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# Advisory

July 18, 2003

## SECURITIES LAW

### Safe Harbor From Definition of "Investment Company"

On June 16, 2003, the Securities and Exchange Commission (SEC) adopted new Rule 3a-8 (the "Rule") under the Investment Company Act of 1940 (the "Act"). The Rule provides a non-exclusive safe harbor from the definition of an "investment company" under the Act for certain *bona fide* research and development companies ("R&D Companies").<sup>1</sup> The Rule updates and codifies the analysis set forth in an order issued by the SEC to the ICOS Corporation in 1993.<sup>2</sup> Under the Rule, a company is eligible to rely on a non-exclusive safe harbor from being defined as an investment company if it:

- has research and development expenses that are a substantial percentage of its total expenses for its last four fiscal quarters combined and that equal at least half of its net-income derived from investments in securities for that period;
- has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined;
- makes its investments in securities to conserve capital and liquidity until it uses the funds in its primary business (so-called "capital preservation investments"), and its non-capital preservation investments are either (a) no more than 10 percent of the company's total assets or (b) no more than 25 percent of the company's total assets, provided that at least 75 percent of the company's non-capital preservation investments were made pursuant to collaborative research and development arrangements;
- is primarily engaged, directly or through a company or companies that it controls primarily, in a non-investment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development;
- has a resolution adopted by its board of directors stating that the company is primarily engaged in a non-investment business; and
- has a written investment policy adopted by its board of directors with respect to its capital preservation investments which assures the company's funds are invested consistent with the goals of capital preservation and liquidity.

<sup>1</sup> *Final Rule: Certain Research and Development Companies*, Release No. IC-26077. If you would like to review the full text of the release, it may be found at <http://www.sec.gov/rules/final/ic-26077.htm>. In addition, attached as Appendix A to this Advisory is the full text of Rule 3a-8 as adopted.

<sup>2</sup> ICOS Corp., Investment Company Act Release Nos. 19274 (Feb. 18, 1993) and 19334 (Mar. 23, 1993) (the "ICOS Order").

## Background of the Rule

The Rule is intended to provide R&D Companies greater flexibility in investing capital, as well as to clarify the rules regarding investments in other R&D Companies pursuant to collaborative research and development arrangements. The need for the Rule stems from the broad definitions of “investment company” under the Act. Included among the definitions of investment company is Section 3(a)(1)(C) of the Act, which defines as an investment company any issuer that 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 having a value exceeding 40 percent of the value of its total assets on an unconsolidated basis. Because of the nature of research and development, and the costs and expenses associated with that activity, an R&D Company could inadvertently fall within the definition of investment company under the Act, forcing the company to follow its stringent and costly regulatory requirements or face severe consequences.

In the absence of SEC rulemaking, R&D Companies have been forced to rely on the ICOS Order when analyzing whether they had inadvertently qualified as an investment company.<sup>3</sup>

Under the ICOS Order, if a company is able to demonstrate that it was actively engaged in *bona fide* research and development activities, the SEC would consider the *use* of the company’s assets, rather than simply the *composition* of the company’s assets and income as in the analysis required under the Act, to determine whether its “primary” business was non-investment oriented. Assuming certain factors were satisfied, the SEC would then examine the company’s historical development, its public representations of policy, and the activities of its officers and directors to conclude whether the company was engaged primarily in a non-investment business. In order to provide companies with greater clarity and flexibility, Rule 3a-8 updates and codifies the ICOS order.

## Discussion of Rule 3a-8

Under the adopted regulatory safe harbor, companies are no longer subject to the uncertainty associated with a non-binding comparison of their circumstances with the factors delineated in the ICOS Order. Instead, a company is eligible to rely on the Rule 3a-8 non-exclusive safe harbor if the following conditions are met:

- The company’s research and development expenses<sup>4</sup> for its last four

fiscal quarters combined are a substantial percentage<sup>5</sup> of its total expenses for that period. The Rule does not define what qualifies as a “substantial percentage,” but in its release the SEC observed that if research and development expenses are the majority of expenses, other than non-recurring items or unusual fluctuations in recurring items, the expenses certainly would qualify as “substantial.”

