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A New Investment Company Status Exemptive Rule Could Provide a Boost to US Capital Markets Activity

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In the course of our work evaluating the investment company status of operating companies, we have noticed a disconnect between the way that common sense and the Investment Company Act of 1940, as amended (1940 Act), view certain operating companies—that is, some companies that clearly do not operate an investment company business find themselves unable to avoid meeting the definition of an investment company. As frequent readers of this publication likely are aware, it can be problematic for an operating company to discover that it meets the definition of an investment company in Section 3 of the 1940 Act. Absent an exemption from this definition, the operating company finds itself subject to the full panoply of regulations imposed by the 1940 Act, including requirements and restrictions related to capital structure, corporate governance, borrowing, and transactions with affiliates. In this article, we propose that the Securities and Exchange Commission (Commission) considers adopting a new exemptive rule under Section 3 that would codify what we view to be routine concepts in exemptive orders that have previously been granted by the Commission under that section of the statute. Model language for this proposed rule is included at the conclusion of this article (the Proposed Rule).

The Commission Has a History of Adopting New Exemptive Rules Under Section 3 of the 1940 Act

Due to the nature of their operations and ownership, operating companies usually are unable to rely on the statutory exemptions from the definition of investment company contained in Section 3(c), such as the private fund exemptions in Sections 3(c)(1) and 3(c)(7). Thus, for an operating company that does not hold itself out to be engaged primarily in the business of investing or trading in securities, the question of whether it meets the definition of an "investment company" in Section 3 is relatively formulaic—if more than 40 percent of the value of its total assets (excluding Government securities and cash items) on an unconsolidated basis are "investment securities" (that is, bad assets) then the operating company is a *prima facie* investment company (the 40 percent test). Conceptually, the 40 percent test and indeed all quantitative investment company status determination tests, are more easily discussed by referring to good assets, which are those that do not count toward the limits of the particular test, and bad assets, which are those that do count toward the limits imposed by the particular test. Many practitioners refer to an operating company whose bad

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assets exceed the 40 percent limit as an "inadvertent" investment company.

The Commission has the authority to issue an exemptive order under Section 3(b)(2), in which the Commission determines that an issuer is primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities and, therefore, is not an investment company within the meaning of the 1940 Act. To receive an order from the Commission under Section 3(b)(2), an issuer initially must establish that it is engaged in a non-investment business. If an identifiable non-investment business exists, the inquiry becomes whether that business is "primary." In *Tonopah Mining Co.*, the Commission stated that its determination of an issuer's primary business under Section 3(b)(2) would be based on five principal factors: (i) the issuer's historical development; (ii) its public representations of policy; (iii) the activities of its officers and directors; (iv) the nature of its present assets; and (v) the sources of its present income.[1] The two most important factors are the composition of the issuer's assets and the sources of its income.[2] In total, the Commission has issued dozens of these exemptive orders, but only a handful in the past 15 years.

The time is ripe for the Commission to codify certain aspects of its prior Section 3(b)(2) exemptive orders into a new exemptive rule. This would not be the first time the Commission undertook such an exercise, having adopted Rule 3a-1 in 1981[3] and Rule 3a-8 in 2003[4] to provide operating companies additional flexibility to avoid becoming inadvertent investment companies in light of exemptive orders granted under Section 3(b)(2).

Rule 3a-1 was proposed by the Commission in 1979 to "obviate the need for issuers to apply for, and the Commission to grant, [Section 3(b)(2) exemptive] orders on a case-by-case basis."[5] Rule 3a-1 was not intended to provide an exemption for all companies that might qualify for an exemptive order under Section 3(b)(2), rather it was designed to provide an exemption for companies "whose asset composition and sources of income would provide conclusive evidence that such companies are not investment companies."[6] Notably, Rule 3a-1 allowed an operating company to treat subsidiaries that it controls primarily as "good assets," so long as it engages in non-investment company business through such subsidiaries. To alleviate the regulatory burden on the Commission and companies, Rule 3a-1 allows a company that meets its requirements to self-determine that it is primarily engaged in a business other than being an investment company.[7]

Rule 3a-8 was adopted in recognition that the 40 percent test and Rule 3a-1 do not adequately account for the business model of research and development companies, which often have internally developed intellectual property that is not recognized as an asset on the issuer's balance sheet, that may make investments to fund their operations and may make strategic non-controlling investments in other companies in furtherance of their research and development business.[8] As with Rule 3a-1, the Commission adopted Rule 3a-8 to codify exemptive orders that had been granted to such companies to avoid the need to weigh in on similar companies' investment company status in the future.

