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SECURITIES LAW

SEC Proposes Safe Harbor from Definition of "Investment Company" for Certain Research and Development Companies

On November 26, 2002, the Securities and Exchange Commission (SEC) issued proposed Rule 3a-8 under the Investment Company Act of 1940, as amended (the "Act"), designed to provide a non-exclusive safe harbor from the definition of investment company for certain *bona fide* research and development companies ("R&D Companies").¹ The proposed rule would update and codify the analysis set forth in the SEC order issued to the ICOS Corporation in 1993.² The proposed rule stems from a recent petition for rulemaking from the Biotechnology Industry Organization (BIO) asking the SEC to update and clarify its interpretations relating to biotechnology companies under the Act.³ To summarize, under the proposed rule a company would be 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 investment revenues 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 to conserve capital and liquidity until it uses the funds in its primary business, subject to certain exceptions (described below); and
- is primarily engaged, directly or through majority-owned subsidiaries or one or more 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.

¹ *Proposed Rule: Certain Research and Development Companies*, Release No. IC-25835. If you would like to review the full text of the proposed rule, it can be found at <http://www.sec.gov/rules/proposed/ic-25835.htm>.

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

³ The petition can be found at <http://www.sec.gov/rules/petitions/petn4-457.htm>.

Objectives of New Proposal

The proposed 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” in 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. The calculation of a company’s total assets does not include cash or U.S. government securities, which may represent a significant proportion of an R&D Company’s capital. The Act defines investment securities to include all securities except government securities, securities issued by employees’ securities companies and securities issued by majority-owned subsidiaries of the issuer which are not investment companies.⁴ In addition, the value of a non-controlling equity stake that one R&D Company has purchased in another R&D Company as part of a collaboration agreement would be included in the measurement above. Further, research and development expenses, even those connected to the development

of “intellectual capital,” are not recognized as assets on balance sheets prepared in accordance with Generally Accepted Accounting Principles (GAAP).⁵ So, based on the methods of calculation required by the Act and the application of GAAP, R&D Companies are at risk of inadvertently falling within the definition of an investment company.

An R&D Company may face severe consequences if it inadvertently meets the definition of an investment company under the Act. Due to the severe penalties under the Act for an unregistered investment company, a company that does not have available any exemption or exception is effectively required to register under the Act and become subject to its regulatory control. Otherwise, the company cannot engage in interstate commerce or sell its securities, and its contracts may be deemed unenforceable, among other penalties. There are also severe criminal penalties for willful violation of any provision of the Act. Once a company is registered, it must comply with the stringent requirements of the Act, including following the Act’s restrictions on capital structure, restrictions on the issuance of warrants, options and other equity incentives commonly used to attract employees, limitations on the ability to borrow, and limitations on the composition of its board of directors.

If a company meets the definition of an investment company, it nevertheless may be temporarily exempted from registration under the Act by

virtue of the one-year “safe harbor” for a transient investment company set forth in Rule 3a-2 under the Act. Because it is a temporary exemption, this safe harbor is insufficient for most R&D Companies that may inadvertently qualify as an investment company. Beyond this temporary “safe harbor,” the Act also provides, in Section 3(b)(i), an exception to the definition of investment company if a company is primarily engaged, directly or through wholly-owned subsidiaries, in a business other than that of investing, reinvesting, owning, holding or trading in securities. It is difficult, however, to determine whether a non-investment business is “primary,” especially for R&D Companies that often raise, and must invest, large amounts of capital in preparation for future research and development expenses. The SEC addressed this issue for R&D Companies in the ICOS Order.

The ICOS Order

In the absence of SEC rulemaking, R&D Companies currently rely on the ICOS Order when analyzing whether they have inadvertently qualified as an investment company. The ICOS Order sets forth various factors to determine the primary business of an R&D Company and represents the current state of the law. Under the ICOS Order, if a company demonstrates that it is actively engaged in *bona fide* research and development activities, the SEC would consider the *use* of the company’s assets, rather than simply the

⁴ “Government security” is defined in the Act to include any security issued or guaranteed as to the principal or interest by the United States; “employees’ securities company” is defined in the Act to mean an investment company owned by employees of a company; and “majority-owned subsidiary” of an issuer is defined to mean a company of which 50 percent or more of the outstanding securities are owned by the issuer or by a majority-owned subsidiary of the issuer.

