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Certain Research and Development Companies; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

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Certain Research and Development Companies

AGENCY: Securities and Exchange Commission (''Commission'').

ACTION: Final rule.

SUMMARY: The Commission is adopting a new rule under the Investment Company Act of 1940 that provides a nonexclusive safe harbor from the definition of investment company for certain bona fide research and development companies.

EFFECTIVE DATE: The rule will become effective on August 19, 2003.

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SUPPLEMENTARY INFORMATION: The Commission is adopting new rule 3a–8 [17 CFR 270.3a–8] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the ''Act'').[1]

Executive Summary

Research and development companies (''R&D companies'') often raise large amounts of capital, invest the proceeds and use the principal and return on these investments to fund their operations during their lengthy product development phase. An R&D company also may purchase a non-controlling equity stake in another company as part of a strategic alliance to conduct research and develop products jointly. Either of these activities may cause an R&D company to fall within the definition of an investment company under the Act. In 1993, a Commission order issued to ICOS Corporation, a biotechnology company, addressed how to determine the status of an R&D company under the Act (the ''ICOS Order'').[2]

Late last year, the Commission issued a release proposing rule 3a–8 (''Proposing Release'') to update and codify the terms of the ICOS Order.[3] The proposed rule was designed to provide R&D companies with greater flexibility to raise and invest capital pending its use in research, development and other operations. The proposed rule also sought to clarify the extent to which an R&D company relying on the rule may make investments in other R&D companies pursuant to collaborative research and development arrangements. The commenters on the Proposing Release generally supported the proposed rule. Today the Commission is adopting rule 3a–8 as a nonexclusive safe harbor from investment company status for certain bona fide R&D companies.[4]

I. Background

A. Definition of Investment Company

Section 3(a) of the Act has two definitions of investment company that may be relevant to R&D companies.[5] Section 3(a)(1)(A) of the Act defines an investment company as any issuer that is, holds itself out as, or proposes to be engaged primarily in the business of investing, reinvesting, or trading in securities.[6] Section 3(a)(1)(C) of the Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and that owns or proposes to acquire investment securities having a value exceeding forty percent of the value of the company's total assets on an unconsolidated basis (exclusive of Government securities and cash items).[7] An issuer that meets the definition of investment company in section 3(a)(1)(C) of the Act nevertheless may be deemed not to be an investment company under two provisions in section 3(b) of the Act.

Section 3(b)(1) of the Act provides a self-executing exclusion from the definition of investment company for a company primarily engaged, directly or through wholly-owned subsidiaries, in a non-investment business.[8] Section 3(b)(2) of the Act allows a company that falls within the definition of investment company in section 3(a)(1)(C) of the Act to apply to the Commission for an order. Pursuant to section 3(b)(2), the Commission, upon application by the company, may find and by order declare the company to be primarily engaged (directly, or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses) in a business other than that of investing, reinvesting, owning, holding or trading in securities.[9]

When the Commission determines whether a company is primarily engaged in a non-investment business pursuant to section 3(b)(2), it looks principally at the composition of the company's assets and the sources of its income, and also considers the company's historical development, its public representations and the activities of its officers and directors.[10] These factors also are used to determine whether a company satisfies the primary business test under section 3(b)(1) of the Act.[11]

B. Research and Development Companies

When applied to R&D companies, the asset and income factors of the traditional primary business test may not appropriately reflect these companies' non-investment business. R&D companies, such as biotechnology companies, frequently require large amounts of capital to fund lengthy periods of research and development, the results of which may not produce income for years. R&D companies also may enter into strategic alliances for joint research and development that include the purchase of non-controlling

[1] Unless otherwise noted, when we refer to rule 3a–8, or any paragraph of the rule, we are referring to 17 CFR 270.3a–8 of the Code of Federal Regulations in which the rule is published, as adopted by this release.

[2] ICOS Corp., Investment Company Act Release Nos. 19274 (Feb. 18, 1993) [58 FR 11426 (Feb. 25, 1993)] (notice) and 19334 (Mar. 16, 1993) [58 FR 15392 (Mar. 22, 1993)] (order).