Why Is a New Exemptive Rule Necessary?

In recent years, certain types of operating companies—online/e-commerce companies, as just one example—are surprised to find that their business models raise 1940 Act status concerns, and may be incompatible with the 40 percent test and Rules 3a-1 and 3a-8. One of the main reasons these types of companies run into investment company status issues is that their strategic investments in other companies frequently count as bad assets.

Strategic investments increasingly have become an important tool for companies with innovative business models, both as investor and investee, but they can pose significant challenges for a parent

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company that does not intend to operate as an investment company. The 40 percent test treats a strategic investment as a good asset for an operating company only if the strategic investment is a majority-owned subsidiary.[9] A majority-owned subsidiary is one in which the operating company owns at least 50 percent of the voting securities.[10] Voting securities are those that entitle the owner to elect directors.[11]

The fact that the 1940 Act equates ownership with the right to elect directors is problematic in the context of strategic investments because such investments generally do not involve an operating company acquiring majority control of the board of the strategic target. Consider an e-commerce company that makes a strategic investment in a company that fits within its ecosystem. This could be an electronic payment company, an online advertising company, or a shipping/delivery company. Such a strategic investment may be predicated upon a variety of business rationales, but passive investment for speculative purposes is highly unlikely to be the primary purpose. In such investments, the operating company may have the right to elect one or more directors (but generally less than a majority of the board) and likely has significant economic rights (possibly reaching or exceeding 50 percent). Those facts, however, do not allow the operating company to treat the strategic investment as a good asset for purposes of the investment company analysis.[12] This discourages an operating company from deploying (and raising) capital for such strategic investments.

As explained in more detail below, the current 1940 Act regulatory framework presents a potentially insurmountable hurdle for US companies with innovative business models, such as internet companies, that may strategically invest in companies within their ecosystem and may prevent similarly situated non-US companies from entering into transactions or conducting offerings in the United States. These regulatory impediments to capital markets and innovation would seem to harm companies and investors alike, and fly in the face of the principles espoused by SEC Chairman Jay Clayton and his goal of reinvigorating US capital markets.[13]

The Foundations of the Proposed Rule

We propose that the Commission consider adopting a new exemptive rule under Section 3 that codifies the more routine aspects of exemptive applications that have previously been granted under Section 3(b)(2). Akin to Rule 3a-1, the main goal of the Proposed Rule is to allow companies that clearly are not investment companies to avoid unnecessary and impractical regulation under the 1940 Act.

We are acutely aware that a sticking point for the Commission will be ensuring that any rule it adopts does not allow a company that is engaged in an investment company business to avoid regulation under the 1940 Act. With this in mind, the elements of the Proposed Rule are based on circumstances where the Commission has been comfortable that a company clearly is not primarily operating an investment company business. The Proposed Rule borrows extensively from Rules 3a-1 and 3a-8, both in terms of structure and mechanics, as well as exemptive orders the Commission has issued to individual operating companies under Section 3(b)(2) of the 1940 Act. Similar to Rules 3a-1 and 3a-8, the Proposed Rule requires an issuer to demonstrate both quantitatively and qualitatively that it is primarily engaged in a non-investment business. The treatment of majority-owned and primarily controlled subsidiaries as good assets also has been carried over from Rule 3a-1. We borrowed from Rule 3a-8 certain defined terms, the notion of treating capital preservation instruments as good assets, and concepts such as an issuer's board adopting policies as a prerequisite to qualifying for the safe harbor. We also drew from other sources, including regulations governing Business Development Companies (BDCs).

