

HOLDING COMPANIES AND THE APPLICATION OF RULE 3a-2 UNDER THE INVESTMENT COMPANY ACT***Summary***

An operating company may find that, upon the occurrence of an extraordinary event, it meets the definition of an investment company under the Investment Company Act of 1940, as amended (the “1940 Act”), even though it intends to remain in such status only temporarily. Absent an exclusion or exemption from this definition, the operating company may be required to register under the 1940 Act and be subject to the 1940 Act’s requirements. Rule 3a-2 under the 1940 Act, however, provides a one-year safe harbor for such transient investment companies if certain conditions are satisfied.

The staff of the Division of Investment Management has received inquiries regarding the commencement of the one-year safe harbor as it applies to holding companies that are engaged in various operating businesses through wholly-owned and majority-owned subsidiaries, where neither the holding companies nor their subsidiaries are regulated as investment companies (“Holding Companies”). The guidance addresses those inquiries by clarifying the application of rule 3a-2 with respect to Holding Companies, and furthers the Commission’s mission to facilitate capital formation.

In particular, Holding Companies may experience “extraordinary events” in their life cycle, some of which facilitate capital formation. This guidance clarifies that the one-year safe harbor period does not begin until the occurrence of an extraordinary event causes a Holding Company to have certain characteristics of an investment company. It is the staff’s view that when adopting rule 3a-2, the Commission did not intend to limit the circumstances under which an issuer could rely on the rule in such a way that Holding Companies are treated differently than other issuers because of the Holding Companies’ organizational structures.



Background

Section 3(a)(1) of the 1940 Act defines the term “investment company.” Specifically, Section 3(a)(1)(A) of the 1940 Act defines “investment company” to mean “any issuer which 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 1940 Act defines “investment company” to mean any 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 securities¹ having a value exceeding 40% of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Rule 3a-2 under the 1940 Act provides a temporary exclusion from the 1940 Act’s provisions to certain issuers that are in transition to a non-investment company business.² Specifically, rule 3a-2 deems an issuer that meets the definition of investment company in section 3(a)(1)(A) or 3(a)(1)(C) of the 1940 Act not to be an investment company for a period not to exceed one year, provided that the conditions of the rule are satisfied.³ The one-year period begins on the earlier of:

- (i) the date on which an issuer owns securities and/or cash having a value exceeding 50% of the value of such issuer’s total assets on either a consolidated or unconsolidated basis (“50% Threshold”);⁴ or
- (i) the date on which an issuer owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis (“40% Threshold” and together with the 50% Threshold, the “Thresholds”).⁵

The Thresholds set forth objective tests that permit an issuer to determine readily, by reviewing the composition of its assets, the starting date of the one-year period.

Issue

A Holding Company may own securities other than equity securities of its majority- or wholly-owned subsidiaries (“Securities Interests”). There are various events that may result in a Holding Company’s ownership of a significant amount of Securities Interests, including, for example: investing its offering proceeds in securities while arranging to acquire a new majority- or wholly-owned subsidiary; selling a large operating division and investing the proceeds in securities pending acquisition of a new majority- or wholly-owned subsidiary; and making a tender offer to stockholders of a non-

investment company and failing to obtain a majority of the target company's stock (these events, collectively, referred to as "extraordinary events").⁶ Such events may help to facilitate capital formation. The occurrence of an extraordinary event may temporarily alter the composition of the Holding Company's total assets such that securities other than the equity securities of its majority- or wholly-owned subsidiaries now comprise a significant portion of the Holding Company's total assets. Consequently, a Holding Company may find that it meets the definition of an "investment company," even though it intends to remain in such status only transiently.⁷ If an extraordinary event causes the Holding Company's investment securities to have a value in excess of 40% of its total assets, the Holding Company may be deemed an "investment company" under section 3(a)(1)(C).

To avoid meeting the definition of an investment company, a Holding Company may seek to rely on the safe harbor in rule 3a-2. However, a literal reading of rule 3a-2 suggests that a Holding Company may be unable to rely on the rule in certain circumstances. As discussed above, the text of rule 3a-2 provides that an issuer may rely upon the rule for one year from the earlier of the date it triggered either the 50% Threshold or the 40% Threshold. The 50% Threshold may be problematic for a Holding Company because the threshold is based on the cash and securities it holds, not simply its investment securities. The securities may include U.S. government securities, as well as equity securities issued by majority- and wholly-owned subsidiaries, all of which are excluded from the definition of "investment securities." In addition, as the 50% Threshold applies on either a consolidated or unconsolidated basis, a Holding Company is unable to look through its equity securities of majority- and wholly-owned subsidiaries on a consolidated basis to analyze its combined assets. Because a Holding Company may, by its nature, continuously hold equity securities of its subsidiaries that amount to more than 50% of its total assets at all times, it could be viewed as continuously satisfying the requirements of the 50% Threshold. As a result, a Holding Company could run out the clock on its one-year period before ever needing to rely upon rule 3a-2.

Concerns have been raised that the relief afforded by the rule therefore never is available to these Holding Companies, and that, had these Holding Companies operated the same businesses at the parent level instead, the relief afforded by rule 3a-2 would have been available.

