

It is late on a Friday afternoon and you are finishing reviewing your company's balance statement for the fiscal year that recently ended. It was a busy year for the company, as it sold a subsidiary just before fiscal year-end. You note that your chief financial officer and his team have invested the proceeds of the sale in short-term debt securities that are paying an attractive interest rate.

Your phone rings, and on the other end is a member of your outside audit team. The auditor tells you that your company's investment of the proceeds from the sale of the subsidiary in short-term debt securities has created a situation where the value of the company's investment in securities exceeds 40 percent of the company's total assets. The auditor then uses a phrase that you have not heard before: inadvertent investment company. What is an inadvertent investment company, and why is your auditor so concerned?

# Strategic Planning Considerations for Companies that Don't Want to Be Investment Companies





By Erik D. Ojala  
and Monica L. Parry

Counsel to mutual funds (which are referred to formally as registered investment companies), are acutely aware that the Investment Company Act of 1940 (the 1940 Act) extensively regulates the activities of investment companies. Corporate counsel who do not focus their practice on investment management law, however, often fail to recognize that the 1940 Act's broad reach can catch many types of operating companies that never intended or wanted to be an investment company.

Common situations where an operating company may *inadvertently* become subject to the 1940 Act include:

- A start-up company raises capital to finance its operations and invests the capital in short-term, high-quality debt securities.
- An operating company sells a substantial subsidiary and, pending redeployment of the sale proceeds, invests the funds in securities.
- An operating company with strong cash flows seeks to increase the earnings on its cash reserves by investing in bonds or equity securities.
- An operating company invests a substantial portion of its assets in securities of subsidiaries that are less than majority-owned.

Investment company status questions frequently arise at inconvenient times. For example, most underwriting agreements require the issuer to represent that it is not, and will not after the offering be, subject to the 1940 Act. Some loan agreements also require this representation. Operating companies, particularly those that are reporting companies under the Securities Exchange Act of 1934 (the 1934 Act), also need to plan carefully to avoid last-minute status issues under the 1940 Act. Alert examiners in the US Securities and Exchange Commission's (SEC) Division of Corporation Finance may spot an investment company status issue when reviewing an operating company's Form 10-K, and refer the filing to the Division of Investment Management for review.

Many practitioners may have missed the case of *Securities and Exchange Commission vs. National Presto Industries, Inc.*<sup>1</sup> (Presto), which was decided last year by the US Court of Appeals for the Seventh Circuit. That the case was not discussed widely outside of investment management practitioners is unfortunate because the case is an important decision for two reasons:

1. Cases that discuss investment company status issues are few and far between, and have generally been decided at the lower court level.



ERIK D. OJALA is senior vice president and associate general counsel of Harbor Capital Advisors, Inc., a registered investment adviser located in Chicago, IL, that provides investment advisory services to institutional investors. This includes the Harbor Funds family of mutual funds and a collective investment fund that is comprised of retirement and employee benefit plan assets. He can be contacted at [erik.ojala@harborfunds.com](mailto:erik.ojala@harborfunds.com).



MONICA L. PARRY is of counsel in the Washington, DC, office of Morgan, Lewis & Bockius, LLP. She is a member of Morgan Lewis' Investment Management Practice and focuses her practice on investment companies and investment advisers. She also represents Google in its application for exemption from the 1940 Act. She can be contacted at [mparry@morganlewis.com](mailto:mparry@morganlewis.com).

2. The case added important new gloss to the SEC's historical interpretation of what it means to be "primarily engaged" in the investment company business.

Using the *Presto* case as a case study, this article focuses on practical tips to help in-house counsel at operating companies avoid inadvertent investment company issues. First examining the definition of an investment company under the 1940 Act, the article then explores the recent *Presto* case in detail. It goes on to discuss the consequences of being an inadvertent investment company and whether it is possible for an operating company to operate as an investment company. Finally, we offer practical advice on how to avoid inadvertent investment company status.

