

ACT ICA of 1940
SECTION 3(a)(1)(C)
RULE 3a-1
PUBLIC
AVAILABILITY Oct. 23, 2000

PUBLIC

October 23, 2000
IM Ref. No. 200010241124
Willkie Farr & Gallagher
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of September 27, 2000 requests our concurrence that an issuer may treat money market fund shares as "cash items," and not as investment securities and adjusted investment securities (as defined below), for purposes of determining whether the issuer is an investment company as defined in section 3(a)(1)(C) of the Investment Company Act of 1940 ("Investment Company Act") and rule 3a-1 thereunder, respectively.

FACTS

You state that you represent a wide variety of industrial operating companies that conduct business in the following industries: information technology, communications, large-scale infrastructure and construction services, natural resources, research, and manufacturing. You assert that, in order to compete successfully in their respective industries, these companies must maintain substantial cash holdings to finance capital expenditures and operations on short notice. You also note that, because of the favorable market environment, these companies are able to raise capital for future use by issuing debt or equity securities or by divesting operating divisions or subsidiaries. You state that the operating companies generally invest their cash holdings, including the proceeds from securities offerings and divestitures, in Government securities and short-term money market instruments, such as time deposits, certificates of deposit, repurchase agreements, commercial paper, bank deposits and bankers' acceptances, demand deposits, and money market fund shares.

You state that many operating companies use money market funds¹ as an alternative to bank checking accounts and other forms of short-term liquid investments because the investment return offered by money market funds is highly competitive compared to the returns offered by those other investments, the risk to principal is minimal, and money market funds are convenient to use. You further state that the financial community generally views money market funds as the functional equivalent of the interest-bearing checking accounts offered by banks.

You assert that an operating company, as a matter of corporate law, has a duty to its shareholders to earn the highest possible investment return on its cash holdings consistent with the preservation of principal, pending use of those cash holdings in the company's operations. You contend, however, that operating companies' decisions about how to manage their cash holdings also are influenced by their desire to ensure that they do not become subject to regulation under the Investment Company Act. You explain that these companies

¹ Money market funds generally are open-end management investment companies registered under the Investment Company Act that have as their investment objective generation of income, preservation of capital and maintenance of liquidity through investment in short-term, high quality securities.

often invest their cash holdings in Government securities rather than in shares of money market funds simply to avoid being deemed to be investment companies under section 3(a)(1)(C) of the Investment Company Act. You assert that when operating companies invest in Government securities that offer a lower rate of return relative to money market funds, those companies may forgo millions of dollars in potential yield. You accordingly request our concurrence that issuers may treat money market fund shares as cash items, and not as investment securities and adjusted investment securities, for purposes of section 3(a)(1)(C) and rule 3a-1 under the Investment Company Act.

ANALYSIS

Legal Framework

Section 3(a)(1)(C) of the Investment Company Act defines the term investment company to mean any issuer which

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 the value of such issuer's total assets (exclusive of Government securities and *cash items*) on an unconsolidated basis [emphasis added].²

As used in section 3(a)(1)(C), the term investment securities includes

all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in [sections 3(c)(1) or 3(c)(7) of the Investment Company Act].³

Thus, an issuer whose holdings of investment securities exceed 40 percent of the value of its total assets (exclusive of Government securities⁴ and cash items) generally implicates section

² In addition, section 3(a)(1)(A) of the Investment Company Act defines the term 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."

³ Section 3(a)(2) of the Investment Company Act.

⁴ Section 2(a)(16) of the Investment Company Act defines "Government security," in part, as any security issued or guaranteed as to principal or interest by the United States.

3(a)(1)(C) -- it has failed the "40 percent test."⁵

In 1981, the Commission adopted rule 3a-1 under the Investment Company Act effectively to exclude certain issuers from regulation under the Investment Company Act.⁶ The rule generally provides that, notwithstanding section 3(a)(1)(C), an issuer will be deemed not to be an investment company if: (i) no more than 45% of the value of the issuer's total assets (exclusive of Government securities and cash items) consists of certain securities that are referred to in this letter as "adjusted investment securities" (the "asset test"), and (ii) no more than 45% of the issuer's net income after taxes is derived from adjusted investment securities (the "income test").⁷

Section 3(a)(1)(C) provides an objective test that permits an issuer holding securities to determine readily, by reviewing the composition of its assets, whether it is considered to be an investment company within the meaning of the Investment Company Act.⁸ Rule 3a-1 likewise permits an issuer subject to section 3(a)(1)(C) to determine readily, based upon objective criteria, whether it nevertheless will be able to avoid regulation as an investment company under the Investment Company Act.⁹ By excluding holdings of Government

⁵ Two elements comprise section 3(a)(1)(C), both of which must be met for a company to be defined as an investment company under the provision. Under the first element, an issuer must engage -- or propose to engage -- in the business of investing, reinvesting, owning, holding or trading in securities. Under the second element, an issuer must fail the 40 percent test.

⁶ Rule 3a-1 is not available for an issuer that is an investment company as defined in section 3(a)(1)(A) of the Investment Company Act.

