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The *Journal* is a peer-reviewed publication. The editors rely on the recommendations of peer reviewers in making all publication decisions. Because the *Journal* is peer-reviewed, potential contributors must provide the *Journal* with the exclusive right of publication. Papers previously published or under review by other journals are unacceptable. Articles adapted from book-length works-in-progress will be considered under acceptable copyright arrangements.

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Statement of Editorial Policy

The Editors

We created the *Villanova Journal of Law and Investment Management* to meet an unmet need. The legal literature lacks a law review devoted to sophisticated discussion of the law of investment management, an area of the law growing exponentially with the industry to which it applies. General law reviews, including business or securities law journals, publish little in the field, and not much of interest to the specialist. We intend the *Journal* to provide a much needed outlet for specialized scholarship in the law of investment management and, by providing a dedicated forum, to stimulate new and challenging scholarship.

Such scholarship is needed badly. The extraordinary growth of the investment industry, the volatility of financial markets and the constant evolution of new market structures has triggered the constant evolution of legal structures. Practitioners, regulators and academics alike struggle not only to keep up with that evolution, but to shape it. We hope that the *Journal* will help those working in the field both understand and lead the ongoing legal transformation.

To that end, we plan to publish articles focusing primarily on the law of investment companies and investment advisers. Of particular interest will be articles on topics under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, relevant aspects of the Securities Act of 1933, the Securities Exchange Act of 1934, and the rules of the self-regulatory organizations. Of similar interest will be work on the relevant portions of the state securities, corporations, trust and partnership laws. In addition, we will publish articles on issues under the federal tax laws and ERISA related to investment companies and investment advisers. The *Journal* also encourages the submission of work on legal aspects of specialized investment vehicles such as real estate investment trusts (REITs).

We read the term "investment management" broadly, and will consider publishing articles on problems in broker-dealer law and regulation and, more generally, articles on securities law topics that may be of interest to our audience.

We intend the articles we publish to be "useful," but they may be useful in a variety of senses. Our articles may help practitioners solve actual problems already on their desks. They may analyze and evaluate the practical impact of recent changes in the law. They may also identify practical or policy problems that call out for law reform. Articles published in the *Journal* may even crystallize possible solutions to fundamental problems of law and policy. To achieve these goals, the articles we publish may employ traditional doctrinal analysis, policy analysis, empirical analysis or other methodologies.

The *Villanova Journal of Law and Investment Management* is an independent, academic publication of Villanova University School of Law. It is dedicated to providing an open forum for writers working from all perspectives, from both sides of the regulatory fence and from all sectors of the industry, the government, the bar and the academy. We encourage the submission of articles that take strong or controversial positions, so long as they are well-researched, well-supported and fairly argued. Some of what you may read in the *Journal*'s pages may provoke you. If so, we invite you to pick up your pen (or boot up your laptop) and write a responding article. We are confident that the collision of different views will yield a deeper understanding of the law of investment management.

Non-Compete Obligations of Departing Star Partners and the Right of Clients to Their Continued Services

Tamar Frankel*

The interests of advisers and their clients may conflict in unexpected ways. One such situation arises when the adviser's partners or managers (portfolio managers) sign a non-compete agreement with the adviser and later, when they leave, are sought after by clients who wish to continue the relationship. The case is clear if the departing portfolio manager solicits the clients of the adviser in violation of its non-compete undertaking. The case is less clear when the clients wish to follow the departing portfolio manager and press to engage her in violation of the non-compete undertaking. The conflict here is between the adviser's right to protect itself against unfair competition by disloyal portfolio managers and to enforce its rights against breach of contract by portfolio managers, and the right of clients to have a portfolio manager of their choice.

The clients' right requires some elaboration. Manager-client relationships are fiduciary relationships based on trust and confidence. If clients for any reason wish to terminate the relationships, the assumption is that their trust and confidence in the portfolio managers have weakened. Therefore, clients should be allowed to sever the relationships on short notice and without penalty. The Investment Company Act of 1940 (1940 Act) provides explicitly that the advisory contract should provide for termination of the relationship upon a notice of sixty days without penalty. Most advisory contracts have adopted a thirty-day notice, or termination without notice.

The position of dominance between advisers and clients shifts significantly after the establishment of the relationship. Advisers court clients; clients have choices and therefore bargaining power. That is so before the advisory contract is signed. Once the contract is signed, however, and once the assets of the client are transferred to the adviser, the bargaining power shifts dramatically. The client is in the adviser's hands, regardless of the terms of the agreement. This bargaining power shift is not the same for all advisers, and depends on the situation. If the client retains the function of executing the portfolio transactions and capability of day-to-day operations of the portfolio, an adviser serves essentially as a consultant -- an independent contractor -- who is close to a professional employee. Such an adviser has far weaker bargaining power compared to an adviser to whom the entire operation of the portfolio has been transferred to a competitor. In the latter situation a client

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*Professor of Law, Boston University School of Law. The author served as an expert witness for RJR Nabisco in Wellington Mgmt. Co. v. RJR Nabisco, Inc., No. 98-10916 (D. Mass. filed May 5, 1998) (parties settled case before trial).

[1] *See* Investment Company Act of 1940 § 15(a)(3), 15 U.S.C. § 80a-15(a)(3) (1994) (stating "that [the contract] may be terminated at any time . . . on not more than sixty days' written notice to the investment adviser").

[2] *See* CLIFFORD E. KIRSCH, INVESTMENT ADVISER REGULATION § 7:8 (1997), *available in* LEXIS, PLI Library, Allpli File (suggesting that advisory contract spell out terms with respect to termination, e.g., "Either party may terminate this agreement upon 30 days' written notice to the other party.").

who wishes to terminate the relationship needs the terminated adviser to help transition the operations of the portfolio to another adviser or to the client. If the client does not have the means to manage the portfolio and has only a skeleton part-time staff to oversee the adviser, termination depends on the full cooperation of the terminated adviser in transferring the operations to a competitor. That is awkward in the best of cases, and may even be impossible without enforcement in other cases. One story demonstrates the legal questions that this situation raises.

Frank Russell Co. v. Wellington Management Co.

The story is well told in *Frank Russell Co. v. Wellington Management Co.* It begins when Arnold Schneider (The Manager) joined Wellington Management Company (The Adviser) in 1983. When he became a partner, The Manager signed a non-compete agreement with The Adviser. When he left in 1996, however, The Manager continued to serve some of The Adviser's existing clients, whom he had served as partner. Being a stellar performer, the clients sought The Manager's service. These clients included Frank Russell Co. (Russell) and RJR Nabisco (RJR).

After Russell cancelled its contract with The Adviser and immediately moved its assets to The Manager, The Adviser brought suit in a Massachusetts court against The Manager for an injunction enforcing the non-compete agreement. The court upheld the five-year ban on doing business with The Adviser's clients (striking down other provisions of the agreement as being in restraint of trade). Russell filed an amicus brief and was well aware of the proceedings.

Three weeks before the effective date of the injunction, Russell brought action in the Eastern District of Pennsylvania, seeking to enjoin The Adviser from enforcing the non-compete agreement. The Adviser sought a declaratory judgment against RJR in Massachusetts, asking that the injunction be declared enforceable. The District Court enjoined The Adviser from enforcing the petition. On appeal from that denial the court of appeals reversed. Russell's arguments were that the enforcement of the injunction would be a breach of its fiduciary duties to Russell, and that when it signed Russell as a client, The Adviser should have informed Russell of the non-compete agreement. The Appeals court found no authority in state law for these propositions, especially the duty to disclose the non-compete agreement; it found no implied private right of action for

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[3] 154 F.3d 97 (3d Cir. 1998) [hereinafter *Russell* II].

[4] *See* McFarland v. Schneider, No. 96-7097, 1998 Mass. Super. LEXIS 711, at *165 (Super. Ct. Feb. 17, 1998).

[5] *See* Frank Russell Co. v. Wellington Mgmt. Co., No. 98-1703, 1998 U.S. Dist. LEXIS 5520, at *3 (E.D. Pa. Apr. 13, 1998), *rev'd*, 154 F.3d 97 (3d Cir. 1998) [hereinafter *Russell* I].

[6] *See* Wellington Mgmt. Co. v. RJR Nabisco, Inc., No. 98-10916 (D. Mass. filed May 5, 1998), *cited in Russell* II, at 100-01.

[7] *See Russell* I, at *6-7.

damages under the Advisers Act, and no cause of action under ERISA. The court distinguished between those facts which the client needs to know and those facts which constitute internal business arrangements of The Adviser, and determined that the non-compete agreement related to the internal business of The Adviser. To be sure, if the client had asked about the existence of such an agreement a truthful answer was required under contract law, but not under fiduciary law. In sum, the court refused to create a new client right of action absent authority to that effect.

Wellington Management Co. v. RJR Nabisco, Inc.

The other client whom The Manager continued to serve was RJR. The Adviser entered into an advisory contract with RJR to manage a portion of RJR's large pension fund. Unlike the Russell contract, RJR's contract contained a provision that required Wellington to transfer RJR's portfolio upon RJR's termination of the contract (by 30 days notice) to whomever RJR would direct. Wellington did not disclose to RJR the existence of the non-compete provisions in the agreement between Wellington and The Manager. After Wellington sued The Manager and obtained an injunction prohibiting The Manager from servicing Wellington's clients for five years, as provided in the contract, Wellington sued RJR seeking to enforce its injunction.

RJR counter-claimed seeking damages for breach of contract. RJR argued that Wellington's actions to deprive RJR of The Manager's services resulted in significant damage to RJR. RJR argued that another portfolio manager, who managed an identical portfolio to that of the Wellington Manager, had performed far worse. Therefore, RJR sought damages measured by the difference in performance between the two portfolio managers. On a motion to dismiss, the court followed the holding in *Russell* and dismissed the claims based on the same causes of action.[13] However, the court distinguished this case on the factual grounds that RJR's contract contained an express provision requiring Wellington, upon termination, to transfer the portfolio "as directed" by RJR. Because Wellington transferred the portfolio to RJR rather than to the portfolio manager of its choice, and in fact precluded RJR by its actions and injunction from using the portfolio manager of RJR's choice, the court allowed RJR's claim on breach of contract to continue.

The Advisory Contract Issues

This case then raised questions of contract interpretation. First, should the contract between a client and an adviser be interpreted literally, or is there a "vagueness door" through which evidence of the parties' intentions can be proven? Second, what is the meaning of "transfer of a portfolio"? Third, what is the meaning of "as directed"? Fourth, how can damages be shown in this case or similar cases? Finally, outside the four corners of this decision, the larger question is, how should the conflict between the adviser's rights against a portfolio manager and the client's rights to the portfolio

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[8] *See Russell* II, at 106 (finding "a weak . . . likelihood of success" on merits).

[9] *See id.* at 103-04 (analyzing Russell's arguments). Presumably a new manager would require the sale of the whole portfolio to avoid responsibility for the performance of the existing portfolio, and that sale would involve significant taxation.

[10] No. 98-10916 (D. Mass. filed May 5, 1998).

[11] *See* McFarland v. Schneider, No. 96-7097, 1998 Mass. Super. LEXIS 711, at *165 (Super. Ct. Feb. 17, 1998).

manager's services be resolved? In this connection, can we draw analogies from similar issues that arise in the context of law firms, their partners and their clients?

Even though the case did not go to trial because the parties settled, one can speculate as to the answers to the above questions. To reach the main interesting issues in this case, I will assume that the contract is vague under contract law. Second, I will assume that industry practice governs the interpretation of such a contract. This practice takes into consideration the policies of the Securities and Exchange Commission that would not allow advisers to impose an onerous condition or a limitation that has a chilling effect on the client's freedom of contract termination.

The next question is the meaning of "transfer of a portfolio." Wellington argued that because it explicitly contracted not to have custody of the portfolio, it had no portfolio to transfer. It interpreted the term "portfolio" literally to mean the assets under custody. Therefore, if the assets were in the hands of a custodian, as they were, and the custodian remains the same institution, Wellington has nothing to transfer. The weakness of this argument is that the parties agreed that Wellington would not have custody of the portfolio. Therefore the provision requiring Wellington to transfer the portfolio is rendered meaningless and superfluous. A rule of interpretation does not favor such an outcome if another interpretation would give the words a clear meaning.

Alternatively, Wellington argued that it did whatever was necessary to transfer the portfolio. It passed to RJR all the necessary documents to enable someone else to continue managing the portfolio. The problem with this interpretation was twofold. First, shortly after the transfer Wellington brought suit to undo the transfer and prevent the transferee (The Manager) from managing the portfolio. Second, the provision is far more meaningful than it appeared in this case because the transfer was easier in comparison to other cases. This is because the person who managed the portfolio under the Wellington contract was The Manager who left Wellington. It would have been far more complex to transfer the functions of management to someone else.

Wellington further argued that its function under the advisory contract was not that of an operational portfolio manager to whom all operations of the portfolio were "outsourced," but rather that of a consultant-employee who merely gave discretionary investment advice. However, in light of the skeleton staff of RJR dealing with its pension funds, it is clear that if Wellington transferred its functions to RJR, the RJR staff could not manage the portfolio. Someone had to perform the functions that Wellington had performed through its portfolio manager and its other facilities.

To be sure, there are pension funds that outsource fewer operational functions than investment companies with external portfolio managers, such as Fidelity. Nonetheless, the issue in any particular case is the importance and weight of the transfer that must occur for there to be a smooth continued operation of the fund in a transitional mode. It is clear that a break in the operation and management of the pension fund can result in significant damage even if the fund does not engage in trading. If part of the portfolio is devoted to active trading, then the damage from a break in the operation can indeed be substantial.

[12] *See Wellington*, No. 98-10916 (D. Mass. filed May 5, 1998).

[13] *See id*.

What is the meaning of "as directed"?

May a terminated adviser transfer the management of the portfolio to anyone as directed except to a portfolio manager whom the terminated adviser can legally prevent from serving a particular client? If the contract provides unambiguously that the transfer should be effected as directed, may the adviser, after the transfer, immediately block the continued service by seeking a court order? Does seeking that court order constitute a breach of the adviser's contractual obligation?

The last question can be answered first, because the judge hearing the case seemed to believe that a transfer, which is followed closely by legal roadblocks raised by the transferor, is less than the transfer envisioned in this case.

Suggested Guidelines

This was a case of first impression because rarely do advisers or any other fiduciaries sue their clients (except for payment of fees). The paucity of cases against clients suggests that market actors do not consider it wise to take such a step. A reputation for suing clients does not endear an adviser to clients and potential clients. It may also be the case that clients rarely insist on following a departing portfolio manager when they find other portfolio managers of the adviser satisfactory and when they have a strong bond with the adviser. Therefore, cases like the one discussed are unusual. However, apart from the wisdom of such a suit, the question remains whether the rights of the adviser and those of the client fully conflict, and under what circumstances one or the other should prevail.

The issues in such a case must be resolved by evaluating numerous factors. A number of guiding principles may be helpful. First, the easiest case is if the portfolio manager solicits the clients rather than the other way around. There is no conflict in this case and the adviser should win against the portfolio manager. It is doubtful whether clients will be involved at all.

Second, even if it seems that the clients solicit the portfolio manager, the adviser may still win. An objective test can be made by measuring the performance of a portfolio manager in comparison to other managers with similar portfolios. In this case it seems that the portfolio manager is "fungible." The question will focus on whether the quality of the portfolio manager's services is unique and whether the portfolio manager's performance is fungible. In today's environment and especially in the area of financial markets, the trust and confidence that clients bestow on their portfolio managers need not be personal. Clients may not know the portfolio managers personally nor have exchanged words with them. Trust and confidence may be impersonal within the boundaries of the services that the portfolio managers perform for their clients. Even so, trust and confidence must exist between the portfolio manager and their clients. In contrast, there are services which clients accept from anyone who is chosen by the trusted portfolio manager. These service providers may be changed, sometimes without the clients' consent or even knowledge. Hence, we must establish the clients' preferences as to the choice of the portfolio managers or other service providers. These choices may determine whether the adviser or the portfolio manager wins. In such situations, the client should always win (either by lack of care or by getting what he cares about).

Furthermore, clients may seek the portfolio manager's services, not because they strongly prefer that portfolio manager but because of other extraneous (e.g., personal) reasons. Arguably, in the merits. This argument, however, may be hard to prove. The rationales are similar to the rationales for efficient breach, but in the reverse. There is no reason not to enforce a non-compete condition, which the portfolio manager signed voluntarily, and to ignore the courts' edict of injunction if the client is not harmed by the exchange of portfolio managers.

The Nature of an Advisory Contract

Unlike the sale of widgets (and the basis for efficient breach), the sale of services, and especially advisory services, involves confidence and trust, which is generally less fungible. Rather, the confidence and trust is unique to the particular relationship of the service provider and the client. In such a case, it seems that the adviser should lose and the client should continue to enjoy the services of the portfolio manager of his choice. The manager-client relationship is a personal trusting relationship. The custom and usage against which the term "as directed" is understood involves the trusting aspect of the manager-client relationship.

The nature of the relationship provides the term "as directed" a meaning that the industry and regulators adopt and understand. Investment management contracts are considered personal contracts in which confidence is reposed in the portfolio manager by the client.[14] Such contracts will not be specifically enforced.[15] Also, an interpretation of an investment management contract that limits the clients' freedom and ability to choose any other portfolio manager is detrimental to our system generally and to clients in particular. Such an interpretation conflicts with the public policy of encouraging competition among portfolio managers.[16] It is not surprising that research has not uncov-

[14] *See* Robert D. Brown Inv. Counsel, Inc., SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2661, at *3 (July 19, 1984) (defining "investment supervisory services" as "the giving of continuous advice . . . on the basis of the individual need of each client."). The SEC staff notes specifically that:

> For an adviser to provide investment supervisory services, there must be effective communication between a client and the adviser; the client informing the adviser of his needs, and the adviser providing the client with advice based on these needs. If the client does not continue to have confidence in the adviser and is unable to communicate effectively with him or rely on the adviser's advise (sic), the basis of their relationship has effectively ended. We believe that generally the continued performance of an adviser's services is dependent upon the client's having trust and confidence in the adviser and a willingness to continue the advisory relation ship. Where the basis for the relationship is ended, and the adviser, accordingly, is unable to continue to perform services under the contract, in our view the adviser's fiduciary duties preclude its receipt of compensation for service it is not able to perform.
> . . . .
> . . . RDBIC would breach its fiduciary duty and violate section 206(2) of the [Advisers] Act by entering into a contract for the provision of investment supervisory services which purports to bar a client from terminating the relationship except annually.