### What is an Investment Company?

Section 3 of the 1940 Act broadly defines the term "investment company." When the 1940 Act was enacted, Congress was concerned that disclosure alone was insufficient to prevent the abuses found in the industry before 1940, which were detailed in a lengthy special study commissioned by Congress on investment companies. As a result, the 1940 Act imposes substantive requirements on an investment company's governance and operations, as well as on company insiders, to prevent the insiders of a fund from using their positions to benefit themselves at the expense of the fund's shareholders.

The drafters of the 1940 Act were concerned that the nature of a fund's assets—liquid securities and cash that could easily be misappropriated—could tempt insiders to favor themselves.

Hence, the drafters of the 1940 Act defined investment companies as not only those pooled vehicles that intended to be, and held themselves out as, investment companies, but also those companies the nature of whose assets resembled those of orthodox investment companies.

The definition of investment company, therefore, includes three types of issuers:

1. The first is any issuer who is, or holds itself out as being, engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. Operating companies are typically not ensnared by this definition of an investment company unless their business consists of investing, reinvesting, or trading in securities.
2. The second definition includes issuers that engage in the business of issuing face amount certificates. Face amount certificates are debt securities that obligate the

issuer to pay a fixed sum (the face amount) at a specific date, and generally at a fixed rate of return. They typically are sold on an installment basis. Again, operating companies typically do not fall within this definition unless they are issuing face amount certificates.

3. The third definition is the one that can trap operating companies. This definition of investment company, which is found in Section 3(a)(1)(C) of the 1940 Act, includes any issuer who is engaged, or proposes to engage, in the business of investing, reinvesting, owning, holding, or trading in securities, and whose assets meet the following objective test:

$$\frac{\text{Investment Securities}}{\text{Total Assets}} > 40\%$$

If an operating company ends up owning or holding (or proposes to acquire) investment securities with a value of more than 40 percent of its total assets, the company may have “inadvertently” become subject to the 1940 Act. Section 2(a)(41) of the 1940 Act requires an issuer to value its “investment securities” using market value; some issuers may use book value instead, and thus would have to look to market quotations to determine fair value.<sup>2</sup>

**Presto invested most of the cash in refunded bonds and variable-rate demand notes to build up a “war chest” in order to acquire other businesses.**

### **How Did National Presto Industries, Inc., Become an Investment Company?**

The *Presto* case illustrates both the consequences and fallout of triggering inadvertent investment company status. The case also adds a new gloss to the SEC’s historical interpretation of what it means to be “primarily engaged” in the investment company business.

National Presto Industries, Inc., (Presto) of Eau Claire, Wisconsin—the maker of the FryDaddy® electric deep fryer, the SaladShooter® electric slicer, and the Pizzazz® pizza oven—designs and markets small appliances and housewares. Most of these products are currently manufactured by subcontractors. Presto also manufactures and distributes absorbent products and munitions. Over the past 30 years, Presto sold some of its subsidiaries and subcontracted much of its manufacturing to others. These actions, along with the closure of a munitions plant, left Presto in 1993 with a large supply of cash. Presto invested most of the cash in refunded bonds and variable-rate demand notes to build up a “war chest” in order to acquire other businesses. Presto also held intellectual property that, in accordance with US Generally Accepted Accounting Principles (GAAP), was not carried on its books at its full economic value. As a result, while Presto had substantial operating income derived from its businesses, its operating assets consisted mostly of financial instruments.

Presto triggered the objective definition of an investment company in Section 3(a)(1)(C) of the 1940 Act because, for some time, more than 40 percent

Your.

**OGILVY  
RENAULT**  
LLP / S.E.N.C.R.L., s.r.l.

of its total assets were invested in “investment securities.” “Investment securities”—the *numerator* in the 40 percent test—include all securities *except*:

- US government securities,
- securities issued by employees’ securities companies (pooled funds sponsored by an employer and generally available only to employees that are accredited investors), and
- securities issued by majority-owned subsidiaries of the issuer that are neither themselves investment companies nor are “private investment companies” (hedge funds, private equity funds, and the like).

Presto had more than 60 percent of its assets in refunded bonds and variable rate demand notes. The SEC considered both to be “investment securities.”

