

# Keeping current: securities

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## Seventh Circuit's test for inadvertent investments

Investment company status cases are rare and have generally been decided at the lower-court level. Recently, the Seventh Circuit in *SEC v. National Presto Industries*, 486 F.3d 305, 2007 U.S. App. LEXIS 11345 (7th Cir. 2007) added a new gloss to the SEC's historical interpretation of what it means to be "primarily engaged" in the investment company business.

Under the Investment Company Act of 1940 (Investment Company Act), an "investment company" includes an issuer that is primarily engaged in investing or trading in securities, and that owns investment securities that have a value exceeding 40 per centum of the value of the issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.

National Presto Industries, Inc.'s (Presto) investment company problems began when it sold its manufacturing operations in favor of using subcontractors. Instead of acquiring capital with its sales proceeds, Presto invested in refunded bonds (a refunded bond is backed by government securities covering the bond's principal amount as well as the issuer's

credit) and variable-rate demand notes. As a result, while Presto had substantial operating income, its operating assets consisted mostly of its investments. As a result, the SEC believed that Presto was an inadvertent investment company—i.e., a company that should be regulated as an investment company, even though the company did not hold itself out as one.

Presto argued unsuccessfully that its investments in refunded bonds and variable-rate demand notes should be considered government securities and cash items, respectively, and, therefore, should not be included in the 40 percent total assets test. Presto then asserted that, assuming it failed the 40 percent total assets test, it nonetheless was entitled to be excepted from the definition of investment company because it was not primarily engaged in the investment company business.

"Primarily engaged" is not defined by statute or rule. The SEC's interpretation was developed 60 years ago in *In re Tonopah Mining Co.* 26 S.E.C. 426 (1947). *Tonopah* set forth five factors to determine whether a company was operating as an inadvertent investment company—the company's history, its public representations, the activities of its officers and directors, the nature of its assets, and the sources of its income—all of which serve as a proxy for what a "reasonable investor" would believe to be an investment company. This approach produced a relatively mechanical, bright-line test that provided some degree of certainty in analyzing whether a company was an inadvertent investment company.

However, in the *Presto* decision, the Seventh Circuit instead interpreted the *Tonopah* test as simply a set of factors that could be outweighed by a reasonable investor's perception, although it provided no guidance on how the reasonable investor determination should be made. The court found that although Presto's assets and income generally exceeded the thresholds for a noninvestment company, Presto was nonetheless not an investment company, simply because no "reasonable investor" would think Presto was actually an investment company. To this end, the court somewhat indignantly pointed out that the SEC "did not identify even one confused investor who bought stock in Presto thinking that he was making an investment" in an investment company.

The court created uncertainty in a relatively settled area of law. Therefore, there is no clear answer on whether the *Presto* decision's net effect will be positive or negative for issuers or whether it will be followed by other jurisdictions. On one hand, the decision might give companies with Investment Company Act status problems a shield in defending their status. If they can demonstrate that no reasonable investor would view them as the equivalent of a mutual fund or closed-end fund, the inquiry is over—at least in the Seventh Circuit. On the other hand, the SEC might use *Presto* as a sword against a company by producing reasonable investors who hold the opposite view. Finally, practitioners may find it more difficult to give clean opinions on a company's status, given the murkiness of the "reasonable investor" test.

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