[3] *See* Certain Research and Development Companies, Investment Company Act Release No. 25835 (Nov. 26, 2002) [67 FR 71915 (Dec. 3, 2002)]. The Commission initially proposed rule 3a–8 in 1993. *See* Certain Research and Development Companies, Investment Company Act Release No. 19566 (July 9, 1993) [58 FR 38095 (July 15, 1993)], but later withdrew it from the Commission's agenda. Regulatory Flexibility Agenda, Investment Company Act Release No. 21795 (Mar. 4, 1996) [61 FR 24066 (May 13, 1996)].

[4] The Commission notes that any company that meets the requirements of the rule we adopt today may rely on its nonexclusive safe harbor, regardless of whether the company is primarily engaged in research and development activities or in some other non-investment business.

[5] A third definition, contained in section 3(a)(1)(B) of the Act [15 U.S.C. 80a–3(a)(1)(B)], defines an investment company to include companies that issue face-amount certificates of the installment type and is not relevant for purposes of this release.

[6] 15 U.S.C. 80a–3(a)(1)(A).

[7] 15 U.S.C. 80a–3(a)(1)(C). Section 3(a)(2) of the Act generally defines ''investment securities'' to include all securities except Government securities, securities issued by employees' securities companies, and securities issued by majority-owned subsidiaries of the owner which are not investment companies. 15 U.S.C. 80a–3(a)(2).

[8] 15 U.S.C. 80a–3(b)(1).

[9] 15 U.S.C. 80a–3(b)(2). A determination under either section 3(b)(2) or section 3(b)(1) of the Act that an issuer is engaged primarily in a non-investment business also means that it is not an investment company under section 3(a)(1)(A) of the Act. *See* M.A. Hanna Co., 10 S.E.C. 581 (1941).

[10] *See* Tonopah Mining Co., 26 S.E.C. 426 (1947).

[11] For a more detailed discussion of the relevant provisions of the Act and Commission rules, *see* Proposing Release, *supra* note 3, at II.A.

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

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

C. The Proposing Release

On November 26, 2002, the Commission issued the Proposing Release proposing rule 3a–8 to update and codify the analysis set forth in the ICOS Order.[14] Under the proposed rule, an R&D company would be deemed not to be an investment company under sections 3(a)(1)(A) and 3(a)(1)(C) of the Act if it met certain requirements designed to demonstrate the company's engagement in a non-investment business. The proposal sought to ensure that bona fide R&D companies do not inadvertently fall within the definition of investment company, while also making sure that investors in companies that are primarily engaged in the investment business receive the protections afforded them under the Act.

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

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

II. Discussion

A. Substantial Research and Development Expenses

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

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

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

B. Net Income from Investments

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

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

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

[14] Rule 3a–8 was proposed, in part, in response to a petition from the Biotechnology Industry Organization (''BIO'') to the Commission for rulemaking to modernize and clarify the analysis set forth in the ICOS Order. Petition for Investment Company Act of 1940 Rulemaking, submitted by Matthew A. Chambers and John C. Nagel, Wilmer, Cutler & Pickering, on behalf of the Biotechnology Industry Organization, File No. 4–457 (May 23, 2002) (''BIO Petition''). For a more detailed discussion of the BIO Petition, *see* Proposing Release, *supra* note 3, at II.D.

[15] *See* Proposing Release, *supra* note 3.

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

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

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

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

[20] Rule 3a–8(a)(1).

