

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 270

[Release No. IC-26077; File No. S7-47-02]

RIN 3235-A157

### Certain Research and Development Companies

**AGENCY:** Securities and Exchange Commission ("Commission").

**ACTION:** Final rule.

**SUMMARY:** The Commission is adopting a new rule under the Investment Company Act of 1940 that provides a nonexclusive safe harbor from the definition of investment company for certain bona fide research and development companies.

**EFFECTIVE DATE:** The rule will become effective on August 19, 2003.

#### FOR FURTHER INFORMATION CONTACT:

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**SUPPLEMENTARY INFORMATION:** The Commission is adopting new rule 3a-8 [17 CFR 270.3a-8] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the "Act").<sup>1</sup>

#### Executive Summary

Research and development companies ("R&D companies") often raise large amounts of capital, invest the proceeds and use the principal and return on these investments to fund their operations during their lengthy product development phase. An R&D company also may purchase a non-controlling equity stake in another company as part of a strategic alliance to conduct research and develop products jointly. Either of these activities may cause an R&D company to fall within the definition of an investment company under the Act. In 1993, a Commission order issued to ICOS Corporation, a biotechnology company, addressed how to determine the status of an R&D company under the Act (the "ICOS Order").<sup>2</sup>

<sup>1</sup> Unless otherwise noted, when we refer to rule 3a-8, or any paragraph of the rule, we are referring to 17 CFR 270.3a-8 of the Code of Federal Regulations in which the rule is published, as adopted by this release.

<sup>2</sup> ICOS Corp., Investment Company Act Release Nos. 19274 (Feb. 18, 1993) [58 FR 11426 (Feb. 25, 1993)] (notice) and 19334 (Mar. 16, 1993) [58 FR 15392 (Mar. 22, 1993)] (order).

Late last year, the Commission issued a release proposing rule 3a-8 ("Proposing Release") to update and codify the terms of the ICOS Order.<sup>3</sup> The proposed rule was designed to provide R&D companies with greater flexibility to raise and invest capital pending its use in research, development and other operations. The proposed rule also sought to clarify the extent to which an R&D company relying on the rule may make investments in other R&D companies pursuant to collaborative research and development arrangements. The commenters on the Proposing Release generally supported the proposed rule. Today the Commission is adopting rule 3a-8 as a nonexclusive safe harbor from investment company status for certain bona fide R&D companies.<sup>4</sup>

#### I. Background

##### A. Definition of Investment Company

Section 3(a) of the Act has two definitions of investment company that may be relevant to R&D companies.<sup>5</sup> Section 3(a)(1)(A) of the Act defines an investment company as any issuer that is, holds itself out as, or proposes to be engaged primarily in the business of investing, reinvesting, or trading in securities.<sup>6</sup> Section 3(a)(1)(C) of the Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and that owns or proposes to acquire investment securities having a value exceeding forty percent of the value of the company's total assets on an unconsolidated basis (exclusive of Government securities and cash items).<sup>7</sup>

<sup>3</sup> See Certain Research and Development Companies, Investment Company Act Release No. 25835 (Nov. 26, 2002) [67 FR 71915 (Dec. 3, 2002)]. The Commission initially proposed rule 3a-8 in 1993. See Certain Research and Development Companies, Investment Company Act Release No. 19566 (July 9, 1993) [58 FR 38095 (July 15, 1993)], but later withdrew it from the Commission's agenda. Regulatory Flexibility Agenda, Investment Company Act Release No. 21795 (Mar. 4, 1996) [61 FR 24066 (May 13, 1996)].

<sup>4</sup> The Commission notes that any company that meets the requirements of the rule we adopt today may rely on its nonexclusive safe harbor, regardless of whether the company is primarily engaged in research and development activities or in some other non-investment business.

<sup>5</sup> A third definition, contained in section 3(a)(1)(B) of the Act [15 U.S.C. 80a-3(a)(1)(B)], defines an investment company to include companies that issue face-amount certificates of the installment type and is not relevant for purposes of this release.

<sup>6</sup> 15 U.S.C. 80a-3(a)(1)(A).

<sup>7</sup> 15 U.S.C. 80a-3(a)(1)(C). Section 3(a)(2) of the Act generally defines "investment securities" to include all securities except Government securities, securities issued by employees' securities companies, and securities issued by majority-

An issuer that meets the definition of investment company in section 3(a)(1)(C) of the Act nevertheless may be deemed not to be an investment company under two provisions in section 3(b) of the Act.

Section 3(b)(1) of the Act provides a self-executing exclusion from the definition of investment company for a company primarily engaged, directly or through wholly-owned subsidiaries, in a non-investment business.<sup>8</sup> Section 3(b)(2) of the Act allows a company that falls within the definition of investment company in section 3(a)(1)(C) of the Act to apply to the Commission for an order. Pursuant to section 3(b)(2), the Commission, upon application by the company, may find and by order declare the company to be primarily engaged (directly, or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses) in a business other than that of investing, reinvesting, owning, holding or trading in securities.<sup>9</sup>

When the Commission determines whether a company is primarily engaged in a non-investment business pursuant to section 3(b)(2), it looks principally at the composition of the company's assets and the sources of its income, and also considers the company's historical development, its public representations and the activities of its officers and directors.<sup>10</sup> These factors also are used to determine whether a company satisfies the primary business test under section 3(b)(1) of the Act.<sup>11</sup>

##### B. Research and Development Companies

When applied to R&D companies, the asset and income factors of the traditional primary business test may not appropriately reflect these companies' non-investment business. R&D companies, such as biotechnology companies, frequently require large amounts of capital to fund lengthy periods of research and development, the results of which may not produce income for years. R&D companies also may enter into strategic alliances for joint research and development that include the purchase of non-controlling

owned subsidiaries of the owner which are not investment companies. 15 U.S.C. 80a-3(a)(2).

<sup>8</sup> 15 U.S.C. 80a-3(b)(1).

<sup>9</sup> 15 U.S.C. 80a-3(b)(2). A determination under either section 3(b)(2) or section 3(b)(1) of the Act that an issuer is engaged primarily in a non-investment business also means that it is not an investment company under section 3(a)(1)(A) of the Act. See *M.A. Hanna Co.*, 10 S.E.C. 581 (1941).

<sup>10</sup> See *Tonopah Mining Co.*, 26 S.E.C. 426 (1947).

<sup>11</sup> For a more detailed discussion of the relevant provisions of the Act and Commission rules, see *Proposing Release*, *supra* note 3, at II.A.