In calculating the *denominator*, “total assets” include all assets of a company *except* US government securities and cash items. Because Presto held few assets other than investment securities, it quickly met the definition of an investment company because the assets in its numerator were substantially the same as those in its denominator.

### Presto Skirmishes with the SEC

The SEC staff raised questions about the nature of Presto’s business during routine reviews of its SEC filings. The SEC then filed suit against Presto in 2002, alleging that it was operating as an unregistered investment company in violation of the 1940 Act, which Presto characterized as “a strained interpretation of an obscure section in a 62-year-old law.”<sup>5</sup>

The district court granted the SEC an injunction, and the SEC ordered Presto to register as an investment company on December 9, 2005.<sup>4</sup> Presto requested a stay of

the injunction on December 23, 2005. On December 27, 2005, Presto filed a Form N-2 with the SEC to register as a closed-end investment company.<sup>5</sup> In 2006, the SEC staff informed Presto that if it filed a Form 10-K under the 1934 Act, its financial statements had to be accompanied by a pro forma financial statement consistent with investment company financial reporting requirements.<sup>6</sup>

Following this correspondence, Presto’s auditor, Grant Thornton, resigned due to the SEC’s concern about its certification of Presto’s financial statements. Grant Thornton then refused to allow Presto to use any of its certified financial statements.<sup>7</sup> As a result, according to the Seventh Circuit decision, Presto could not file any of the financial reports required under either the 1940 Act or the 1934 Act. The New York Stock Exchange then threatened to delist Presto due to its inability to file the financial reports required by the 1934 Act.<sup>8</sup>

### Presto in the Seventh Circuit

Before the Seventh Circuit, Presto argued that its investments in refunded bonds and variable-rate demand notes should be considered government securities and cash, respectively, which would have reduced its holdings of “investment securities,” but also would have reduced its total assets. While the Seventh Circuit disagreed with Presto’s arguments as to the treatment of these two securities, it was sympathetic to Presto’s other argument that it was not “engaged in the business” of being an investment company.

Presto 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 investing, reinvesting, owning, holding, or trading in securities,” which is an exception (Section 3(b)(1)) from the third definition of investment company under Section 3(a)(1)(C) of the 1940 Act.<sup>9</sup>

“Primarily engaged” is not defined by statute or rule. The SEC’s longstanding interpretation of what it means to be “primarily engaged” in the investment company business is *In re Tonopah Mining Co. (Tonopah)*.<sup>10</sup> *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 activi-

## What are Cash and Government Securities?

The SEC staff uses a definition of cash that is narrower than the GAAP definition, so counsel may need to question finance or treasury staff as to the assets behind this line item on the balance sheet. In the SEC staff’s view, cash items are cash on hand, demand deposits at a bank, and shares of money market funds. Certificates of deposit can be considered cash items only in rare circumstances. Also, “US government securities” include Treasury securities, as well as securities issued by US agencies and instrumentalities, such as Freddie Mac. Municipal bonds and other securities issued by state or local issuers are not government securities.

## What is an Accredited Investor?

An accredited investor is an individual that has either a net worth of \$1 million (including assets held jointly with a spouse), or had income of over \$200,000 for the past two years (or joint income of over \$300,000 with a spouse).

ties 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. *Tonopah* identified the most important factor as whether “the nature of the assets and income of the company ... was such as to lead investors to believe that the principal activity of the company was trading and investing in securities.”<sup>11</sup> This approach produced a relatively mechanistic, bright line test that provided some degree of certainty in analyzing whether a company was an inadvertent investment company.

In reviewing the *Tonopah* factors, the Seventh Circuit dispensed easily with the first three finding that Presto’s history and public representations had always been that of an active business selling consumer and military products, and that Presto’s directors were primarily engaged in running Presto’s operating business. The court also chastised the SEC for arguing that a firm “with such a substantial ongoing presence in product markets is an inadvertent investment company.”<sup>12</sup>

While the **Seventh Circuit** disagreed with Presto’s arguments as to the **treatment of these two securities**, it was sympathetic to Presto’s other argument that it was not **“engaged in the business”** of being an investment company.