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

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

C. Insignificant Investment-Related Expenses

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

D. Investments in Securities

1. Capital Preservation Investments

i. Definition

To qualify for the nonexclusive safe harbor under rule 3a–8 as proposed, an R&D company's investments in securities were required to be capital preservation investments, subject to two exceptions for ''other investments,'' discussed below. The proposed rule defined ''capital preservation investments'' as investments made to conserve an R&D company's capital and liquidity until the funds are used in its primary business or businesses. The Proposing Release stated that, in general, capital preservation investments are liquid so that they can be readily sold to support the R&D company's research and development activities as necessary and present limited credit risk.[27]

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

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

We believe that attempting to specify such objective criteria would render the rule unnecessarily complex and inflexible. Moreover, we continue to believe that the approach we proposed is appropriate given the variety of circumstances that an R&D company may face.[29] Therefore, we are adopting the definition of capital preservation investments as proposed.[30] Our adopted definition is consistent with the ICOS Order, which has been applied as a standard to determine the status of R&D companies under the Act for over ten years.[31]

ii. Board-Approved Policy

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

2. ''Other Investments''

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

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

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

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

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

[24] Rule 3a–8(a)(2).

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

[26] Rule 3a–8(a)(3).

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

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

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

[30] Rule 3a–8(b)(4).

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

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

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

[34] Rule 3a–8(A)(7).

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

collaborative research and development arrangement and other investments that are not made to preserve capital and liquidity. As proposed, rule 3a–8 permitted an R&D company to acquire investments that are not capital preservation investments if, immediately after the acquisition, no more than 10 percent of the company's total assets consisted of other investments or no more than 20 percent of the company's total assets consisted of other investmens so long as at least 75 percent of those investments were made pursuant to collaborative research and development arrangements. The Proposing Release also explained that the Commission intended that the proposed rule's limits on other investments would be calculated at the time other investments are acquired.[36]

The Proposing Release requested comment on the proposed limits.[37] We also requested comment on whether the percentage limits should be applicable at any time, rather than being calculated only at the time other investments are acquired.[38] The commenters that addressed these issues all suggested that we make the limits applicable at all times and that we raise the applicable percentage limit when at least 75 percent of the R&D company's other investments were made pursuant to collaborative research and development arrangements.

Specifically, two commenters expressed concern that the rule as proposed could be interpreted to require the R&D company to determine its compliance with the percentage limits at the time of every acquisition it ever made, including acquisitions made years prior to relying on the rule.[39] These commenters also recommended raising the 20 percent limit to 30 percent. Another commenter suggested that compliance with the percentage limits should be required at all times to avoid the possibility that the value of an R&D company's other investments could greatly exceed the value of its capital preservation investments and its primary business. This commenter also suggested increasing the 20 percent limit to 25 percent.

The Commission agrees that it would enhance investor protection if the percentage limits were applicable at all times that an R&D company seeks to rely on the rule. We also note that this approach is consistent with the way both the Act and the Commission have formulated asset tests for purposes of determining a company's status under the Act.[40] We also believe that it would be more appropriate to address our concerns about market fluctuations in the value of investments made pursuant to collaborative research and development arrangements by raising the applicable percentage limit.

Although specifically requested in the Proposing Release,[41] the commenters that recommended raising the 20 percent limit 30 percent did not provide any information or data to support their request and to demonstrate the need for R&D companies to include a non-controlling investment as a part of a collaborative research and development arrangement. The Commission continues to be concerned that non-controlling investments constituting a significant portion of a company's assets, even if those investments potentially can be characterized as ''strategic,'' may indicate that the company's primary business is that of an investment company.[42] We believe, however, that raising the 20 percent limit to 25 percent would reflect an appropriate balance between this concern and the needs for R&D companies both to have greater flexibility to enter into strategic alliances and to deal with fluctuations in the value of strategic investments.[43] Accordingly, the Commission is adopting a 25 percent limit that would be applicable at all times that an R&D company seeks to rely on the rule.[44]

E. Collaborative Research and Development Arrangements

Rule 3a–8 as proposed defined a collaborative research and development arrangement as a business relationship which (i) is designed to achieve narrowly focused goals that are directly related to, and an integral part of, the issuer's research and development activities; (ii) calls for the issuer to conduct joint research and development activities with one or more other parties, and (iii) is not entered into for the purpose of avoiding regulation under the Act. For the reasons discussed below, the Commission is adopting the definition of a collaborative research and development arrangement substantially as proposed. The Commission is making a technical clarification to the definition to the effect that an investment in securities made pursuant to a collaborative research and development arrangement must be an investment in securities of a company (or of a company controlled primarily by, or which controls primarily, the company) with which the R&D company is engaged in the collaborative research and development arrangement.[45]

