

SECURITIES AND EXCHANGE COMMISSION

[Investment Company Act Release No. 27804; 812-13255]

Hill Physicians Medical Group, Inc.; Notice of Application

April 26, 2007

Agency: Securities and Exchange Commission (“Commission”).

Actions: Notice of application for an order under section 3(b)(2), or, alternatively, under section 6(c) of the Investment Company Act of 1940 (the “Act”).

Applicant: Hill Physicians Medical Group, Inc. (“Hill Physicians”).

Summary of Application: Applicant seeks an order under section 3(b)(2) of the Act declaring it to be primarily engaged in a business other than that of investing, reinvesting, owning, holding or trading in securities or, alternatively, under section 6(c) of the Act granting it an exemption from all provisions of the Act and the rules and regulations thereunder. Applicant is in the business of providing or arranging to provide physician services in Northern California to individual enrollee members of various health plans, including health maintenance organizations (“HMOs”) and other third party payors (collectively, “Health Plans”).

Filing Dates: The application was filed on January 18, 2006, and amended on January 29, 2007.

Hearing or Notification of Hearing: An order granting the requested relief will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission’s Secretary and serving applicant with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on May 21, 2007, and should be accompanied by proof of service on applicant, in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer’s interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission’s Secretary.

Addresses: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549-1090. Applicant, c/o Paul A. Stewart, Esq., Foley and Lardner LLP, One Maritime Plaza, 6th Floor, San Francisco, CA 94111.

For Further Information Contact: Jean E. Minarick, Senior Counsel, at (202) 551-6811, or Janet M. Grossnickle, Branch Chief, at (202) 551-6821 (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a summary of the application. The complete application may be obtained for a fee at the Commission's Public Reference Branch, 100 F Street, NE, Washington, DC, 20549-0102 (tel. 202-551-5850).

Applicant's Representations:

1. Formed in 1983, Hill Physicians is a physician's independent practice association organized as a California for-profit private professional medical corporation. Applicant represents that its shares can only be held by medical Providers (as defined below) and that the shares confer procedural rights to the Providers that hold them, not economic rights.¹ There is no trading market for Hill Physicians' stock. The non-transferable shares may only be sold to and redeemed by Hill Physicians at a price not to exceed the original issuance price of the share. Applicant further states that no dividends have ever been paid on its shares and none are expected to be paid.

2. Hill Physicians provides or arranges to provide physician services through California licensed practicing physicians ("Providers") to members of Health Plans in northern California. Applicant states that these services are provided pursuant to a written contract with each Health Plan. Under each contract, Hill Physicians is obligated to provide the covered physician services

¹ Hill Physicians only has one class of stock. Each shareholder Provider may hold only one share of Hill Physicians' stock.

that individual enrollee members of a Health Plan may later need. Hill Physicians is paid by the Health Plans on a fixed fee or “capitated” basis, meaning that Hill Physicians is paid monthly in advance a flat per member fee for each Health Plan member assigned to Hill Physicians. The capitation rates are set in advance, typically for two-year periods, and the payment covers all physician and certain ancillary services that any or all of the Health Plan members may need. The Providers, each of whom has signed substantially identical independent contractor agreements with Hill Physicians, provide the services at their individual offices. The Providers then send bills for payment to Hill Physicians, rather than the Health Plans. Hill Physicians pays the Providers mostly on a fee for service, not capitated, basis, as and when Provider bills are submitted to it.

3. This payment structure means that Hill Physicians bears the economic risk that its payments to Providers for medical services will exceed the fixed amounts it receives from the Health Plans. Applicant states that it maintains a substantial amount of invested reserves, including investment securities, to manage this risk. Applicant further states that the accumulation of cash and investments is an inherent part of its business structure because of the regularity of the capitation payments it receives and the delayed and uncertain amount of the payments it makes to Providers. Applicant also represents that it maintains its investment portfolio to meet California regulatory requirements.

4. Applicant states that it is registered with, and subject to regulatory oversight by, the Medical Board of California. Applicant states that it is a “risk bearing organization” within the meaning of the California Health and Safety Code and it is subject to regulation of its solvency by California’s Department of Managed Healthcare. Applicant also states that it is required by law, regulation and governmental policy to maintain positive levels of working capital and tangible net equity.

Applicant's Legal Analysis:

1. Section 3(a)(1)(A) of the Act defines the term "investment company" to include an issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(C) of the Act further defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value in excess of 40 percent of the value of the issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Applicant states that it has not held itself out as being engaged primarily in the business of investing, reinvesting or trading in securities within the meaning of section 3(a)(1)(A) of the Act.