Id. at *4; *see generally* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983) (suggesting rationale for imposition of fiduciary duties).

[15] *See* 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.7 (2d ed. 1998) (citing Fitzpatrick v. Michael, 9 A.2d 639, 641 (Md. 1939)) (stating "court will not grant specific performance of a contract to provide a service that is personal in nature").

[16] This is especially important as between advisers and their employee portfolio managers. The staff of the Securities and Exchange Commission has permitted such employees to establish their own business by allowing them to advertise the performance of funds which they managed while employed, to demonstrate their past experience. *See* 3 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS ch. XXV § 8 (Supp. 2000) (noting that SEC granted no-action letters allowing related performance information in sales materials and prospectuses).

such a case the adviser should win because it does not seem that the clients prefer the portfolio manager on the merits. This argument, however, may be hard to prove. The rationales are similar to the rationales for efficient breach, but in the reverse. There is no reason not to enforce a non-compete condition, which the portfolio manager signed voluntarily, and to ignore the courts' edict of injunction if the client is not harmed by the exchange of portfolio managers.

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The nature of the relationship provides the term "as directed" a meaning that the industry and regulators adopt and understand. Investment management contracts are considered personal contracts in which confidence is reposed in the portfolio manager by the client. Such contracts will not be specifically enforced. Also, an interpretation of an investment management contract that limits the clients' freedom and ability to choose any other portfolio manager is detrimental to our system generally and to clients in particular. Such an interpretation conflicts with the public policy of encouraging competition among portfolio managers. It is not surprising that research has not uncovered a single case in which an adviser sued a client for breaching his contract by seeking the services of another portfolio manager. I have not discovered such a case either under the common law or under the federal regulatory law.

To perform his functions efficiently, a portfolio manager must exercise significant powers over the client's portfolio. Such powers put investors at risk from the potential of the portfolio manager's abuse of power. The powers will not be granted unless the client has confidence in his portfolio manager. If the client's confidence is lost, the client will withdraw these powers. To encourage investors to risk putting their money and liquid assets in the hands of others, public policy has long mandated that a client should not be required to continue its relationship with a portfolio manager against his wishes. The marketplace accepts the proposition that a client may choose its portfolio manager and can terminate the relationship on short notice.[17]

Portfolio managers are not always happy with this freedom of clients to move to competitors. Therefore, portfolio managers seek ways to impose costs on clients who might wish to change portfolio managers. Unregulated portfolio managers may require a contract for a minimum (in reality

[17] Advisory contracts usually entitle the client to terminate the relationship by a 30-day notice. *See* Investment Company Act of 1940 § 15(a)(3), 15 U.S.C. § 80a-15(a)(3) (1994) (stating explicitly that advisory contract should provide for termination of relationship upon notice of sixty days without penalty); KIRSCH, *supra* note 2, at § 7:8 (suggesting that advisory contract spell out terms with respect to termination, e.g., "Either party may terminate this agreement upon 30 days' written notice to the other party").

long) period or a fee forfeiture. But regulated advisers (which nearly all portfolio managers are) may not. "[T]he SEC staff has expressed the view that an adviser's fiduciary duty would preclude an adviser from enforcing a contract that unreasonably limits a client's right of termination."[18]

The staff of the Securities and Exchange Commission has long interpreted federal law to prohibit advisers from entering into a long-term advisory contract (e.g., a year) or impose upon termination of the contract a penalty or fee forfeiture. The staff explained that in a client-manager confidential relationship a client should be permitted to terminate the relationship on short notice without penalty.[19]

What signals would establish the clients' preferences to retain the departing portfolio manager's services?

In the *RJR Nabisco* case the signal was clear and, at the outset, stated in the contract. However, if advisory contracts do not contain the specific statutory language but merely provide for the right of termination with a short notice and without penalty, the answer is more complex. One possible answer is to look at the statutory interpretation by courts and regulators and the legislative history. After all, the parties' contracts follow the statute, to which they consider themselves, and are, bound. But this argument is circular because the interpretation of the statute is affected by the parties' expectations and behavior. Therefore, in advisory contracts that do not specifically provide for the client's choice of the portfolio manager, other signals may be helpful, such as the insistence of the clients on continued services of the portfolio manager, the objective dependence of the client on the portfolio manager's services, the previous relationships between the parties and as mentioned before, the performance of the portfolio manager as compared to others who offer the same type of services, which would justify a rational client's insistence.

A second answer would be based on the adviser's approach to the termination. In many cases, but not all, an adviser may wish to prevent termination by disqualifying its competitor. The adviser may say to the client: I will indeed transfer the portfolio to whomever you direct, except this competitor of mine, who enticed you to transfer the business to her. No adviser or other fiduciary should be allowed to do that. Therefore, the adviser's attempts to disqualify a competitor are circumspect. If the adviser must transfer the portfolio notwithstanding the fact that the competitor is a

[18] KIRSCH, *supra* note 2, at § 8.2 n.1 (citing National Deferred Compensation, Inc., SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,543, at 77,764 (Aug. 31, 1987)); *see* Robert D. Brown Inv. Counsel, *supra* note 14, at *2 (noting that once a year termination is too restrictive of client's right to terminate advisory contract). The SEC further notes that a fee schedule based on the assumption that client relationship would extend from year to year denies clients' right to terminate the contract, and constitute adviser's breach of fiduciary duty. *See* Robert D. Brown Inv. Counsel, *supra* note 14, at *19 (believing these restrictions obligated clients to accept and pay for advisory services whether or not such services were satisfactory).

[19] Such a specific requirement is imposed on advisers that serve investment companies. *See* 15 U.S.C. § 80a-15(a)(3) (1994); *cf.* Steven Lubet, *The Rush to Remedies: Some Conceptual Questions About Nonrefundable Retainers*, 73 N.C. L. REV. 271, 284-85 (1994) (citing *In re* Cooperman, 633 N.E.2d 1069, 1072-73 (N.Y. 1994)) (discussing fiduciary duties in context of attorney-client relationship and noting court's concern that penalty would render clients "hostage to an unwanted fiduciary relationship" and inhibit clients' right to discharge their lawyers, but arguing against absolute right in certain cases); Lisa Estrada, Note, *An Assessment of* Qui Tam *Suits by Corporate Counsel Under the False Claims Act:* United States *ex rel.* Doe v. X Corp., 7 GEO. MASON L. REV. 163, 175-77 (1998) (analyzing incentives for lawyers in light of their client relationships which require trust to ensure effectiveness).

person who signed a non-compete agreement, and is under a duty and a court order not to provide the services, the situation does not change. We can assume that the adviser will try to prevent the transfer and should not be permitted to impede it by selecting or disqualifying the client's choice. Such an action is detrimental to healthy competition and the client's interests. In addition, allowing a terminated adviser to disqualify its successor may enable the terminated adviser to extract payments from the designated successor or even stay as a silent partner to that successor.

A more difficult question arises, for example, if the client requires the terminated adviser to transfer the management of the portfolio to an adviser whose registration was revoked, and who is therefore prohibited from serving. A similar question would arise if the client insists on resorting to a disbarred lawyer.

Analysis of the Issue

The issue involves a conflict between the client's rights to choose an adviser and the legal prohibitions for the adviser to serve. Presumably, the client's rights should be subject to legal prohibitions. But that is not the issue in our context. The question is whether the adviser can use the disqualification of the transferee adviser as a defense for preventing the transfer. I believe that the adviser should not be permitted to use legal limitations as protection from his contract violation.

The one exception may be if the adviser would be liable as aider and abettor to a violation of the law. Further, the adviser may have a duty to notify the client of the successor's disqualification. But if the client persists, the adviser should transfer the portfolio nonetheless. Otherwise, the illegality of involving another adviser should not provide the terminated adviser with a reason to avoid transfer.

In the *RJR Nabisco* case The Adviser's arguments based on legal constraints to the transfer seem weak because, but for The Adviser's actions, the transferee adviser (The Manager) would not be prevented from serving the client.

However, as the *Russell* court has noted, the adviser has a legal right to prevent the disloyal portfolio manager from serving its clients. The conflict is therefore between the rights of the client and those of the adviser. The reason it feels uncomfortable to allow the terminated adviser to do anything but what the client orders it to do is that the terminated adviser has a sharp conflict of interest with the client. In the conflict with the portfolio manager the law is on the side of the adviser. However, in the conflict with the client, the court's order does not apply to the client.

I would prefer that courts avoid this vicious circular argumentation, and provide a straightforward argument. I suggest that if the client truly wants the portfolio manager to continue to serve, the adviser should not be permitted to invoke the court's injunction to prevent the service. However, even if the injunction does not apply to the client, what other remedies does the adviser have against the portfolio manager?

First, the adviser can seek the remedy of accounting for the portfolio manager's profits. Such a remedy is likely to prevent the portfolio manager from serving in violation of the injunction, because he would be required to serve without compensation. This prevention may raise the same questions that an injunction raises: is this prevention violating the client's rights to the portfolio manager of its choice? If it does, then under certain conditions, the adviser cannot exercise his rights.

Second, the adviser may claim damages from the portfolio manager. These damages would reduce, but not eliminate, the portfolio manager's compensation, and keeping good clients for some time with low fees may be attractive to the portfolio manager.

Third, and this may be the best answer, the adviser should be protected by extra-legal remedies. Protections of the adviser must derive from behavioral patterns, market reputation and business relationships rather than from the law.

Against this background, I conclude that an obligation to transfer the portfolio as provided in the contract provision means the transfer of the portfolio management operation to another portfolio manager. It is a crucial and important obligation of the portfolio manager in light of the difficulties that the portfolio manager can create and the damages and losses it can inflict. Whether or not the assets are moved to another custodian is irrelevant.

How should advisers and clients prepare for such a situation in the future? After all, most advisers impose non-compete obligations on their partners and their portfolio managers. Clients, however, may not necessarily insist on the services of a particular portfolio manager, yet on other occasions may wish to retain the services of a favored manager even if she leaves the adviser. A number of scenarios are possible to imagine. The adviser has the option of notifying the client of the non-compete condition. The adviser, however, risks the possibility that, in light of this disclosure, the client will insist on the freedom to follow the manager, and bargain for a specific contract provision to that effect.

Another possibility is that the client will raise the issue before the service knot is tied. At that stage, the client has a strong bargaining position vis-à-vis the adviser, and the adviser may concede. There is also a possibility that if the parties agree on all other terms they will decide not to raise the issue in the hope that it will not arise. The probability that such an issue will arise may be indeed quite low. However, if such a situation does arise, a client may have a far weaker position after the relationship has been established than at the bargaining stage, and unless it "costs" the client some other bargaining advantages, the issue is best resolved in advance of establishing this relationship. These speculations lead me to the conclusion that negotiations on specific contract terms may not be the solution, and are not an effective way to start the relationship. The way advisers' behave in the marketplace seems to be the wisest one: refrain from raising the issue. But if the issue arises, cut your losses. Allow (even help) clients to depart and follow the disloyal partner or portfolio manager with as little emotion as is humanly possible, and without much ado.

The Investment Company Act of 1940: Why the Time Has Come to Revive Section 3(b)(1)

By Brian J. Lane and Gillian McPhee*

The "new economy" of the high-technology era has brought with it fundamental changes in the way that companies operate. Increasingly, today's high-technology companies are acquiring substantial minority interests in other companies as a means of securing access to intellectual property, computer hardware, technology and other equipment and resources that are essential to their businesses. Companies have also been engaging in strategic partnering in order to accelerate growth, strengthen relationships with suppliers and customers, and attract investment capital. Frequently, the "glue" that holds these partnerships together is cross-ownership of equity capital. On a parallel track, the "new economy" has seen the emergence of the "internet incubator," which is exemplified by entities such as Bill Gross' idealab!, CMGI and Internet Capital Group, Inc. An incubator not only takes equity interests in a number of fledgling companies, but it also participates actively in the management of companies in its network, provides them with advisory and operational services, and assists them in identifying alliances and cementing business relationships with other network members.

While companies have always held securities of other companies, these new investment patterns are challenging traditional regulatory analysis. Increasingly, companies that hold portfolios of securities have found themselves steering a direct collision course with the Investment Company Act of 1940 (the "'40 Act"). This is particularly true of high-technology companies. The '40 Act was drafted at a time when no one could have contemplated the business models of the "new economy." A number of high-technology companies have sought exemption from the provisions of the '40 Act by applying to the Securities and Exchange Commission (the "Commission"). The increasing number of exemptions being sought, however, raises the question of whether it is practical for companies to continue to look to the exemptive process for relief, whether companies should restructure and/or limit their securities holdings to avoid the reach of the '40 Act, or whether the '40 Act should be amended to reflect the new paradigms of the high-technology world.

This article begins by discussing the history and application of the '40 Act, which, because it focuses on regulating managed pools of securities, applies to any company that falls within the definition of "investment company" established in the statute. The article then argues that it may be time for companies to take advantage of, and for the Commission staff to issue guidance on, the little-used exemption found in Section 3(b)(1) of the '40 Act. Since this exemption purports to offer relief to companies primarily engaged in businesses other than investing in, owning, or holding securities, presumably without regard to the amount of their securities holdings, Section 3(b)(1) could be of tremendous use to companies pursuing business strategies that make them resemble investment companies but that are not in fact engaged in the business of investing in securities

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because their investments are actually operational assets. Section 3(b)(1) would be particularly useful for those high-technology companies that have substantial non-investment operations but find themselves caught in the grasp of the '40 Act because they have acquired securities of other companies through cross-marketing arrangements, to ensure supplies of particular products offered by those companies, or for some other non-investment purpose. Permitting such companies to rely on Section 3(b)(1) would afford them the benefit of a self-executing exemption from the regulatory provisions of the '40 Act while leaving the statute itself intact. It would also free the Commission staff from an increasing number of exemptive requests under Sections 3(b)(2) and 6(c) of the '40 Act.

The article will conclude by proposing an alternative test for investment company status. This test would entail an assessment of (1) how a company represents itself to the public and how the public perceives the nature of the company's business; (2) whether the company itself, or one or more of the company's wholly-owned subsidiaries, has substantial non-investment operations, or whether the company has only *de minimis* operations designed to mask the investment nature of its business; and (3) whether the company's equity interests in subsidiaries that are less than wholly owned are held primarily as investments or instead relate to the company's primary business. While this test does not remove the element of subjectivity from a determination of investment company status, it should serve to ensure that most companies with substantial non-investment operations do not find themselves subject to regulation as investment companies simply because they also happen to hold securities in amounts that exceed the limits established by the '40 Act.

I. Background

The proposition that the time may have come to reevaluate, and perhaps modify, the '40 Act seems particularly appropriate when viewed against the background that led to its passage. The '40 Act was preceded by an extensive examination of many hundreds of companies doing business in the United States in the late 1920's and early 1930's. From the very beginning, however, it was presumed that certain companies – such as the large railroad, oil and other industrial conglomerates of the first part of this century – were properly beyond the purview of the '40 Act because they were clearly not investment companies. Over time, the primacy of these conglomerates has been surpassed by the Internet and by e-businesses and strategic partnerships that produce, market and sell everything from information to microchips to pet products. Today, companies like Microsoft and Intel have supplanted companies like General Motors and U.S. Steel as the paradigmatic operating companies of the "new economy." If there has been a change over time in the type of company that is clearly not an investment company, arguably this should be acknowledged and reflected in the application of the '40 Act.

A. Legislative History

The '40 Act grew out of Congressional concern that existing securities legislation did not adequately protect the purchasers of investment company securities and was the result of a collaborative effort between the Commission and the investment company industry.[1] In 1935, Congress directed the Commission to conduct a study of investment trusts and companies pursuant to a grant of

[1] For a discussion of this effort by one of the principal drafters of the '40 Act, see Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 308–11 (1941).

statutory authority contained in the Public Utility Holding Company Act of 1935 (the "Study").[2] Using questionnaires prepared in consultation with the investment company industry, the Commission collected data from and prepared individual reports on approximately 700 investment trusts and investment companies and approximately 400 investment advisers.[3] Field studies were conducted of three types of investment companies: those that had acquired and absorbed other investment companies, those that had complicated structures and/or had engaged in numerous transactions with entities or persons over which they had no control, and those that had been liquidated or nearly wiped out by losses.[4] It was thought important to survey the last category – defunct investment companies – because "the public had sustained most substantial losses in these companies."[5] In addition, the Commission held public examinations on nearly every investment company having $10 million or more of assets – nearly 250 investment companies in all.[6] Through a combination of the foregoing methods, the Commission was able to gather at least some information on the great majority of investment trusts and investment companies known to have existed in the United States between 1927 and 1936 – approximately 1,272 companies in all.[7]

Based on the data it had gathered, the Commission prepared and, between 1938 and 1941, submitted to Congress in five parts, a report entitled *Report on the Study of Investment Trusts and Investment Companies*, accompanied by six supplemental reports (collectively, the "Report").[8]

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[2] *See* Public Utility Holding Company Act of 1935, ch. 687, § 30, 49 Stat. 837 (1935) (current version at 15 U.S.C. § 79z-4 (2000)). Congress stated that:

> The Commission is authorized and directed to make a study of the functions and activities of investment trusts and investment companies, the corporate structures, and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to the Congress on or before January 4, 1937.