Discussion

The purpose of rule 3a-2 is to temporarily relieve certain issuers that are in transition to a non-investment company business from the registration and other requirements of the 1940 Act.⁸ For instance, the Commission has recognized that a company that

has sold substantial operating assets and intends to invest the proceeds pending the acquisition of new operating assets may own or propose to acquire investment securities representing greater than 40% of the issuer's total assets.⁹ The Commission explained:

Frequently, such issuers have a bona fide intent to change their operations or assets within a short period of time so that they would no longer meet the statutory definition of an investment company. In many such instances, the issuer may argue that it is not in the "business" of investing, reinvesting, owning, holding or trading in securities for purposes of determining whether it is an investment company. Moreover, it may not be appropriate to require an issuer to effect for only an interim period the significant operational modifications - including modifications to its capital structure - which may be necessary to comply with the [1940] Act.¹⁰

Furthermore, the 3a-2 Adopting Release noted that "the one-year period should be measured from the time an issuer has the characteristics which would cause it to be defined as an investment company." The Thresholds attempt to pinpoint the time that an issuer would have the characteristics of an investment company.¹¹

The staff believes that a Holding Company may not have the characteristics¹² of an investment company until it fails the 40% Threshold.¹³ Accordingly, the staff believes that, generally, rule 3a-2's one-year safe harbor should not begin until the occurrence of an extraordinary event and thus when the Holding Company may seek to rely on the rule. In this regard, the staff believes that the one-year period for transient investment companies should be available to issuers that have a bona fide intent to be engaged primarily in a non-investment company business, regardless of whether they operate directly or through a holding company structure.¹⁴

Endnotes

- 1 Section 3(a)(2) of the 1940 Act defines "investment securities" to include all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries which (i) are not investment companies and (ii) are not relying on the exception from the definition of investment company in section 3(c)(1) or 3(c)(7) of the 1940 Act.
- 2 See Transient Investment Companies, Investment Company Act Release No. 10943 (Nov. 16, 1979) ("3a-2 Proposing Release"). See *also* Transient Investment Companies, Investment Company Act Release No. 11552 (Jan. 14, 1981) ("3a-2 Adopting Release").

- 3 The issuer must have a bona fide intent to be engaged primarily, as soon as is reasonably possible (in any event by the termination of such one-year period), in a business other than that of investing, reinvesting, owning, holding or trading in securities. Intent may be evidenced by the issuer's business activities and an appropriate resolution of the issuer's board of directors (or by appropriate action of person(s) performing similar functions for any issuer without a board of directors), which has been recorded contemporaneously in its minute books or comparable documents. See rule 3a-2(a). In addition, the rule may be relied on only once during any three-year period. See rule 3a-2(c).
- 4 Rule 3a-2(b)(1).
- 5 Rule 3a-2(b)(2).
- 6 See 3a-2 Proposing Release. Rule 3a-2 does not specify the kinds of events that would allow an issuer to rely on the rule. The staff believes that, consistent with the wording of rule 3a-2, the Commission intended only to provide examples of why an issuer would need to rely on rule 3a-2 drawn from the staff no-action letters that had preceded the adoption of the rule. The staff further believes that the Commission did not intend to limit the circumstances under which an issuer could rely on rule 3a-2 to the examples in the releases proposing and adopting the rule.
- 7 *See Id.*
- 8 *See Id.*
- 9 See 3a-2 Adopting Release.
- 10 See 3a-2 Proposing Release.
- 11 The Commission has also recognized that a start-up enterprise may temporarily be engaged in investment activities prior to the launch of its operating business and may own securities and/or cash having a value in excess of 50% of the value of such issuer's total assets. See 3a-2 Adopting Release. While the 3a-2 Adopting Release did not address the impact of an extraordinary event on a Holding Company, we believe that the Commission did not intend to limit the circumstances under which an issuer could rely on rule 3a-2.

- 12 See OnePoint Communications Corp., SEC Staff No-Action Letter (June 12, 1998) (stating that the staff would not recommend enforcement action to the Commission under section 7 of the 1940 Act if OnePoint Communications Corp. (“OnePoint”) relies on the safe harbor afforded by rule 3a-2 for one year from the date that it no longer qualifies to be excluded from the definition of investment company under 3(c)(1), even though prior to that date, one of its wholly-owned subsidiaries owned interests in two companies that would cause OnePoint to be viewed as an investment company if not for its reliance on section 3(c)(1)).
- 13 The staff recognizes that some Holding Companies engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities through wholly-owned subsidiaries may be able to rely on section 3(b)(1) in certain circumstances.
- 14 The staff notes that the Commission has recognized in other contexts that issuers that operate primarily through subsidiaries should not be treated differently based on the structure of their operations. See, e.g., Investment Company Act Release No. 12679 (Sept. 22, 1982) (proposing rule 3a-5 which is designed to enable an operating company to engage in the same type of financing activities through a finance subsidiary that it could engage in directly, without becoming subject to the 1940 Act); Investment Company Act Release No. 14275 (Dec. 14, 1984) (adopting rule 3a-5).

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