⁷ Adjusted investment securities are securities other than (1) Government securities, (2) securities issued by employees' securities companies, (3) securities issued by certain majority-owned subsidiaries of the issuer which are not investment companies, and (4) securities issued by certain controlled companies through which the issuer engages in a non-investment company business.

⁸ See *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong. 101 (1940)*. Congress and the Commission in 1940 believed that section 3(a)(1)(C) "would effectively exclude most ordinary holding and [operating] companies" from the purview of the Investment Company Act. See Investment Company Act Rel. No. 10937, at text accompanying n.11 (Nov. 13, 1979) (proposing rule 3a-1) ("3a-1 Proposing Release").

⁹ In proposing rule 3a-1, the Commission stated that the rule would exclude from regulation issuers "whose asset composition and sources of income would provide conclusive evidence that such [issuers] are not investment companies for purposes of section [3(a)(1)(C)]." *Id.* at text preceding n.28. The Commission explained that, as a general matter, an issuer that satisfies the asset and income tests is primarily engaged in a business other than

securities and cash items from the calculation of the amount of an issuer's total assets, Congress and the Commission apparently recognized that these uses of the issuer's assets usually are not determinative of whether the issuer is an investment company, because issuers generally need easily accessible funds to cover expenses incurred in their business operations.¹⁰

The 40 Percent Test and the Asset and Income Tests Were Not Designed to Accommodate Securities as Cash Items

You request our concurrence that an issuer may treat money market fund shares as cash items, and not as investment securities and adjusted investment securities, for purposes of the 40 percent test in section 3(a)(1)(C) and the asset and income tests in rule 3a-1. The term "cash item" is not defined in the text of the Investment Company Act or in the rule.¹¹ We believe, however, that the wording of section 3(a)(1)(C) and rule 3a-1 provides evidence about the meaning of that term. In the 40 percent test, cash items are expressly excluded from the calculation of the amount of an issuer's total assets, but cash items are not expressly excluded from the definition of investment securities. We believe that the wording of the section indicates that Congress did not contemplate securities as cash items. Because Congress did not contemplate securities as cash items, an explicit exclusion for cash items

that of being an investment company and, accordingly, regulating such an issuer as an investment company would not appear to be necessary or appropriate in the public interest. *Id.* at text accompanying n.27.

¹⁰ Indeed, in proposing rule 3a-1, the Commission indicated that Congress presumably excluded Government securities from the definition of investment securities because it considered these securities to be an appropriate short-term use for the surplus funds of operating companies for purposes of section 3(a)(1)(C). *Id.* at n.6. The legislative history of section 3(a)(1)(C) and the administrative history of rule 3a-1 do not expressly address the purpose of the exclusions for cash items from the calculation of the amount of an issuer's total assets. The exclusions appear to reflect Congress and the Commission's recognition that all issuers -- regardless of the type of business -- may have surplus funds. We note that, absent these exclusions, an issuer could borrow enough cash to pass the 40 percent test in section 3(a)(1)(C) and the asset and income tests in rule 3a-1, no matter how large its holdings of investment securities and adjusted investment securities, respectively.

¹¹ An early draft of the Investment Company Act that was prepared by the Commission's staff defined the term "cash item" to include cash, bank deposits, and current accounts receivable. *Id.* at n.4. This definition did not appear in the bill introduced in Congress. See Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 Stan. L. Rev. 29, 38 n.50 (1959).

from the definition of investment securities was unnecessary.¹² Similarly, in the asset and income tests in rule 3a-1, cash items are expressly excluded from the calculation of the amount of an issuer's total assets, but cash items are not expressly excluded from adjusted investment securities. We believe that the wording of the rule indicates that the Commission likewise did not contemplate securities as cash items.

Treatment of Money Market Fund Shares Under the 40 Percent Test and the Asset and Income Tests

In any event, money market funds did not exist when Congress drafted section 3(a)(1)(C) in 1940. Nor did money market funds exist in their current form when the Commission adopted rule 3a-1 in 1981.¹³ We believe that if they had, Congress and the Commission would have concluded that an issuer's holdings of money market fund shares -- even though they are securities -- usually are not determinative of an investment company business, because money market fund shares generally are equivalent to cash items.

As stated above, the term "cash item" is not defined in the text of the Investment Company Act, or in rule 3a-1.¹⁴ In proposing rule 3a-1, however, the Commission set forth

¹² We note that, if securities *could be* cash items for purposes of section 3(a)(1)(C), the 40 percent test would penalize issuers that hold such cash items (rule 3a-1 similarly would penalize issuers). For example, an issuer with \$1 million in securities that were cash items and \$1 million in equipment (\$1 million in total assets as defined in section 3(a)(1)(C)) would have investment securities that would be 100% of the issuer's total assets, and would thus be deemed to be an investment company under section 3(a)(1)(C). We believe that this result would be contrary to Congress' express exclusion for cash items in the 40 percent test.