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Elements of the Proposed Rule

(a) No more than 45 percent of the value (as defined in section 2(a)(41) of the 1940 Act) of such issuer's total assets (exclusive of Government securities and cash management investments) consists of, and no more than 45 percent of such issuer's net income after taxes, or 10 percent of such issuer's revenue (for the last four fiscal quarters combined) is derived from, securities other than;
  (i) Government securities;
  (ii) Strategic investments;
  (iii) Capital preservation investments;
  (iv) Securities issued by employees' securities companies;
  (v) Securities issued by majority owned subsidiaries of the issuer which:
    (A) are not investment companies, and
    (B) are not relying on the exception from the definition of investment company in section (c)(1) or (c)(7) of the Act (15 U.S.C. § 80a-3(c)(1) or 80a-3(c)(7)); and
  (vi) Securities issued by companies:
    (A) Which are controlled primarily by the issuer;
    (B) Through which such issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities; and
    (C) Which are not investment companies;

With respect to element (a), the Proposed Rule departs from Rule 3a-1 in two key ways:

1. Strategic investments and capital preservation instruments, concepts borrowed from both Rule 3a-8 and prior Section 3(b)(2) orders, would be categorized as good assets under the Proposed Rule, whereas such securities are treated as bad assets under Rule 3a-1.
2. While the thresholds concerning the allowable amount of an issuer's assets and net income that remain unchanged, an alternative to the net income metric based on revenue derived from bad assets has been introduced.

Rationale for Treating Certain Strategic Investments as Good Assets

The Proposed Rule incorporates a modified version of the strategic investments concept used in Rule 3a-8 and numerous Section 3(b)(2) orders. For many operating companies, the traditional quantitative tests under Section 3 of the 1940 Act and the rules thereunder yield unfavorable results as it becomes increasingly common for companies to rely on strategic collaborations with other firms as a pathway towards driving the growth of their primary business. Companies rely on strategic collaboration with other firms to, among other reasons: achieve cost and risk sharing; obtain or exploit research, technology, or expertise; obtain financing, management, marketing, distribution assistance; to enter or access new markets; effect synergies; or to share complementary business skills.[14]

While strategic collaboration is commercially valuable for a variety of reasons, it is problematic from a 1940 Act perspective because strategic collaborations often involve the exchange of securities as opposed to merely being contractual relationships. A common scenario under which a strategic collaboration will arise is one where a large, well-funded corporation will take a minority equity position in a smaller, start-up company. The investing company is, in many cases, motivated more by strategic reasons, such as obtaining the ability to influence or control the smaller company's business plan in a manner that is beneficial to the investing company's primary business, than it is motivated by speculatively obtaining financial rewards from its equity investment. Similarly, a start-up company may approach a larger company with a

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robust library of intellectual property or a well-established platform and negotiate a deal whereby it, the smaller company, will acquire access to intellectual property or a platform, which often conveys valuable market insights, vendor relationships, and distribution support to the smaller company.[15] In many cases, the smaller company will ask to pay license fees, milestone payments, or other compensation using its stock in lieu of cash. For the larger company, allowing a cash-poor company access to its intellectual property or its platform is, in many instances, motivated more by a desire to grow its primary business, rather than a plan to bet speculatively on big investment returns.

Most strategic investments are not controlling interests and are, thus, treated as bad assets under the traditional tests for determining investment company status. The high valuations the market has given to many start-up companies in recent years exacerbates this problem. The issue has become more noticeable as an increasing number of companies build themselves as technological platforms, rather than as traditional companies that make specific products or provide services directly to consumers. As a result of the 1940 Act concerns involved in making strategic investments, many operating companies are concerned about their status because they may have to carefully monitor their balance sheets to avoid becoming an inadvertent investment company (or find that they already have that issue). These concerns become practical barriers to operations and expansion when companies are faced with the potential inability to access capital markets or engage in ordinary course corporate transactions because they cannot assert with a high degree of certainty that they are not an investment company.[16]

