



**Bridgebay**  
*Investment Consulting Services*



**Northern Trust**

# The Investment Company Act of 1940

**The Corporate Treasurers' Seminar**

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# *Investment Company Act Origins*

- Passed by Congress in 1940
  - Investment trust abuses
  - Existing federal security laws insufficient
- Intent
  - Establish a standard to demarcate *investment companies* from operating companies as well as initiate regulatory oversight by the SEC
  - Impose certain “merit regulations,” disclosure requirements, prohibitions, and parameters for organizing and operating investment companies

# *Representative Provisions*

Compliance with the provisions of the 1940 Act would be extremely burdensome for industrial or operating businesses. Investment companies are subject to:

- Custodial requirements for holding assets
- Restrictions on transactions with affiliates
- Restrictions on the granting of stock options
- Required to have at least 60% independent directors
- Various limitations on capital structures and investment policies

# *Definition of an Investment Company*

Section 3(a)(1) of the 1940 Act defines an “investment company” as any issuer which:

- (A) is, or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities;
- (B) is engaged in the business of issuing face-amount certificates of the installment type or
- (C) 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 exceeding 40 per centum of such issuer’s total assets (exclusive of Government Securities and Cash Items) on an unconsolidated basis.

# *Investment Company - Not*

- To fall outside of the definition of an investment company under Section 3(a)(1)(A), a Company must be able to conclude that it:
  - is not **engaged primarily** in,
  - does not **hold itself out** as being engaged primarily in, or
  - does not **propose** to engage primarily in the business of investing, reinvesting or trading in Securities
- Whether an issuer “is” engaged primarily in the business of investing, reinvesting or trading in Securities depends on facts surrounding the issuer’s business activities
- Whether an issuer “holds itself out” as being or “proposes” to engage primarily in such business is a subjective determination which depends on the issuer’s intent

# *The main test* - Section 3(a)(1)(C)

Section 3(a)(1)(C) of the '40 Act defines an “investment company” as an entity which is engaged in the business of investing, reinvesting, owning, holding or trading securities and owns investment securities having a value exceeding 40% of its total assets according to the following formula on an unconsolidated basis:

$$\frac{\text{Investment Securities}}{\text{Total Assets} - (\text{Cash} + \text{Government Securities})} > 40\%$$

# *What's counted – What's not*

**Not counted** as Investment Securities and therefore excluded from the numerator and denominator of the calculation are the following asset classes:

- Government Securities (only U.S. Governments and Agency securities),
- Securities issued by majority-owned subsidiaries which are not investment companies
- Highly rated money market funds

**Counted:**

- The 1940 Act broadly defines Investment Securities to include almost every other financial asset.

# *Important Details*

**Valuation** - Section 2(a)(41) of the '40 Act provides the following guidance on asset valuation:

- Market value for securities owned at the end of the quarter, if market quotes are readily available;
- Securities owned at the end of a quarter which do not have readily determinable market values - the fair value at the end of the quarter as determined by the board of directors; and
- The cost of securities acquired after the end of a quarter

## **Compliance**

- Determined on a continuous basis
- Particularly germane when external counsel is called upon to opine that the company is not an Investment Company