¹³ The Commission adopted Rule 2a-7 in 1983 (two years after adopting rule 3a-1) to permit money market funds to use certain valuation and pricing methods to maintain a stable net asset value per share. *See* Investment Company Act Rel. No. 13380 (July 11, 1983) (adopting Rule 2a-7) ("Release 13380"). Previously, the Commission granted individual exemptive orders to permit money market funds to use those valuation and pricing methods. *See, e.g.,* Investment Company Act Rel. No. 10451 (Oct. 26, 1978); Investment Company Act Rel. No. 10824 (Aug. 8, 1979). Since adopting the rule in 1983, the Commission has amended it by adding and enhancing conditions to "ensure that money market funds meet investors' expectations for safety, soundness and convenience...." *See* Investment Company Act Rel. No. 18005 (Feb. 20, 1991) ("Release 18005"). *See also* Investment Company Act Rel. No. 22921 (Dec. 9, 1997); Investment Company Act Rel. No. 21837 (Mar. 28, 1996) ("Release 21837"); and Investment Company Act Rel. No. 14983 (Mar. 12, 1986) ("Release 14983"). In particular, the Commission's amendments to the rule relate to, among other things, money market fund portfolio maturity, quality, and diversification.

¹⁴ *See supra* note 11 and accompanying text.

the following list of what would be considered to be cash items for purposes of the rule: cash, coins, paper currency, demand deposits with banks, timely checks of others, cashier checks, certified checks, bank drafts, money orders, travelers checks, and letters of credit.¹⁵ This list illustrates what we believe to be the essential qualities of a cash item for purposes of section 3(a)(1)(C) and rule 3a-1 -- a high degree of liquidity and relative safety of principal. In our view, money market fund shares have these same qualities because of the specific regulatory requirements with which money market funds must comply.

In particular, rule 2a-7 subjects an investment company holding itself out as a money market fund to strict risk-limiting conditions relating to portfolio maturity, quality, and diversification.¹⁶ Money market funds that satisfy those conditions, and that seek to maintain a stable net asset value ("NAV") of \$1.00 per share, are designed to preserve the principal value of their assets.¹⁷ In addition, section 22(e) of the Investment Company Act helps to ensure the liquidity of money market fund shares by generally requiring a money market fund to pay redemption proceeds to a redeeming shareholder within seven days.¹⁸

¹⁵ See 3a-1 Proposing Release at n.29. We note that the Commission's list consists of cash items that are not securities. You have not asked about, and we have not addressed, the treatment of certificates of deposit for purposes of the 40 percent test and the asset and income tests.

¹⁶ See rule 2a-7(c)(2) through (c)(4). The Commission has stated that the rule's risk-limiting conditions reflect investor expectations that money market funds are secure investments. See Release 18005 at text accompanying n.86.

¹⁷ A money market fund that complies with the risk-limiting conditions in rule 2a-7 may use either the amortized cost method or the penny rounding method, rather than market value, to calculate its NAV. See rule 2a-7(c)(1). The Commission has determined that use of these methods is appropriate because the risk-limiting conditions serve to minimize the deviation between a money market fund's stabilized NAV and the market value of its portfolio, and because the conditions make it unlikely that the fund will incur capital losses or gains. See Release 21837 at text accompanying n.9; Release 18005 at text preceding n.90. The amortized cost method and the penny-rounding method are defined in paragraphs (a)(2) and (a)(18) of rule 2a-7, respectively.

¹⁸ This requirement in section 22(e) also has served as the basis for the Commission's standard for determining liquidity. See, e.g., Investment Company Institute (pub. avail. May 26, 1995). The Commission considers a security to be illiquid if it cannot be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it. *Id.* (citing Release 14983).

As the Commission has recognized, most money market funds represent that their investors ordinarily will receive proceeds much sooner, often on the same day that the fund receives the redemption request. The Commission also has recognized that money market funds, because they are primarily vehicles for short-term investments, experience a greater

As the Commission has recognized, the stable NAV and other characteristics offered by money market funds -- a diversified and professionally managed portfolio of securities, relative safety of principal, a high degree of liquidity, and a wide range of shareholder services (including check writing) -- have made money market funds a popular cash management tool for institutions and businesses, as well as for individual investors.¹⁹ Because money market funds largely have been successful in maintaining a stable NAV, investors view these funds as an alternative to bank deposits and checking accounts, even though money market funds lack federal deposit insurance and there is no guarantee that the funds will maintain a stable NAV.²⁰ As with bank deposits and checking accounts, investments in money market funds permit an issuer to maintain ready cash reserves for use in meeting its business expenses.

Conclusion

We accordingly would not object if an issuer, in calculating the amount of its total assets and its investment securities for purposes of the 40 percent test, does not include the shares of a registered investment company that holds itself out as a money market fund and seeks to maintain a stable NAV of \$1.00 per share. We likewise would not object if an issuer, in calculating the amount of its total assets and its adjusted investment securities for purposes of the asset and income tests in rule 3a-1, does not include the shares of a registered investment company that holds itself out as a money market fund and seeks to maintain a stable NAV of \$1.00 per share. Thus, we would not recommend enforcement action to the Commission under section 7 of the Investment Company Act against any issuer that, as a result of its holdings of shares of money market funds, fails the 40 percent test in section 3(a)(1)(C) or the asset and income tests in rule 3a-1.