However, the Seventh Circuit, in a significant departure from longstanding SEC positions on the assets and income tests, treated them as a single test, focusing on whether the company’s assets *and* income would lead an investor to believe that the company was an investment company. The SEC typically has viewed these factors as separate inquiries.

Presto’s assets consisted of more than 60 percent of investment securities. However, the Seventh Circuit said that the balance sheet had “a potential to mislead,”<sup>13</sup> given that Presto had substantial patents and trademarks that were not assessed at their market value on Presto’s balance sheet. In spite of the undervalued patents and trademarks that, therefore, would have increased Presto’s assets, the Seventh Circuit still believed that “no investor would perceive such a firm as a substitute for a closed-end mutual fund”<sup>14</sup> and informed Presto that it could deregister as a closed-end fund, without waiting for any action by the SEC.<sup>15</sup>

How was the Seventh Circuit able to reach this result? The Seventh Circuit stated that *Tonopah* identified the most important factor as whether “the nature of the assets and income of the company... was such as to lead investors to believe that the principal activity of the company was trading and investing in securities” [emphasis added].<sup>16</sup> The Seventh Circuit, therefore, interpreted *Tonopah*’s five factors as being subordinate to a relatively subjective factor: the perception of a reasonable investor. In other words, the *Tonopah* test was not a proxy for what a reasonable investor would believe to be an investment company, but was simply a set of factors that could be outweighed by a reasonable investor’s perception. To this end, the court somewhat indignantly pointed out

Best.

OGILVY  
RENAULT  
LLP / S.E.N.C.R.L., s.r.l.

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.<sup>17</sup>

The Seventh Circuit went so far as to characterize the SEC as being “in a snit” because Presto refused to seek an order exempting it from the 1940 Act, and chastised the SEC for forcing Presto investors to bear the “unnecessary costs” of Presto’s registration as a closed-end fund, asking, “Why is the SEC bent on grinding down a corporation that it appears to acknowledge would not mislead or otherwise injure investors by using the governance and reporting devices appropriate to an operating company?”<sup>18</sup>

The Seventh Circuit’s decision produced two significant results. First, given the inherently subjective “reasonable investor” perception test, companies now have a potential shield to protect themselves from being considered an inadvertent investment company, particularly if they do not meet the five-factor *Tonopah* test—assuming that a law firm is willing to opine on the undeveloped, ambiguous language in the *Presto* decision. Second, the decision introduced the possibility that the SEC will try to develop the “reasonable

investor” test as an additional weapon in its enforcement artillery. For example, if a company is not deemed to be an inadvertent investment company under the *Tonopah* test, the SEC might then seek out reasonable investors to attest that they believe the company is an investment company.

### **Consequences of Being an “Inadvertent” Investment Company**

The consequences of being an investment company are, in short, not good. A company that operates as an unregistered investment company would violate various substantive provisions of the 1940 Act and could be subject to private litigation and SEC enforcement action.

One example of such an enforcement action involved Dart Group, whose subsidiaries included Dart Drug, Crown Books, and Trak Auto Parts. The SEC alleged that for a five year period a majority of Dart Group’s total consolidated assets were composed of investments in securities; that for most of those five years, more than 50 percent of its pretax income was derived from investing, reinvesting, and trading in securities; and that it met the definition

## **The Blackstone Group and the AFL-CIO**

The *Presto* case was not the only big development in this area in 2007. The Blackstone Group L.P. (Blackstone) attracted major interest in March 2007 when it filed a Registration Statement on Form S-1 with the SEC for a proposed initial public offering of common units representing limited partner interests in Blackstone. As the first major public offering by a private equity and hedge fund management company, Blackstone’s filing attracted significant public attention. Much of this public attention centered on whether Blackstone should be regulated as an investment company under the 1940 Act. In particular, the AFL-CIO sent a letter to the SEC in May analyzing this question in detail, arguing that Blackstone’s offering was actually an offering of interests in pools of investment securities, which would require Blackstone to register as an investment company under the 1940 Act.<sup>22</sup>

Why did the AFL-CIO consider Blackstone an investment company? The AFL-CIO argued that more than 40 percent of Blackstone’s assets were its general partner interests in the private funds it managed. As general partner, Blackstone was entitled by contract to receive performance fees from the private funds. The AFL-CIO asserted that, economically, the performance fees were call options on these funds. As call options are securities under the 1940 Act, the AFL-CIO argued that Blackstone’s interests in the funds were securities. The SEC

apparently disagreed with the AFL-CIO, accepting Blackstone’s argument that the management contracts Blackstone had with its funds, which entitled it to performance fees, were not themselves securities.

