

Such agreements may simply reflect a preference for securities over cash considerations.⁴⁶

The Commission also requested comment in the Proposing Release on whether other activities, such as manufacturing and joint marketing activities, should be included in the definition of a collaborative research and development arrangement. In this regard, we specifically asked commenters to address whether R&D companies face any unique challenges that are not faced by other operating companies seeking to produce and market their products. One commenter recommended that manufacturing and marketing activities be included, but did not address why R&D companies have a greater need than other operating companies to make strategic investments to manufacture and market their products. We thus are not including manufacturing and marketing activities in the definition at this time.⁴⁷

F. Other Requirements

1. Valuation

As proposed, rule 3a-8 required a company to value its assets in accordance with section 2(a)(41)(A) of the Act. Section 2(a)(41)(A) provides, in relevant part, that for purposes of section 3 of the Act, the term "value" means, (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.⁴⁸ Two commenters opposed this requirement, arguing that an R&D company's assets may be difficult to value. They recommended allowing R&D companies to have the option of valuing their assets according to GAAP, which provides for the valuation of some, but not all, assets at market or fair value.

We note that Congress specifically mandated in section 2(a)(41)(A) of the Act that companies use market or fair values for their assets when determining their status under section 3 of the Act. The Commission consistently has required the same when exempting operating companies from the Act by order or rule, irrespective of any difficulty that may be involved in

valuing the assets. We therefore do not believe that a departure from the valuation requirements under the Act in rule 3a-8 would be consistent with the protection of investors or the purposes intended by the policy and provisions of the Act. We also note that the increased percentage limit applicable when at least 75 percent of an R&D company's "other investments" were made pursuant to collaborative research and development arrangements under rule 3a-8 as adopted should reduce any burdens associated with determining fair values by giving R&D companies more flexibility to hold such investments. Accordingly, the Commission is adopting the requirement to comply with section 2(a)(41)(A) of the Act as proposed.⁴⁹

2. Consolidation

Proposed rule 3a-8 provided that the percentages relating to assets, expenses and revenues set forth in the rule were to be determined on an unconsolidated basis, except that an R&D company should consolidate its financial statements with the financial statements of any wholly-owned subsidiaries. This approach was consistent with the method used in rule 3a-1 to determine a company's status under the Act.⁵⁰ We requested comment, however, on whether it would be more appropriate for rule 3a-8 to require or permit consolidation of an R&D company's financial statements with those of its majority-owned subsidiaries, as is done under GAAP.⁵¹

One commenter supported this alternative approach, arguing that the use of a non-GAAP consolidated standard would impose a burden on some R&D companies and possibly produce less reliable, unaudited numbers. We note that all operating companies face similar burdens when determining their status under section 3(a)(1)(C) of the Act or rule 3a-1 under the Act. Moreover, an R&D company that sought to rely on rule 3a-8 already would have determined that it met the definition contained in section 3(a)(1)(C) of the Act, which requires unconsolidated asset figures that differ from GAAP. Accordingly, the Commission is adopting this requirement as proposed.⁵²

III. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits of its rules. New rule 3a-8 provides a nonexclusive safe

harbor from the definition of investment company for R&D companies. Under the rule, an R&D company is eligible for the safe harbor if it: (a) 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 for that period; (b) has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined; (c) makes its investments to conserve capital and liquidity until it uses the funds in its primary business, subject to certain exceptions; and (d) is 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.

New rule 3a-8 is designed largely to benefit R&D companies that currently are relying on the ICOS Order by updating and codifying the analysis in that order. The ICOS Order requires that an R&D company generally spend more on research and development than it earns on its investments. To allow R&D companies greater flexibility to raise and invest capital pending its use in research, development and other operations, the new rule modifies this requirement to require that an R&D company's net income derived from investments not exceed twice the amount of the company's research and development expenses.⁵³ The new rule also clarifies the extent to which R&D companies may make investments in other companies pursuant to collaborative research and development arrangements. Under the analysis in the ICOS Order, an R&D company could make a limited amount of these investments so long as "substantially all of its securities * * * present limited credit risk."⁵⁴ New rule 3a-8 specifies that an R&D company may make investments that are not made to conserve capital and liquidity, so long as these "other investments" do not exceed (a) 10 percent of the R&D company's total assets, or (b) 25 percent of the R&D company's total assets, so long as at least 75 percent of these other investments are investments made pursuant to a collaborative research and development arrangement.⁵⁵

The new rule also imposes two conditions on R&D companies relying on the safe harbor that are not required

⁴⁶ The Commission notes that licensor-licensee relationships may not involve any collaboration between the parties, making it unlikely that parties are engaged in "joint" research and development activities within the meaning of the rule.

⁴⁷ The Commission and its staff are able to consider any unique manufacturing or marketing circumstances faced by a particular company on a case-by-case basis.

⁴⁸ 15 U.S.C. 80a-2(a)(41)(A).

⁴⁹ Rule 3a-8(b)(1).

⁵⁰ See *supra* note 23.

⁵¹ Proposing Release, *supra* note 3, at III.E.

⁵² Rule 3a-8(b)(2).

⁵³ Rule 3a-8(a)(2).

⁵⁴ See the ICOS Order, *supra* note 2, at II.C.

⁵⁵ Rule 3a-8(a)(4)(i) and (ii).