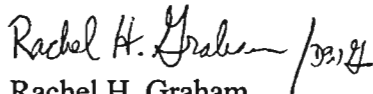
We believe that treating money market fund shares in the manner outlined above provides operating companies with appropriate flexibility in managing their cash holdings. We caution those companies and their counsel, however, that an issuer's "primary

and perhaps less predictable volume of redemption transactions than do other investment companies. The Commission has stated that money market funds accordingly must have sufficient liquidity to meet redemption requests on a more immediate basis. *See* Release 13380 at text accompanying n.39.

¹⁹ *See* Investment Company Act Rel. No. 24082 (Oct. 14, 1999), at text accompanying n.6; Investment Company Act Rel. No. 21216 (July 19, 1995).

²⁰ *See* Release 21837 at text accompanying n.5. The Commission has observed that when money market funds have held securities that are no longer eligible for fund investment, fund advisers or related persons frequently have repurchased the securities from the funds at their amortized cost value to avoid any fund shareholder loss. *Id.* at text accompanying n.190.

engagement” remains a benchmark for determining whether the issuer is an investment company for purposes of section 3(a)(1)(A). For example, an issuer with a very large percentage of its total assets in money market fund shares may now be able to satisfy the 40 percent test in section 3(a)(1)(C) and the asset and income tests in rule 3a-1 as a result of the position we set forth here. That issuer nevertheless may be an investment company under section 3(a)(1)(A) of the Investment Company Act if its primary business is investing, reinvesting, or trading in shares of money market funds (or in shares of money market funds and other securities), or if it holds itself out as being primarily engaged in such a business.²¹


Rachel H. Graham
Senior Counsel

²¹ The issue of how an issuer’s investments in money market fund shares affects its primary engagement for purposes of section 3(a)(1)(A) is identical to the issue raised by an issuer’s investments in Government securities for purposes of section 3(a)(1)(A).

WILLKIE FARR & GALLAGHER

787 Seventh Avenue
New York, NY 10019-6099
212 728 8000

Direct: 212 728 8256
Fax: 212 728 8111
jrand@willkie.com

Jon S. Rand

September 27, 2000

1940 Act § 3(a)(1)(C) 1940 Act Rule 3a-1

Office of the Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549

Ladies and Gentlemen:

We are writing to request the concurrence of the staff of the Division of Investment Management (the "Staff") with our view that investments in money market funds should be treated as "cash items" and not as "investment securities"¹ for purposes of determining an industrial company's status under Section 3(a)(1)(C) of, and Rule 3a-1 under, the Investment Company Act of 1940, as amended (the "Act"), under the circumstances described below.

I. Background

We represent a wide variety of industrial operating companies ("Industrial Companies") engaged in capital intensive businesses in the information technology, communications, large scale infrastructure and construction services, natural resources, research and manufacturing sectors. Many Industrial Companies have in the recent past raised substantial amounts of funds through debt and equity offerings or divestitures of operating divisions or subsidiaries. The net proceeds of these transactions are currently and will be used to finance current operating losses and capital expenditures during the implementation of business plans to increase substantially the Industrial Companies' businesses and to expand the range of facilities, services and products they offer, as well as to provide capital for acquisition and other business development initiatives.

In order to compete successfully in their respective industries, the Industrial Companies need the financial ability to move quickly to capitalize on new developments as they occur, which in turn requires that the Industrial Companies maintain a substantial amount of liquid assets available for commitment to capital expenditures and operations on short notice. In addition, the current favorable

¹ See Note 8, *infra*.

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market environment is conducive to generating funds from debt and equity offerings or operating asset divestitures for future commitment.

The Industrial Companies' need to raise and maintain large amounts of capital to meet their anticipated capital expenditures, together with the need to invest cash temporarily at the highest rates of interest consistent with the goal of preserving principal, may create uncertainty as to an Industrial Company's status as an investment company under Section 3(a) of the Act. Typically, pursuant to the terms of a Company's indenture (in the case of debt offerings), or "use of proceeds" disclosure (in offering documents for equity offerings), Industrial Companies may invest the offering proceeds in a variety of money market instruments to protect the value of the proceeds pending permanent disposition.² However, because the Industrial Companies are not investment companies and have no intention of operating as such, Industrial Companies have instead invested the proceeds in "Government securities," as defined in Section 2(a)(16) of the Act in sufficient proportion to ensure that their holdings of "investment securities" (including money market instruments other than Government securities, such as shares of money market funds) would not exceed the thresholds set forth in Section 3(a)(1)(C) of the Act or Rule 3a-1 thereunder. As a result of investing substantially in Government securities at times when they offer a lower rate of return than other non-speculative short-term money market instruments, including shares of money market funds, Industrial Companies are losing millions of dollars in potential yield.

To be sure, the yield available on money market funds does not always exceed that on short term Government securities and Industrial Companies would like to maintain freedom of action to deploy cash to the higher yielding of the two asset classes. However, to illustrate the magnitude of even a very small yield differential over a period of one year, if an Industrial Company invested \$1 billion in short-term Government securities instead of shares of money market funds in circumstances where the latter were yielding just 10 basis points (0.10%) higher than the former, the loss in return would be \$1 million.