1. ''Joint Research and Development''

Two commenters requested clarification of the term ''joint research and development activities'' within the proposed definition. One commenter was concerned that the term ''joint'' could be interpreted to require the companies to be equally involved in the research and development throughout the entire research and development process. This commenter noted that research and development activities within collaborative arrangements often are guided by a joint steering committee with members from both companies, with one company or the other primarily responsible for conducting research and development at different stages. The Commission would consider an arrangement involving research and development activities done sequentially or through a joint steering committee to be ''joint'' within the meaning of the definition.

2. Other Relationships

The Proposing Release requested comment on whether other relationships, such as a licensor-licensee relationship with respect to a patent or other intellectual property rights, should be included in the definition of a collaborative research and development arrangement. One commenter suggested that licensor-licensee and similar contractual relationships should be included if they relate to product development activities because such relationships are legitimate and common. While we do not dispute the legitimacy or prevalence of licensing agreements, we do not believe that a licensing or similar agreement, by itself, demonstrates a sufficient nexus to the licensor's primary business to justify treating an investment in the licensee differently from any other speculative investment.

[36] *See id.*

[37] *See id.*

[38] *See id.*

[39] One of these commenters responded to a request for clarification from members of the Commission staff concerning its comment on this issue made in its comment letter. These discussions are summarized in a memorandum available in the public file. *See supra* note 16.

[40] *See, e.g.,* 15 U.S.C. 80a–3(a); 17 CFR 270.3a–1; and the ICOS Order, *supra* note 2.

[41] *See* Proposing Release, *supra* note 3, at III.A.4.b.

[42] *See id.*

[43] We note that the rule is designed to serve as a nonexclusive safe harbor. We are willing to consider, on a case-by-case basis, the status of R&D companies that cannot meet certain of the requirements of the rule.

[44] Rule 3a–8(a)(4)(i)–(ii).

[45] Rule 3a–8(b)(6). The Commission recognizes that a collaborative research and development arrangement may involve additional parties as well.

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

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

F. Other Requirements

1. Valuation

As proposed, rule 3a–8 required a company to value its assets in accordance with section 2(a)(41)(A) of the Act. Section 2(a)(41)(A) provides, in relevant part, that for purposes of section 3 of the Act, the term ''value'' means, (i) with respect to securities for which market quotations are readily available, the market value of those securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.[48] Two commenters opposed this requirement, arguing that an R&D company's assets may be difficult to value. They recommended allowing R&D companies to have the option of valuing their assets according to GAAP, which provides for the valuation of some, but not all, assets at market or fair value.

We note that Congress specifically mandated in section 2(a)(41)(A) of the Act that companies use market or fair values for their assets when determining their status under section 3 of the Act. The Commission consistently has required the same when exempting operating companies from the Act by order or rule, irrespective of any difficulty that may be involved in valuing the assets. We therefore do not believe that a departure from the valuation requirements under the Act in rule 3a–8 would be consistent with the protection of investors or the purposes intended by the policy and provisions of the Act. We also note that the increased percentage limit applicable when at least 75 percent of an R&D company's ''other investments'' were made pursuant to collaborative research and development arrangements under rule 3a–8 as adopted should reduce any burdens associated with determining fair values by giving R&D companies more flexibility to hold such investments. Accordingly, the Commission is adopting the requirement to comply with section 2(a)(41)(A) of the Act as proposed.[49]

2. Consolidation

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

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

III. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits of its rules. New rule 3a–8 provides a nonexclusive safe harbor from the definition of investment company for R&D companies. Under the rule, an R&D company is eligible for the safe harbor if it: (a) Has research and development expenses that are a substantial percentage of its total expenses for its last four fiscal quarters combined and that equal at least half of its net income derived from investments for that period; (b) has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined; (c) makes its investments to conserve capital and liquidity until it uses the funds in its primary business, subject to certain exceptions; and (d) is primarily engaged, directly or through a company or companies that it controls primarily, in a noninvestment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development.