Id.

[3] *See* THE NATURE, CLASSIFICATION, AND ORIGINS OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 75-707, at 6-9 (1938) [hereinafter REPORT PART ONE].

[4] *See id*. at 9–10 (outlining situations in which field studies were used to gather more information).

[5] *Id*. at 10.

[6] *See id*. at 11; *see also* SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 5 (1940) [hereinafter SENATE REPORT].

[7] *See* REPORT PART ONE, *supra* note 3, at 4.

[8] The five parts of the Report are: REPORT PART ONE, *supra* note 3; STATISTICAL SURVEY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-70 (1939); ABUSES AND DEFICIENCIES IN THE ORGANIZATION AND OPERATION OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-279 (1939-40) & H.R. DOC. NO. 77-136 (1941); CONTROL AND INFLUENCE OVER INDUSTRY AND ECONOMIC SIGNIFICANCE OF INVESTMENT COMPANIES, H.R. DOC. NO. 77-246 (1941); and CONCLUSIONS AND RECOMMENDATIONS, H.R. DOC. NO. 77-246 (1941).

The original bill submitted to Congress was an outgrowth of the Study and was the subject of four weeks of hearings before a subcommittee of the Senate Committee on Banking and Commerce.[9] While there was a nearly unanimous consensus among those at the hearings regarding the need for regulation of some sort, many representatives of the investment company industry expressed concerns about specific provisions of the bill.[10] At the conclusion of the hearings, these representatives joined in submitting to the subcommittee a proposed statutory framework that was acceptable to virtually all of the investment company representatives that had appeared at the hearings.[11] This framework was used as a basis for negotiations between the Commission and representatives of the investment company industry, who worked jointly to redraft the bill.[12] The bill, as redrafted, had the nearly unanimous support of both the Commission and the investment company industry.[13] After additional hearings in both houses of Congress, the substitute bill was passed by both houses with no opposition.[14]

The Study and the Congressional hearings had confirmed the concerns that prompted Congress to initiate the Study, as well as the need for federal oversight of investment companies and investment trusts:

FUNDS ADMINISTERED BY BANKS AND TRUST COMPANIES, H.R. DOC. NO. 76-476 (1939); INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES, H.R. DOC. NO. 76-477 (1939); COMPANIES SPONSORING INSTALLMENT INVESTMENT PLANS, H.R. DOC. NO. 76-482 (1939); FIXED AND SEMI-FIXED INVESTMENT TRUSTS, H.R. DOC. NO. 76-567 (1940); and COMPANIES ISSUING FACE AMOUNT INSTALLMENT CERTIFICATES, H.R. DOC. NO. 76-659 (1940). As the dates of these documents reflect, not all parts of the Report were submitted to Congress prior to the deadline of January 4, 1937 established in Section 30 of the Public Utility Holding Company Act. *See* Public Utility Holding Company Act of 1935, ch. 687, § 30, 49 Stat. 837 (1935) (current version at 15 U.S.C. § 79z-4 (2000)). Some parts of the Report were not actually submitted to Congress until after the passage of the '40 Act.

9 *See* S. 3580, 76th Cong. (1940).

10 *See* SENATE REPORT, *supra* note 6, at 1.

11 *See id.*; *see also Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 1052–59 (1940) [hereinafter *Senate Hearings*] (Statement of Arthur H. Bunker, Executive Vice President, Lehman Corporation).

12 *See* SENATE REPORT, *supra* note 6, at 1; *see also* S. 4108, 76th Cong. (1940).

13 *See* SENATE REPORT, *supra* note 6, at 2.

14 *See* Jaretzki, *supra* note 1, at 310 (footnote omitted). For a complete discussion of the history of both bills, see *id.* at 308–11.

> It is not to be implied or inferred that most investment trusts and investment companies at present operating in this country were guilty of unfair practice or were mismanaged. . . . However, it is clear that malpractices cannot be eliminated without the enactment of a Federal law to regulate these institutions. This conclusion was conceded by virtually every witness who appeared before [the House Committee on Interstate and Foreign Commerce] and is the virtually unanimous opinion of the entire industry itself.
>
> The Securities Act of 1933 and the Securities Exchange Act of 1934 have not acted as deterrents to the continuous occurrence of abuses in the organization and operation of investment companies. Generally these acts provide only for publicity. The record is clear that publicity alone is insufficient to eliminate malpractices in investment companies. Further, the great majority of investment companies have never come within the purview of these acts.
>
> In the opinion of the [House Committee on Interstate and Foreign Commerce], the [Commission], and the industry itself, this legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managements and to provide such investors with a regulated institution for the investment of their savings. This legislation will also prevent those abuses which have damaged the reputation of the industry as a whole.[15]

It was also recognized, however, that only certain types of companies were proper subjects of the Study and the federal regulatory regime that would eventually result. One of the major difficulties that the Commission confronted when it began the Study was distinguishing between an "investment company" and a holding company:

> On the one extreme there is the company whose sole business is the investing and reinvesting of its funds in diversified securities—obviously an investment company—and on the other, the company whose assets consist solely of stock of wholly owned subsidiaries not engaged in the investment business—obviously a holding company.[16]

The statutory grant of authority from Congress did not define the terms "investment company" or "investment trust." As a result, one of the first tasks that the Commission undertook as part of the Study was to develop criteria that would segregate, for purposes of the Study, investment companies and investment trusts from other companies that owned securities of corporations.[17] Banks and trust companies, as well as insurance companies, were not included in the Study even though they owned securities of other corporations because their primary businesses were banking and insurance, respectively, and not the ownership of securities.[18] Other types of compa

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[15] HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, H.R. REP. NO. 76-2639, at 9–10 (1940). For a discussion of the specific abuses the '40 Act was designed to remedy, see SENATE REPORT, *supra* note 6, at 6–12.

[16] Jaretzki, *supra* note 1, at 312.

[17] *See* REPORT PART ONE, *supra* note 3, at 15 (noting no precise or generally accepted definition or classification existed).

[18] *See id*. at 16.

nies that owned securities were classified in a broad category labeled "securities companies" [19] and were then further subdivided into four groups, based on "the extent and proportion of ownership by them of the outstanding securities of other corporations and, as a corollary thereto, the extent of the influence and control exercised by them over their portfolio corporations."[20] These four groups consisted of "securities companies" whose assets were comprised primarily of investments in:

(1) wholly-owned subsidiaries, *i.e.*, subsidiaries over which the parent company had "absolute" control and that were no different, "in essence, from operating divisions or units within a single organization";[21]

(2) non-wholly-owned subsidiaries, *i.e.*, subsidiaries in which a "securities company" held more than 50% but less than 100% of the outstanding voting shares – " an amount sufficient to insure absolute control under ordinary circumstances";[22]

(3) "working-controlled companies," *i.e.*, companies in which a "securities company" held between 10% and 50% of the outstanding voting shares – "blocks of such size that may enable the securities company to exercise effective working control, although they constitute less than 50 percent of the total of such securities outstanding. . . . [T]he retention of working control is usually insured by wide distribution of the remaining shares among numerous holders who are unable or unwilling to combine their voting strength"; [23] and

(4) diversified securities, *i.e.*, securities owned in such small blocks as to have a negligible effect on control or influence.[24]

Of these four groups, the first – consisting of "securities companies" with investments primarily in wholly-owned subsidiaries – was also excluded from the Study on the theory that these "securities companies" were, in essence, engaged in the operating businesses of their wholly-owned subsidiaries by virtue of their absolute control over those subsidiaries.[25]

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[19] "Securities companies" included "all types of companies owning securities of other corporations, exclusive of banks and trust companies, insurance companies, and similar organizations . . . ." *Id*.

[20] *Id.* (footnote omitted).

[21] *See id*. (outlining aspects of securities companies with investments primarily in wholly-owned subsidiaries).

[22] *See id*. at 17 (defining concept of non-wholly-owned subsidiaries).

[23] *See id*. (defining concept of working-controlled corporations).

[24] *See id*. (outlining aspects of securities companies with investments primarily in diversified securities).

[25] *See id*. at 16, 18 (eliminating group from study to “delimit the entire expanse of securities companies").

The Commission used this system of classification as a convenient means of subdividing the range of "securities companies."[26] It recognized, however, that in practice, the portfolios of most "securities companies" would consist of different combinations of holdings.[27] The problem confronting the Commission was to create a formula or definition that would "segregate investment trusts and investment companies from the remaining groups and combinations of types of securities companies."[28] The Commission believed that, in order for the formula or definition to be effective, it had to be objective and based on factors common to all "securities companies," rather than on subjective elements such as the intent to exercise control or influence.[29] Based on its analysis of the various types of "securities companies," the Commission determined that the most accurate and effective measure of whether a particular "securities company" was a proper subject of the Study was the one element common to all such companies – security holdings.[30] The "primary device" to which the Commission turned in defining the parameters of the Study was (1) the proportion of a "securities company"'s assets held in securities of other corporations and (2) the proportion of those corporations' outstanding securities held by the "securities company."[31]

The key number for assessing both of these proportions was 50%. With regard to the second calculation – the percentage of a corporation's outstanding voting securities held by a "securities company" – the Commission distinguished between holdings in majority-owned companies (defined as "subsidiaries"[32]) and holdings in less than majority-owned ("controlled" companies). The latter were considered investments; the former were not, on the theory that a company's ownership interest in a "subsidiary" was sufficient to permit it to exercise control over, and thereby engage in, the subsidiary's business operations. With regard to the first calculation, a "securities company" with more than 50% of its assets in "subsidiaries" was considered a holding company and beyond the scope of the Study. By contrast, a "securities company" was deemed to be an "investment company" if:

> more than one-half of its assets, other than cash and United States Government securities, consisted of securities other than United States Government securities and securities of subsidiary companies which were not investment companies.[33]

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[26] *See id*. at 17.

[27] *See id*. at 17–18 (noting that in actuality companies tend to "graduate from one type to another, and various combinations exist").

[28] *Id*. at 18.

[29] *See id*. at 19.

[30] *See id*. (stating that security holdings were "the common denominator of all securities companies").

[31] *See id*. (trying to limit study to certain securities companies).

[32] *See id.* (restricting definition of "subsidiaries" to companies "of which more than 50 percent of the voting shares was owned or controlled by" corporation).

[33] *Id.* (footnotes omitted).

The effect of this *prima facie* definition of "investment company" was to eliminate the majority of companies that were considered to be definitively outside the scope of the Study, including nearly all holding companies. For borderline cases – that is, where the proportion of investments in securities of subsidiaries was near the 50% threshold, the Commission intended that additional factors should be considered to determine whether a company in fact conducted business through its subsidiaries or whether the company was an investment company.[34] The Commission applied the 50% test to approximately 2,000 corporations registered under the Securities Exchange Act of 1934 and listed on national securities exchanges to determine whether it "would encompass corporations not ordinarily regarded as investment companies."[35] Only 25 of the 2,000 were *prima facie* investment companies under the 50% definition articulated by the Commission.[36]

B. Statutory Definitions and Exemptions

1. The Definition of "Investment Company"

Many of the thresholds used in the Study were subsequently codified as part of the '40 Act.[37] The statutory definition of "investment company" is contained in Section 3(a)(1) of the '40 Act. An issuer is deemed to be an investment company under Section 3(a)(1)(A) of the '40 Act if it "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[38] Alternatively, an issuer will be treated as an investment company under Section 3(a)(1)(C) of the '40 Act if it "is engaged or proposes to engage in the

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[34] *See id.* (developing factors to assist in determining whether company was to be included as investment company). These factors included:

> control or influence exercised, the integration or nonintegration of the business of various subsidiaries and affiliates, the volume of trading by the company in its portfolio securities, the frequency of shifts in portfolio securities, the terms of and the representations upon the original public offering of its securities, and the various activities and transactions of the organization . . . .

[35] *Id*.

[36] *Id.* at 20.

[37] *See id.* (noting only 25 satisfied test for prima facie investment company). Of the 2,000 corporations, 523 (or approximately 25%) had investments in securities of non-"subsidiary" corporations in excess of 5% of their respective total assets. *See id*. Of these 523 corporations, only 25 had 50% or more of their total assets invested in securities of non-"subsidiary" corporations and therefore were considered *prima facie* investment companies under the 50% test. *See id*. Upon further examination, however, it was determined that the securities holdings of 15 of these companies either (1) consisted primarily of U.S. government securities, or (2) together with interests in related companies, suggested that these companies were holding companies outside the scope of the Study. Thus, only the remaining ten companies were considered to be investment companies and were included in the Study. *See id*. (stating that these companies were management investment companies).

[38] Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq*. (2000).

[39] 15 U.S.C. § 80a-3(a)(1)(A). Throughout this article, portions of the references to sections 3(a)(1)(A) and 3(a)(1)(C) of the '40 Act appear in brackets. The bracketed text has been included to reflect current statutory references. Certain sections of the '40 Act, including sections 3(a)(1)(A) and 3(a)(1)(C), were renumbered pursuant to Section 209(c) of the National Securities Markets Improvement Act of 1996. *See* Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of the United States Code).

business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value[39] exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities[40] and cash items[41]) on an unconsolidated basis."[42] "Investment securities" is defined in Section 3(a)(2) of the '40 Act to include all securities except "Government securities," securities issued by employees' securities companies,[43] and "securities issued by majority-owned subsidiaries[44] of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in

[39] The '40 Act contains specific requirements for valuing assets. Generally, securities for which market quotations are readily available must be valued at market value, as of the end of the most recent fiscal quarter; other securities and all other assets must be valued at "fair value," as determined in good faith by the company's board of directors, as of the end of the most recent fiscal quarter. Securities and other assets acquired during the quarter must be valued at cost. *See* 15 U.S.C. § 80a-2(a)(41).

[40] *See* 15 U.S.C. § 80a-2(a)(16) (defining "Government securities"). Section 2(a)(16) of the '40 Act defines a "Government securities" as

> any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing.

Id.

[41] The '40 Act does not define the term "cash items." Although an early draft of the '40 Act defined the term to include "cash, bank deposits and current accounts receivable," no definition appeared in the bill presented to Congress. *See* Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STAN. L. REV. 29, 38 n.50 (1959) (noting definition given in author's typewritten draft). For purposes of Rule 3a-1, discussed in Section I.B.3. below, the Commission has indicated that

> cash, coins, paper currency, demand deposits with banks, timely checks of others (which are orders on banks to immediately supply funds), cashier checks, certified checks, bank drafts, money orders, traveler's checks and letters of credit generally would be considered cash items. Certificates of deposits and time deposits typically would not be considered cash items absent convincing evidence of no investment intent.

Certain Prima Facie Investment Companies; Proposed Rule, Investment Co. Act Release No. 10,937, 44 Fed. Reg. 66,608, 66,611 n.29 (Nov. 20, 1979) (final rule in Release No. 11,551) [hereinafter Release No. 10,937]. This list illustrates what the staff believes to be the essential qualities of a "cash item" for purposes of section 3(a)(1)(C) and Rule 3a-1: "a high degree of liquidity and relative safety of principal." Wilkie Farr & Gallagher, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 916, at *12 (Oct. 23, 2000).

[42] 15 U.S.C. § 80a-3(a)(1)(C).

[43] *See* 15 U.S.C. § 80a-2(a)(13).

[44] A company is a "majority-owned subsidiary" of an issuer for purposes of the '40 Act if 50% or more of the company's outstanding voting securities are held by the issuer. *See* 15 U.S.C. § 80a-2(a)(24). A company is a "wholly-owned subsidiary" of an issuer if 95% or more of the company's outstanding voting securities are held by the issuer. *See* 15 U.S.C. § 80a-2(a)(43).

paragraph (1) or (7) of subsection (c)"[45] of the '40 Act.

The first test, in Section 3(a)(1)(A), is for an "'orthodox investment company,' *i.e.*, a company that knows that it is an investment company and does not claim to be anything else."[46]

It typically applies to mutual funds and other companies that hold themselves out as investment companies. The second test, in Section 3(a)(1)(C), is a purely objective test that captures any company having more than 40% of its assets in "investment securities." The 40% test in Section 3(a)(1)(C) was adopted from the 50% threshold that the Commission had established for purposes of the Study. For reasons that are lost to history, however, the 50% threshold was reduced to 40% when the numerical test was incorporated into the '40 Act:

> The ['40] Act's legislative history does not explain specifically the reasons why a 50 percent portfolio composition of investment securities test was used to define an investment company for purposes of the [Study], but a 40 percent figure was incorporated into section 3(a)[(1)(C)] of the ['40] Act. However, it should be noted that the 50 percent formula was employed in the [Study] only to determine whether "the formula would encompass corporations not ordinarily regarded as investment companies." [REPORT PART ONE, *supra* note 3, at 20]. That standard was not used to ascertain whether any companies which might arguably be investment companies were *excluded* from the [Study] by the 50 percent formula. Rather, that determination was to be made based on all the facts and circumstances in those cases where the percentage of a company's non-subsidiary securities was less than, but approaching, 50 percent. . . . Thus, adoption of a 40 percent figure is not inconsistent with the 50 percent figure used for the [Study]. Indeed, Congress might have believed that neither a 50 percent nor a 40 percent cut-off point would bring ordinary industrial companies within the jurisdiction of the ['40] Act. This theory is supported by the ['40] Act's legislative history which indicates that, although the 40 percent figure was tested extensively to determine whether it would bring any non-investment companies within the purview of the ['40] Act, "very, very few companies were caught by this [40 percent] formula."[47]

Because it is a numerical test, the 40% threshold can have the effect of catching the unwary company in its web. Such a company is often called an "inadvertent investment company." Increasing numbers of high-technology companies are becoming inadvertent investment companies by virtue of their securities holdings.

