

development expenses.²¹ The Commission explained in the Proposing Release that this requirement would allow R&D companies to meet their increased capital needs by raising and holding more capital than currently permitted under the ICOS Order, while ensuring that an R&D company's primary focus remains funding its research and development activities, rather than generating revenue from its investments.²²

All of the commenters generally supported this provision. One commenter suggested that the phrase "revenues from investments" is ambiguous and that the phrase "net income," which would parallel a provision in rule 3a-1 under the Act, may be more clear and appropriate.²³ The Commission agrees. Rule 3a-8 as adopted today, therefore, uses the term "net income," and the Commission intends that it be interpreted for purposes of this rule consistently with rule 3a-1 under the Act.²⁴

C. Insignificant Investment-Related Expenses

Rule 3a-8 as proposed required that an R&D company relying on the nonexclusive safe harbor devote no more than five percent of its total expenses for its last four fiscal quarters combined to investment advisory and management activities, investment research and selection, and supervisory and custodial fees.²⁵ The commenters supported this provision, and the Commission is adopting it as proposed.²⁶

D. Investments in Securities

1. Capital Preservation Investments

i. Definition

To qualify for the nonexclusive safe harbor under rule 3a-8 as proposed, an R&D company's investments in securities were required to be capital preservation investments, subject to two

exceptions for "other investments," discussed below. The proposed rule defined "capital preservation investments" as investments made to conserve an R&D company's capital and liquidity until the funds are used in its primary business or businesses. The Proposing Release stated that, in general, capital preservation investments are liquid so that they can be readily sold to support the R&D company's research and development activities as necessary and present limited credit risk.²⁷

One commenter suggested that the Commission provide additional guidance concerning capital preservation investments to prevent companies from considering speculative investments to be capital preservation investments. We note that, in the ICOS Order, the Commission stated that "[s]ignificant investments in equity or speculative debt would indicate that the company is acting as an investment company rather than preserving its capital for research and development."²⁸ Similarly, under rule 3a-8 as proposed, investments in equity or speculative debt would not meet the definition of capital preservation investments, but would be considered "other investments" subject to the limits set forth in the rule.

One commenter suggested that capital preservation investments be defined using specific objective standards for credit quality, maturity and liquidity to minimize the risk that an R&D company would purchase speculative investments. Another commenter opposed this recommendation as unnecessary and one that would introduce undue complexity into the rule.

We believe that attempting to specify such objective criteria would render the rule unnecessarily complex and inflexible. Moreover, we continue to believe that the approach we proposed is appropriate given the variety of circumstances that an R&D company may face.²⁹ Therefore, we are adopting the definition of capital preservation investments as proposed.³⁰ Our adopted definition is consistent with the ICOS Order, which has been applied as a standard to determine the status of R&D

companies under the Act for over ten years.³¹

ii. Board-Approved Policy

The Proposing Release requested comment on whether rule 3a-8 should require the board of directors of the R&D company to adopt investment guidelines designed to assure that the company's funds are invested consistent with the goals of capital preservation and liquidity.³² Two commenters addressed this issue, and both supported such a requirement. Since rule 3a-8 would give R&D companies greater flexibility to raise and invest capital, we believe that requiring the boards of directors of R&D companies seeking to rely on the nonexclusive safe harbor to focus on how their companies invest their capital would enhance investor protection.³³ Accordingly, the Commission is adopting rule 3a-8 with this requirement.³⁴

2. "Other Investments"

As discussed in greater detail in the Proposing Release, companies increasingly are collaborating with other companies to conduct joint research and development, and it is not uncommon for an R&D company to seek to acquire a non-controlling interest in securities of another company pursuant to such a collaborative arrangement (a "strategic investment").³⁵ Proposed rule 3a-8 sought both to clarify the extent to which an R&D company relying on the nonexclusive safe harbor may make investments other than capital preservation investments, and specifically to reflect the increased use of collaborative relationships to conduct research and development.

As proposed, rule 3a-8 allowed an R&D company to make investments other than capital preservation investments ("other investments") to a limited extent. In setting the limits, the proposed rule distinguished between investments made pursuant to a

²¹ Proposed rule 3a-8 defined "investments in securities" to include all securities owned by the R&D company other than securities issued by majority-owned subsidiaries and companies controlled primarily by the R&D company that conducts similar types of businesses, through which the R&D company is engaged primarily in a business other than that of investing, reinvesting, owning, holding, or trading in securities.

²² See Proposing Release, *supra* note 3, at III.A.2.

²³ Rule 3a-1 under the Act, adopted in 1981 as a nonexclusive safe harbor from investment company status, codified a series of Commission orders issued under section 3(b)(2) of the Act. 17 CFR 270.3a-1.

²⁴ Rule 3a-8(a)(2).

²⁵ See 17 CFR 210.6-07.2(a) (Regulation S-X). We note that the investment-related expenses that are subject to the five percent limit would include any investment advisory fees paid to an outside adviser.

²⁶ Rule 3a-8(a)(3).

²⁷ Proposing Release, *supra* note 3, at III.A.4.a.

²⁸ See the ICOS order, *supra* note 2, at II.C.

²⁹ For example, we would expect the portfolio of an R&D company whose products require, on average, an additional eight years to develop to differ from the portfolio of another R&D company whose products are expected, on average, to be ready in two years, even though both companies would be investing with the goal of preserving capital and liquidity.

³⁰ Rule 3a-8(b)(4).

³¹ One commenter requested clarification that the statement in the Proposing Release that capital preservation investments "present limited credit risk" would be interpreted consistently with the ICOS order. We did not intend a different meaning. We note, however, that the ICOS order required an R&D company's portfolio, taken as a whole, to present limited credit risk. Under rule 3a-8, each investment is evaluated separately and categorized as either a capital preservation investment or another investment; each capital preservation investment must present limited credit risk.

³² Proposing Release, *supra* note 3, at III.A.4.a.

³³ We also believe that this requirement may enhance an R&D company's ability to monitor its compliance with the requirements of the rule that relate to its investments in securities.

³⁴ Rule 3a-8(A)(7).

³⁵ See Proposing Release, *supra* note 3, at III.A.4.b.