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

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

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

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

[48] 15 U.S.C. 80a–2(a)(41)(A).

[49] Rule 3a–8(b)(1).

[50] *See supra* note 23.

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

[52] Rule 3a–8(b)(2).

[53] Rule 3a–8(a)(2).

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

[55] Rule 3a–8(a)(4)(i) and (ii).

under the ICOS Order. Under the new rule, the board of directors of an R&D company relying on the rule's safe harbor must adopt and record a resolution that the company is primarily engaged in a non-investment business [56] and adopt a written investment policy.[57]

Although we have identified certain costs and benefits that may result from the new rule, rule 3a–8 is exemptive, rather than prescriptive, and R&D companies are not required to rely on it. Therefore, we assume that R&D companies will rely on the rule only if the anticipated benefit from doing so exceeds the anticipated cost. In the Proposing Release, we requested comment and specific data regarding the costs and benefits of the proposed rule. We did not receive any comments or data regarding the costs and benefits of the rule from commenters.

A. Benefits

The Commission expects rule 3a–8 to benefit R&D companies in a number of ways. As mentioned, the new rule affords R&D companies greater flexibility to both raise and invest capital than currently allowed. The requirement under the ICOS Order that an R&D company's research and development expenses equal or exceed gross investment revenues, in effect, imposed a ''burn rate,'' requiring the R&D company to spend the income from and the principal amount of its investments in its research and development business. As a result of these limitations, R&D companies may have forgone opportunities to access the markets or may have reduced the amounts raised when accessing the markets. These limits also may have discouraged investment in higher yielding capital preservation instruments. The rule allows R&D companies to raise larger amounts of capital in a more cost-effective manner and to formulate more efficient asset allocations than is permitted under the existing tests. Thus, the rule should reduce any costs that may be associated with a lack of flexibility (1) to access fully the markets when conditions are favorable, and (2) to make capital preservation investments.

Furthermore, by clarifying the extent to which R&D companies may make investments in other companies pursuant to collaborative research and development arrangements, rule 3a–8 will provide R&D companies increased certainty as to the amount of these investments they may make without becoming subject to regulation under the Act. The Commission anticipates that this will reduce costs on an ongoing basis. When an R&D company's status under the Act is uncertain, it may experience higher costs when issuing securities or when borrowing. The Commission expects clarification of the test to both reduce the costs that an R&D company may need to incur to determine its status under the Act and reduce any uncertainty in such determination, which may reduce costs when issuing securities or borrowing.

B. Costs

R&D companies that choose to rely on the new rule's nonexclusive safe harbor will incur certain costs in complying with the rule's conditions that are not currently imposed under the ICOS Order. The rule requires an R&D company's board of directors to adopt and record a resolution that the company is primarily engaged in a non-investment business and also to adopt a written investment policy concerning the company's capital preservation investments. Because these requirements need to be fulfilled only once, the Commission believes the cost of the requirements to be minimal relative to the benefits provided by the safe harbor. We estimate that to comply with the requirement that the board of directors adopt and record a resolution, and R&D company would need to have its in-house counsel spend 45 minutes preparing the resolution, and its board of directors spend 15 minutes adopting the resolution. We expect the board of directors to have based its decision to adopt the resolution, in part, on investment guidelines the R&D company has established to ensure its investment portfolio is in compliance with the rule's requirements.[58] We therefore believe that no additional time will be required for the board of directors to formally adopt a written investment policy, as required by the rule, along with the resolution. Based on our estimate that 500 companies will rely on the rule, one hour per company at a blended hourly rate results in a total costs of $103,750.[59] In the Proposing Release, the Commission solicited comment on the number of companies that may rely on the rule, the amount of time needed to adopt the required resolution and the costs of such time. We did not receive any comments on our estimates.