In order to assure compliance with the relevant financial tests and thereby make manifest an Industrial Company's status under the Act, we believe it would be appropriate to consider as a "cash item" rather than an "investment security" an investment in shares of a registered investment company operating as a money market fund that seeks to maintain a stable net asset value per share of \$1.00 by valuing its portfolio using the amortized cost or penny-rounding method in compliance with Rule 2a-7 under the Act ("money fund").

² Pursuant to the terms of a typical indenture, in order to preserve the value of its assets pending permanent disposition, an Industrial Company would otherwise be permitted to invest the proceeds of the debt offering in short-term money market instruments, in addition to Government securities, such as (i) time deposits, (ii) certificates of deposit, (iii) repurchase agreements, (iv) commercial paper, (v) bank deposits and bankers' acceptances, (vi) deposits available for withdrawal on demand and (vii) shares of money market funds. Our experience has been that cash holdings of Industrial Companies, including the proceeds of equity offerings and divestitures, would typically be invested in the same classes of instruments.

As a matter of corporate law, Industrial Companies have a fiduciary duty to their security holders to maintain the principal value of their cash and to earn the highest rate of interest thereon. Based on indenture terms and/or offering document disclosure, security holders expect an Industrial Company to invest the net proceeds of an offering in non-speculative high quality money market instruments pending its use in the company's operations. If an Industrial Company cannot invest its cash in money funds and must instead invest in Government securities purely to avoid registering as an investment company, it cannot fully discharge its obligations to its security holders. These Industrial Companies are clearly not investment companies under the five *Tonopah Mining* factors, as discussed below. To compel them to invest their funds in Government securities simply to avoid the inadvertent application of the Act while the funds await investment in operations would be uneconomical and would serve neither the best interests of the companies nor their security holders, nor would it advance any of the policies and purposes of the Act.

II. Analysis

A. Investment Company Status

In general, all companies that satisfy certain statutory criteria based on their asset composition or business activities are defined as investment companies and are required to register and be regulated under the Act unless an exclusion or exemption is available. The Act has two relevant and closely related but alternative definitions of an investment company. The first, Section 3(a)(1)(A), defines the term "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." Whether a company is engaged "primarily" in any of the specified businesses is a factual issue and takes account of all relevant factors, as described below.

The second definition, found in Section 3(a)(1)(C) of the Act, defines an "investment company" as:

any issuer which 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 the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

For purposes of Section 3(a)(1)(C), the term "investment securities" is defined in Section 3(a)(2) to include:

all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

Section 3(b)(1) provides that notwithstanding the objective test found in Section 3(a)(1)(C) "[a]ny issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities" is not an investment company for purposes of the Act.

Because this statutory exclusion roughly states the converse of the Section 3(a)(1)(A) definition, some courts contend that the 40% statistical test set forth in Section 3(a)(1)(C) is essentially just a "red flag" or warning sign that close analysis is required and that the "primary engagement" test is the ultimate determinant of investment company status.³ In *Giordano* the district court found that a material fact existed as to the defendant's status as an investment company and dismissed plaintiff's motion for partial summary judgment which was based on that issue. The district court stated that "the Court does not agree that Section 3(a)[(1)(C)] established a bright-line 40% rule. Although the SEC may find that its enforcement efforts are enhanced by such an interpretation, the language of the statute itself clearly incorporates a 40% requirement and an 'in the business' requirement."⁴ The court, however, was not persuaded that the "in the business" requirement is controlled by a company's subjective intent. The court stated that "whether a company is or holds itself out to be 'engaged primarily' in investing entails more than an analysis of the company's assets and a limited review of its statements."⁵ The court stressed that it must consider the defendant's "total activities of all sorts."⁶

Rule 3a-1 under the Act is intended to exclude from the Act certain *prima facie* investment companies "whose asset composition and sources of income would provide conclusive evidence that such companies are not investment companies for purposes of Section [3(a)(1)] of the Act."⁷ Rule 3a-1 provides a non-exclusive safe harbor for issuers that otherwise would meet the definition of investment company set forth in Section 3(a)(1)(C), provided that:

No more than 45 percent of the value (as defined in Section 2(a)(41) of the Act) of such issuer's total assets (exclusive of Government securities and cash items) consists of, and no more than 45 percent of such issuer's net income after taxes (for the last four fiscal quarters combined) is derived from, [certain specified securities].

Among the specified, excludable securities are Government securities, securities issued by majority owned subsidiaries and companies controlled primarily by the issuer that meet certain criteria.⁸

³ See *Allison Lynne Siimes v. Salvatore Giordano* Civil No. 92-302 (1992 U.S. Dist. LEXIS 16235) (Dist. N.J. Oct. 8, 1992).

⁴ *Id.* at 16.

⁵ *Id.* at 11.

⁶ *Id.* at 11 citing, *Securities and Exchange Commission v. Fifth Avenue Coach Lines, Inc.* 289 F. Supp. 3, 28 (S.D.N.Y. 1968) and *Dan River, Inc. v. Icahn*, 701 F.2d 278, 291 n. 14 (4th Cir. 1983).

⁷ See *Certain Prima Facie Investment Companies*, Investment Company Act Release No. 10937 (Nov. 13, 1979), [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,348, at 82,466 (proposing Rule 3a-1) ("*Release 10937*").

