

Torys on Private Equity

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Investing Entities with U.S. Equity Holders May Be Required to Register with SEC

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The Hedge Fund Transparency Act would require many private equity funds, hedge funds and other investing entities (including those formed in Canada) with equity holders in the United States to register with the Securities and Exchange Commission and be subject to other disclosure in order to avoid being required to become registered investment companies in the United States. This bill, which was introduced on January 29, 2009 by Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan), is currently being considered by the U.S. Senate.

This bill has received much media attention, given its potential implications (including its application to investing entities other than hedge funds, despite the bill's title) and broad application to companies both in the United States and outside the country.

The entities affected by this bill would be those that are currently not required to register as an investment company under the U.S. Investment Company Act of 1940, as amended, by relying on exceptions in Section 3(c)(1) (i.e., issuers with outstanding securities owned by no more than 100 persons and that are not making a public offering) and/or Section 3(c)(7) (i.e., issuers with outstanding securities owned by qualified purchasers and that are not making a public offering) ("the exception sections").

Investment Company Act

The Investment Company Act generally requires registration of an issuer (defined as a person who issues or proposes to issue any security or has outstanding any security that it has issued) that (i) holds itself out as being engaged or proposes to engage primarily in the business of investing, reinvesting or trading in securities; or (ii) 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 (which excludes government securities and securities issued by majority-owned subsidiaries that are not investment companies and that do not themselves rely on the exception sections) having a value exceeding 40% of the value of the issuer's total assets (excluding cash) on an unconsolidated basis.

Even if an issuer meets those criteria, it could still currently avoid the requirement to register by relying on exceptions such as Section 3(c)(1) and/or Section 3(c)(7). Note that although there are other exceptions, those set forth in the exception sections are the most common. For example, most private equity funds rely on the exception sections to avoid having to register as an investment company.

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Implications of the Bill's Adoption

In essence, the bill would recharacterize the exception sections as exemptions (but otherwise keep the language in substantially the same form); however, to avail itself of such exemptions from registration as an investment company, an issuer with assets, or assets under management, of \$50 million or more would be required to


- register with the SEC (in a form yet to be prescribed);
- file a detailed information form electronically at least annually to be made available to the public, which would include the current value of the issuer's assets, an explanation of the issuer's ownership structure and disclosure of each person with an ownership interest in the issuer;¹
- maintain such books and records as the SEC may require; and
- cooperate with the SEC regarding any request for information or examination.

In addition, as a condition of relying on either exemption, the issuer (regardless of its size) would be required to establish an anti-money-laundering program within one year of the bill becoming law.

Status of the Bill

At this point, the bill has been referred to the U.S. Senate Committee on Banking, Housing, and Urban Affairs. Therefore, it is premature to speculate on what the law, if ultimately adopted, may look like. It is noteworthy that a similar version of this bill was introduced two years ago by Senator Grassley but was never considered by Congress. However, since the economic world and political climate has changed dramatically since then, the bill may have greater support now.

If the bill is adopted in its current form, any companies previously relying on the exception sections should consider working with counsel to update their analysis of the Investment Company Act and its application to them to ensure that no other exceptions or exemptions are applicable.

We are continuing to follow the passage of this bill and will keep you apprised of developments. In the interim, please feel free to let us know if you have any questions or if further discussion would be helpful. 

¹ Despite the bill's broad language, in a joint statement on February 5, 2009, Senators Grassley and Levin said, "The bill requires disclosure of a hedge fund's beneficial owners, who profit from the fees generated in operating the fund," but would not require the disclosure of the names of outside owners (e.g., third party limited partners in a private equity fund).