With respect to certain research and development companies, Rule 3a-8 provides some flexibility regarding strategic investments, but the relief is too limited to fully address the issues discussed above. Under Rule 3a-8, where an otherwise qualifying research and development company adopts a policy providing that at least 75 percent of its investments in bad assets will be made pursuant to a collaborative research and development arrangement (an arrangement that approximates a strategic investment relationship), the issuer is permitted to have 15 percent more bad assets than is otherwise permitted while still remaining under the rule's safe harbor. Essentially, under Rule 3a-8 strategic investments are still treated as bad assets, but issuers that utilize them frequently are permitted to maintain a higher ratio of bad assets before falling out of the safe harbor's protections. Notably, if a parent company's stake in a subsidiary rapidly increases in value as a result of a high valuation of the subsidiary at some point down the road, the parent could suddenly become an investment company simply because it had a strategic investment that has become unexpectedly valuable, notwithstanding the fact that the vast majority of its operations, employees and expertise will remain concentrated in its primary, non-investment business. In our view, this is an absurd result.

The Proposed Rule would relieve this tension by allowing companies to treat certain non-controlling strategic investments as good assets for purposes of determining their investment company status.

Definition of Strategic Investments That Qualify as Good Assets

The proposed definition of strategic investments that would qualify as good assets is included in Section (f)(5) of the Proposed Rule, copied below:

> (5) *Strategic Investment* means a non-controlling investment in securities issued by an affiliated person (as such term is defined in Section 2(a)(3)(A)), to which the issuer makes available significant managerial assistance (as that term is defined in Section 2(a)(47)), through which the issuer complements or enhances its primary business or businesses, provided that such affiliated person is not an investment company.

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The requirement that a strategic investment is a good asset only if it relates to an affiliated company is designed to ensure a certain amount of meaningful relationship with the strategic ally, and to ensure that the definition of "good" strategic investments is not over inclusive. As an initial proposal, we are suggesting that the investing company must own at least 5 percent of the target's voting securities at the time the analysis under the Proposed Rule is conducted. In practice, this likely means that a strategic investment that gives an operating company the right to elect a director would qualify as a "good" strategic investment.

In the same vein, the Proposed Rule would require that the investing company make available significant managerial assistance to the target of a strategic investment. The concept of significant managerial assistance is borrowed from BDC regulations and is meant to serve as an indicator that an investing company is actively involved in the investment (and is not merely a passive investor).[17] It can be satisfied through any relationship whereby an investing company, through its directors, officers, employees, or general partners offers significant guidance and counsel concerning the management, operations, or business objectives, and policies of the investee. It may also be satisfied through the exercise by an investor of significant controlling influence over the management or policies of the investee. With respect to BDCs, the requirement that they make available significant managerial assistance to portfolio companies is a prerequisite to treating such companies as qualifying investments for purposes of the quantitative test that determines eligibility for BDC status. This element is required in the BDC context because, unlike typical registered investment companies, BDCs are not intended to be merely passive investors. In the context of the Proposed Rule, the element would serve the same purpose by further establishing that any strategic investments that are intended to be treated as good assets are not merely passive investments.

The proposed definition of strategic investment would also require that a good strategic investment complement or enhance the issuer's primary business. This component is derived from Section 3(b)(2) applications and orders discussing strategic investments.[18] Yahoo!, for instance, stated in its 3(b)(2) application that it entered into strategic, non-controlling investments in companies that could complement or enhance its Internet and new media businesses as a means to solidify relationships and outsourcing research and development.[19] The requirement here is intended to codify that type of representation.

Rationale for Treating Capital Preservation Investments as Good Assets

The proposed rule also incorporates the concept of capital preservation investments, which has been discussed in several Section 3(b)(2) orders and is codified in Rule 3a-8. Under Rule 3a-8, a capital preservation investment is "an investment that is made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses," and issuers may essentially treat them as good assets. In Yahoo!'s 3(b)(2) application, the company stated that it would "hold predominately short-term high quality instruments that are consistent with its [board approved] policy of preserving its capital until the capital is needed to fund operations, research and development, future acquisitions and other bona fide business purposes."[20]