⁵ Under GAAP, costs of self-developed intangible assets, generally, and research and development expenses for “intellectual assets,” in particular, are charged to expense when incurred.

composition of the company's assets and income as in the traditional analysis, to determine whether its "primary" business is noninvestment-oriented. The SEC currently focuses on the following factors under the ICOS Order: (i) whether the company uses its securities and cash to finance its research and development activities; (ii) whether the company has substantial research and development expenses and insignificant investment-related expenses; and (iii) whether the company invests in securities in a manner that is consistent with the preservation of its assets until needed to finance operations. Assuming these 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 determine whether the company was engaged primarily in a non-investment business. In order to provide greater clarity, the proposed rule updates and codifies the ICOS order.

The Proposed Rule

Under the proposed regulatory safe harbor, companies would no longer be subject to the uncertainty associated with a non-binding comparison of their circumstances with the factors delineated in the ICOS Order. Instead, a company would be eligible to rely on the proposed rule's non-exclusive safe harbor under the following conditions:

- The company's research and development expenses⁶ for its last four fiscal quarters combined are a substantial percentage⁷ of its total expenses for that period. The proposed rule does not define what qualifies as a "substantial percentage," but 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 revenues from investments in securities⁸ do not exceed twice the amount of its research and development expenses. For purposes of the proposed rule, investment revenues would include all investment returns, including amounts earned from dividends, interest on securities, and profits on securities (net of losses). This represents a relaxation of the requirement under the ICOS Order, under which an R&D Company is 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.
- The company's investments in securities must be capital preservation investments, with certain limited exceptions related to collaborative research and development arrangements. Under the proposed rule, capital preservation investments are defined as "investments that are made to conserve capital and liquidity until the funds are used by 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. As in the ICOS Order, the proposed rule does not limit such capital preservation investments relative to the company's total assets. Nor does the proposed rule specify the particular type of capital preservation investment that would be acceptable.
- 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

⁶ 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.

⁷ The percentages described under the proposed rule are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries.

⁸ 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.

development must all demonstrate that it is primarily engaged in a business or businesses other than investing, reinvesting, owning, holding or trading in securities.

- The company's board of directors must adopt an appropriate resolution stating that the company is primarily engaged in a non-investment business in order to rely on the proposed rule's safe harbor.

Collaborative Research and Development Arrangements

As noted above, under the proposed rule, R&D Companies must limit their investments in securities to capital preservation investments, with certain exceptions. The exceptions have been written into the proposed rule to allow R&D Companies some flexibility to acquire equity stakes that could advance their strategic or business goals, and to continue to enter into collaborative research and development arrangements, 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 immediately after the acquisition 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 20 percent of its total assets, so long as 75 percent of those investments were made pursuant to collaborative research and development arrangements.

Under both alternatives, the limits on the non-capital preservation investments would be calculated only at the time they are acquired. If the non-capital preservation investments increase in value due to market fluctuations, the company would not be required to sell any investments it already owns. But it would not be able to continue to acquire other such non-capital preservation investments. Assets are to be valued according to Section 2(a)(41) 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 "collaborative research and development arrangement" as 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 one or more other

parties; and (iii) is not entered into for the purpose of avoiding regulation under the Act."

Conclusion

The proposed rule is an important development for R&D Companies, especially in the current economic environment. Many R&D Companies are reducing research and development expenses and investing available cash in order to preserve capital until the public markets are again available as a financing source. Doing so increases the likelihood that an R&D Company might inadvertently qualify as an investment company. The proposed new regulatory scheme is intended to create greater certainty through a safe harbor and to clarify the requirements to qualify for an exemption from the definition of investment company. In addition, such guidelines may provide biotechnology and other R&D Companies with greater flexibility to raise capital and make strategic investments in other R&D Companies. As the proposed rule is subject to change, Mintz Levin will provide updates with respect to new developments.

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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.