[45] 15 U.S.C. § 80a-3(a)(2). Section 3(c)(1) exempts from the definition of "investment company" any issuer whose securities are beneficially owned by not more than 100 persons. *See* 15 U.S.C. § 80a-3(c)(1). Section 3(c)(7) exempts any issuer whose securities are held exclusively by "qualified purchasers," as defined in Section 2(a)(51) of the '40 Act. *See* 15 U.S.C. § 80a-3(c)(7); *see also* 15 U.S.C. § 80a-2(a)(51).

[46] Securities and Exchange Comm'n v. Fifth Avenue Coach Lines, Inc., 289 F. Supp. 3, 27 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970) (citation omitted).

[47] Release No. 10,937, *supra* note 41, at 66,609 n.9 (quoting *Senate Hearings, supra* note 11, at 176–77 (Further Statement of David Schenker, Chief Counsel, Study)). According to David Schenker, the 40% figure was tested against 1,800 companies registered under the Securities Act of 1933 and the Securities Exchange Act of 1934 (excluding all companies that considered themselves investment companies). *See Senate Hearings, supra* note 11, at 176 (Further Statement of David Schenker, Chief Counsel, Study).

A company that meets the definition of "investment company" under Section 3(a)(1)(C) may also be an investment company under Section 3(a)(1)(A). The "inadvertent investment company," however, exemplifies the circumstance in which this is not the case. The two definitions differ in a number of ways:

> [S]ection 3(a)(1)[(A)] requires the issuer to be "primarily" engaged in the business of investing, reinvesting or trading in securities while section 3(a)[(1)(C)] requires only that the issuer be "engaged" in that business; section 3(a)(1)[(A)] applies to companies which invest in any type of security, while section 3(a)[(1)(C)] applies only to companies investing in "investment securities"; and section 3(a)(1)[(A)] does not apply to companies which merely "own or hold" securities, while section 3(a)[(1)(C)] applies to such companies.[48]

In addition, Section 3(a)(1)(C) requires an unconsolidated review of a company's financial statements and looks only to the assets of the company whose investment company status is in question. Section 3(a)(1)(A) contains no such limitation.[49]

2. Exemptions from the Definition of "Investment Company"

Although "virtually no company, that [was] not popularly regarded as an investment company" was caught by the 40% formula,[50] both the Commission and Congress recognized that some operating companies might satisfy the numerical definition of "investment company" in Section 3(a)(1)(C) of the '40 Act even though they were not of the type intended to be subjected to the statute's extensive scheme of regulation. Therefore, "in order to be meticulously careful,"[51] two exceptions from this section were included in the '40 Act.[52] Section 3(b)(1) excludes an "issuer primarily

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[48] Release No. 10,937, *supra* note 41, at 66,609 n.8.

[49] *See* Certain Prima Facie Investment Companies, Investment Co. Act Release No. 11,551, 46 Fed. Reg. 6879, 6880-81 n.9 (Jan. 22, 1981) [hereinafter Release No. 11,551].

[50] *See Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 101 (1940) [hereinafter *House Hearings*] (Testimony of David Schenker, Chief Counsel, Study).

[51] *Id.*

[52] By its terms, section 3(b)(1) exempts issuers only from the numerical definition of "investment company" in section 3(a)(1)(C) of the '40 Act, and not from the subjective definition in section 3(a)(1)(A). The Commission has taken the position, however, that where an issuer is primarily engaged in a non-investment related business, such that the issuer is exempt from the section 3(a)(1)(C) definition of "investment company" by section 3(b)(1) or 3(b)(2), the issuer is also not an investment company under section 3(a)(1)(A). *See* Certain Research and Development Companies, Investment Co. Act Release No. 19,566, 58 Fed. Reg. 38,095, 38,096 (July 15, 1993) [hereinafter Release No. 19,566] ("A determination under either § 3(b)(2) or § 3(b)(1) that an issuer primarily is engaged in a noninvestment business also means that it is not an investment company under § 3(a)(1)."); ICOS Corporation, Investment Co. Act Release No. 19,334, 51 S.E.C. 322 (Mar. 16, 1993) [hereinafter ICOS Release No. 19,334]; M.A. Hanna Co., 10 S.E.C. 581, 583 (1941) (eligibility for exemption under section 3(b)(2) would also determine company's status under section 3(a)(1)(A), "since the issue presented is [a] factual one as to what the actual nature of the company's business is").

engaged, *directly* or through a *wholly-owned* subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."[53] Section 3(b)(2) authorizes the Commission to issue an order declaring that a company is "primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either *directly* or (A) through *majority-owned* subsidiaries or (B) through *controlled companies conducting similar types of businesses*."[54] A "controlled company" generally is a company in which an issuer owns more than 25% of the voting securities.[55] The good-faith filing of an application with the Commission under Section 3(b)(2) exempts an applicant from all provisions of the '40 Act for a period of 60 days, which is subject to extension upon a showing of cause.[56] If the Commission subsequently determines, following the issuance of a Section 3(b)(2) exemptive order, that the circumstances that gave rise to the issuance of the order have changed, the Commission may revoke the order.[57]

Both Sections 3(b)(1) and 3(b)(2) contemplate that a company may engage in a non-investment company business in two ways: directly[58] and/or through companies in which it owns securities. In order to be eligible for an exemption under either Section 3(b)(1) or Section 3(b)(2), the Commission has indicated that an issuer conducting an operating business through subsidiary companies must both control the companies through which it claims to do business and "actively exercise that control, i.e., it must engage in the non-investment company business 'through' the controlled or subsidiary companies."[59] The exemptions also contain important differences, however:

> Section 3(b)(1) is self-operating, while section 3(b)(2) requires a Commission order. Additionally, section 3(b)(1) applies only to companies operating either directly or through *wholly-owned* subsidiaries, while section 3(b)(2) applies additionally to companies operating through *majority-owned* subsidiaries and certain *controlled* companies.[60]

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[53] Investment Company Act of 1940 § 3(b)(1), 15 U.S.C. § 80a-3(b)(1) (2000) (emphasis added).

[54] 15 U.S.C. § 80a-3(b)(2) (emphasis added).

[55] *See* 15 U.S.C. § 80-2(a)(9) (defining "control" as "the power to exercise a controlling influence over the management or policies of a company"). Under this definition, a presumption of control arises where a person holds more than 25% of the voting securities of a company. *See id*.

[56] *See* 15 U.S.C. § 80a-3(b)(2).

[57] *See id.*

[58] *See*, *e.g*., Real Silk Hosiery Mills, Inc., 36 S.E.C. 365 (1955) (declaring that manufacturing company investing excess capital in securities was "primarily engaged in a business other than that of investing"); Hoskins Mfg. Co., 8 S.E.C. 578 (1941) (same).

[59] Release No. 10,937, *supra* note 41, at 66,610 n.19 (citing Business Prop. Assocs., 12 S.E.C. 845 (1943); Atlantic Coast Line Co., 11 S.E.C. 661 (1942)).

[60] *Id*. at 66,610.

The rationale behind the latter difference appears to be based on the presumption that an issuer having one or more wholly- or majority-owned operating subsidiaries, regardless of whether they engage in similar businesses, and an issuer having controlled companies that engage in similar businesses, "generally would be involved in operating the businesses of those subsidiaries and controlled companies, and . . . would not be involved in trading the securities of their subsidiaries and controlled companies in a manner giving rise to the concerns that led to the enactment" of the '40 Act.[61] Conversely, Congress apparently determined that an issuer with interests in a number of controlled companies that engaged in unrelated businesses should be subject to the '40 Act because such an issuer presented the same concerns as more traditional investment companies.[62]

3. The *Tonopah* Factors and Rule 3a-1

Despite the differences between Sections 3(b)(1) and 3(b)(2), the fundamental inquiry behind the two exemptions appears to be the same. That inquiry involves a determination as to the business or businesses in which a company is "primarily engaged." The determination of a company's primary business is a factual issue concerning the nature of its business.[63] Once a company establishes that "an identifiable noninvestment business exists, the inquiry then shifts to whether that business is 'primary.'"[64]

The Commission adopted a five-factor test for determining an issuer's primary business in *Tonopah Mining Co. of Nevada.*[65] While *Tonopah* involved a request for exemptive relief under Section 3(b)(2), over time, it appears to have become generally accepted that the *Tonopah* factors should be used for assessing an issuer's primary business for purposes of the exemption in Section 3(b)(1).[66] The reasons for this are not entirely clear. As will be discussed below, however, the use of the *Tonopah* factors in the Section 3(b)(1) context has imported a numerical threshold into Section 3(b)(1), thereby blurring the distinction between this exemption and the exemption afforded by Section 3(b)(2). This does not appear to be the result that Congress intended when it adopted the two seemingly distinct exemptions contained in Section 3(b)(1) and 3(b)(2).

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[61] ROBERT H. ROSENBLUM, INVESTMENT COMPANY DETERMINATIONS UNDER THE 1940 ACT: EXEMPTIONS AND EXCEPTIONS § 6.04[D] (Supp. 1998).

[62] *See id.*

[63] *See* M.A. Hanna Co., 10 S.E.C. 581, 583 (1941) (noting that Commission will study history and business activities of applicant when making its determination).

[64] Release No. 19,566, *supra* note 52, at 38,096.

[65] Tonopah Mining Co. of Nevada, 26 S.E.C. 426 (1947).

[66] *See*, *e.g*., Release No. 19,566, *supra* note 52, at 38,096 (citation omitted); Release No. 10,937, *supra* note 41, at 66,610 n.24 ("Although [*Tonopah*] was decided under section 3(b)(2) of the ['40] Act, the 'primary engagement' standard set forth in that case also appears to be applicable to the identical standard of section 3(a)(1) and 3(b)(1).") (citations omitted); Moses v. Black, No. 78 Civ. 1913, 1981 U.S. Dist. LEXIS 10870, at *15 (S.D.N.Y. 1981) ("The well settled principles developed by the [Commission] in connection with Section 3(b)(2) applications are equally applicable to this court's determination of whether Chock [Full O'Nuts Corporation] is excepted from the definition of an investment company pursuant to Section 3(b)(1).") (citation omitted); Cannon Craft Co., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 3057, at *1 (June 22, 1979) (listing *Tonopah* factors as those to be considered for granting an exemption order under section 3(b)(1)).

The five-factor test established in *Tonopah* requires an examination of:

(1) a company's historical development;

(2) its public representations of policy;

(3) the activities of its officers and directors;

(4) the nature of its present assets; and

(5) the sources of its present income.[67]

Of these factors, the asset and income factors are considered most important.[68] The Commission staff has even indicated that, because important assets may produce little or no income, the asset factor "is often most important."[69] The asset factor involves an assessment of the overall character of a company's assets, as evidenced by the percentage of assets held in "investment securities."[70] The income factor involves an assessment of the sources of a company's income, as evidenced by the percentage of its income derived from "investment securities."[71] The Commission has indicated that, "[a]s a general rule . . . if a company has no more than 45 percent of its assets invested in–and derives no more than 45% of its income from–investment securities, it is primarily engaged in a business other than being an investment company."[72]

Rule 3a-1[73] codifies the 45% asset and income thresholds applied by the Commission staff in orders issued under Section 3(b)(2).[74] It is a safe harbor that deems certain companies not to be investment companies even though they satisfy the definition of "investment company" in Section 3(a)(1)(C) of the '40 Act because they have more than 40% of their assets in "investment securities."

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67 *See Tonopah*, 26 S.E.C. at 427 (outlining principal factors).

68 *See* Release No. 10,937, *supra* note 41, at 66,610 (stating that "character of a company's assets . . . and the sources of the company's present income" are most important).

69 Synercon Corp., SEC No-Action Letter, 1971 SEC No-Act. LEXIS 1444, at *2 (July 30, 1971).

70 *See* Release No. 10,937, *supra* note 41, at 66,610 (citing *Tonopah*, 26 S.E.C. at 427, 430-31) (providing framework to assess company's assets when determining "the nature of [the companies'] present assets").

71 *See id*. (providing framework to assess company's income when determining "the sources of [the companies'] present income").

72 *Id*. at 66,610–11.

73 SEC Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270.3a-1 (1998).

74 *See* Release No. 10,937, *supra* note 41, at 66,611-12 (providing text of proposed rule).

Rule 3a-1 provides that an issuer that would otherwise meet the definition of "investment company" in Section 3(a)(1)(C) of the '40 Act is not an investment company if no more than 45% of the value of its total assets (exclusive of "Government securities" and "cash items") consists of, and no more than 45% of its net income after taxes for the last four fiscal quarters combined is derived from, securities other than:

- "Government securities";
- securities issued by majority-owned subsidiaries (other than subsidiaries relying on the exclusions from the definition of investment company in Section 3(b)(3)[75] or (3)(c)(1)[76] of the '40 Act) that are not investment companies; and
- securities issued by companies:
  - that are controlled primarily by the issuer;
  - through which the issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities; and
  - that are not investment companies.[77]

The 45% thresholds are determined on an unconsolidated basis, except in the case of wholly-owned subsidiaries, whose financial statements must be consolidated with those of the issuer.[78] Rule 3a-1does not apply to companies that are investment companies under the subjective definition of Section 3(a)(1)(A) of the '40 Act or to special situation investment companies.[79]

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[75] *See* Investment Company Act of 1940 § 3(b)(3), 15 U.S.C. § 80a-3(b)(3) (2000) (exempting banks, insurance companies and other similar institutions from definition of "investment company").

[76] For a further discussion of section 3(c)(1), see *supra* note 45.

[77] *See* 17 C.F.R. § 270.3a-1(a).

[78] *See* 17 C.F.R. § 270.3a-1(c).

[79] *See* 17 C.F.R. § 270.3a-1(b). The '40 Act does not define the term "special situation investment company." In the release proposing Rule 3a-1, however, the Commission indicated that special situation investment companies are "companies which secure control of other companies primarily for the purpose of making a profit in the sale of the controlled company's securities. Accordingly, they are considered to be investment companies for purposes of the ['40] Act." Release No. 10,937, *supra* note 41, at 66,610 (footnotes omitted). In contrast:

> a holding company generally secures control of other companies primarily for the purpose of engaging in the other companies' line of business . . . .
>
> . . . Although a company may actively manage its portfolio companies and thus appear superficially to be a holding company, an examination of its operating history may disclose that it is a special situation investment company. Such would be the case, for example, if the company had a history of buying or selling controlling interests in companies. In this regard, the Commission notes that a special situation investment company may operate by purchasing and selling securities of controlled companies, majority-owned subsidiaries or wholly-owned subsidiaries.

Id. at 66,610 nn. 19 & 20 (citing Frobisher Ltd., 27 S.E.C. 944, 950 (1948); Bankers Sec. Corp., 15 S.E.C. 695, 146 F.2d 88 (3d Cir. 1944)).

The asset test in Rule 3a-1 is advantageous for two reasons. First, the 45% threshold permits a company to hold a greater percentage of its assets in "investment securities" than the 40% limit established in Section 3(a)(1)(C) of the '40 Act. Second, it excludes from the definition of "investment securities" not only securities of majority-owned subsidiaries, but also securities of "primarily controlled" companies through which an issuer engages in a non-investment company business. While the exclusion of securities of controlled companies would appear to make it easier to satisfy the asset test, Rule 3a-1 imposes the additional requirement of "primary control." "Primary control" exists for purposes of Rule 3a-1 where an individual or entity has "control" of a company within the meaning of Section 2(a)(9) – that is, where it owns more than 25% of the company's outstanding voting securities – and, in addition, has a degree of control over the company that is greater than that of any other person.[80] The requirement of primary control was intended to exclude holding companies from the purview of the '40 Act:

> To ensure that only holding companies can rely on it, [Rule 3a-1] incorporates the statutory requirements of section 3(b)(1) and section 3(b)(2) that the issuer do business "through" the controlled company. Since such an issuer would presumably be more likely to maintain an active role in managing its affairs with a controlled company–that is, it would do business "through" the controlled company–than would an issuer which may control jointly another company, the proposed rule would require the issuer to *primarily* control the controlled company.[81]

Thus, the advantage of Rule 3a-1 is that it permits an issuer to exclude certain companies in which it has less than a majority ownership interest – *i.e.*, companies that it primarily controls – when calculating the percentage of the issuer's assets that are held in "investment securities." In this respect, Rule 3a-1 is broader than Section 3(a)(1)(C).

One disadvantage to Rule 3a-1 is that it includes an income test. While this test is not present in the statute, it is imposed under the five-factor *Tonopah* test, which has been followed faithfully for nearly 60 years. The rule requires a company to satisfy both the asset and income tests.[82]

C. Traditional Alternatives to Registering as an Investment Company

Historically, if a company could not satisfy the 40% test in Section 3(a)(1)(C) and could not qualify for the safe harbor provided by Rule 3a-1, it still had other alternatives to registering as an investment company. These alternatives are outlined below, but, as we will see, none of them is without its limitations. High-technology companies in particular have experienced difficulties when attempting to rely on exemptions or other alternatives that companies have traditionally used when seeking to avoid registration under the '40 Act.

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[80] *See* Health Communications Servs., Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2214, at *1 (Apr. 26, 1985) (stating Commission test for determining when company is not "controlled primarily" by issuer); *see also* Tele-Communications Int'l, Inc., Investment Co. Act Release No. 22,797 (Aug. 22, 1997).

[81] Release No. 10,937, *supra* note 41, at 66,611 n.32.

[82] *See* DRX, Inc., SEC No-Action Letter, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,859, at 78,324 (June 28, 1988) (stating that company cannot "merely meet the asset test without meeting the income test in order to rely on Rule 3a-1").