Importing a similar carve-out into the Proposed Rule is valuable and necessary for several reasons. First, many companies have significant amounts of cash on hand that they intend to use in their primary business, but for a variety of reasons cannot do so immediately. Under the status quo, many of these companies are forced to invest a significant amount of their cash into government securities or similarly low-yielding cash items that are excluded from the traditional investment company status

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determination tests.[21] In crafting and ultimately adopting Rule 3a-8, the Commission accepted that it did not make sense to restrict the ability of certain companies to invest in the high-quality debt instruments with higher yields than government securities. Similarly, when granting Section 3(b)(2) orders to Yahoo! and Microsoft, the Commission accepted representations from those companies that they would invest their capital conservatively in order to preserve it until it can be deployed.[22] This flexibility should be extended to similarly situated companies through the Proposed Rule as well.

Definition of Capital Preservation Investments That Qualify as Good Assets

The proposed definition of capital preservation investment is included in Section (f)(4) of the Proposed Rule, copied below, and is identical to the definition provided under Rule 3a-8.

> (4) *Capital Preservation Investment* means an investment that is made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses;

Rationale for Providing the Ability to Consider Revenue Instead of Income

Element (a) of the Proposed Rule, in keeping with element (a) of Rule 3a-1, essentially satisfies what the Commission has identified as the most significant of the *Tonopah* factors, the composition of an issuer's assets and the sources of its income. In numerous contexts under the 1940 Act, the Commission has determined that an issuer may be deemed to be primarily engaged in a certain activity or business when 55 percent of its assets and income are derived from a particular source. For instance, Rule 3a-1 follows this rule of thumb, as does Section 3(c)(5).

The Proposed Rule introduces a slight modification to this well-established practice, and would permit that the net income prong may be alternatively satisfied by a demonstration that 90 percent of the issuer's revenues is derived from non-investment sources (styled as a 10 percent limit on revenues derived from bad assets). Notwithstanding the well-established 55 percent interpretation of primarily engaged, the Commission has issued Section 3(b)(2) orders to companies that derive less than 55 percent of their income from investment securities when the factual context warranted such findings. For instance, in the case of an issuer with significant pretax deductions relating to its primary business that skewed their net income toward investments, the Commission accepted the applicant's argument that "rather than focusing upon after-tax earnings, [the issuer's] status as an operating company, rather than an investment company, can be more appropriately ascertained by comparing its investment income with total revenues."[23] The Proposed Rule would codify the same concept in recognition of the fact that certain operating companies might, for a variety of reasons that are a natural result of their primary business, face similar problems with respect to net income providing a skewed picture of their business.[24]

The traditional tests for determining investment company status essentially compare the amount of income an issuer derives from its bad assets to the amount of income it derives from its good assets and if the company's primary business is not yet profitable, even a small amount of income generated by bad assets can potentially cause it to fail the test. Revenue, alternatively, provides a clearer picture of the scale of the issuer's primary business relative to its investment revenues generated by any bad assets.

By way of example, in three previously granted Section 3(b)(2) orders, the applicants reported that income derived from "bad assets" made up 56

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percent, 49 percent, and 45 percent of their respective total incomes, whereas the same companies reported that just 14 percent 1 percent and 1 percent of their respective revenues were attributable to "bad assets."[25] Out of a sampling of eight of the more recently granted Section 3(b)(2) orders, the average revenues attributable to bad assets was 7.375 percent.[26]

Under the Proposed Rule, we have suggested that a company whose percentage of revenue attributable to bad assets is below 10 percent would not also need to satisfy the 45 percent net income test. If the Proposed Rule were considered by the Commission, it would need to conduct a more thorough economic analysis to determine whether a 10 percent threshold would be appropriate to achieve investor protection goals (or if the threshold should be higher or lower), but conceptually it is important to provide an alternative option to the income test to account for companies whose primary business may not yet be profitable.

Board Responsibilities Serve as a Check on Abuse of the Proposed Rule

(b) The issuer is primarily engaged, directly, through majority-owned subsidiaries, or through companies which it controls primarily, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, as evidenced by:
- (i) The activities of its officers, directors and employees;
- (ii) Its public representations of policies;
- (iii) Its historical development; and
- (iv) An appropriate resolution of its board of directors, which resolution or action has been recorded contemporaneously in its minute books or comparable documents.