IV. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Act provides that whenever the Commission is engaged in rulemaking under the Act and is required to consider or determine whether an action is consistent with the public interest, the Commission also must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission believes that, by clarifying the status of certain R&D companies under the Act, and allowing R&D companies greater flexibility to raise and invest capital, the rule is consistent with the public interest and will positively affect capital formation. The Commission also believes that the rule will promote efficiency and competition, and that the rule will not be unduly burdensome to those companies wishing to rely on it. In the Proposing Release, the Commission solicited comments on this section, but did not receive any.

V. Paperwork Reduction Act

New rule 3a–8 requires R&D companies wishing to rely on the safe harbor provided under the rule to fulfill a number of conditions. Certain of these conditions constitute ''collections of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA'') [44 U.S.C. 3501 *et seq.*]. One condition is that the board of directors of the company adopt an appropriate resolution evidencing that the company is primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities. The rule requires that the resolution be recorded contemporaneously in the company's minute books or comparable documents. The Commission submitted this collection of information to the Office of Management and Budge (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is ''Rule 3a–8 under the Investment Company Act.'' OMB has approved the collection of information for rule 3a–8; the OMB control number is 3235–0574 (expires March 31, 2006).

In the Proposing Release, the Commission estimated that the total

[56] Rule 3a–8(a)(6)(iv).

[57] *See* Proposing Release, *supra* note 3, at III.A.4.b.

[58] We believe that many of the companies that will seek to rely on the rule already have written investment guidelines.

[59] The Commission's estimate concerning the weighted average hourly wage rate is based on salary information for the securities industry compiled by the Securities Industry Association. *See* Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry—2001. The weighted average hourly wage rate of $207.50 includes overhead costs and assumes that 75 percent of the time will be by in-house counsel at a rate of $110 per hour and 25 percent by the board of directors at a rate of $500 per hour.

aggregate annual reporting burden associated with the proposed rule's requirements is 500 hours. The Commission estimated that of the 500 R&D companies that may take advantage of the proposed rule, the reporting burden imposed by rule 3a–8 is one hour per company, for a total aggregate reporting burden of 500 hours. No commenters addressed these burden estimates for the collection of information requirements and we continue to believe they are appropriate.

The rule we are adopting today contains an additional requirement that is also a collection of information within the meaning of the PRA. The board of directors of a company wishing to rely on the safe harbor under rule 3a–8, must adopt a written policy with respect to the company's capital preservation investments. We expect that the board of directors will base its decision to adopt the resolution discussed above, in part, on investment guidelines that the company will follow to ensure its investment portfolio is in compliance with the rule's requirements. We believe that many of the companies that will seek to rely on the rule already have written investment guidelines. For those that do not, we expect the board of directors to adopt the guidelines simultaneously with the resolution. Furthermore, like the required board resolution, the investment guidelines will generally need to be adopted only once (unless relevant circumstances change). The Commission therefore believes this additional collection of information will not create additional time burdens, but can be accounted for in the current burden hour estimate of 500 hours.

VI. Summary of Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis (''FRFA'') in accordance with 5 U.S.C. 604 regarding the adoption of new rule 3a–8 under the Act. A summary of the Initial Regulatory Flexibility Analysis (''IRFA''), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release. The Commission received no comments on the IRFA. The following summarizes the FRFA.

The FRFA discusses the need for, and objectives of, the new rule. The FRFA explains that the rule provides a nonexclusive safe harbor to allow R&D companies more investment flexibility and the ability to hold and invest more capital without becoming subject to the Act. The FRFA also explains that in order to be eligible for the safe harbor provided by the rule, an R&D company must have research and development expenses that are a substantial percentage of its total expenses and that equal at least half of its net income derived from investments for its last four fiscal quarters combined, have relatively small investment-related expenses, make its investments to conserve capital and liquidity until it uses the funds in its primary business, subject to certain exceptions, and be primarily engaged, directly or through a company or companies that it controls primarily, in a noninvestment business.