One alternative to registering as an investment company that has received some recent attention is electing to be regulated as a "business development company" under the '40 Act. This has been suggested as a possibility primarily for companies pursuing incubator-like business models. A business development company is a type of closed-end investment company that, although subject to the '40 Act, is exempt from many of its provisions.[83] It has two distinguishing characteristics. First, it must hold 70% of the value of its total assets in "eligible portfolio companies," which include privately placed securities issued by U.S. companies only.[84] Second, with limited exceptions, it must provide "significant managerial assistance" to its portfolio companies by providing guidance and counsel concerning their management, operations or business objectives, and policies, or by exercising a controlling influence over their management and policies.[85] The latter requirement lends itself particularly well to the internet incubator model because it makes provision for one of the primary activities of incubators – participating actively in the management and operations of network companies.

For companies that do not engage in active management of companies in which they hold securities, electing to be regulated as a business development company is not a realistic option. This is true for a number of reasons over and above the statutory requirement of significant managerial assistance. While business development companies are exempt from some provisions of the '40 Act, they are still subject to fairly significant regulation (including prohibitions on affiliated transactions[86]). In addition, because they are closed-end investment companies, their securities trade at a significant discount to net asset value. They are precluded from making significant foreign investments. Finally, they have yet to receive widespread acceptance in the underwriting community. Accordingly, companies that acquire securities to secure access to supplies or that engage in strategic partnering must find another alternative to registering as an investment company. The following section discusses some of the alternatives to which companies have traditionally looked and explains why the investment patterns of the "new economy" have put these alternatives to the test.

1. Sections 3(c)(1) and 3(c)(7) – "Private Investment Companies"

Section 3(c)(1) exempts from the definition of "investment company" any issuer whose securities are beneficially owned by not more than 100 persons,[87] and Section 3(c)(7) exempts any

[83] The term "business development company" is defined in section 2(a)(48) of the '40 Act. *See* Investment Company Act of 1940 § 2(a)(48), 15 U.S.C. § 80a-2(a)(48) (2000). A business development company that has a class of equity securities registered under section 12 of the Securities Exchange Act of 1934 may elect to be subject to the provisions of sections 54 through 64 of the '40 Act. *See* 15 U.S.C. § 80a-53(a).

[84] *See* 15 U.S.C. §§ 80a-2(a)(46), 54(a).

[85] *See* 15 U.S.C. §§ 80a-2(a)(47), (48).

[86] *See* 15 U.S.C. § 80a-56.

[87] *See* 15 U.S.C. § 80a-3(c)(1).

issuer whose securities are held exclusively by "qualified purchasers," as defined in Section 2(a)(51) of the '40 Act.[88] While these exemptions can be quite useful, they cease to be available once a company makes or proposes to make a public offering of its securities, and Section 3(c)(1) ceases to be available once a company exceeds the limit of 100 beneficial owners. For example, Bill Gross' idealab!, an internet incubator company, initially relied on Section 3(c)(1), but became ineligible for the exemption once its board of directors authorized a grant of stock options, which caused the company to exceed the statutory limit of 100 security holders.[89] Likewise, Internet Capital Group, Inc., also an internet incubator, relied on this exemption, but became ineligible when its board of directors authorized both the issuance of additional securities, increasing the number of its beneficial owners to over 100, and the filing of a registration statement for the initial public offering of the company's common stock.[90]

2. Restructuring and/or Disposing of Securities Holdings

One obvious means of avoiding the need to register under the '40 Act would be for an issuer to restructure and/or dispose of a portion of its securities holdings so that it could then satisfy the requirements of Section 3(a)(1)(C) or Rule 3a-1. For example, an issuer might dispose of enough of its holdings so that it would fall below the 40% asset threshold imposed in Section 3(a)(1)(C). Alternatively, an issuer might increase its ownership of certain subsidiaries so that they would be majority-owned and thus, excludable from the definition of "investment securities." An issuer with substantial cash proceeds from an offering might invest these in "Government securities," as opposed to "investment securities," pending the use of these proceeds for operating purposes, so that it would not exceed the asset thresholds in Section 3(a)(1)(C) and Rule 3a-1. The issuer might also use the cash proceeds to purchase real estate or other hard assets that could be resold if the issuer later needed cash.

From a practical perspective, the feasibility of restructuring securities holdings depends on an issuer's business model. For example, the very nature of an internet incubator's business model makes it unlikely that the incubator company could engage in such a restructuring.[91] While an incubator may strive to retain at least a 50% voting interest in network companies to preserve the ability

[88] *See* 15 U.S.C. §§ 80a-3(c)(7), 2(a)(51).

[89] *See* Bill Gross' idealab!, Amendment No. 2 to the Application Pursuant to Section 3(b)(2) of the Investment Company Act of 1940 (the "1940 Act") for (1) a Permanent Order Declaring that [Bill Gross'] idealab! is Primarily Engaged in a Business other than that of Investing, Reinvesting, Owning, Holding, or Trading in Securities, (2) a Temporary Order Extending the 60-Day Period of Exemption under Section 3(b)(2) for an Additional 120-Day Period and (3) a Temporary Order Extending the 120-Day Exemption for an Additional 60-Day Period or until the Permanent Order is Granted, Whichever is Sooner, at 3 (File No. 812-11962) (filed July 19, 2000) [hereinafter idealab! Application].

[90] *See* Internet Capital Group, Inc., Amendment No. 1 to the Application Pursuant to Section 3(b)(2) of the Investment Company Act of 1940, as Amended (the "1940 Act") for an Order Declaring that Internet Capital Group, Inc. ("ICG") is Primarily Engaged in Businesses other than that of Investing, Reinvesting, Owning, Holding or Trading in Securities, at 2 (File No. 812-11202) (filed July 26, 1999) [hereinafter Internet Capital Application].

[91] *But see* Jon G. Auerbach, *AltaVista Says CMGI Position May Bar Deals*, WALL ST. J., Feb. 17, 2000, at B10 (explaining that '40 Act might motivate CMGI, internet incubator that owned 82% of AltaVista, to retain at least 50% ownership in AltaVista following company's proposed public offering).

to control those companies, this interest may be reduced if there is a need for additional capital, if equity is given to strategic investors as an inducement to establishing business relationships with network companies, or if the incubator's interest is diluted when a network company goes public.[92] Furthermore, an incubator may intentionally acquire non-controlling (*i.e.*, less than 25%) interests in existing businesses that are strategically important to its network.[93]

In addition, restructuring or disposing of assets may have unintended consequences. For example, prior to filing an application for exemptive relief under Section 3(b)(2), Bill Gross' idealab! ("idealab!") disposed of certain shares of eToys Inc. ("eToys") in an effort to resolve its investment company status. The disposition enabled idealab! to satisfy the asset test of Rule 3a-1, but resulted in $193 million in income. Because idealab! held only 24.9% of the voting securities of eToys prior to the disposition, it did not "control" eToys within the meaning of the '40 Act. As a result, the $193 million in income was derived from "investment securities." Because the income from idealab!'s network companies was comparatively insignificant, the $193 million in income from the disposition of a portion of its eToys holdings caused idealab! to fail the income test of Rule 3a-1.[94]

One consequence of the '40 Act that many companies have found unappealing is the need to invest their offering proceeds in "Government securities" so as not to exceed the asset limits imposed in Section 3(a)(1)(C) and Rule 3a-1. Relative to other types of "investment securities," "Government securities" have a significantly lower pre-tax yield. While tax-exempt securities such as municipal bonds offer a better rate of return, these do not meet the definition of "Government securities" because they are not issued by the U.S. government. In its application for exemptive relief under Section 3(b)(2), Yahoo! Inc. ("Yahoo!") indicated that, following the expiration of the one-year period under Rule 3a-2 (discussed in Section I.C.3. below), it invested its cash position primarily in "Government securities" in order to comply with Section 3(a)(1)(C), "despite its continuing belief that it has been engaged primarily in a business other than that of investing, reinvesting or trading in securities, and therefore, is not an investment company pursuant to Section 3(b)(1) of the ['40] Act."[95] Other companies have pointed out in their exemptive applications that the lower yield on "Government securities" may not be in the best interests of a company or its shareholders

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[92] *See*, *e.g.*, idealab! Application, *supra* note 89, at 3, 5.

[93] *See id.* at 6.

[94] *See id.* at 3–4. Bill Gross' idealab! recently received its exemptive order. *See* Bill Gross' idealab!, Investment Co. Act Release No. 24,682, 73 S.E.C. Docket 1245, (Oct. 10, 2000) [hereinafter idealab! Release No. 24,682] (finding that "applicant is primarily engaged in a business other than that of investing").

[95] Yahoo! Inc., Amendment No. 2 to Application for Order of Exemption Pursuant to Section 3(b)(2) of the Investment Company Act of 1940, as Amended, at 2 (File No. 812-11976) (filed May 16, 2000) [hereinafter Yahoo! Application].

because it means that a company's offering proceeds will yield less income for use in funding operating costs.[96]

One recent development that suggests the possibility of some relief – at least for companies seeking to invest substantial cash assets on a temporary basis before using them to fund operations – is the Commission staff's recent no-action letter to Wilkie Farr & Gallagher ("Wilkie").[97] Wilkie requested a no-action position from the staff because, according to its letter, it represents numerous "industrial operating companies . . . engaged in capital intensive businesses" that raise substantial amounts of capital through equity and debt offerings as well as through dispositions of operating subsidiaries or divisions. The proceeds of these offerings are used to finance operations and to provide capital for acquisitions and other business development projects. These companies require a high degree of liquidity as well as a high rate of return not available from "Government securities." Wilkie sought the staff's assurance that it would consider as a "cash item" rather than "investment securities" an investment in shares of a registered money market fund.[98] The staff granted Wilkie's request, and indicated that it would not take any enforcement action if issuers did not include shares of registered money market funds that seek to maintain a stable net asset value of $1.00 per share for purposes of the 40% test in Section 3(a)(1)(C) and the asset and income tests in Rule 3a-1.[99]

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[96] *See*, *e.g.*, Allscripts, Inc., Application for an Order Pursuant to Section 3(b)(2) of the Investment Company Act of 1940 Declaring that Allscripts, Inc., is Not an Investment Company under the ['40] Act, at 7 (File No. 812-11996) (filed Mar. 3, 2000) [hereinafter Allscripts Application] (arguing harm to operations and stockholders by investing in government obligations and cash items). In its application Allscripts stated that:

> Were the Company to invest a sufficient amount of its liquid assets in government obligations and cash items to satisfy Section 3(a)(1)(C), thereby foregoing the more attractive yields usually available on other short-term instruments, the Company would be failing to preserve its liquid assets. This would work considerable harm to the Company's operations and stockholders in that it would substantially decrease the funds available for the Company's operations.

Id.; i2 Technologies, Inc., Application of i2 Technologies, Inc. Pursuant to Section 3(b)(2) of the Investment Company Act of 1940 for an Order Declaring that Applicant is Engaged in Businesses Other than that of Investing, Reinvesting, Owning, Holding or Trading in Securities, at 10 (File No. 812-11970) (filed Feb. 9, 2000) [hereinafter i2 Application] ("[I]t would not be in the best interest of Applicant to invest these cash proceeds exclusively in government securities.").

[97] *See* Wilkie Farr & Gallagher, *supra* note 41, at *2, *16 (allowing Wilkie to treat money market fund shares as cash items, and not investment securities).

[98] Money market funds generally are open-end management investment companies registered under the '40 Act that have as their investment objectives generating income, preserving capital and maintaining liquidity through investment in short-term, high quality securities. *See id*. at *2 (stating Commission's view of money market funds).

[99] *See id*. at *16 (providing Commission's conclusion).

3. Rule 3a-2 – Temporary Investment Companies

A company that becomes an inadvertent investment company may also rely on the exemption provided in Rule 3a-2[100] for temporary, or so-called "transient," investment companies. Rule 3a-2 permits a company to avoid being deemed an investment company for a period of one year following the date on which it falls out of compliance with either Section 3(a)(1)(A) or Section 3(a)(1)(C) of the '40 Act, provided that the company has a *bona fide* intention to be engaged primarily in a non-investment company business within that time.[101] The one-year period begins either on (1) the date that the company owns or proposes to acquire "investment securities" in excess of 40% of its total assets, as determined in accordance with Section 3(a)(1)(C), or (2) the date on which the company owns "securities and/or cash" in excess of 50% of the value of its total assets.[102]

The primary disadvantage of Rule 3a-2 is that it offers only temporary relief. If a company is unable to get back into compliance with the '40 Act within the one-year period afforded by the rule, it must petition the Commission for an exemption under Section 3(b)(2). Rule 3a-2 is also subject to the limitation that a company may only rely on it once every three years.[103]

Rule 3a-2 was intended to afford temporary relief to companies that might inadvertently

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[100] *See* SEC Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270.3a-2 (1998).

[101] Rule 3a-2 provides as follows:

> (a) For purposes of section 3(a)(1)[(A)] and 3(a)[(1)(C)] of the Act, an issuer is deemed not to be engaged in the business of investing, reinvesting, owning, holding or trading in securities during a period of time not to exceed one year; Provided, That the issuer has a bona fide intent to be engaged primarily, as soon as is reasonably possible (in any event by the termination of such period of time), in a business other than that of investing, reinvesting, owning, holding or trading in securities, such intent to be evidenced by:
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> (1) The issuer's business activities; and
>
> (2) An appropriate resolution of the issuer's board of directors, or by an appropriate action of the person or persons performing similar functions for any issuer not having a board of directors, which resolution or action has been recorded contemporaneously in its minute books or comparable documents.

17 C.F.R. § 270.3a-2.

[102] *See* 17 C.F.R. § 270.3a-2(b). The term "security" is defined in Section 2(a)(36) of the '40 Act to mean:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Investment Company Act of 1940 § 2(a)(36), 15 U.S.C. § 80a-2(a)(36) (2000).

[103] *See* 17 C.F.R. § 270.3a-2(c).

become investment companies as a result of unusual business occurrences.[104] Many high-technology companies have relied upon it as an interim safeguard pending the filing of an application for a Section 3(b)(2) exemption,[105] which provides an exemption from all the provisions of the '40 Act for 60 days following the filing of the application.[106]

The feasibility of relying on Rule 3a-2, however, also depends on the nature of a company's business. For example, an internet incubator that has exceeded the asset thresholds of Section 3(a)(1)(C) and Rule 3a-1 is unlikely to come back into compliance with the '40 Act. By the very nature of its business, an incubator will always have most of its assets in securities of other companies, and typically in some combination of majority-owned and controlled subsidiaries. Similarly, Rule 3a-2 may not be a practical alternative for a company that intends to do multiple rounds of financing and invest the proceeds of its offerings in "investment securities" pending the use of those proceeds for working capital and general business purposes. In its Section 3(b)(2) application, i2 Technologies, Inc. ("i2") sought relief from the '40 Act following an initial debt offering, the proceeds of which were to be invested primarily in interest-bearing, investment grade debt securities until such time as they were used to cover operating expenses.[107] i2 indicated that it intended to make future offerings of debt and equity and to invest the proceeds in debt securities. The amount of cash that i2 invested would fluctuate – it would be highest immediately after each offering and would decrease gradually until the next offering.[108] i2 pointed out in its application that Rule 3a-2 would not meet its needs "because Applicant expects its cash position to exceed 40% of total assets intermittently and repeatedly, rather than for only one continuous year, during any three-year period."[109] The i2 Application was filed in February, 2000 and has not yet been acted upon.

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[104] *See* Transient Investment Companies, Investment Co. Act Release No. 10,943, 44 Fed. Reg. 67,152 (Nov. 23, 1979) (stating Commission's reasons for proposing rule). Among the "unusual business occurrences" that the Commission named in the release proposing Rule 3a-2 were (1) a start-up company that invests the proceeds of an initial public offering in securities while arranging to purchase operating assets, (2) a company that sells a large operating division and invests the proceeds in securities pending the acquisition of additional operating assets, and (3) a company that makes a tender offer to shareholders of a target non-investment company and subsequently fails to obtain a majority of the target's stock. *See id*. at 67,153 (providing examples of "unusual business occurrences") (footnotes omitted).

[105] *See*, *e.g.*, idealab! Application, *supra* note 89, at 3; Yahoo! Application, *supra* note 95, at 2; Internet Capital Application, *supra* note 90, at 2.

[106] For a further discussion of the 60 day exemption, see *supra* note 56 and accompanying text.

[107] *See* i2 Application, *supra* note 96, at 2–3.

[108] *See id.* at 3.

[109] *Id.*

4. Section 3(b)(2) – Exemptive Relief

For a company that is unable to restructure or dispose of its securities holdings, or to qualify for any of the exemptions discussed above, there has typically been no recourse but to petition the Commission for an exemptive order under Section 3(b)(2). As discussed in Section I.B.3. above, the Commission applies the five-factor test established in *Tonopah* to determine whether a company is eligible for an exemption under Section 3(b)(2).

Since the beginning of this year, a number of Section 3(b)(2) applications have been filed by high-technology companies, several of which have already received exemptive orders.[110] In their respective applications, these companies have attempted to apply the *Tonopah* factors to their businesses. The problems that many high-technology companies encounter in applying the *Tonopah* test, however, are two-fold. First, these companies typically have more than 45% of their non-cash assets in "investment securities." Second, because many of these companies generate little or no operating income, they will have a disproportionate amount of their annual incomes attributable to gain from dispositions of portfolio securities during the period.

The Commission has shown both flexibility and a willingness to work with companies in the Section 3(b)(2) area.[111] In spite of this, the exemption process can be time-consuming and burdensome for companies and the Commission alike. Moreover, exemptions may be granted subject to certain conditions.[112] Finally, as discussed above, Section 3(b)(2) does not provide a lifetime exemption from the '40 Act. If the basis for an order changes (because, for example, a company's business changes and it subsequently meets the definition of an "investment company"), the company may lose the protection of the order. While there may be some authority in the existing exemptive orders under Section 3(b)(2) for a new exemptive rule or for a modification of Rule 3a-1, we believe that the existing statutory framework offers a viable alternative for companies that have both substantial non-investment operations and substantial securities holdings. This alternative is found in Section 3(b)(1), which provides an existing, but seldom-used, self-executing exemption from the regulatory provisions of the '40 Act.