⁸ Although somewhat different from the usage of the term in Section 3(a)(2), for ease of discussion securities other than those excluded from the 45% tests in Rule 3a-1 are also referred to herein as "investment securities."

Because the rule explicitly does not exempt an issuer that is an investment company as defined in Section 3(a)(1) or Section 3(a)(2) of the Act or is a special situation investment company, the inquiry as to a company's primary business engagement remains relevant to a company seeking to rely on the rule.

The Commission and the courts have developed a number of criteria to be used in determining whether a company is, for purposes of Section 3(a)(1)(A), engaged "primarily" in non-investment businesses. The criteria applied to nearly every situation are: (i) the company's historical development, (ii) its public representations of policy, (iii) the activities of its officers and directors, (iv) the nature of its present assets, and (v) the sources of its present income.⁹ Any other relevant factors must also be considered, among them being the intention of a company not to be an investment company. Of the five listed criteria, ordinarily the most significant are the character of a company's assets (as evidenced by the percentage of the company's assets invested in investment securities), and the sources of the company's present income (as evidenced by the percentage of the company's income derived from investment securities).¹⁰ Other factors, however, may outweigh these, such as the company's need for cash for operations or acquisitions or other needs.¹¹ In general, Commission decisions indicate that if an applicant has shown significant activity in a non-investment business, a need for available capital, and no public representations that indicate it is in the investment business, registration has not been required.¹²

Each of the Industrial Companies is in possession of a favorable opinion of counsel regarding its status under the Act based on a careful and in-depth inquiry as to its historic development, its public representations and policy, the activities of its officers and directors, the nature of its present assets, the sources of its income, its *bona fide* need for substantial amounts of cash and all other factors deemed relevant in accordance with existing precedent. However, if an Industrial Company were to transfer the proceeds of securities offerings or asset sales from Government securities to shares of money funds in order to enhance the income on these holdings, its development, representations, activities and general character of its assets and income would remain the same, but counsel's ability to render a

⁹ *Tonopah Mining Company of Nevada*, 26 SEC 426, 427 (1947); *Release 10937*, *supra* note 6.

¹⁰ *Release 10937*, *supra* note 6; *Tonopah*.

¹¹ *See, e.g.*, proposed Rule 3a-8 under the 1940 Act, Investment Company Act Release No. 19566 (July 9, 1993), which recognizes the long-term cash needs of biotechnology companies, and numerous letters and releases related thereto, including *ICES Corporation*, Investment Company Act Release Nos. 19334 (order) (March 16, 1993) and 19274 (notice) (Feb. 18, 1993).

¹² *See, e.g., In the Matter of Newmont Mining Corporation*, 36 S.E.C. 429 (1955) (the Commission found under the facts that a company that was registered as an investment company has ceased to be one and was primarily engaged in mining operations through subsidiaries even though more than 40% of its assets were investment securities), and *In the Matter of American Manufacturing Company, Inc.*, 41 S.E.C. 415 (1963) ("primarily engaged" is factual analysis and can include dissimilar types of businesses and business lines between majority-owned subsidiaries and controlled companies within the same company).

favorable opinion regarding its status under the Act may be impaired if money fund share holdings exceeded the thresholds set forth in Section 3(a)(1)(C) or Rule 3a-1.

If the Staff concurs with our view that money fund shares should be treated as cash items rather than investment securities under the circumstances described herein, we would expressly condition reliance on that position on the rendering of a favorable opinion of counsel as to an Industrial Company's status under the Act based on all other relevant factors, including particularly those described above. Put another way, the requested interpretive advice would be used *solely* in the context of evaluating an Industrial Company under the objective financial tests in Section 3(a)(1)(C) and Rule 3a-1, and not for conclusively determining its status in light of an analysis of other aspects of the section and rule, as described above.

B. Cash Items

As discussed above, Section 3(a)(1)(C) and Rule 3a-1 define an investment company, in part, as an issuer that holds investment securities with a value exceeding a specified proportion of its total assets, exclusive of Government securities and cash items. Though the Act does not define the term "cash item," the Commission has noted that an early draft of the Act defined the term to include cash, bank deposits, and current accounts receivable.¹³ Further, the Commission has stated that, for purposes of Rule 3a-1 under the Act, cash items generally would include: "cash, coins, paper currency, demand deposits with banks, timely checks of others (which are orders on banks to immediately supply funds), cashier checks, certified checks, bank drafts, money orders, traveler's checks and letters of credit."¹⁴ Because of the commonality of purpose and general similarity of Section 3(a)(1)(C) and Rule 3a-1, this list of cash items presumably also applies under Section 3(a)(1)(C).¹⁵ Other instruments also can be considered cash items under appropriate circumstances. For example, in *Fifth Avenue Coach Lines*,

¹³ See Release 10937, *supra* note 6, at 82,461, 82,462 n.4, citing Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 Stan. L. Rev. 29 n.50 (1959).