- The company’s net-income<sup>6</sup> derived from investments in securities<sup>7</sup> for its last four fiscal quarters combined does not exceed twice the amount of its research and development expenses for the same period. This represents a relaxation of the requirement under the ICOS Order, under which an R&D Company was expected to spend more on research and development than its gross investment income.
- The company has spent no more than five percent of its total expenses for its last four fiscal quarters combined on investment related expenses. Such expenses include investment advisory and management activities, investment research and selection, and supervisory and custodial fees, including investment advisory fees paid to an outside advisor.

<sup>3</sup> For a more detailed discussion of the ICOS order, which is still available to be used as an exemption, kindly see our January 15, 2003 Advisory entitled *SEC Proposes Safe Harbor from Definition of “Investment Company” for Certain Research and Development Companies*, which may be found at the following link: <http://www.mintz.com/images/dyn/publications/SECAdvisory1-15-03.pdf>.

<sup>4</sup> Research and development expenses generally include costs incurred for materials, equipment, facilities, personnel, and intangible and indirect costs that are clearly related to research and development activities. See *Accounting for Research and Development Costs*, Statement of Financial Accounting Standards No. 2 (FASB 1974) at p. 11.

<sup>5</sup> The percentages described under the Rule are determined on an unconsolidated basis, except that the company is required to consolidate its financial statements with the financial statements of any wholly-owned subsidiaries.

<sup>6</sup> For purposes of this Rule, net-income is to be interpreted consistently with Rule 3a-1 of the Act. Rule 3a-1 calculates net-income on an unconsolidated basis, except that the issuer must consolidate its financial statements with any wholly-owned subsidiaries. The Rule also implicitly requires that a company match its investment expenses with investment income to ensure that only income or loss generated by investment activities are compared to the company’s total net-income.

<sup>7</sup> Investments in securities is defined to mean all securities other than securities issued by majority-owned subsidiaries and companies controlled primarily by the issuer that conduct similar types of businesses, through which the issuer is engaged primarily in a business other than that of investing, reinvesting, owning, holding or trading in securities.

- The company’s investments in securities must be capital preservation investments, with certain limited exceptions related to collaborative research and development arrangements, as described below. Under the Rule, capital preservation investments are defined as investments that are “made to conserve capital and liquidity until the funds are used in the issuer’s primary business or businesses.” Capital preservation investments should be liquid so they can be readily sold to support the company’s research and development activities as needed. The investments should present limited credit risk to ensure that they are being used to support the company’s research and development activities rather than being used in a speculative manner characteristic of an investment company. Consistent with the ICOS Order, the Rule does not limit the amount of a company’s permitted capital preservation investments relative to the company’s total assets, nor does the Rule specify the particular type of capital preservation investment that would be acceptable. **However, in order to take advantage of this safe harbor, the new Rule now requires the board of directors of the R&D Company to adopt a written investment policy with respect to its capital preservation investments, to assure the company’s funds are invested consistent with the goals of capital preservation and liquidity.** Please contact the Mintz Levin attorney who handles your corporate and securities law matters for assistance in assembling such a policy.
- The company must be primarily engaged, directly or through a company or companies it controls, primarily in a non-investment business. The activities of the company’s

officers, directors and employees, its public representations of policies, and its historical development must all demonstrate that it is primarily engaged in a business or businesses other than investing, reinvesting, owning, holding or trading in securities.

- In addition to adopting a written investment policy, the company’s board of directors must also adopt an appropriate resolution stating that the company is primarily engaged in a non-investment business in order to rely on the new Rule’s safe harbor.

### **Collaborative Research and Development Arrangements**

As noted above, under the Rule, R&D Companies must limit their investments in securities to capital preservation investments, with certain exceptions. The exceptions have been written into the Rule to allow R&D Companies some flexibility to acquire equity stakes in other companies that could advance their strategic or business goals, and to continue to enter into collaborative research and development arrangements with other companies, as long as one of two alternatives have been followed:

- The company would be permitted to acquire investments that are not capital preservation investments, provided that no more than 10 percent of the company’s total assets consist of such non-capital preservation investments; or
- The company would be permitted to have a larger “basket” of non-capital preservation investments of no more than 25 percent of its total assets, so long as at least 75 percent of those investments were made pursuant to collaborative research and development arrangements.