(c) The issuer's board of directors adopt and record a resolution or written investment policy based on its findings that such issuer intends to make strategic investments:
- (i) which will be or are being carried on the issuer's balance sheet as long term assets, rather than for short-term or speculative purposes;
- (ii) which will be or are primarily being held as a means to enter into or solidify business relationships with companies that complement or expand its primary business or businesses; and
- (iii) which will involve the offer of significant managerial assistance to the target company.

(d) The issuer's board of directors has adopted a written investment policy with respect to the issuer's capital preservation investments.

With respect to elements (b) (c) and (d), the Proposed Rule borrows the concept of prerequisite board-adopted resolutions or investment policies from Rule 3a-8 in order to introduce an element of accountability and as additional safeguards against abuse—that is, to ensure that the Proposed Rule is aligned with the Commission's responsibility to protect investors. Pursuant to element (b), a company that intends to rely on the Proposed Rule would need to make a finding at the board level that its business operations are consistent with the remaining three *Tonopah* factors (other than the nature of its assets and income), similar to the representations that the company would have to make to the Commission if it sought a Section 3(b)(2) order. Pursuant to elements (c) and (d), a company that intends to rely on the Proposed Rule would need to adopt an investment policy that ensures it is counting

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investments as "good" strategic investments or capital preservation investments only if they are consistent with the definitions provided in the Proposed Rule.

The Potential Benefits of the Proposed Rule Clearly Outweigh Any Potential Costs

Considering that the Commission would need to engage in a cost-benefit analysis with respect to the Proposed Rule, as with any other rulemaking, it is worth noting that the Proposed Rule offers a number of potential benefits with few potential downsides. The Proposed Rule would reduce unnecessary burdens on operating companies that clearly engage primarily in non-investment business, relieving a potentially significant burden on new and growing companies with innovative business models and facilitating capital formation. Additionally, the Commission would no longer need to consider exemptive applications from companies that clearly fit within existing precedent set by numerous Section 3(b)(2) orders.

Any exemptive rule carries a risk that it could be too broad and be abused to the detriment of investors, but we have attempted to build in significant safeguards against that risk. The Commission (and commenters) will likely have additional thoughts on possible safeguards, but given the existence of Rules 3a-1 and 3a-8, and the body of existing Commission guidance as precedent in this area, this risk should not prevent the Commission from adopting a form of the Proposed Rule.

In Jay Clayton's first public speech as Commission chairman, he noted that one of the principles that should guide the Commission is that "regulatory actions drive change, and change can have lasting effects."[27] In connection with this principle, he raised the concern that companies have been avoiding US public markets, to the detriment of "Main Street" investors that are deprived of the ability to participate in their growth. The Proposed Rule has the potential to help address this concern, and the Commission should give it meaningful consideration.

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NOTES

1. In re Tonopah Mining Co., 26 S.E.C. 426 at 427 (1947).
2. *Id.*
3. *Certain Prima Facie Investment Companies,* 1940 Act Release No. 11551 (Jan. 14, 1981).
4. *Certain Research and Development Companies*, 1940 Act Release No. 26077 (June 16, 2003), *https://www.sec.gov/rules/final/ic-26077.htm.*
5. *See Certain Prima Facie Investment Companies*, 1940 Act Release No. 10937 (Nov. 13, 1979).
6. *See id.*
7. Operating companies generally seek an opinion from counsel when they need to support this self-determination, such as in connection with a commercial transaction (*e.g.*, taking out a loan or participating in a merger or acquisition).
8. Rule 3a-8 was based, in large part, on a petition for rulemaking that cited concerns and proposed a similar approach to this article. Petition for Investment Company Act of 1940 Rulemaking, submitted by Matthew A. Chambers and John C. Nagel, Wilmer, Cutler & Pickering, on behalf of the Biotechnology Industry Organization, File No. 4-457 (May 23, 2002), *https://www.sec.gov/rules/petitions/petn4-457.htm.*
9. 15 USC § 80a-3(a)(2).
10. 15 USC § 80a-2(a)(24). Under the 1940 Act, a company can have two 50 percent "majority owners."
11. 15 USC § 80a-2(a)(42).