¹⁴ See Release 10937, *supra* note 6 at 82,466 n.29. Similarly, in the context of proposing to include cash and cash equivalents as "investments," as that term is defined in Rule 2a51-1 under the Act (which defines the term "investments" for purposes of Section 3(c)(7)), the Commission stated:

Cash and cash equivalents would generally be considered to include cash, bank deposits, certificates of deposit, bankers acceptances and other bank instruments . . . the cash surrender value of an insurance policy (net of any loans) would also be considered to be a cash equivalent. Certain of the instruments are considered to be cash equivalents (*e.g.*, shares of money market mutual funds, certain Government securities) for purposes of these sources are securities and would be treated as investments for purposes of the proposed rule. (Citations omitted).

See *Private Investment Companies*, Investment Company Act Release No. 22405 (Dec. 24, 1996), [61 Fed. Reg. 68100, 68104 n.48 (Dec. 26, 1996)].

¹⁵ Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions*, at § 5.06.

the court held that certain certificates of deposit were cash items.¹⁶ We are aware, however, that the Staff's view on certificates of deposit is that they are often securities under Section 3(a)(1)(A), and investment securities under Section 3(a)(1)(C).¹⁷

C. Money Fund Shares as Cash Items

The Staff has not yet definitively stated whether shares of money funds are investment securities, cash items, or even akin to Government securities for purposes of Section 3(a)(1)(C).¹⁸ We view money market instruments as most closely related to cash items. Investing the proceeds from the debt and equity offerings in either money funds, interest-bearing checking accounts or Government securities serves the same purpose -- to protect the value of an Industrial Company's funds temporarily until they are ready to be used for operating purposes with little risk to security holders owing to the non-speculative nature of these types of holdings. Indeed, it is important to note that, though money funds are not entirely risk-free, substantial losses can be incurred in demand deposits if the issuing institution fails; moreover, it is quite possible to realize a loss on a Government security if it is purchased at a premium and/or sold prior to maturity in the secondary market.

¹⁶ 289 F. Supp. at 31. In this regard, the Court noted that, under the relevant provisions of Regulation S-X then in effect with respect to registered investment companies, time deposits were considered to be cash items. The Court observed that:

[a] certificate of deposit is merely a piece of paper evidencing the existence of a time deposit. The court sees no valid distinction, as far as Section [3(a)(1)(C)] is concerned, between a time deposit which is not evidenced by a certificate and one that is. Except in special circumstances, a time deposit is defined to be a cash item. When it is evidenced by a certificate, it should still be regarded as a cash item.

Id. Regulation S-X has since been amended to delete the reference to time deposits being cash items. See Item 6-04.5 of Regulation S-X (requiring an investment company's balance sheet to include under the caption labeled "cash" all cash on hand and demand deposits).

¹⁷ Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions*, at § 5.06.

¹⁸ See *Johnstown American Companies*, Investment Company Act Release Nos. 14681 (Aug. 16, 1985) (Order), and 14596 (Jun. 24, 1985) (Notice) (applicant considered money market instruments to be investment securities); See also *San Luis Mining Company*, Investment Company Act Release Nos. 9689 (Mar. 22, 1977)(Order), and 9651 (Feb. 18, 1977)(Notice) (applicant considered its holdings of short term money market instruments the same as cash and had, therefore, not characterized those holdings as investment securities in its asset ratios); *Pay 'n Save, Inc.*, Investment Company Act Release Nos. 17078 (Jul. 21, 1989)(Order), and 17028 (Notice)(applicant considered short-term high quality money market instruments to be akin to Government securities and did not consider money market instruments to be investment securities).

In several no-action letters, the Staff has stated its position regarding certain types of securities that serve the same purpose as Government securities. The Staff has stated that:

Generally, we would not recommend that the Commission take enforcement action against a company for not registering under the [Act] when the company, following receipt of the proceeds of a securities offering which are to be invested in a non-investment company business, or of a sale of operating assets, temporarily invests such proceeds, in order to preserve their value pending their investment in a non-investment company business or the liquidation of the company, in government securities, certificates of deposit, or other securities appropriate for that purpose, provided that the company intends to engage primarily in a non-investment company business or liquidate as soon as possible. Any speculation by the company in securities, even in government securities, would be a factor indicating that the company may be required to register under the 1940 Act.¹⁹

Even though the Staff's guidelines stated in the no-action letters involved what now would be called transient investment companies under Rule 3a-2 under the 1940 Act, the guidelines stated above are still relevant for purposes of determining whether other types of securities such as shares of money funds may be akin to Government securities or cash items.

Many Industrial Companies use money funds as an alternative to bank checking accounts and other forms of short-term liquid investments because the interest rate earned on these funds is highly competitive, the risk of diminution of principal is minimal and they are as operationally convenient as an interest bearing checking account. Indeed, the financial community regards money funds as the functional equivalent of interest bearing checking accounts offered by banks.²⁰

19 See Encore Industries, Inc. (SEC No-Action Letter), pub. avail. Sep. 11, 1980 (emphasis added); Genentech, Inc. (SEC No-Action Letter), pub. avail. Sep. 24, 1980.