# *Recommendation: Approach to compliance*

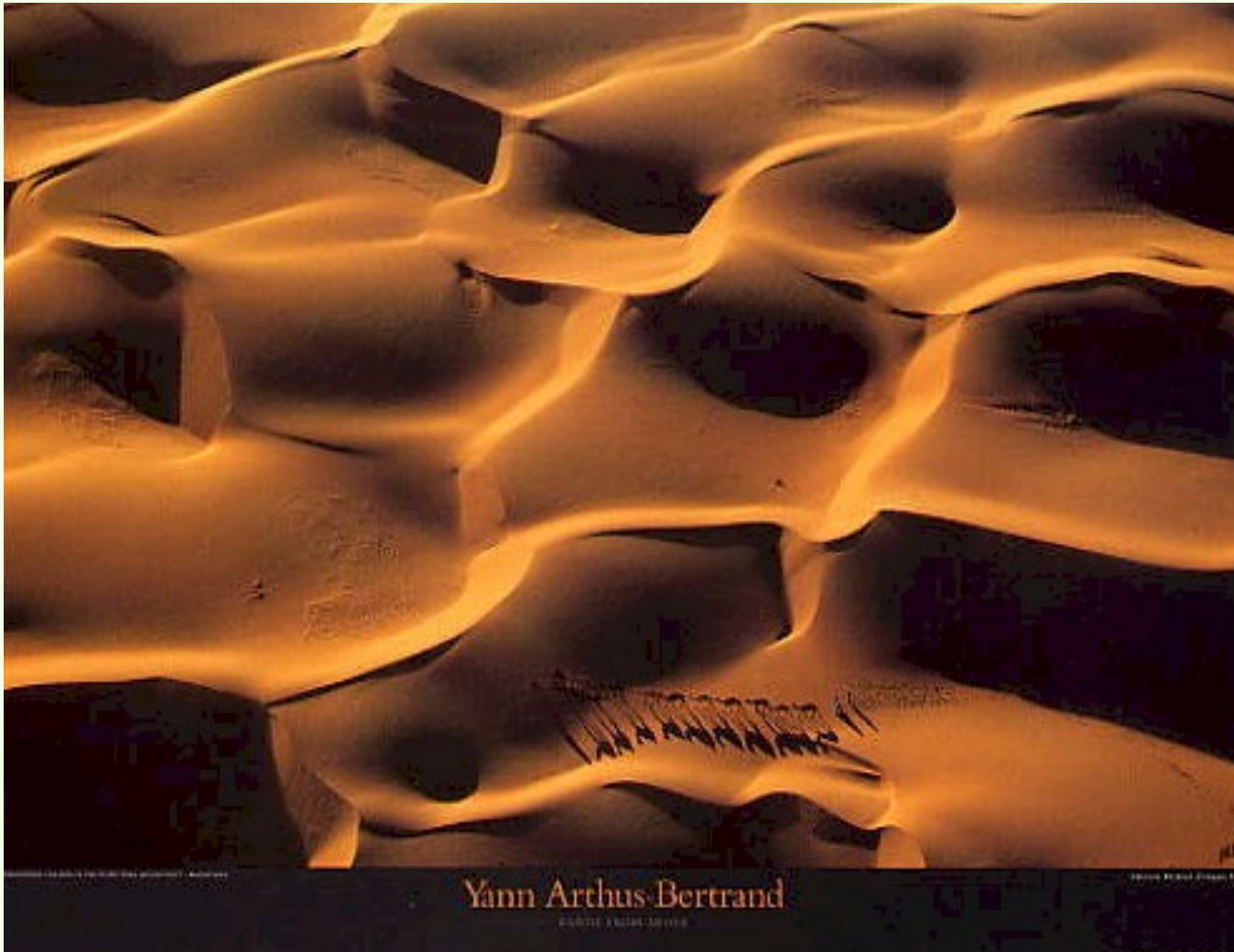
- Gather relevant amounts and calculate the 40% test on an **unconsolidated** basis
- Establish a periodic process to calculate and report out to senior management compliance with the 1940 Act

## **In compliance**

- Consult outside counsel to obtain their assurance that the calculation the company is using is appropriate
- Understand what counsel would do in the event that the company requires an opinion of counsel attesting 1940 Act compliance
- Determine what type of evidence or “compliance certificate” counsel would require the company to provide in order for counsel to issue the opinion.

## **Not in compliance**

- Develop a strategy to get in compliance
- Pursue one of a few possible exemptions to compliance



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# *Ya got trouble*



Yes, ya got lots and lots o' trouble  
I'm thinkin' of the kids in the knickerbockers,  
shirttails, young ones  
Peekin' in the pool hall window after school  
Ya got trouble, folks, right here in River City With a  
capital 'T' and that rhymes with 'P' And that  
stands for 'pool'

# *Trouble – Trouble – Trouble*

## *Internet – Incubators – Software – Bio Tech*

### Examples of Investment Company Act SEC - Corporate Activity

- Yahoo! Inc.
- Safeguard Scientifics, Inc.
- Internet Capital Group
- National Presto Industries Inc.