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12 Similarly, strategic investments are unlikely to count as primarily controlled investments under Rule 3a-1, because there likely exists another owner with a larger stake.

13 Chair Jay Clayton, "Remarks at the Economic Club of New York," (Jan. 17, 2017), *https://www.sec.gov/news/speech/remarks-economic-club-new-york*.

14 *See, e.g.*, Sunny Dhillon, "Why Strategic Investment Isn't Always A Good Strategy For Startups," Forbes (Jan. 9, 2017), *https://www.forbes.com/sites/valleyvoices/2017/01/09/why-strategic-investment-isnt-always-a-good-strategy-for-startups/#4ef53cb2777c*.

15 *See, e.g.*, Sunny Dhillon, "Startups: Here's How To Get The Most Out Of A Strategic Investor," Forbes (Jan. 27, 2017), *https://www.forbes.com/sites/valleyvoices/2017/01/27/startups-heres-how-to-get-the-most-out-of-a-strategic-investor/#762ba899f16f*.

16 A company's inability to assure a counterparty or investor that it is not an investment company is often the death knell for a potential transaction. For example, when a bank lends a company money, the bank is primarily concerned with the company's ability to make interest payments and repay the principal amount of the loan. If the company might be an inadvertent investment company, the bank will not accept the risk that the burdensome restrictions imposed by the 1940 Act might cripple the borrower's business and jeopardize its ability to honor its obligations to the bank.

17 While "significant managerial assistance" is a concept primarily related to BDCs, the Commission has previously allowed the concept to be used in other contexts. Notably, the Commission granted an exemptive order under Section 6(c) to an investment vehicle called a "managerial strategic investment company" that proposed to acquire minority equity interests in public operating companies and to offer to provide significant managerial assistance and financing to those companies and sought to be subject to BDC regulations instead of certain 1940 Act regulations applicable to closed-end investment companies. *See XSource, Inc.,* 1940 Act Release No. 24637 (Sept. 6, 2000) (Order), and 1940 Act Release No. 24596 (Aug. 11, 2000) (Notice).

18 *See*, *e.g.*, *Corvis Corp.,* 1940 Act Release No. 25804 (Nov. 18, 2002) (Order), and 1940 Act Release No. 25774 (Oct. 21, 2002) (Notice); *Yahoo! Inc.,* 1940 Act Release No. 29494 (June 13, 2000) (Order), and 1940 Act Release No. 24459 (May 18, 2000) (Notice).

19 *Yahoo! Inc.,* 1940 Act Release No. 24459 (May 18, 2000) (Notice).

20 *Id.*

21 *See*, *e.g.*, *Corvis Corp*., 1940 Act Release No. 25804 (Nov. 18, 2002) (Order), and 1940 Act Release No. 25774 (Oct. 21, 2002) (Notice); *Yahoo! Inc*., 1940 Act Release No. 29494 (June 13, 2000) (Order), and 1940 Act Release No. 24459 (May 18, 2000) (Notice).

22 *Yahoo! Inc.,* Act Release No. 29494 (June 13, 2000) (Order).

23 *American Trading and Prod. Corp.,* 1940 Act Release No. 13228 (May 10, 1983) (Order), and 1940 Act Release No. 13159 (Apr. 13, 1983) (Notice).

24 Consider, for instance, large and recognizable technology companies such as Twitter (publicly traded) and Uber (private company) that do not generate much, if any, net income from their primary businesses at this stage in their maturity despite generating substantial revenue (and investor interest).

25 *See Hill Physicians Medical Group, Inc.,* Investment Company Act Release No. 27824 (May 22, 2007) (Notice); *PacifiCare of Arizona, Inc.,* Investment Company Act Release No. 26643 (Oct. 25, 2004) (Notice); *Yahoo! Inc*., 1940 Act Release No. 24459 (May 18, 2000) (Notice).