As the debate over Blackstone’s status continued into the summer last year, Congress became involved. The House Domestic Policy Subcommittee held hearings on July 11 that focused on the status of Blackstone as an investment company. The hearing focused on whether the 1940 Act should be construed literally, so as to pick up only those companies that technically fall within the 1940 Act’s definition of investment company; or whether, as a matter of public policy, the Act should be read broadly to encompass companies whose shareholders might benefit from the protections afforded by the 1940 Act. Among those who were asked to testify at the hearing was Andrew “Buddy” Donohue, director of the SEC’s Division of Investment Management—the division of the SEC that regulates investment companies and investment advisers.

Ultimately, the SEC’s Division of Investment Management determined that Blackstone was not operating as an unregistered investment company and declined to regulate it as such. The ensuing public debate, however, was a good reminder of the importance of inadvertent investment company status issues.

of investment company but had failed to register as such. The SEC also alleged that Dart Group violated the 1940 Act by having a class of non-voting capital stock, and by engaging in prohibited joint transactions with certain of its affiliated persons. Dart Group consented to a permanent injunction barring it from selling or redeeming its securities, or engaging in any business in interstate commerce, while it remained an unregistered investment company.<sup>19</sup>

As the *Presto* case demonstrates, it is not practical for an operating company to operate as an investment company. An operating company that inadvertently comes within the 1940 Act could theoretically register with the SEC (as *Presto* attempted to do), but this option is not practical for most, if not all, operating companies. The 1940 Act is a notoriously complicated statute that is not designed for, and does not work well with, companies whose primary business is not buying and selling securities.

Among other things, the 1940 Act severely limits a company's ability to raise equity capital, as a registered fund can issue only a single class of common stock. The Dart Group found itself in violation of the 1940 Act because, as an unregistered investment company, it had issued a class of non-voting stock.

The 1940 Act also curbs a company's ability to issue debt, rights, or warrants, or borrow money. Further, registered funds cannot issue options, which are a key recruitment and retention tool for many operating companies. Most importantly, the heart of the 1940 Act—Section 17—prohibits or severely limits a company's ability to do business with affiliated persons. These affiliates include:

- Officers, directors, and employees of the company,
- Any person five percent or more of whose voting shares are owned by the company, and
- Any person that own five percent or more of the voting shares of the company.

**As the *Presto* case demonstrates, it is not practical for an operating company to operate as an investment company.**

Section 17 also reaches second-tier affiliated persons (for example, a director of a company that owns five percent or more of the inadvertent investment company). In other words, related party transactions, while perhaps not unusual for certain operating companies, are the exception rather than the rule for investment companies.

The 1940 Act also requires that at least 40 percent of a company's directors be independent of the company, and that these independent directors approve certain key agreements between the company and its adviser and principal underwriter. A company like Dart Group or *Presto* would have found it nearly impossible to exist under the 1940 Act without severely reworking its structure and operations. More significantly, any contract made in violation of the 1940 Act, or whose performance involves a violation, is unenforceable unless a court finds that enforcement would produce a more equitable result and would not be inconsistent with the 1940 Act.<sup>20</sup>

**The Solution Requires Finding the Right “Out” from the 1940 Act**

Fortunately, a number of statutory exclusions and exemptions are available to operating companies that do not wish to register and be regulated under

Defense.

Business Law / Employment and Labour Law /  
Intellectual Property / Litigation  
Montréal / Ottawa / Québec / Toronto / London

[ogilvyrenault.com](http://ogilvyrenault.com)

OGILVY  
RENAULT  
LLP / S.É.N.C.R.L., s.r.l.

the 1940 Act, and an extensive body of SEC interpretive materials provides guidance on how to apply them.