# *Caveat re: 1940 Act exemptions*

*The exemptions and techniques that follow require complicated analysis and legal judgments. Companies evaluating these exemptions and techniques should obtain expert advice from legal counsel specializing in these exemptions.*

# *Five Factor - 45% consolidated test*

## Rule 3a-1 Prima Facie Investment Companies

- 1940 Act Section 3(b)(1) - Notwithstanding Section 3(a)(1)(C), an issuer is not an investment company if the issuer is “*primarily engaged*” in a business other than that of investing, reinvesting, owning, holding or trading in securities

## Rule 3a-2 Transient Investment Companies

- 1940 Act Section 3(b)(2) - Notwithstanding Section 3(a)(1)(C), an issuer is not an investment company if, upon filing an application to SEC, the SEC finds and by order declares such issuer to be “*primarily engaged*” in a business other than that of investing, reinvesting, owning, holding or trading in securities.

# *Five Factor Test – Tonopah Mining*

Case Law: Five factors were applied to determine whether Tonopah Mining Co. was “primarily engaged” in a non-investment company business

- the issuer’s historical development
- its public representations of policy
- the activities of its officers and directors
- the nature of its present assets
- the sources of its present income

Sections 3(b)(1) and Section 3(b)(2) rely on a 45% test that evaluates sources of income and character of assets calculated at a subsidiary level and on a unconsolidated and **consolidated basis**

# 45 % Test

- No more than 45 percent of the value of total assets (excluding Government securities and cash items) consists of, and no more than 45% of net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than:
  - Government securities;
  - Securities issued by employees' securities companies;
  - Securities issued by majority-owned subsidiaries of the issuer (other than subsidiaries relying on the exclusion from the definition of investment company in [section 3\(b\)\(3\)](#) or [section 3\(c\)\(1\)](#) of the Act) which are not investment companies; and
  - Securities issued by companies:
    - Which are controlled primarily by such issuer;
    - Through which such issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities; and
    - Which are not investment companies;
- The percentages are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries

# *Rule 3a-8*

## *Research and Development Companies*

A non-exclusive safe harbor from the definition of an "investment company" for certain bona fide research and development companies

### **Determination**

- R&D expenses for its last four fiscal quarters combined are a substantial percentage of its total expenses for that period.
- Company's net-income derived from investments in securities for its last four fiscal quarters combined does not exceed twice the amount of its research and development expenses for the same period.
- Company has spent no more than five percent of its total expenses for its last four fiscal quarters combined on investment related expenses.
- Company's investments in securities must be capital preservation investments, with certain limited exceptions related to collaborative research and development arrangements
- Company must be primarily engaged, directly or through a company or companies it controls, primarily in a non-investment business
- In addition to adopting a written investment policy, the company's board of directors must also adopt an appropriate resolution stating that the company is primarily engaged in a non-investment business in order to rely on the new Rule's safe harbor.

## *Speaker Biography*

# *Maeve Richard*

*Maeve Richard* is Principal of CLM Associates. She was previously Vice President & Treasurer of McAfee, Inc. (formerly Network Associates, Inc.) where she directed worldwide cash and investments management, risk management and credit and collections. She was responsible for global treasury strategies, products, services and operations as well as financial and insurance risk management activities worldwide. She directed the Americas credit, collections and cash application, and global stock administration departments. She was responsible for the overall organization consisting of 32 professionals.

Ms. Richard has held various positions of increasing responsibility in corporate finance, relationship management and treasury at SRI International, JP Morgan & Co., Levi Strauss & Co. and served as the Assistant Treasurer of Sun Microsystems.

Ms. Richard earned an A.B. degree in Political Economy, University of California, Berkeley and a MBA from Graduate School of Business, Stanford University. She is a frequent speaker at regional and national AFP/TMA conferences.

She is active in the community, has been a board Member of Community Bank of the Bay and currently serves on the board of Handsnet, a human services online community, and is a mentor for CollegeTrack.

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