The FRFA states that rule 3a–8 is designed to clarify, and provide greater certainty concerning, the status of an R&D company under the Act. Rule 3a–8 has no reporting requirements, but the board of directors of a company seeking to rely on the rule would need to adopt a board resolution, record that resolution contemporaneously in its minute books or comparable documents and adopt written investment guidelines related to its capital preservation investments. The FRFA states that the only significant alternative to the rule would be for an R&D company to engage in its own analysis and application of existing statutory provisions, Commission orders and interpretations to determine the R&D company's status under the Act. The Commission therefore concluded that the rule, although it could affect small entities, would be less burdensome than this alternative and, thus, should minimize any impact upon, or cost to, small businesses. Any company with net assets of $50 million or less would be a small entity for purposes of the rule.

The FRFA is available for public inspection in File No. S7–47–02, and a copy may be obtained by contacting Karen L. Goldstein, Office of Investment Company Regulation, Securities and Exchange Commission, 450 5th Street, NW., Washington DC 20549–0506.

VII. Statutory Authority

We are adopting rule 3a–8 pursuant to our authority set forth in section 6(c) and 38(a) of the Act [15 U.S.C. 80a–6(c) and 80a–38(a)].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Rule

■ For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

■ 1. The authority citation of part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.,* 80a–34(d), 80a–37, and 80a–39, unless otherwise noted;

* * * * *

■ 2. Section 270.3a–8 is added to read as follows:

§ 270.3a–8 Certain research and development companies.

(a) Notwithstanding sections 3(a)(1)(A) and 3(a)(1)(C) of the Act (15 U.S.C. 80a–3(a)(1)(A) and 80a–3(a)(1)(C)), an issuer will be deemed not to be an investment company if:

(1) Its research and development expenses, for the last four fiscal quarters combined, are a substantial percentage of its total expense for the same period;

(2) Its net income derived from investments in securities, for the last four fiscal quarters combined, does not exceed twice the amount of its research and development expenses for the same period;

(3) Its expenses for investment advisory and management activities, investment research and custody, for the last four fiscal quarters, combined, do not exceed five percent of its total expenses for the same period;

(4) Its investments in securities are capital preservation investments, except that:

(i) No more than 10 percent of the issuer's total assets may consist of other investments, or

(ii) No more than 25 percent of the issuer's total assets may consist of other investments, provided that at least 75 percent of such other investments are investments made pursuant to a collaborative research and development arrangement;

(5) It does not hold itself out as being engaged in the business of investing, reinvesting or trading in securities, and it is not a special situation investment company;

(6) It 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

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

(b) For purposes of this section:

(1) All assets shall be valued in accordance with section 2(a)(41)(A) of the Act (15 U.S.C. 80a–2(a)(41)(A));

(2) The percentages described in 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;

(3) *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;

(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) *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;

(6) *Investment made pursuant to a collaborative research and development arrangement* means an investment in an investee made pursuant to a business relationship which:

(i) Is designed to achieve narrowly focused goals that are directly related to, and an integral part of, the issue's research and development activities;

(ii) Calls for the issuer to conduct joint research and development activities with the investee or a company controlled primarily by, or which controls primarily, the investee; and

(iii) Is not entered into for the purpose of avoiding regulation under the Act;

(7) *Investments in securities* means all securities other than securities issued by majority-owned subsidiaries and companies controlled primarily by the issuer that conduct similar types of businesses, through which the issuer is engaged primarily in a business other than that of investing, reinvesting, owning, holding, or trading in securities;

(8) *Other investment* means an investment in securities that is not a capital preservation investment; and

(9) *Research and development expenses* means research and development expenses as defined in FASB Statement of Financial Accounting Standards No. 2, Accounting for Research and Development Costs, as currently in effect or as it may be subsequently revised.

By the Commission.

Dated: June 16, 2003.

Jill M. Peterson,

Assistant Secretary.

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