a comprehensive document that will take a fair amount of time to complete and requires a fee for filing.

Hiring good legal counsel is an investment. An experienced hedge fund lawyer can help you avoid pitfalls and build relationships and bring you into networking events such as private-capital introduction dinners.

It will also show others in the industry that you are investing in your own business because you aim to be in the industry for the long haul.

Strategies for Marketing Your Hedge Fund to Investors

The rules that govern the marketing activities for hedge funds have changed as a result of the Jumpstart Our Business Startups Act of 2012 (JOBS Act).¹¹ As a result of these changes, hedge fund managers have greater flexibility in marketing their hedge funds to potential investors. In the United States, hedge funds can be legally marketed to investors who satisfy certain standards of sophistication.¹²

In addition, hedge funds can be marketed to the general public, provided all purchasers are accredited investors and certain other conditions are met. According to the SEC, an issuer cannot rely on both Rule 506(b) and Rule 506(c) in the same offering, except in the case of a limited transition provision.

The Bottom Line

The complexity of starting a hedge fund firm is dependent upon the number of investors invested in the fund, the value of assets under management, and the complexity of the hedge fund's strategy for investors. There are a few hoops and hurdles to establishing a hedge fund firm in the United States, but these are easily understood. The greater challenge will be raising the necessary investment capital to operate the hedge fund firm as a going concern, and generating consistent hedge fund investment returns that outperform their representative benchmark proxy on a net-of-fee basis over time.