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[110] *See*, *e.g.*, AirTouch Communications, Inc., Investment Co. Act Release No. 24,294, 71 S.E.C. Docket 1773 (Feb. 23, 2000) (granting section 3(b)(2) order) (application for section 3(b)(2) relief filed on January 24, 2000); idealab! Release No. 24,682, *supra* note 94 (granting section 3(b)(2) order) (application filed on January 28, 2000; amended application filed on March 14, 2000; second amended application filed on July 19, 2000); Yahoo! Inc., Investment Co. Act Release No. 24,494, 72 S.E.C. Docket 1632 (June 13, 2000) [hereinafter Yahoo! Release No. 24,494] (granting section 3(b)(2) order) (application filed on February 11, 2000; amended application filed on April 5, 2000; second amended application filed on May 16, 2000). *See also* i2 Application, *supra* note 96; Allscripts Application, *supra* note 96; CyberStarts, Inc., Application for an Order under Section 3(b)(2) of the Investment Company Act of 1940 (File No. 812-12186) (filed July 21, 2000). Like the i2 Application, both the Allscripts Application and the application of CyberStarts, Inc. have not yet been acted upon.

[111] Bill Gross' idealab! began working with the Commission in October 1999 and filed two amendments to its application before receiving an exemptive order on October 10, 2000. *See* idealab! Release No. 24,682, *supra* note 94; idealab! Application, *supra* note 89, at 35.

[112] The order granted to Yahoo! Inc. on June 13, 2000 was granted subject to the conditions that the company (1) continue to allocate and utilize its accumulated cash and Cash Management Investments [corporate bonds, high-quality debt securities, cash items and government securities] for *bona fide* business purposes, and (2) refrain from investing or trading in securities for short-term speculative purposes. *See, e.g.*, Yahoo! Release No. 24,494, *supra* note 110; Yahoo! Application, *supra* note 95, at 22.

II. Section 3(b)(1) Beckons

Companies have historically been extremely reluctant to rely on the exemption in Section 3(b)(1) of the '40 Act, which excludes from the definition of an "investment company" any company that is "primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."[113] Unlike Section 3(b)(2), which requires the filing of an application with, and a determination of investment company status by, the Commission, Section 3(b)(1) is "self-operating."[114] Not only is the standard in Section 3(b)(1) subjective, but it also has been the subject of only minimal interpretive guidance for a number of years. Since 1979, the Commission staff has been reluctant to issue no-action letters under Section 3(b)(1). According to one authority, there are two reasons for this.[115] First, the question of a company's primary business is a factual matter,[116] and second, companies seeking a determination of their status may apply to the Commission for an exemptive order under Section 3(b)(2).[117]

The widespread reluctance to rely on Section 3(b)(1) is understandable. If a company chooses to rely on Section 3(b)(1) and is later found to be acting as an unregistered investment company, it faces severe consequences, including the possible nullification of all of its contracts under Section 47(b) of the '40 Act.[118] Nevertheless, Section 3(b)(1) appears to establish a relatively straightforward test for whether an issuer is an investment company: *is the issuer primarily engaged in a business other than investing in securities*?

As we have indicated, the *Tonopah* factors have been used as the test for investment company status under both Sections 3(b)(1) and 3(b)(2). The practice of applying the *Tonopah* factors in the Section 3(b)(1) context has developed because *Tonopah* has become the litmus test for determining whether a company is "primarily engaged" in an operating business, a determination that is important under both exemptions. Unfortunately, this practice has had the effect of blurring the distinctions between Section 3(b)(1) and Section 3(b)(2) and of sapping the vitality out of Section 3(b)(1) because of the inherent uncertainty of the *Tonopah* test. Also, *Tonopah's* strict adherence to an asset and income test threatens to render meaningless the Section 3(b)(1) test. This could not have been the intent of Congress. To restore the practical availability of Section 3(b)(1), perhaps a different test is required, or perhaps the *Tonopah* test could be modified to better encompass a self-effectuating exemption.

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[113] Investment Company Act of 1940 § 3(b)(1), 15 U.S.C. § 80a-3(b)(1) (2000) (emphasis added).

[114] *See* Release No. 10,937, *supra* note 41, at 66,610 (noting existing operational differences between sections).

[115] *See* ROSENBLUM, s*upra* note 61, at § 6.01 (providing author's reasoning).

[116] *See* M.A. Hanna Co., 10 S.E.C. 581, 583 (1941) (stating that issue of determining "the actual nature of the company's business is" factual); ROSENBLUM, *supra* note 61, at § 6.01 (viewing question of issuer's primary engagement as largely factual matter).

[117] *See* ROSENBLUM, *supra* note 61, at § 6.01 (stating that company may apply for "an order pursuant to" section 3(b)(2)); Cannon Craft Co., *supra* note 66, at *1 (same).

[118] *See* 15 U.S.C. § 80a-46(b) ("A contract that is made, or whose performance involves, a violation of [the 1940 Act] is unenforceable by either party").

A. An Independent Exemption

Section 3(b)(1) exempts from the definition of "investment company" any issuer that is "primarily engaged" in a non-investment company business either directly or through wholly-owned subsidiaries. The legislative history of the '40 Act strongly suggests that Section 3(b)(1) was intended to provide an independent exemption from the definition of "investment company," distinct from the exemption provided in Section 3(b)(2). This is reflected in two aspects of the legislative history – the discussion of the connection between Section 3(b)(1) and the 40% asset test in Section 3(a)(1)(C), and the comparison of Sections 3(b)(1) and 3(b)(2). As the following discussion will illustrate, the better view is that Section 3(b)(1) provides an independent exemption for companies that meet its standards, thereby relieving them of the need to apply to the Commission for an exemptive order under Section 3(b)(2). This in turn suggests that a different test, or a modified version of the *Tonopah* test, might provide a more appropriate means of determining investment company status under Section 3(b)(1).

1. The Meaning of Section 3(b)(1)

By its language, Section 3(b)(1) exempts from the definition of "investment company" any issuer that is "primarily engaged" in a non-investment company business either directly or through wholly-owned subsidiaries. The exemption was designed primarily to ensure that holding companies would fall squarely outside the reach of the '40 Act. Because it was presumed that holding companies were more likely to hold securities of wholly-owned subsidiaries in order to conduct operating businesses through those subsidiaries (as opposed to holding them for investment purposes), Section 3(b)(1) afforded holding companies the benefit of collapsing any wholly-owned subsidiaries for purposes of the investment company analysis.

Unlike Section 3(b)(2), Section 3(b)(1) does not expressly apply to an issuer that does business through other types of subsidiaries, such as majority-owned subsidiaries and controlled companies. This does not necessarily mean, however, that Section 3(b)(1) is available only to companies engaged in operating businesses exclusively through wholly-owned subsidiaries. Like Section 3(b)(2), Section 3(b)(1) exempts an issuer engaged "directly" in a non-investment company business. As a result, Section 3(b)(1) can be read to exempt a parent company from the '40 Act, even if it has *non*-wholly-owned subsidiaries, without regard to the level of the parent company's ownership in those subsidiaries, as long as the parent company is primarily an operating company.

While it is easy to focus on the fact that Section 3(b)(1) applies to wholly-owned subsidiaries and Section 3(b)(2) does not, this should not diminish the fact that both exemptions are directed at determining whether a parent company is an operating company. Section 3(b)(1) gives a parent company "credit" for any wholly-owned subsidiaries that are operating companies, whereas Section 3(b)(2) is a broader exemption, insofar as it gives a parent company "credit" for partially-owned subsidiaries. The trade-off with regard to the exemption in Section 3(b)(2) is that a company must seek an order from the Commission in order to rely on the exemption. The legislative history makes clear why a different analysis is warranted for wholly-owned subsidiaries:

> [Section 3(b)(1)] excludes an issuer who, through a wholly-owned subsidiary or subsidiaries, is engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities. That subsection covers the pure holding type corporation like the United States Steel, or General Motors. That is, if you pierced the corporate structure and removed the corporate veil, and looked down through the companies, the General Motors is engaged in the business of making auto-

mobiles and not the business of holding securities. That provision therefore is an added caution to exclude companies which are not investment companies. If companies are engaged in a business other than that of an investment company, whether directly or indirectly through wholly owned subsidiary [sic], this bill does not cover them.[119]

While Congress was concerned about capturing "pure" holding companies (a structure more common in the banking industry today), the last sentence in the above quote makes clear that an operating company, regardless of whether it has *any* subsidiaries, can rely on Section 3(b)(1). The Commission in fact agreed with this conclusion in the order it issued to ICOS Corporation under Section 3(b)(2), discussed in Section II.B.2. *infra*.

2. The Legislative History

a. Section 3(b)(1) and the 40% Test

The legislative history to the '40 Act confirms not only that the exemption in Section 3(b)(1) was not intended to function as a purely numerical test, but also that it was intended to apply to companies with assets in excess of the 40% threshold established in Section 3(a)(1)(C) of the '40 Act.

The purpose behind including Section 3(b)(1) in the '40 Act was closely linked to the function of what the Commission called the "statistical formula" in Section 3(a)(1)(C). Section 3(a)(1)(C) was designed, in the first instance, to exempt holding companies from the scope of the '40 Act. The 40% formula was intended to:

eliminate *all* industrial companies which may have invested a substantial part of their funds in fairly small blocks of the securities of other corporations.

We took this formula and checked it against 1,800 companies which registered with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934. We excluded all companies which considered themselves investment companies. When we analyzed the balance sheets of these companies we found that . . . very, very few companies were caught by this formula.

. . . The number of instances that have created difficulty are really negligible. There was only one instance, as I remember it now, where there was some doubt as to whether this formula caught that company as an investment company, and we have made provision for that situation.[120]

It was thought that the 40% threshold in Section 3(a)(1)(C) was sufficiently high to exclude all holding companies:

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[119] *House Hearings*, *supra* note 50, at 102 (Testimony of David Schenker, Chief Counsel, Study).

[120] *Senate Hearings*, *supra* note 11, at 176–77 (Further Statement of David Schenker, Chief Counsel, Study) (emphasis added).

> The advantage of this formula has been and will be that a company examines its assets and if it does not have the prescribed percentage in diversified securities (securities of companies which are not subsidiaries[121]) the company knows that it is not an investment company. Immediately, all of the holding companies in this country can look at their portfolios and say, "Well, we do not have 40 percent of our assets invested in securities other than our subsidiary companies, so we are not touched by this legislation." And the formula has worked out.[122]

Section 3(b)(1) was designed to provide an extra measure of protection for holding companies. In the event that a company might have more than 40% of its holdings in securities of companies that were not majority-owned, it could rely on Section 3(b)(1):

> [E]ven if you find that more than 40 percent of the assets of a company are in marketable securities, securities of companies which are not its own subsidiaries, we still say that it cannot be an investment company, within the purview of this legislation if . . . this company is engaged primarily directly or through wholly owned subsidiaries in a business other than that of investing and reinvesting or trading in securities.
>
> That means what, Senator? It simply means this. Take the Standard Oil Co. The top holding company holds securities of all its subsidiary operating companies. We are not even remotely interested in holding companies. They are not within the scope of this legislation. The Commission does not want any part of that type of situation. So if you take that type of company, even though it may fall within this 40-percent provision, we say it is not an investment company. We say, "You are not within the purview of this legislation if you are primarily engaged in any other business even though you may have a substantial part of your assets in marketable securities."
>
> So that such holding companies are specifically exempt. That will fortify the exemption of companies which are essentially industrial corporations or railway companies which may have a substantial part of their assets in marketable securities.[123]

The legislative history of Section 3(b)(1) highlights the relationship of this section to the definition of "investment company" in Section 3(a)(1)(C) and suggests that Section 3(b)(1) was in fact intended to pick up where Section 3(a)(1)(C) left off. If a company exceeded the 40% asset test in Section 3(a)(1)(C), it could rely on Section 3(b)(1) if it was "primarily engaged" in a non-investment company business, regardless of how much of its assets consisted of "investment securities." The Commission confirmed this proposition more recently, when it adopted Rule 3a-1. In response to a comment letter expressing concern that the proposed numerical tests in Rule 3a-1 might preclude an issuer that could not satisfy the rule's requirements from relying on the exemption in Section 3(b)(1), the Commission "emphasize[d] that an issuer not meeting the requirements of rule 3a-1 *could nevertheless rely on Section 3(b)(1) of the ['40] Act provided the standards of that section were independently met by the issuer*."[124]

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[121] For a further discussion of "subsidiary," see *supra* note 32.

[122] *House Hearings*, *supra* note 50, at 101 (Testimony of David Schenker, Chief Counsel, Study).

[123] *Senate Hearings*, *supra* note 11, at 177 (Further Statement of David Schenker, Chief Counsel, Study).

[124] Release No. 11,551, *supra* note 49, at 6881 (emphasis added).

b. Wholly- and Majority-owned Subsidiaries and Controlled Companies

The comparison of Sections 3(b)(1) and 3(b)(2) in the legislative history of the '40 Act also makes clear that Section 3(b)(1) and 3(b)(2) were intended to cover two distinctly different types of companies. If a company is not engaged directly in an operating business, Section 3(b)(1) provides an exemption where the company does business through a wholly-owned subsidiary, while Section 3 (b)(2) provides an exemption where the company does business through majority-owned subsidiaries or controlled companies conducting similar types of businesses.[125]

The legislative history reflects that the distinction between wholly-owned subsidiaries on the one hand, and majority-owned subsidiaries and controlled companies on the other, was a fundamental one. The importance of the distinction stemmed from the role it would play in separating out pure holding companies from "borderline" companies that bore a strong resemblance to investment companies because of their securities holdings. The former would be exempt from '40 Act regulation under Section 3(a)(1)(C) and the belt and suspenders provided by Section 3(b)(1); the latter would have to use the exemptive process set forth in Section 3(b)(2):

> Now, we make a distinction between wholly owned subsidiaries and a majority-owned subsidiary, because you might get a situation–and there are such investment companies in the country today–where they buy a controlling interest in a company, not because they desire to engage in that business, but as an investment in that company and get out of that investment when the value of the investment increases. So they are not engaged in manufacturing steel, or automobiles, for instances. Then they have made an investment, a substantial investment in a company, and if the stock goes up they get out of their investment. We have to distinguish between the company which, through a majority-owned subsidiary or controlled subsidiary, is in the business of manufacturing or operating a company, and a company which invests a substantial portion of its assets in a company merely for investment or holding for other purposes.[126]

In addition, the legislative history indicates that while Section 3(b)(2) was intended to address the "closer cases," Section 3(b)(1) would provide an automatic exemption:

> [W]ith respect to a company which is engaged in a business other than investing in securities through wholly owned subsidiaries, *we have no discretion in that at all. That company has an exemption.*
>
> . . . .
>
> So you have this gradation of corporations from the situation where it is clear that the holding company is really engaged in an industrial enterprise to the other extreme where it is clear that the investment company owns small blocks–100 or 500 shares of United States Steel–and cannot even remotely be considered as being in the steel business. Somewhere along that area you have to draw a line as to when it is an investment company and when it is an operating company. And it is with respect to that situation that the Commission says, 'You have to make an application so we can take a look at your activities and your assets and then determine whether you are an investment company or not.'[127]

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[125] *See* Investment Company Act of 1940 §§ 3(b)(1), 3(b)(2), 15 U.S.C. §§ 80a-3(b)(1), (2) (2000).

[126] *House Hearings*, *supra* note 50, at 102 (Testimony of David Schenker, Chief Counsel, Study).

[127] *Senate Hearings*, *supra* note 11, at 178–79 (Further Statement of David Schenker, Chief Counsel, Study) (emphasis added).

The legislative history clearly contemplates that a company seeking to rely on the exemption in Section 3(b)(2) should be subjected to a facts-and-circumstances analysis to determine the nature of its business. The legislative history also establishes that Sections 3(b)(1) and 3(b)(2) embody standards that are substantively different. For these reasons, it is necessary to reexamine whether *Tonopah* should be the standard for determining an issuer's primary business under Section 3(b)(1).

B. A Suitable Test for Investment Company Status

1. Moving Away from *Tonopah*

For the reasons discussed above, we do not believe that *Tonopah* is the best standard for determining an issuer's primary business under Section 3(b)(1). Not only does the use of the *Tonopah* factors indirectly import a numerical threshold into Section 3(b)(1), but the standard also is too vague and weakens the distinctions between Section 3(b)(1) and 3(b)(2).

Beyond these reasons, however, there is an additional justification for moving away from the *Tonopah* factors, or perhaps even discarding them entirely, in the Section 3(b)(1) context. The *Tonopah* factors were developed in 1947, 53 years ago. The Tonopah Mining Company of Nevada (the "Tonopah Company") had started business in 1901 as a company that was, according to the Commission, "undoubtedly primarily engaged"[128] in the mining business, both directly and through wholly-owned subsidiaries. Over time, however, its subsidiaries gradually became inactive, so that by the time it filed its Section 3(b)(2) application with the Commission, it held approximately 94% of its total assets (exclusive of "Government securities" and "cash items") in "investment securities" and all of its net income was derived from interest on, and dividends and profits derived from, its securities holdings.[129] While its "investment securities" were primarily securities of mining-related companies, according to the Commission, it had not acquired and held those securities "with a view to exercising control or engaging in the business of mining; on the contrary it has assumed the position of an investor."[130] Thus, the Tonopah Company went from one end of the "gradation of corporations"[131] to the other and, over time, became an investment company in the classic sense of the-word, making the determination of its investment company status an easy case.