20 See Russ Wiles, Many Nervous Investors Flood Money-Market Funds With Cash, THE ARIZONA REPUBLIC, Sep. 5, 1999, (Business), at D1 (noting that money funds continue to replace bank accounts as cash repositories); Robert K. Heardy, Money Funds Beating the Banks on Yields, SUN-SENTINEL (FT. LAUDERDALE, FL), Apr. 26, 1999, (Your Business), at 26 (noting that money funds are taking banks' checking business); Tom Petrino, Record Amounts Sent to Money Funds Not Necessarily a Bad Sign, AUSTIN AMERICAN-STATESMAN, Mar. 6, 1999, (Weekly Business Review), at 4 (observing that over the past two decades, money funds have become a substitute for bank checking and savings accounts); Lori Pizzani, Money Funds Attract Record Assets, MUTUAL FUND MARKET NEWS, Vol. VII, No. 6, at 1 (noting the movement from checking and savings accounts to money funds); Charles A. Jaffe, Finding a Safe Harbor in a Storm; Market's Downturn Sends Many Nervous Investors Scrambling for the Security of Money-Market Funds, CHICAGO TRIBUNE, Sep. 9, 1998, (Your Money), at 5 (observing that the current trend is to make money funds appear to be as similar to checking accounts as possible). See, e.g., Jon Birger, Edgy Investors Flee to Money Funds: Firms Cash in with New Products, CRAIN'S NEW YORK BUSINESS, Apr. 19, 1999, (News), at 1.

A shareholder of a money fund expects to receive the entire principal amount invested from the fund upon demand. However, this expectation must be reconciled with the fact that a money fund's shares are not generally backed by insurance and the value of a fund's shares is dependent upon the value of the fund's assets. Mutual fund sponsors are deeply concerned that an event that caused a loss to be realized by a money fund and to be borne by fund shareholders, even if relatively small, could cause the financial community to lose confidence in money funds as an appropriate form of short-term liquid investment. This event is perceived as catastrophic by the mutual fund industry.

The Commission apparently shares this view. Rule 2a-7(c) of the Act permits a money market fund that satisfies the rule's requirements to use two alternatives to mark-to-market valuation of its assets - the amortized cost method and the penny-rounding method. These alternative methods essentially permit a money market fund's shares to be redeemed at their full dollar price. In order to take advantage of these methods, a money fund must satisfy the rule's myriad requirements, which are intended to limit the risk that a fund will realize a loss on its investments. To this end, the Commission has amended and refined Rule 2a-7(c) and its applicability to money market funds on numerous occasions in response to market developments and the availability of new instruments to better ensure that money funds maintain a stable net asset value per share.²¹

Money funds did not exist when Congress drafted Section 3(a)(1)(C) in 1940. We believe that if it had, Congress would have concluded that holdings of money fund shares -- even though they are securities -- usually are not determinative of an investment company business because money fund shares generally are equivalent to cash. Similarly, in the asset and income tests in Rule 3a-1, cash items are expressly excluded from the calculation of the amount of an issuer's total assets, but cash items are not expressly excluded from investment securities. We believe that the wording of the Rule indicates that the Commission likewise did not contemplate securities as cash items. Because neither Congress nor the Commission contemplated that securities could in some instances be cash items, an explicit exclusion for cash items from the definition of investment securities in both cases was unnecessary. As described above, however, market practices have changed and the financial community now regards money funds as the equivalent of interest bearing checking accounts offered by banks. We believe that treating shares of money funds as cash items and not as investment securities would lend appropriate regulatory recognition to this fundamental change in circumstances without in any way compromising the policy and purposes underlying Section 3(a)(1)(C) and Rule 3a-1.

21 See Technical Revisions to the Rules and Forms Regulating Money Market Funds, Investment Company Act Release No. 22921 (Dec. 2, 1997), [(62 FR 64968 (Dec. 9, 1997))]; Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996), [61 FR 13956 (Mar. 28, 1996)]; Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993), [58 FR 68585 (Dec. 28, 1993)]; Amendment to Rule 2a-7 under the Investment Company Act, Investment Company Act Release No. 18177, (May 31, 1991); Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 17589, (Jul. 17, 1990), [55 FR 30239 (Jul. 25, 1990)].

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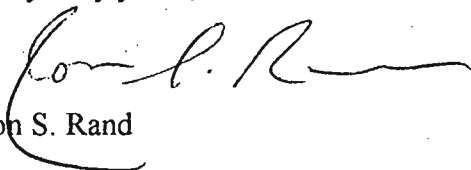
III. Conclusion

We believe that if an Industrial Company were to continue to hold the proceeds from securities offerings and divestiture transactions in Government securities, it would clearly not be an investment company and consequently would not be subject to regulation under the Act. However, continuing this course of action could cause the Industrial Company to lose potentially millions of dollars in yield and thereby hamper the company in fulfilling its obligations to its security holders to both protect the value of, and earn the highest rate of interest on, the funds of the company. In order to avoid these detrimental effects, we believe Industrial Companies should be able to commit otherwise uninvested cash to shares of money funds.

In view of the foregoing, we respectfully request the Staff's concurrence with our view that shares of money funds should be considered cash items rather than investment securities for purposes of the financial tests set forth in Section 3(a)(1)(C) and Rule 3a-1 under the circumstances and subject to the conditions described above.

Should the Staff have any questions or comments concerning this request, they should be directed to the undersigned.

Very truly yours,

A handwritten signature in black ink, appearing to read "Jon S. Rand", with a long horizontal flourish extending to the right.

Jon S. Rand