

investments in their partners. These non-controlling investments and many of the instruments in which R&D companies invest their capital are investment securities counted toward the forty percent asset test under section 3(a)(1)(C) of the Act. Moreover, research and development expenses and any resulting “intellectual capital,” are not recognized as assets on balance sheets prepared in accordance with Generally Accepted Accounting Principles (“GAAP”). Thus, R&D companies may have few assets other than investment securities and little operating income, which may cause them both to fall within the definition of investment company and to be ineligible for an exclusion using the traditional primary business test.¹²

The Commission recognized the unique nature of R&D companies when it issued the ICOS Order in 1993. In the ICOS Order, the Commission set forth an alternative test for determining the primary business of an R&D company under sections 3(b)(1) and 3(b)(2) of the Act that was based upon how the company uses its income and assets, instead of their sources and composition. Under the ICOS Order, this status determination focuses on three factors: (1) Whether the company uses its securities and cash to finance its research and development activities; (2) whether the company has substantial research and development expenses and insignificant investment-related expenses; and (3) whether the company invests in securities in a manner that is consistent with the preservation of its assets until needed to finance operations. If a company satisfies these factors, the remaining factors of the traditional primary business test—the company’s historical development, its public representations of policy, and the activities of its officers and directors—are examined.¹³

C. The Proposing Release

On November 26, 2002, the Commission issued the Proposing Release proposing rule 3a–8 to update and codify the analysis set forth in the ICOS Order.¹⁴ Under the proposed rule,

an R&D company would be deemed not to be an investment company under sections 3(a)(1)(A) and 3(a)(1)(C) of the Act if it met certain requirements designed to demonstrate the company’s engagement in a non-investment business. The proposal sought to ensure that bona fide R&D companies do not inadvertently fall within the definition of investment company, while also making sure that investors in companies that are primarily engaged in the investment business receive the protections afforded them under the Act.

Under rule 3a–8 as proposed, a company could rely on the rule’s nonexclusive safe harbor if it: (a) Had research and development expenses that were a substantial percentage of its total expenses for its last four fiscal quarters combined and that equaled at least half of its investment revenues for that period; (b) had investment-related expenses that did not exceed five percent of its total expenses for its last four fiscal quarters combined; (c) made its investments to conserve capital and liquidity until it used the funds in its primary business; and (d) was primarily engaged, directly or through a company or companies that it controls primarily, in a noninvestment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development.¹⁵

The Commission received six comment letters on the Proposing Release.¹⁶ The commenters generally supported the proposed rule, but suggested certain changes to and clarifications of several of the proposed rule’s provisions. Today we are adopting rule 3a–8 substantially as proposed, with certain changes that respond to the issues raised by the commenters.¹⁷

Industry Organization, File No. 4–457 (May 23, 2002) (“BIO Petition”). For a more detailed discussion of the BIO Petition, see Proposing Release, *supra* note 3, at II.D.

¹⁵ See Proposing Release, *supra* note 3.

¹⁶ The comment letters came from five commenters (one of the commenters submitted an initial letter and a subsequent letter discussing issues raised by another commenter). The comment letters are available for public inspection and copying in the Commission’s Public Reference Room, 450 5th Street, NW., Washington, DC (File No. S7–47–02).

¹⁷ We note that the adoption of rule 3a–8 is not intended to preclude R&D companies from using the test set forth in the ICOS Order under section 3(b)(1) of the Act. Any company that wishes to determine its status under the Act in accordance with the ICOS Order may continue to do so.

II. Discussion

A. Substantial Research and Development Expenses

To qualify for the nonexclusive safe harbor from investment company status, proposed rule 3a–8 required that a company’s research and development expenses, for the last four fiscal quarters combined, constitute a substantial percentage of its total expenses for the same period. In the Proposing Release, the Commission stated that it proposed leaving the term “substantial” undefined in order to allow R&D companies to take into account fluctuations in the composition of their expenses over time, but requested comment on this approach.¹⁸

Two commenters agreed that leaving the term “substantial” undefined provides R&D companies the flexibility to accommodate variations in expenses and fluctuations in research and development budgets over time, and that an objective standard would be unnecessarily restrictive. One commenter, however, stated that without an objective standard, the rule potentially could allow companies primarily engaged in the investment business to escape regulation under the Act. This commenter suggested requiring a company’s research and development expenses to constitute a majority of its total expenses.

The Commission is sensitive to the concerns of excluding companies from the Act that should be subject to its requirements, but notes that the approach of the proposed rule is consistent with the ICOS Order. That approach has been used by R&D companies for over ten years to determine their status under the Act. In light of that fact and the other safeguards contained in the rule, the Commission believes that the approach of the proposed rule would provide the necessary flexibility without jeopardizing investor protection.¹⁹ Therefore, the Commission is adopting this provision as proposed.²⁰

B. Net Income from Investments

Rule 3a–8 as proposed also required that an R&D company’s “revenues from investments in securities” not exceed twice the amount of its research and

¹⁸ See Proposing Release, *supra* note 3, at III.A.1.

¹⁹ While research and development expenses that constitute a majority of a company’s total expenses certainly would be considered substantial, we note that there are circumstances when research and development expenses that constitute less than a majority of the company’s total expenses, notwithstanding nonrecurring items or unusual fluctuations in recurring items, also may be considered substantial.

²⁰ Rule 3a–8(a)(1).

¹² For a more detailed discussion of the nature of R&D companies’ activities, see Proposing Release, *supra* note 3, at II.B.

¹³ See *supra* note 2. For a more detailed discussion of the analysis set forth in the ICOS Order, see Proposing Release, *supra* note 3, at II.C.

¹⁴ Rule 3a–8 was proposed, in part, in response to a petition from the Biotechnology Industry Organization (“BIO”) to the Commission for rulemaking to modernize and clarify the analysis set forth in the ICOS Order. Petition for Investment Company Act of 1940 Rulemaking, submitted by Matthew A. Chambers and John C. Nagel, Wilmer, Cutler & Pickering, on behalf of the Biotechnology