The sheer age of the *Tonopah* test should not, in and of itself, be a sufficient basis for modifying the *Tonopah* test if the test continues to provide a complete measure of investment company status. The *Tonopah* factors were developed, however, at a time when Internet and other high-technology companies did not exist. Many of these companies have substantial holdings in other

[128] Tonopah Mining Co. of Nevada, 26 S.E.C. 426, 432 (1947).

[129] *See id.* at 432 (outlining how Tonopah changed its character and became engaged "in the business of holding and trading in securities").

[130] *Id.*

[131] For a further discussion of "gradation of corporations," see s*upra* note 127 and accompanying text.

companies – holdings that, more often than not, were acquired for business and strategic, rather than investment, purposes. Many of them generate no current income at all, thereby failing the most important of the five factors. Many high-technology companies conduct securities offerings from time to time to raise money to fund their operating costs. Understandably, they would prefer to invest these proceeds in securities having a high rate of return until the proceeds are required to fund operations. In addition, many high-technology companies have little or no operating income. They may have interest income from companies whose securities were acquired for strategic purposes; they may have income from the disposition of all or portions of their minority holdings. Under these circumstances, a test that focuses on assets and income has the effect of distorting the true nature of a company's business: its operations are underemphasized and overshadowed by what appear, at least in the eyes of the '40 Act, to be investment activities. When applied to these types of companies, the *Tonopah* test captures entire industries and business classifications – an incongruous result, and surely one that neither the Commission nor Congress intended. We propose an alternative test at the end of this article.

2. *ICOS Corporation* and Proposed Rule 3a-8

In one noteworthy instance, the Commission indicated that it would be appropriate to deviate from a strict application of the *Tonopah* asset and income factors. In *ICOS Corporation*,[132] the Commission considered the Section 3(b)(2) application of ICOS Corporation ("ICOS"), an issuer with no subsidiaries that engaged directly in biotechnology research and development. ICOS had no revenue from drug sales, and expected to operate at a loss for several years while its products were developed, tested and approved for commercial sale. ICOS obtained the substantial amounts of working capital needed to fund its research, development and clinical trials through offerings of it stock. It then invested the proceeds of these offerings in "investment securities" pending their use in funding research and development operations. As a result, most of ICOS' income and assets were derived from "investment securities," making it an investment company under Section 3(a)(1)(C).

Significantly, before analyzing the ICOS application under Section 3(b)(2), the Commission noted that ICOS could have relied upon the automatic exemption in Section 3(b)(1) because it engaged directly in its primary business – that of developing medications for the treatment of chronic inflammatory diseases. The Commission went on to grant the exemptive order, stating that:

> The Commission ordinarily would be unwilling to issue an order under section 3(b)(2) when section 3 (b)(1) provides an automatic exclusion. The Commission, however, believes an order is appropriate here to modify the analysis for determining the primary business of *bona fide* research and development companies.[133]

The Commission concluded, however, that applying the *Tonopah* factors to research and development companies was problematic because of the nature of their business model:

[132] ICOS Release No. 19,334, *supra* note 52.

[133] *Id.* at 323.

> The Commission believes that *Tonopah*'s focus on the composition of present income and assets is ill-suited to ICOS and similar companies. The biotechnology industry did not exist at the time the Commission decided *Tonopah*. In contrast to the companies contemplated in *Tonopah*, research and development companies require large amounts of capital to fund the development of products that may not produce income for many years. Given such requirements, research and development companies seek to raise capital whenever market conditions are favorable. Such capital must be invested in relatively liquid assets to ensure access to funds needed for operations.[134]

To accommodate the business model of research and development companies, the Commission expanded the *Tonopah* test, and indicated that, if a company could show that it was "engaged actively in *bona fide* research and development activities, the Commission would consider the use, rather than simply the composition, of that company's assets and income."[135] Such a consideration would involve an examination of three factors: (1) whether the company used its securities and cash to finance its research and development, (2) whether a substantial portion of the company's gross expenses consisted of research and development expenses and a comparatively *de minimis* proportion consisted of gross investment expenses, and (3) whether the company invested in securities in a manner consistent with the need to preserve its assets until required to fund operations.[136] Furthermore, the converse of these factors would be considered indicia of an investment company. Where a company's gross investment income consistently exceeded its research and development expenses, the majority of the company's expenses were investment related and/or the company made significant investments in equity or speculative debt, the company would look more like a traditional investment company.[137]

Subsequent to the issuance of the *ICOS* order, the Commission published for comment a proposed rule (Rule 3a-8) that would have provided a safe harbor from the '40 Act for research and development companies.[138] While the rule has not been adopted, it again reflected a recognition on the part of the Commission that the *Tonopah* test might inaccurately cast some issuers as investment companies. The rule was intended to provide a non-exclusive safe harbor from investment company status for *bona fide* research and development companies and to "clarify that R&D companies may invest in securities other than Government securities without becoming subject to the ['40] Act."[139]

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[134] *Id*. at 324.

[135] *Id*.

[136] *See id.* at 325-326 (outlining factors).

[137] *See id.* (providing examples on uses of company's assets and income that would indicate traditional investment company status).

[138] *See* Release No. 19,566, *supra* note 52, at 38,095 (addressing special circumstances of research and development companies).

[139] *Id*. at 38,096.

Like the test applied in the *ICOS* order, the test in proposed Rule 3a-8 would have focused on how research and development companies used their income and assets, rather than on the source and composition of the income and assets.[140] Again, this focus was intended to remedy the effects of the *Tonopah* test. Because the *Tonopah* test focuses on income and assets, "when it is applied to R&D companies the test understates their noninvestment business, which produces little or no income or assets during their product development phase."[141]

III. Other Possible Tests for Investment Company Status under Section 3 (b)(1)

The Commission's order in *ICOS* was, and remains, a milestone amidst the authority on investment companies because it represents the first departure from the *Tonopah* factors and a recognition of the fact that the *Tonopah* test may not be an appropriate gauge of a company's primary business under Section 3(b)(2) (and, by extension, Section 3(b)(1)). With respect to Section 3(b)(1) in particular, the *ICOS* order provides further support for the view that Section 3(b)(1) does not require a strict assessment of an issuer's income and assets. The asset and income tests are one means, but need not be the only means, for determining that a company has substantial business operations. Similarly, the exemptive orders granted recently to a number of internet incubators[142] reflect a significant

[140] Rule 3a-8 ("Certain research and development companies") would have provided as follows:

> Notwithstanding sections 3(a)(1)[(A)] or 3(a)[(1)(C)] of the ['40] Act, an issuer will be deemed not to be an investment company if, directly or through one or more companies which it controls:
>
> (a) it has held itself out, and currently holds itself out, as being primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities;
>
> (b) it has, on the basis of financial statements prepared in accordance with generally accepted accounting principles or other financial data derived therefrom:
>
> > (1) a substantial percentage of its total expenses for the most recent four fiscal quarters that are research and development expenses and those expenses equal or exceed its revenues from investing, reinvesting, owning, holding, or trading in securities; and
> >
> > (2) expenses for investment advisory and management activities, investment research and selection, and supervisory and custodial fees and expenses for the most recent four fiscal quarters that do not exceed 5 percent of its total expenses; and
>
> (c) its investments in securities, taken as a whole, are made to conserve its capital and liquidity until funds are used in its primary business or businesses.
>
> (d) For purposes of this section:
>
> > (1) "control" shall have the same meaning as in section 2(a)(9) of the ['40] Act; and
> >
> > (2) "investments in securities" shall include all securities owned by the issuer other than securities issued by persons controlled by the issuer that conduct types of businesses that are similar to the issuer's.
>
> *Id*. at 38,099–100 (to be codified at 17 C.F.R. § 270.3a-8).

[141] *Id.* at 38,095.

[142] *See* idealab! Release No. 24,682, *supra* note 94; Yahoo! Release No. 24,494, *supra* note 110; Internet Capital Group, Inc., Investment Co. Act Release No. 23,961, 70 S.E.C. Docket 1004, 1004 (Aug. 23, 1999) [hereinafter ICG Release No. 23,961].

departure from the traditional income test in favor of a test that focuses on revenue. For example, in its application to the Commission, Internet Capital Group, Inc. (formerly, Internet Capital Group, L.L.C.) emphasized the difficulty of applying the traditional income analysis to Internet companies and urged the Commission to focus on those activities that would bring revenue to the company:

> [F]or the year ending December 31, 1998, ICG [Internet Capital Group, Inc.] had $13.9 million in net income due to the divestiture of certain minority interests. Since it otherwise would have had net losses, all of ICG's consolidated net income for the period was attributable to non-controlled assets. As a result, it is difficult to apply a traditional income analysis in determining the nature of ICG's business. ICG believes that the Commission's net income test underestimates ICG's non-investment company businesses, which generally produce little or no income during the early stages of development.
>
> . . . ICG believes that its activities as an operating company are more appropriately analyzed by evaluating ICG's proportionate share of the revenues of [companies it controls within the meaning of the '40 Act] as well as ICG's total revenues.[143]

Based on this argument, and on the application of the four remaining *Tonopah* factors, the Commission granted Internet Capital Group, Inc. an exemptive order under Section 3(b)(2) of the '40 Act.[144]

Notwithstanding these developments, *ICOS* did not go far enough. While *ICOS* could be read to apply to research and development companies generally,[145] it is not clear that companies in other industries could rely on the principles established in the *ICOS* order. The same general principles, however, would seem to apply, at least with respect to high-technology companies that seek to invest their offering proceeds or otherwise conduct their businesses in a way that is inconsistent with the income or asset tests. Unfortunately, companies may not safely rely on Section 3(b)(2) exemptive orders granted to other companies.

A. A Perception Test

Rather than placing the focus of an investment company inquiry on the nature of a company's assets, income or revenue, Section 3(b)(1) could be interpreted using different standards. Since the exemption clearly applies to companies with "investment securities" in excess of 40% of their total assets (exclusive of "Government securities" and "cash items"), an asset calculation is not as relevant. Similarly, because the sources of a company's income may not accurately represent the nature of its business activities, an income calculation is not very reliable.

One alternative would be to focus on the public's perception of a company. While public *representations* of policy are determinative, or at least are a factor, under Section 3(a)(1)(A), perhaps public *perceptions* of a company should be determinative, or at least be a factor, under Section

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[143] Internet Capital Application, *supra* note 90, at 17–18 (footnotes omitted).

[144] *See* ICG Release No. 23,961, *supra* note 142, at 1004 (believing applicant is "primarily engaged in a business other than investing").

[145] In the release proposing Rule 3a-8, the Commission characterized the *ICOS* order, and section 3(b)(1), as being applicable to research and development companies generally: "In its order, the Commission noted that ICOS appeared to be excluded from the definition of investment company by section 3(b)(1), and that similarly-situated issuers also would be excluded." Release No. 19,566, *supra* note 52, at 38,097.

3(b)(1).[146] While a perception test would not be less subjective, it is arguably more relevant. If the public invests in an issuer because of its investment acumen, rather than because of its goods or services, this should suggest that the issuer is an investment company. Conversely, if a company is best known for its goods and services, there should be a strong presumption that it is not an investment company. For example, should IBM ever be viewed as an investment company, even if over half of its assets were "investment securities"? Should Yahoo! ever be viewed as anything other than an internet portal business, notwithstanding the composition of its securities portfolio? We believe that investors likely invest in Microsoft, for example, because of its software business, rather than its investment portfolio. Yet, we note that, like the Tonopah Company, any company over the course of decades may exit its primary business and become a passive investor in other businesses. In those cases, the public perception would shift as well.

Over the years, both the Commission staff and the courts have exempted companies from the '40 Act where they were perceived to be operating companies first and investment companies second. The staff issued at least one such exemption under Section 3(b)(1) prior to the adoption of the policy against taking no-action positions with respect to this provision.[147] In *Younker Brothers, Inc.*,[148] the staff took a no-action position with respect to a department store where its "investment securities" represented between 39% and 41% of its total assets (exclusive of "Government securities" and "cash items"), depending on whether certain certificates of deposit were considered to be "cash items."[149] Younker Brothers, Inc. ("Younker") also held 19% of the outstanding securities of a real estate investment trust ("REIT") that had interests in a number of shopping centers. Younker had purchased these securities in part with an eye toward locating its stores in shopping centers financed and developed by the REIT. Because of a significant increase in the value of the securities, the value of Younker's interest in the REIT had increased, over the course of just a year, from 19.9% of its assets to 30.3% of its assets. In addition, although substantially all of Younker's net income had been derived from its department store business, its investment income was relatively high during certain periods of the year due to seasonal fluctuations in the department store business. Younker proposed to dispose of a portion of its holdings in the REIT, both to generate working capital and to avoid any ambiguity as to its investment company status. The staff issued a no-action letter under Section 3(b)(1)[150] and subsequently clarified, at Younker's request, that the availability of the exemption was not contingent on the disposition of a portion of Younker's holdings in the REIT.[151]

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[147] *See* M.A. Hanna Co., 10 S.E.C. 581, 590 (1941) (granting exemption order under section 3(b)(2)).

[148] *See* Younker Bros., Inc., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 3006, at *1 (Feb. 5, 1973) [hereinafter Younker II]; Younker Bros., Inc., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4428, at * 1 (Dec. 14, 1972) [hereinafter Younker I].

[149] For a further discussion on "cash items," see *supra* note 41.

[150] *See* Younker I, *supra* note 148, at *1.

[151] *See* Younker II, *supra* note 148, at *1. *See also* Union Sugar Co., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 381, *1 (Sept. 30, 1973) (taking no-action position with respect to company that argued it was primarily engaged in management and administration of diverse land holdings, where value of company's security holdings had increased dramatically relative to value of its land holdings; Commission's position was expressly made contingent, however, on company continuing to engage in its "present activities" and completing its plan to dispose of certain securities so that it would fall below 40% threshold in section 3(a)(1)(C)).

Similarly, but without taking a position as to the company's status under Section 3(b)(1), the staff noted that a plastic novelty company with 70% of its assets comprising certificates of deposit would have been an investment company but for Section 3(b)(1).[152] The company was "actively engaged in an operating business" and its operating income exceeded its investment income. Four years after its initial public offering, however, the company still held the majority of the offering proceeds in certificates of deposit and had not invested them in its operating business. The staff went on to note that Section 3(b)(1) might cease to apply, and the company would be engaged primarily in the business of investing in securities, if the company earned more income from its investments than from operations. In *Alpha-Delta Fund*,[153] in response to a request for clarification from the American Bar Association, the staff indicated that a limited partnership organized for the purpose of trading in commodities would not be an investment company because of Section 3(b)(1), even though virtually all of the fund's capital was invested in U.S. Treasury Bills. The fund invested in the U.S. Treasury Bills for cash utilization purposes and to offset commission charges and other expenses. The American Bar Association argued that the mere fact that the U.S. Treasury Bills generated income for the fund should not be viewed to alter the fund's primary business. The staff agreed:

> [W]e did not, nor did we intend to, imply that the investment of margin deposits in Treasury bills in order to earn income to offset brokerage and other costs will invariably result in investment company status, even if more than 50% of a company's capital is devoted to such use, *provided* it can be demonstrated factually that the primary engagement of such company is in commodities activities.[154]

In a rare litigated case, a district court found that Chock Full O'Nuts Corporation was not an investment company by virtue of Section 3(b)(1).[155] The court based its ruling on the fact that over 90% of the company's income was derived from its restaurant and coffee business, rather than investments. While the court applied the *Tonopah* test, it emphasized the public perception factor:

> As the evidence overwhelmingly indicates, Chock [Chock Full O'Nuts Corporation] had, from its inception, followed a course of development in the retail food and restaurant business. It is well-known as a fast food chain, certainly in those metropolitan areas where its restaurants are located, by virtue of its distinctive and prominent restaurant facades, identical food selections in all locations and unique menu logo. There is no evidence before the court which would indicate that historically or in the statements of policy appearing in annual reports and public filings, Chock either considered itself or was known to the public as anything but primarily a fast food business operation, with subsidiaries that have developed to sell certain of the popular products in retail food stores. The pattern of acquisitions further confirms that Chock intended to continue its development along similar lines.[156]

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[152] *See* GPI, Inc., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 3142, at *2, 3 (July 12, 1973) (stating that it believed "the question of [GPI's] primary business is a very close one" but concluding [GPI] was primarily engaged in "a business other than investing in securities").

[153] Alpha-Delta Fund, SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,606, at 86,524 (May 4, 1976).

[154] *Id.*

[155] *See* Moses v. Black, No. 78 Civ. 1913, 1981 U.S. Dist. LEXIS 10870, at *18-19 (S.D.N.Y. 1981) (finding company engaged in fast food restaurant business and its securities investment were insignificant part of its total assets).

[156] *Id.* at *16.

These decisions suggest that a company could rely on the exemption in Section 3(b)(1) if it could demonstrate that it was not perceived as an investment company. While a public perception standard likely is equally as subjective as the *Tonopah* test, it is arguably more relevant. A former director of the Commission's Division of Investment Management has argued that *Tonopah* itself is a perception test.[157] In an article on inadvertent investment companies, Sydney Mendelsohn argued that, although the Commission has never articulated the theory underlying the use of the *Tonopah* factors in the Section 3(b)(2) context, "it appears that its analysis of such applications is intended to construct the perception that a reasonable public investor would have of the issuer."[158] In support of this argument, the former director pointed to a statement made by the Commission in its decision in *Tonopah*:

> More important, however . . . the nature of the assets and income of the company, disclosed in the annual reports filed with the Commission and in reports sent to stockholders, *was such as to lead investors to believe* that the principal activity of the company was trading and investing in securities.[159]

A more recent article has theorized that the Commission may have relied on an investor perception standard in granting a Section 3(b)(2) order to Internet Capital Group, Inc.:

> Although it did not expressly say so, it would appear that the [Commission] was convinced, upon application of the *Tonopah* factors, that a reasonable investor would not view this company as being engaged primarily in an investment company business . . . .[160]

If it is true that the five factors in *Tonopah* were intended to serve as a proxy for the public's perception of companies in the marketplace, it may be time to reevaluate the factors that ostensibly bear on the construction of this perception. Arguably the public pays less attention to detailed calculations of assets and income than it does to a company's products and services, press releases and periodic reports. If a company is not perceived as an investment company, has substantial operations, and derives much of its income (or losses)[161] from those operations, it should be able to rely on Section 3(b)(1) without regard to the amount or nature of its securities holdings.