If an operating company falls within the 40 percent test in Section 3(a)(1)(C), the next step should be to see if the company can rely on Rule 3a-1, which would allow it to hold up to 45 percent of its assets in investment securities and securities of primarily controlled companies, subject to other conditions. Rule 3a-1 is more generous than Section 3(a)(1)(C) and allows an issuer to exclude from its 45 percent numerator securities issued by companies the issuer “primarily controls” (meaning at least 25 percent ownership, and no other owner has a larger stake) and which are not themselves investment companies. In the *Presto* case, Presto could have avoided inadvertent investment company issues by reducing its investments in refunded bonds and variable-rate demand notes so that less than 45 percent of its assets were invested in investment securities. Presto could have invested its cash in US government securities, such as treasury securities, or in a money market fund.

## Careful planning can help a company in transition avoid the 1940 Act while not substantially affecting its operations.

If Rule 3a-1 is not available, there are a number of other statutory exclusions available for:

- Banks, broker-dealers, insurance companies,
- Companies in the business of owning real estate and real-estate related securities,
- Charitable organizations, and
- Pension funds.

In addition, the SEC has adopted several exemptive rules that provide temporary or permanent relief in situations where the 1940 Act was not intended to apply. These include exclusions for:

- Certain research and development companies,
- Finance subsidiaries of operating companies,
- Asset-backed pools, and
- Companies that will extract themselves from the 1940 Act within one year from the date they became subject to the Act (note that this rule can be used only once in a three-year period).

The 1940 Act also permits operating companies to apply for individual exemptions from the 1940 Act, provided they can make the necessary showing that the exemption is “necessary or appropriate in the public interest and consistent with the protection of investors.”<sup>21</sup> Microsoft, Applied Materials, Yahoo!, and Airtouch

Communications have obtained such exemptions; Google has applied for exemptive relief. What follows is a brief summary of the circumstances that caused each company to seek exemptive relief.

- **Microsoft.** Nearly two years after its 1986 public offering, Microsoft still had substantial short-term investments. It asserted that it needed to maintain a cash reserve not only for its “sizable operating cash requirements,” but also for domestic equipment and facilities; foreign operations; possible acquisitions; investments in operating companies, strategic alliances, and joint developments; possible payment of dividends; and a contingency fund.
- **Applied Materials.** Applied Materials makes equipment used to manufacture semiconductor chips. It argued that it required substantial liquid capital to fund its global operations and its research and development, as well as to acquire businesses with complementary products. Because the chip industry is highly volatile, Applied Materials stated that it needed to preserve its capital in liquid, low-risk securities pending its use.
- **Yahoo!** Yahoo! had three types of “bad assets” on its books. First, it needed short-term investments for operations, research and development, and potential acquisition opportunities. Second, it owned minority interests in foreign subsidiaries. Third, it sought to make non-controlling investments in complementary businesses.
- **AirTouch.** AirTouch and Bell Atlantic proposed to form a joint venture and transfer their cell phone businesses and assets to a new company, Wireless. AirTouch would receive 45 percent of the interests in Wireless. At that point, AirTouch would have, on an unconsolidated basis, approximately 62 percent of its total assets in securities of controlled companies, approximately 17 percent in securities of wholly and majority-owned subsidiaries, approximately 19 percent in other securities, and the rest in non-securities—leaving it with more than 80 percent of its total assets in “bad assets.”
- **Google.** Google is seeking exemptive relief to permit it to maintain both capital preservation investments and to make strategic, noncontrolling investments in companies that complement Google’s business.

The SEC granted exemptive relief in the first four cases, and the companies generally agreed to use their accumulated cash and short-term securities for bona fide business purposes and refrain from investing or trading in securities for short-term speculative purposes.

### Solutions for In-house Counsel

In-house counsel can encounter the 1940 Act in a number of ways, such as when planning a transaction that will

result in the need for investment of proceeds, or when the nature of a company's assets changes significantly. Careful planning can help a company in transition avoid the 1940 Act while not substantially affecting its operations.