Applicant states that it would fall within the definition of investment company under section 3(a)(1)(C) of the Act because more than 40 percent of its total assets consist of investment securities as defined in section 3(a)(2) of the Act.

2. Rule 3a-1 under the Act provides an exemption from the definition of investment company if no more than 45 percent of a company's total assets consist of, and not more than 45 percent of its net income over the last four quarters is derived from, securities other than Government securities and securities of majority-owned subsidiaries and companies primarily controlled by it. Applicant states that it has not been able to rely on rule 3a-1 because its securities comprise a large percentage of its total assets.

3. Section 3(b)(2) of the Act provides that, notwithstanding section 3(a)(1)(C), the Commission may issue an order declaring an issuer to be primarily engaged in a business other than that of investing, reinvesting, owning, holding or trading in securities directly, through majority-owned subsidiaries, or controlled companies conducting similar types of businesses. Applicant requests an order under section 3(b)(2) of the Act declaring that it 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 as defined in the Act. In determining whether an issuer is “primarily engaged” in a non-investment company business under section 3(b)(2), the Commission considers the following factors: (a) the company’s historical development, (b) its public representations of policy, (c) the activities of its officers and directors, (d) the nature of its present assets (the “Asset Factor”), and (e) the sources of its present income (the “Income Factor”).²

4. Recently, the Commission set forth its belief that it is appropriate for HMOs to determine whether they are primarily engaged in a non-investment business for purposes of section 3(b)(2) without considering the Asset Factor provided that they met certain conditions.³ Generally, the Commission indicated that the Asset Factor need not be considered by an HMO that (a) provides or arranges for the provision of health care services to subscribers or enrollees of the HMO; (b) is licensed under the laws of a state as a health care service plan, a health care service contractor, a health maintenance organization or a similar health plan company, and is subject to supervision by the insurance commissioner or a similar official; (c) allocates, manages and uses its investment securities in a manner consistent with its business as an HMO and in accordance with an investment policy adopted by its board of directors; and (d) bears a substantial amount of the risk that covered health care costs of the subscribers or enrollees of its health care products will differ from the prepaid or periodic charges paid by or on behalf of such persons (“underwriting risk”). In connection with the Income Factor, the Commission also clarified that an HMO may consider the sources of its present revenues so long as it derives substantially all of its total revenues from health care operations.

² Tonopah Mining Company of Nevada, 26 SEC 426, 427 (1947).

5. Applicant submits that it satisfies the criteria for the issuance of an order under section 3(b)(2) because the facts show that Hill Physicians is primarily engaged in providing physician and related health care services, and not in the business of investing, reinvesting, owning, holding or trading in securities.

a. Historical Development

Applicant states that it was formed in 1983 as an independent practice association for the express purpose of providing or arranging to provide physician services and that all of its activities since formation have been devoted to this purpose. Applicant also states that it intends to continue to be primarily engaged in the business of providing physician and related health care services.

b. Public Representations of Policy

Applicant states that all of the annual reports, internet postings, press releases and written communications it has issued have related to its business of providing physician services. Applicant also states that it has never held itself out as an investment company within the meaning of the Act and has never made any public representations that would indicate that it is in any business other than providing or arranging to provide physician services. Applicant represents that it has not issued any press release, advertising, promotional piece or other communication concerning its holdings of investment securities or its capital investment policies, or concerning any potential for profit or appreciation in value relating to its own shares.

c. Activities of Officers and Directors

Applicant represents that neither the directors nor the officers of Hill Physicians devote any significant part of their time to Hill Physicians' investment process. Applicant states that the

³ PacifiCare of Arizona, Inc. et al., Investment Company Act Rel. Nos. 26643 (Oct. 25, 2004) (notice) and 26679 (Nov. 22, 2004) (order).

members of its board of directors (“Board”) are all practicing physicians and were part of its physician network prior to serving on the Board. Applicant states that all of its directors and officers devote substantially all of their time spent on Hill Physicians matters on its business of providing or arranging to provide physician services. Applicant estimates that the Board and its executive committee spends approximately 20% of its time on each of strategy, operations, membership and quality improvement, 15% of its time on education, technology and all other topics and 5% of its time on finance, including less than 1% on investment matters. The Board’s involvement with respect to the investment portfolio consists of adopting an investment policy and reviewing periodic reports from its unaffiliated investment adviser and broker. Only three out of approximately 420 employees devote a de minimis amount of time to supporting Hill Physicians’ investment process.⁴

d. Nature of Assets

Applicant states that it owns no fixed assets and has a relatively small asset base because it is a service organization whose workforce consists solely of independent contractor physicians working out of their own offices. Further, Applicant maintains a substantial amount of liquid assets, including investment securities, to: (a) manage the risk that the aggregate capitated payments it receives from Health Plans will not adequately cover the actual amounts paid to Providers for services rendered; (b) ensure its ability to make timely payments during months when Hill Physicians’ payment obligations to Providers for their services significantly exceed its month capitation revenue; (c) meet the statutory or regulatory requirements with respect to its