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[157] *See* Sydney H. Mendelsohn et al., *Status Seeking: Resolving the Status of Inadvertent Investment Companies*, 38 BUS. LAW. 193, 200–01 n.31 (1982) (noting that he "did not disagree with the general import" of ABA's suggestion that Commission apply "perception test").

[158] *Id*. at 200–01 (footnote omitted).

[159] Tonopah Mining Co. of Nevada, 26 S.E.C. 426, 430 (1947) (*quoted in* Mendelsohn, *supra* note 157, at 201 n.31) (emphasis added).

[160] Robert E. Carlson et al., *Investment Company Act Status Questions*, THE INVESTMENT LAWYER, Nov. 1999, at 9 (Nov. 1999).

[161] *See* DRX, Inc., *supra* note 82, at 78,324 (stating that company with net losses may not ignore income test in Rule 3a-1 and satisfy only asset test). The position taken by the Commission staff in its letter to DRX, Inc. may be of use to high-technology companies. The staff indicated that a company may satisfy the income test provided that it has both net investment losses and total net losses and not more than 45% of its total net losses after taxes are derived from activities relating to securities that are considered "investment securities" for purposes of Rule 3a-1. According to the staff, the purpose of the income test in Rule 3a-1 is "to focus on activities that generate revenue for the company. Whether the net result is positive or negative, the purpose is to review the company's day-to-day activities by looking at its sources of income." *Id*. at 78,326.

B. A New Definition of "Investment Securities"

Reviving Section 3(b)(1) may also necessitate reconsidering the meaning of the term "investment securities" and the purpose that this definition was intended to serve. As discussed above, the '40 Act defines "investment securities" to include all securities except "Government securities," securities issued by employees' securities companies, and securities issued by majority-owned subsidiaries[162] that are not themselves investment companies and that are not relying on the exceptions in Sections 3(c)(1) (for companies with less than 100 security holders) and 3(c)(7) (for companies whose security holders are exclusively "qualified purchasers").

If a company acquires and continues to hold securities of another company not for investment purposes, but rather for operating purposes – such as securing access to the goods and services provided by that company – this should be taken into account when assessing whether those securities are "investment securities" within the meaning of Section 3(a)(2). The acquisition, or retention, of less than a majority or controlling interest in a company should not automatically equate with an investment intent. While many high-technology companies have recently argued this point to the Commission, the Commission and its staff appear to have acknowledged this implicitly almost since the passage of the '40 Act. In 1943, the Commission considered a Section 3(b)(2) exemptive application submitted by Mission Corporation ("Mission").[163] In that decision, the Commission determined that Mission was not an investment company even though its assets consisted almost entirely of oil companies' securities. Mission held 56% of the outstanding voting securities of an oil company, and 20% of the outstanding voting securities of an oil refining company. Mission argued, and the Commission agreed, that Mission had not acquired the stock of the oil refinery for investment purposes,[164] but rather, for reasons related to its primary business:

> The chief importance to applicant of its [oil refinery] investment arises not from the income derived but from its assurance of an outlet for the oil produced by applicant and its associated companies.[165]

While the Commission noted that even if the oil refinery securities were considered "investment securities," they would only constitute 41% of Mission's assets, the Commission granted the exemptive order because Mission's primary business was oil production and not investing.[166]

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[162] For a further discussion of "majority-owned subsidiaries," see *supra* note 44.

[163] Mission Corp., 12 S.E.C. 1138 (1943).

[164] *See id.* at 1143 n.12 (noting that evidence produced at hearing indicated that acquisition of oil refinery stock was most effective solution to market its crude oil, therefore it was not acquired for investment purposes).

[165] Id. at 1146 (footnote omitted).

[166] *See id.* (finding that because Mission held 56% of outstanding stock of oil company, this company was majority-owned subsidiary, not "investment security," and thus could be excluded from asset calculation under section 3(a)(1)(C)).

Similarly, in *Younker Brothers, Inc.*,[167] the Commission appears to have accepted the argument that Younker's 19% interest in a REIT was strategically related to its department store business and was not a pure investment:

> The Company initially purchased shares of [the REIT] for business as well as investment purposes. It is to the Company's advantage to have its stores located in shopping centers financed and developed by a major firm such as [the REIT]. At present five of the Company's stores are leased in shopping centers owned by [the REIT]. Moreover, through its stock interest in [the REIT], the Company participates in the ownership of shopping centers in which its stores are located. A director of the Company and the Chairman of its Executive Committee is one of the five Trustees of [the REIT].[168]

The Commission, too, has endorsed the notion that "securities of controlled companies through which a holding company engages in a business other than an investment company business effectively are not considered to be investment securities."[169]

Focusing on the reasons why a company has acquired and continues to hold its securities could provide valuable, relevant evidence of the company's primary engagement under Section 3(b)(1).[170] If a company invests in a strategic partner or a company with a complementary technology or business – if, for example, a computer company holds a 20% interest in a chip manufacturer that is also its principal supplier – this would suggest a business, rather than an investment purpose. If 80% of the value of the computer company's assets consists of 20% interests in its suppliers, the result should be the same, and Section 3(b)(1) should apply. If a chipmaker owns a 15% stake in a silicon company to help assure its supply of silicon, this holding should not be viewed as an investment. Similarly, it would be useful to examine how a company invests in and disposes of its "investment securities." A company that limits trading of its portfolio securities should have a stronger argument that it qualifies for Section 3(b)(1) than a company that trades its portfolio stocks regularly.

As discussed in Section I.C.2. above, in a recent no-action letter to Wilkie Farr & Gallagher, the Commission staff indicated that it would not take any enforcement action against an issuer if the issuer did not include shares of registered money market funds that seek to maintain a stable net asset value of $1.00 per share for purposes of the 40% test in Section 3(a)(1)(C) and the asset and income tests in Rule 3a-1.[171] The staff's position in *Wilkie* should provide some relief to high-technology companies with large cash positions, so that they may obtain a higher rate of return without the risk of being considered investment companies.[172]

[167] Younker II, *supra* note 148; Younker I, *supra* note 148.

[168] Younker I, *supra* note 148, at *6.

[169] Release No. 10,937, *supra* note 41, at 66,610.

[170] This focus is consistent with the fourth factor of the *Tonopah* test – the nature of a company's present assets.

[171] *See* Wilkie Farr & Gallagher, *supra* note 41, at *16 (allowing issuer to treat money market fund shares as "cash items," and not as investment securities).

[172] *See id*. (allowing operating companies with "appropriate flexibility in managing their cash holdings"). The staff cautioned in the letter, however, that an issuer with a large percentage of its assets in money market funds could nevertheless be considered an investment company under the "primary engagement" test in Section 3(a)(1)(A), in the same way that an issuer with large amounts of "Government securities" would meet the definition of investment company in that section. *See id*. at 16-17 & n.21 (stating that issuer's "primary engagement" remains as benchmark for section 3(a)(1)(A) determinations).

C. The Need for Additional Guidance

For high-technology companies that run the risk of being considered investment companies for other reasons, additional guidance is needed. This guidance should clarify the existing standards for relying on Section 3(b)(1), or establish new standards, that would recognize that high-technology companies with operating activities are not investment companies simply because they have substantial securities holdings. In addition, the guidance should provide some measure of certainty so that, when a company makes a determination that it is an operating company and is eligible for the exemption in Section 3(b)(1) – a determination that even the Commission has recognized is inherently factual and best left to the company – it can rest assured that it will not later be determined to be operating as an unregistered investment company in violation of the '40 Act. This would be preferable to the current process of analyzing each Section 3(b)(2) order to determine whether there has been a shift in the Commission's policies.

D. The Authors' Suggested Test for Section 3(b)(1): An Alternative to Tonopah

The authors cannot resist the opportunity to suggest to the readership and to the Commission an evolution of the *Tonopah* test. This would result in a new three-factor test, based on the alternative measures discussed in preceding paragraphs, that companies could satisfy as an alternative to the *Tonopah* test. This test would not provide an automatic exemption for all high-technology companies. For example, internet incubators might, or might not, satisfy the test, depending on the nature of their operations. We envision that the test would, however, provide a basis for exempting under Section 3(b)(1) most companies with substantial non-investment operations. The factors, all of which would have to be satisfied in order for a company to rely on the exemption in Section 3(b)(1), would be as follows:

1. *Does the company represent itself, and does the public perceive the company, as an operating company*?

If a company markets itself as an astute investor in other companies, or it becomes apparent to the market that a company will only succeed or fail based on its investment prowess (instead of its operating business), the company will fail this test. If, however, upon review of the company's periodic reports, its advertising, and its website, it is apparent that the company is marketing its goods and services, the company will pass this prong of the test.

A perception test is admittedly subjective, but we believe that the true nature of a company will not be difficult to divine. We expect that mutual funds will have a hard time attracting investors without advertising their historical investment returns (with the proper caveats). We believe that the strongest indicator of a company's true nature is its advertising, including its website. If a company is advertising to find customers, it will pass this prong of the test. If a company is advertising to find investors, further analysis will be needed. If a company widely advertises how the market value of its subsidiaries has increased, it should be viewed as an investment company, barring other strong indicia to the contrary. We believe that chat room discussions should not be relevant, since competitors, short sellers, and disgruntled employees will have strong motivations to post messages suggesting that a company's true value rests with its investments.

Internet incubators would be an interesting test. If incubators are advertising to find new companies to join their networks and are not hyping the investment returns of network companies in order to attract investors, they will pass this prong of the test.

2. *Does the company itself, or through one or more wholly-owned subsidiaries, have significant operations?*

This factor would test whether a company has only *de minimis* operations that serve to mask the investment nature of its business. This prong of the test would be a facts-and-circumstances inquiry to determine whether a company that holds itself out as a provider of goods and services actually has facilities to support its operations. Examples of such facilities would include factories, warehouses, stores, heavy equipment, or other assets devoted to its primary business. For high-technology companies, there would need to be laboratories or sufficient computer equipment and intellectual property to accomplish the business plan. We would also support, as part of this factor, retaining the *Tonopah* requirement that the majority of a company's employees devote their time to the company's primary business. This factor should be ignored for development-stage and start-up companies, as well as for research and development and other types of companies that do not generally have operations. Development-stage and start-up companies, however, would be subject to a reasonableness limitation similar to the one-year period in Rule 3a-2, so that they would need to demonstrate the existence of significant operations within a reasonable period of time or risk failing to satisfy this prong of the test.

Internet incubators probably should be treated as start-up companies for purposes of this prong of the test since they are in the start-up assistance business. Thus, this factor would be ignored. Alternatively, an incubator that supplies office space, staffing, or other tangible assets could satisfy this prong of the test because it has the facilities to support its operations.

3. *What is the nature of the company's securities holdings in other companies?*

Since a company generally is presumed to be engaged in the businesses of its wholly-owned subsidiaries, the third prong of the test would focus on a company's investments in entities that it does not wholly own. While a company might not *conduct* business through entities in which it holds only partial equity interests, as we have discussed above, a company may nonetheless acquire such interests for reasons that are closely related to the company's primary operating business. The third prong of the test would take into account this reality by examining the relationship between a company's primary business and its securities holdings in subsidiaries that are less than wholly owned. The primary function of this prong of the test would be to discern whether a company has business reasons for investing in the securities of such subsidiaries and/or a business relationship with those subsidiaries. The existence of business reasons and/or a business relationship would constitute *prima facie* evidence that particular securities were not being held for investment purposes and would enable a company to satisfy the third prong of the test.

A company only needs to rely on Section 3(b)(1) if its investment securities exceed 40% of its total assets (exclusive of "Government securities" and "cash items"). Thus, an examination of the nature of a company's securities holdings in subsidiaries that are less than wholly owned should be conducted in light of the fact that a company's securities holdings may outweigh the value of its operating assets. The existence of business reasons and/or a business relationship should be reflected by expanding the category of assets that are considered operational assets, as opposed to "investment securities," for purposes of the Section 3(b)(1) analysis. For any equity holdings in other companies, an operating company should be able to count as operational assets any holdings that the company acquired in order to: (1) achieve a strategic partnering (such as in connection with a joint marketing agreement); (2) assist in assuring a supply of raw materials; or (3) provide for expansion of the company's goods or services (*e.g.*, a department store investing in a shopping center REIT, a manufacturer investing in its outlet and distribution channels, or an e-commerce company seeking to invest in a company with a promising technology that could be useful to the company's primary business). In each of these cases, the company acquired equity investments for reasons related to its primary business. Any investments in the same industry in which an operating company does business should be treated similarly. Likewise, it is possible that an operating company would lend money to companies, on both a short- and long-term basis, for the same reasons that it might take an equity stake in those companies. These "investment securities" also should be counted as operating assets since they were acquired to enhance the operating business.

As with the second prong of the authors' proposed test, different considerations would be appropriate for development-stage, research and development, or start-up companies, as well as for internet incubators. In the same way that proposed Rule 3a-8 would have taken into consideration characteristics unique to these types of companies, under the proposed test, such companies would not be penalized for investing their cash in short-term liquid investments made to preserve assets in order to fund their significant operating losses. Similarly, the securities holdings of internet incubators would be viewed in light of the fact that incubators typically take equity interests in numerous companies. If the businesses of one or more companies were wholly unrelated, such that they would have no need for the goods and services of other companies in the network, this could suggest that the network companies' securities should be characterized as "investment securities" rather than operational assets.

Although a numerical test has its limits, it becomes most problematic when it is applied blindly. A dynamic test, however – one that is more qualitative in its application – may be more practical. With the adjustments suggested under the third factor of the proposed test, it may be appropriate to determine if a company's remaining "investment securities" exceed 40% of its assets.

E. Application of the Proposed Test

The authors' proposed alternative test is not a radical departure from *Tonopah*. The most significant difference is the absence of an income test. We believe that an income test is most prone to misapplication because of the unusual one-time gains or losses that many companies experience in their primary businesses. In addition, because the proposed test is merely an alternative to *Tonopah*, companies that satisfy the income test and otherwise meet the requirements of the traditional analysis would be free to rely on *Tonopah* to establish that they are not investment companies.

It should be recognized, however, that the proposed test is designed only for a company that can, in good faith, demonstrate that it is an operating company eligible for the exemption in Section 3(b)(1). Like *Tonopah*, the proposed test has subjective elements that decrease the certainty with which it can be applied. We believe, however, that the proposed test would be easier to apply. A perception test is fairly straightforward. An investment company needs to advertise its investment prowess. It is not seeking to sell goods and services in the traditional sense; it wants the public to buy shares of its stock or funds based on the promise of returns on the company's own investments. Likewise, an operations test is fairly straightforward. Does a company work to provide goods and services? Do the company's employees work to discover or develop a new technology, or do they devote their time to finding promising investments? Lastly, a company is best able to determine which of its investments were made to increase the revenues of its primary business and which investments are not related to that core business. The company would need to be comfortable with respect to such determinations because it could be second-guessed at a later date and face severe consequences.

The biggest drawback of the alternative test is that it remains a subjective test that does not provide a bright line for practitioners to follow. For this reason, counsel may continue to face difficulties, even under the proposed alternative test, in rendering opinions regarding the availability of Section 3(b)(1). This is particularly true because underwriters and their counsel are typically reluctant to accept reasoned '40 Act opinions. Taken collectively, however, we believe that the factors comprising the proposed test provide the certainty necessary to establish a test that will be more effective in ensuring that operating companies remain safely beyond the scope of the '40 Act.

If the Commission seeks a more objective alternative, we would propose amending the definition of "investment security" to exclude all loans made and equity holdings acquired in order to assist suppliers, customers, and joint ventures. This would include an equity position, for example, in a technology company that is developing a technology that would be used by the acquiring company in its operations. This would protect incubators that hold positions in their customers.

This definitional change alone would go a long way toward protecting operating companies from being "mislabeled" as investment companies.

IV. Conclusion

The recent wave of exemptive orders under Section 3(b)(2) suggests that the current regulatory framework is under stress. When a new economic paradigm encourages cross ownership of allied companies and operating companies are forced to curtail investments important to their growth for fear of triggering a regulatory scheme more appropriate for investment vehicles that advertise their investment prowess, it is time to revisit assumptions underlying the regulatory approach.

We believe that one way to accommodate the new paradigm is to provide better guidance on the application of Section 3(b)(1). Section 3(b)(1) should no longer be confused with the exemptive process outlined in Section 3(b)(2); rather, Section 3(b)(1) should have a separate test for determining when a company is an operating company, as opposed to an investment company. A new test, such as the one proposed in this article, should exempt all companies that the public would perceive as operating companies. The test would not provide protection, however, for companies seeking to mask their investment activities with *de minimis* operations. Indeed, even some "new economy" companies might have difficulty satisfying the test proposed in this article. For those companies that could not pass the test, Section 3(b)(2) would remain available.

Should the Commission adopt a test similar to that proposed in this article, it would mean that thousands of public operating companies could make securities acquisition decisions based on what is in the best interests of their respective businesses, rather than based on whether an acquisition of securities would cause them to become inadvertent investment companies. Likewise, a sudden increase in the market value of a company's "investment securities" would become a call for congratulations, rather than a call for company counsel to worry about a "blind" 40% test.