Corporate counsel can ward off 1940 Act issues by taking these five relatively simple, proactive steps:

1. Running a 40 percent investment securities test at least annually, such as during the preparation of the Form 10-K (for public companies), or at the close of each fiscal year (for private companies).
2. Annually analyzing potential investment company status issues, keeping in mind the 1940 Act's treatment of majority-owned subsidiaries and primarily controlled subsidiaries.
3. When reviewing any potential deal where part or all of

- the consideration is cash, considering and understanding how the cash will be invested, especially if there is no immediate plan to deploy the cash into non-securities assets.
4. Structuring acquisitions to avoid owning less than 50 percent of a company. If this is not possible, seek to primarily control the company by taking at least a 25 percent stake and ensuring there are no larger owners.
5. Where an operating company is relying on a statutory or rule exemption or exclusion from the 1940 Act, in-house counsel should check the continued availability of the exemption or exclusion at least annually and before entering into major transactions. For example, a company relying on the research and development company rule may, if successful, grow out of that rule, as its R&D expenses decline.

## ACC Extras on ... Strategic Planning

### Online CLE

- *Structuring a Corporate Compliance Function.* You've taken the plunge and are determined to build a dedicated compliance function. Explore key strategies and tactics for structuring and maintaining a compliance program that fosters ethical, legal, and productive operations while also minimizing business risk. Review the impact of recent legal and business developments on compliance strategy. Learn how to maintain leadership buy-in and commitment, and avoid common pitfalls that make a compliance program difficult to maintain. [www.acc.com/resource/v7878](http://www.acc.com/resource/v7878)
- *Was It Legal? A Case Study of Corporate Governance Practices.* The news is full of tales of corporate wrongdoing, along with pundits preaching "better corporate governance" as the answer. While everyone is talking about corporate governance reform, your clients will depend on you to make it happen. This online CLE focuses on what went wrong in some high-profile cases, and will present some specific corporate governance changes that could have helped. The discussion includes federal and state governance requirements and the legal role of in-house counsel in these initiatives. [www.acc.com/resource/v5846](http://www.acc.com/resource/v5846)

### Program Material

- *Dealing with Accountants and Auditors.* The lawyers and accountants made a treaty in 1976 that forms the basis on which attorneys can respond to audit letters inquiring about loss contingencies (particularly pending or threatened litigation) in a way that provides the accountants information needed for financial statements while protecting

the attorney-client privilege. Recent corporate disclosure scandals have resulted in increasing pressure for additional disclosures. This session examines the current legal and accounting requirements in this area, including management and lawyer responses to auditor requests for information, Sarbanes-Oxley Act Section 303, and other touchy issues. [www.acc.com/resource/v6903](http://www.acc.com/resource/v6903)

- *Working with Your Company's Shareholders.* Shareholders are important stakeholders for every company; however, recent events have shown the risks and legal liabilities a company faces when dealing with them. Recent regulatory and legislative developments, such as new SEC rules permitting electronic proxy distribution, and the New York Stock Exchange's action to eliminate broker non-votes, add complexity to these matters. Our expert panel discusses a range of legal issues relating to conducting the annual meeting, proxy disclosure and solicitation issues, the legal response to possible shareholder activism, and the role of proxy service provider Institutional Shareholder Services in your company's relationship with shareholders. [www.acc.com/resource/v9208](http://www.acc.com/resource/v9208)


### Quick References

- *Example Guidelines and Process for Issuing In-house Legal Opinions.* Issuing in-house legal opinions is a touchy subject. It is always preferable to avoid issuing one at all, but it cannot always be avoided. These useful guidelines and associated materials can be used when an in-house legal opinion is required in connection with a transaction. [www.acc.com/resource/v7990](http://www.acc.com/resource/v7990)

## No Clear Answer Yet

Bad facts often result in laws with limited predictive value. The Seventh Circuit's *Presto* decision created uncertainty in a relatively settled area of law, as the court subordinated the relatively straightforward *Tonopah* factors to the ambiguous "reasonable investor" perception test. In so doing, the court did not provide any guidance on how the SEC or companies should assure themselves of what a reasonable investor would believe. For example, should the "reasonable investor" perception test resemble other reasonable investor inquiries (e.g., Rule 10b-5 actions, prospectus disclosures, and Regulation FD disclosures) or should companies conduct focus group tests?