⁴ Hill Physicians itself has no employees. Its management team and substantially all management services it requires are provided by a management company, PriMed Management Consulting Services, Inc. (“PriMed”). PriMed is compensated on the basis of cost plus incentives related to revenue growth, operating results and administrative efficiency and its compensation is not affected by the performance or value of Hill Physicians’ investment securities. PriMed is owned by Hill Physicians, Catholic Healthcare West and the individuals who serve as Hill Physicians’ chief executive officer and chief operating officer.

cash-to-claims ratio, working capital and tangible net equity; and (d) cover its payment obligations to Providers and its operating expenses. Accordingly, Hill Physicians' cash, investment securities and accounts receivable comprised 83.2% of its total assets as of September 30, 2006, and it owned investment securities on that date representing approximately 65.9% of its total assets excluding Government securities and cash items. Applicant does not invest or trade in securities for speculative purposes.

e. Sources of Income

Applicant states that 49% of its total income for the four fiscal quarters ended September 30, 2006 combined was derived from investment securities. Applicant states that this percentage is much higher than historical levels because of a non-recurring investment gain transaction and the realization of accumulated gains when a new investment advisor adjusted the portfolio, selling most of the marketable securities. Hill Physicians anticipates that approximately 35% of its net income after taxes will be derived from investment securities in the future as it retains earnings for the purpose of providing operating capital and accumulates resources to strengthen infrastructure, e.g., implementing electronic medical records and practice management systems in Providers' offices.

Applicant believes, however, that its sources of revenue are more representative of its activity as an operating company than its sources of income. Applicant states that income generation is not integral to its business because it, as an independent medical practice association, essentially acts as a "cooperative" for the benefit of the Providers. Applicant asserts that independent practice associations try to maximize the revenues they receive and fairly distribute them to the participating medical service providers. If Hill Physicians chooses not to retain earnings (and in years when it sustained operating losses), earnings from investment securities could represent all of its total income. Applicant states that revenues from the

provision of physicians' services have always represented over 99 percent of its gross revenue, while revenues from investments constituted the remaining less than one percent. Applicant does not expect that the percentage of its total revenue derived from investment securities would ever represent other than an insignificant part of its total revenues.

6. As discussed more fully in the application, Applicant believes that it shares with HMOs the characteristics necessary to permit a determination of its primary business without regard to the nature of its assets. Hill Physicians provides or arranges to provide health care services to enrollees of Health Plans in return for capitation payments. While not licensed under state law as a health care service plan, health care service contractor, HMO or similar health plan company, Hill Physicians is subject to similar regulation by the California agency that regulates Health Plans and by the Medical Board of California. Hill Physicians allocates, manages and uses its investment securities in a manner consistent with its business of providing or arranging to provide physician services to members of Health Plans, and its Board has approved its investment policies. Applicant further argues that it meets the last condition because it bears the entire underwriting risk for payments to Providers, none of which is transferred to, or shared with, a third party under any contracts or other arrangements. Accordingly, Applicant submits that its primary business for purposes of section 3(b)(2) of the Act should be determined without considering the nature of its assets.

7. Applicant asserts that its sources of revenues, its historical development, its public representations of policy and the activities of its officers and directors, as discussed in the application, demonstrate that it is engaged primarily in a health care, and not in an investment, business, and thus satisfies the criteria for issuing an order under section 3(b)(2) of the Act.

8. In the alternative to exemptive relief under section 3(b)(2), Hill Physicians requests an order under section 6(c) of the Act exempting it from all provisions of the Act.⁵ Applicant states that it has no public shareholders since it is privately held by its shareholder physicians and there is no trading market in its nontransferable shares. Applicant further states that there is no financial gain incentive associated with ownership of its shares. Furthermore, applicant believes that it is not the type of company the Act was designed to regulate and that compliance with the Act would be unnecessary, expensive and incompatible with its primary business of delivering health care. Consequently, Hill Physicians submits that the requested exemption is necessary and appropriate in the public interest, is consistent with the protection of investors, and is consistent with the purposes of the Act.

For the Commission, by the Division of Investment Management, under delegated authority.

Florence E. Harmon
Deputy Secretary

⁵ Section 6(c) provides, in relevant part, that the Commission may issue a conditional or unconditional exemption from any provisions of the Act or rule thereunder if the exemption is “necessary or appropriate in the public interest” and is “consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act].”