The percentage limits under both alternatives are applicable at all times that an R&D Company seeks to rely on the Rule (as opposed to only being applicable at the time new investments are made). In addition, for purposes of this test, the investment assets are to be valued in accordance with Section 2(a)(41)(A) of the Act, meaning (i) with respect to securities for which market quotations are readily available, the market value of those securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.

Under the requirements of the second alternative, the proposed Rule defines an investment in a “collaborative research and development arrangement” as an “investment in an investee made pursuant to a business relationship which (i) is designed to achieve narrowly focused goals that are directly related to, and an integral part of, the issuer’s research and development activities; (ii) calls for the issuer to conduct joint research and development activities with the investee or a company controlled primarily by, or which controls primarily, the investee; and (iii) is not entered into for the purpose of avoiding regulation under the Act.” In its release, the SEC observed that mere licensor-licensee type relationships lack a sufficient nexus to the licensor’s primary business to fall within the meaning of a collaborative research and development arrangement for purposes of this Rule.

**Rule 3a-8 will become effective on August 19, 2003.**

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*Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions regarding this information.*

## Appendix A:

### Sec. 270.3a-8 – Certain research and development companies.

- a) Notwithstanding sections 3(a)(1)(A) and 3(a)(1)(C) of the Act [15 U.S.C. 80a-3(a)(1)(A) and 80a-3(a)(1)(C)], an issuer will be deemed not to be an investment company if:
- 1) Its research and development expenses, for the last four fiscal quarters combined, are a substantial percentage of its total expense for the same period;
  - 2) Its net income derived from investments in securities, for the last four fiscal quarters combined, does not exceed twice the amount of its research and development expenses for the same period;
  - 3) Its expenses for investment advisory and management activities, investment research and custody, for the last four fiscal quarters, combined, do not exceed five percent of its total expenses for the same period;
  - 4) Its investments in securities are capital preservation investments, except that:
    - i) no more than 10 percent of the issuer's total assets may consist of other investments, or
    - ii) no more than 25 percent of the issuer's total assets may consist of other investments, provided that at least 75 percent of such other investments are investments made pursuant to a collaborative research and development arrangement;
  - 5) It does not hold itself out as being engaged in the business of investing, reinvesting or trading in securities, and it is not a special situation investment company;
  - 6) It is primarily engaged, directly, through majority-owned subsidiaries, or through companies which it controls primarily, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, as evidenced by:
    - i) the activities of its officers, directors and employees;
    - ii) its public representations of policies;
    - iii) its historical development; and
    - iv) an appropriate resolution of its board of directors, which resolution or action has been recorded contemporaneously in its minute books or comparable documents; and
  - 7) Its board of directors has adopted a written investment policy with respect to the issuer's capital preservation investments.
- b) For purposes of this section:
- 1) All assets shall be valued in accordance with section 2(a)(41)(A) of the Act [15 U.S.C. 80a-2(a)(41)(A)];
  - 2) The percentages described in this section are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries;
  - 3) Board of directors means the issuer's board of directors or an appropriate person or persons performing similar functions for any issuer not having a board of directors;
  - 4) Capital preservation investment means an investment that is made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses;
  - 5) Controlled primarily means controlled within the meaning of section 2(a)(9) of the Act [15 U.S.C. 80a-2(a)(9)] with a degree of control that is greater than that of any other person;
  - 6) Investment made pursuant to a collaborative research and development arrangement means an investment in an investee made pursuant to a business relationship which:
    - i) is designed to achieve narrowly focused goals that are directly related to, and an integral part of, the issuer's research and development activities;
    - ii) calls for the issuer to conduct joint research and development activities with the investee or a company controlled primarily by, or which controls primarily, the investee; and
    - iii) is not entered into for the purpose of avoiding regulation under the Act;
  - 7) Investments in securities means all securities other than securities issued by majority-owned subsidiaries and companies controlled primarily by the issuer that conduct similar types of businesses, through which the issuer is engaged primarily in a business other than that of investing, reinvesting, owning, holding, or trading in securities;
  - 8) Other investment means an investment in securities that is not a capital preservation investment; and
  - 9) Research and development expenses means research and development expenses as defined in FASB Statement of Financial Accounting Standards No. 2, Accounting for Research and Development Costs, as currently in effect or as it may be subsequently revised.