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 1940 Act status problems a shield in defending their status. If they can demonstrate that no reasonable investor would view them as the equivalent of an investment company, the inquiry is over—at least in the Seventh Circuit. On the other hand, the SEC might try to use that weapon against a company by producing reasonable investors who hold the opposite view. Practitioners may find it more difficult to give clean opinions on an operating company's status, given the murkiness of the "reasonable investor" test.

Nevertheless, the *Presto* case remains an important case study that illustrates the perils and pitfalls for operating companies that become entangled in the complex rules regarding investment companies. 

The authors thank Charles F. McCain, general counsel and chief compliance officer of Harbor Capital Advisors, Inc.; Thomas S. Harman, a partner in Morgan Lewis' Investment Management Practice; Thomas P. Lemke, general counsel of Legg Mason, Inc.; and Holly Hunter-Ceci, formerly a Morgan Lewis associate and now an attorney adviser in the Office of Chief Counsel in the SEC's Division of Investment Management, for their contributions to this article.

Have a comment on this article? Email [editorinchief@acc.com](mailto:editorinchief@acc.com).

## For More Information

R. Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions* (2003).

### NOTES

1. 486 F.3d 305 (7th Cir. 2007) ("Presto II").
2. If a company cannot find market quotation for its investment securities, the company's board of directors must establish a

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.

"fair value" for the securities in order to determine whether the company meets the 40 percent test.

3. See Presto's Form 8-K filed with the SEC via EDGAR on July 15, 2002, at [www.sec.gov/archives/edgar/data/80172/000089710102000488/presto02521-8k.txt](http://www.sec.gov/archives/edgar/data/80172/000089710102000488/presto02521-8k.txt).
4. *Securities and Exchange Commission v. National Presto Industries, Inc.*, 397 F.Supp. 2d 943 (N.D. Ill. 2005) (Presto I).
5. A closed-end investment company is a mutual fund that issues a fixed number of shares in an initial public offering, after which time shares in the fund are bought and sold on a stock exchange. Closed-end funds are not obligated to issue new shares or redeem outstanding shares the way a typical mutual fund (referred to formally as an open-end investment company) does.
6. See correspondence from Brian D. Bullard, Chief Accountant of the SEC, to Martin E. Lybecker of WilmerHale filed as Exhibit 10 to Presto's Form 8-K/A filed on April 25, 2006 at [www.sec.gov/archives/edgar/data/80172/000089710106000869/presto061759\\_ex99-10.htm](http://www.sec.gov/archives/edgar/data/80172/000089710106000869/presto061759_ex99-10.htm) ("Amended Form 8-K").
7. Amended Form 8-K at Exhibits 8 and 11.
8. Presto II at 308.
9. See Sections 3(b)(1) (a self-operative exception) and 3(b)(2) (Commission order finding the application is not an investment company) of the 1940 Act.
10. 26 S.E.C. 426 (1947). The SEC, in the release adopting Rule 3a-1 under the 1940 Act, defined "primarily engaged" as having 55 percent of income from, and assets in, a non-investment company business. See Investment Company Act Release No. 10937 (Nov. 13, 1979).
11. *Id.*
12. Presto II at 313.
13. *Id.* at 314.
14. *Id.*
15. *Id.* at 315.
16. *Id.*
17. *Id.* at 313.
18. *Id.* at 308. During oral argument, the SEC had implied that an exemptive order would have been granted. See Presto II at 308.
19. *Securities and Exchange Commission v. Dart Group Corporation*, Civil Action No. 90-0461 (D.D.C.), 1990 US Dist. LEXIS 3063; Fed. Sec. L. Rep. (CCH) ¶ 94,953.
20. See Section 47 of the 1940 Act.
21. Section 6(c) of the 1940 Act.
22. See [www.aflcio.org/corporatewatch/capital/upload/blackstone%20sec%20letter%20final.pdf](http://www.aflcio.org/corporatewatch/capital/upload/blackstone%20sec%20letter%20final.pdf).