26 *See Dolby Laboratories, Inc*., Investment Company Act Release No. 29454 (Oct. 1, 2010) (Notice); *RealNetworks, Inc*., Investment Company Act Release No. 27877 (June 28, 2007) (Notice); *Hill Physicians Medical Group, Inc*., Investment Company Act Release No. 27824 (May 22, 2007) (Notice); *Hutchinson Technology Incorporated*, Investment Company Act Release No. 27215 (Jan. 25, 2006) (Notice); *Applied Materials, Inc*., Investment Company Act Release No. 27064

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(Sept. 13, 2005) (Notice); *PacifiCare of Arizona, Inc.,* Investment Company Act Release No. 26643 (Oct. 25, 2004) (Notice); *Corvis Corporation*, Investment Company Act Release No. 25774 (Oct. 21, 2002) (Notice); *Yahoo! Inc.,* Investment Company Act Release No. 24459 (May 18, 2000) (Notice).

27 Chair Jay Clayton, "Remarks at the Economic Club of New York," (Jan. 17, 2017), *https://www.sec.gov/news/speech/remarks-economic-club-new-york.*

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Proposed Text of New Exemptive Rule under Section 3 of the 1940 Act

Rule

Notwithstanding section 3(a)(1)(C) of the Act (15 USC § 80a-3(a)(1)(C)), an issuer will be deemed not to be an investment company under the Act; *Provided*, That:

(a) No more than 45 percent of the value (as defined in section 2(a)(41) of the Act) of such issuer's total assets (exclusive of Government securities and cash management investments) consists of, and no more than 45 percent of such issuer's net income after taxes, or 10 percent of such issuer's revenue (for the last four fiscal quarters combined) is derived from, securities other than;
- (i) Government securities;
- (ii) Strategic investments;
- (iii) Capital preservation investments;
- (iv) Securities issued by employees' securities companies;
- (v) Securities issued by majority owned subsidiaries of the issuer which:
  - (A) are not investment companies, and
  - (B) are not relying on the exception from the definition of investment company in section (c)(1) or (c)(7) of the Act (15 USC § 80a-3(c)(1) or 80a-3(c)(7)); and
- (vi) Securities issued by companies:
  - (A) Which are controlled primarily by the issuer;
  - (B) Through which such issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities; and
  - (C) Which are not investment companies;

(b) The issuer is primarily engaged, directly, through majority-owned subsidiaries, or through companies which it controls primarily, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, as evidenced by:
- (i) The activities of its officers, directors and employees;
- (ii) Its public representations of policies;
- (iii) Its historical development; and
- (iv) An appropriate resolution of its board of directors, which resolution or action has been recorded contemporaneously in its minute books or comparable documents; and

(c) The issuer's board of directors adopt and record a resolution or written investment policy based on its findings that such issuer intends to make strategic investments:
- (i) which will be or are being carried on the issuer's balance sheet as long-term assets, rather than for short-term or speculative purposes;
- (ii) which will be or are primarily being held as a means to enter into or solidify business relationships with companies that complement or expand its primary business or businesses; and
- (iii) which will involve the offer of significant managerial assistance to the target company.

(d) The issuer's board of directors has adopted a written investment policy with respect to the issuer's capital preservation investments.

(e) For purposes of this section:
- (1) The percentages described in paragraphs (a) and (b) of this section are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries;
- (2) ***Board of directors*** means the issuer's board of directors or an appropriate person or persons performing similar functions for any issuer not having a board of directors;
- (3) ***Cash Management Investments*** means investments that consist of only certain high-quality predominately short-term debt instruments (together with cash items and government securities);

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(4) ***Capital Preservation Investment*** means an investment that is made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses;

(5) ***Strategic Investment*** means a non-controlling investment in securities issued by an affiliated person (as such term is defined in Section 2(a)(3)(A)), to which the issuer makes available significant managerial assistance (as that term is defined in Section 2(a)(47)), through which the issuer complements or enhances its primary business or businesses, provided that such affiliated person is not an investment company; and

(6) ***Controlled Primarily*** means controlled within the meaning of Section 2(a)(9) of the Act (15 U.S.C. § 80a-2(a)(9)) with a degree of control that is greater than that of any other person.

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