List of Subjects in 17 CFR Part 240

Brokers, Customers, Dealers, Reporting and recordkeeping.

Text of Proposed Rule

For the reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulation as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.17a–5 is amended by:

a. Revising the phrase ''except if the activities'' to read ''except as provided in paragraph (c)(5) of this section or if the activities'' in the introduction text of paragraph (c); and

b. Adding paragraph (c)(5).

The addition reads as follows:

§ 240.17a–5 Reports to be made by certain brokers and dealers.

* * * * *

(c) * * *

(5) *Exemption from sending certain financial information to customers.* A broker or dealer is not required to send to its customers the statements prescribed by paragraphs (c)(2) and (c)(3) of this section if the following conditions are met:

(i) The broker or dealer semi-annually sends its customers, at the times it otherwise is required to send its customers the statements prescribed by paragraphs (c)(2) and (c)(3) of this section, a financial disclosure statement that includes:

(A) The amount of the broker's or dealer's net capital and its required net capital in accordance with § 240.15c3–1, as of the date of the statements prescribed by paragraphs (c)(2) and (c)(3) of this section;

(B) To the extent required under paragraph (c)(2)(ii) of this section, a description of the effect on the broker's or dealer's net capital and required net capital of the consolidation of the assets and liabilities of subsidiaries or affiliates consolidated pursuant to Appendix C of § 240.15c3–1; and

(C) Any statements otherwise required by paragraph (c)(2)(iii) and (iv) of this section.

(ii) The financial disclosure statement is given prominence in the materials delivered to customers of the broker or dealer and includes an appropriate caption stating that customers may obtain the statements prescribed by paragraphs (c)(2) and (c)(3) of this section, at no cost, by:

(A) Accessing the broker's or dealer's Web site at the specified Internet Uniform Resource Locator (URL); or

(B) Calling the broker's or dealer's specified toll-free telephone number.

(iii) The broker or dealer publishes the statements in accordance with paragraphs (c)(2) and (c)(3) of this section on its Web site, accessible by hyperlinks, in either textual or button format, which are separate, prominent links, are clearly visible, and are placed in each of the following locations:

(A) On the broker's or dealer's Web site home page; and

(B) On each page at which a customer can enter or log on to the broker's or dealer's Web site; and

(C) If the Web sites for two or more brokers or dealers can be accessed from the same home page, on the home page of the Web site of each broker or dealer.

(iv) The broker or dealer maintains a toll-free telephone number that customers can call to request a copy of the statements prescribed by paragraphs (c)(2) and (c)(3) of this section.

(v) If a customer requests a copy of the statements prescribed by paragraphs (c)(2) and (c)(3) of this section, the broker or dealer sends it promptly at no cost to the customer.

(vi) During the year prior to the date as of which the statements prescribed by paragraphs (c)(2) and (c)(3) of this section were prepared, the broker or dealer was not required to provide notice to the Commission of the occurrence of any circumstance enumerated in paragraph (b)(1), (c)(1), (c)(2), (c)(3), (d), or (e) of § 240.17a–11.

* * * * *

Dated: November 26, 2002.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–30664 Filed 12–2–02; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–25835; File No. S7–47–02]

RIN 3235–AI57

Certain Research and Development Companies

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is publishing for comment a new rule under the Investment Company Act of 1940 that would provide a nonexclusive safe harbor from the definition of investment company for certain bona fide research and development companies. The rule is intended to allow research and development companies greater flexibility to raise and invest capital pending its use in research, development and other operations and would also clarify the extent to which a company relying on the rule may make investments in other research and development companies pursuant to collaborative research and development arrangements.

DATES: Comments must be received on or before January 15, 2003.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by one method only.

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically at the following E-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–47–02; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (*http://www.sec.gov*).[1]

FOR FURTHER INFORMATION CONTACT: Karen L. Goldstein, Senior Counsel, Janet M. Grossnickle, Branch Chief, or Nadya B. Roytblat, Assistant Director, at (202) 942–0564, Office of Investment Company Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed rule 3a–8 [17 CFR 270.3a–8] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the ''Act'').

I. Introduction and Summary

The Commission is proposing for comment new rule 3a–8 under the Act

[1] We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

as a nonexclusive safe harbor from investment company status for certain bona fide research and development companies (''R&D companies''). The Commission previously proposed rule 3a–8 in 1993 (''1993 Proposal'').[2] The 1993 Proposal was intended to codify the terms of a Commission order under section 3(b)(2) of the Act issued to ICOS Corporation, a biotechnology company (''ICOS order'').[3] In the ICOS order, the Commission addressed how the status of a company engaged largely in research and development activities should be determined under the Act. The Commission recently received a petition for rulemaking from the Biotechnology Industry Organization (''BIO'') asking the Commission to update and clarify Commission interpretations relating to the status of biotechnology companies under the Act.[4]

R&D companies often raise large amounts of capital, invest the proceeds and use the principal and return on these investments to fund research and development activities during their lengthy product development phase. An R&D company also may purchase a non-controlling equity stake in another R&D company as part of a strategic alliance with the other company to conduct research and develop products jointly. Either or both of these activities may cause an R&D company to fall within the definition of investment company and to fail to qualify for an exclusion from the definition when using the Commission's traditional analysis to determine a company's primary business for purposes of the Act.

The Act defines an ''investment company'' rather broadly. Among other definitions, the Act provides that any company that owns or proposes to acquire certain types of securities having a value exceeding 40 percent of the value of the company's total assets on an unconsolidated basis (exclusive of U.S. government securities and cash items) is an investment company. The Act also provides certain exclusions from the definition of investment company for a company that is primarily engaged in a non-investment business. When the Commission determines whether a company is primarily engaged in a non-investment business, we principally look at the composition of the company's assets and the sources of its income. We also consider the company's historical development, its public representations, and the activities of its officers and directors.[5]

In the ICOS order, the Commission recognized that the traditional analysis emphasizing the composition of a company's assets and income might not appropriately reflect an R&D company's non-investment business activities. Accordingly, we modified the traditional analysis of a company's primary business to better fit the business realities of R&D companies.

According to BIO, the analysis set forth in the ICOS order no longer provides some biotechnology companies sufficient flexibility or clarity to raise capital or enter into strategic alliances.[6] The Commission believes that it may be appropriate for biotechnology and other R&D companies to have greater flexibility to raise capital and make strategic investments in other R&D companies. Therefore, we are proposing new rule 3a–8 to update and codify the analysis set forth in the ICOS order with respect to R&D companies. We believe that it is in the public interest to ensure that bona fide R&D companies do not inadvertently fall within the definition of investment company and are not unnecessarily hindered in their operations by the Act.[7] We are equally concerned, however, that companies that are primarily engaged in the investment business not escape regulation under the Act and thereby deny their investors the protections afforded by the Act.

In order to accomplish these goals, the proposed rule generally would determine the primary business activity of a company based on how the company uses its assets and income. A company would be eligible to rely on the rule's nonexclusive safe harbor if it: (a) Has research and development expenses that are a substantial percentage of its total expenses for its last four fiscal quarters combined and that equal at least half of its investment revenues for that period; (b) has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined; (c) makes its investments to conserve capital and liquidity until it uses the funds in its primary business subject to certain exceptions; and (d) is primarily engaged, directly or through a company or companies that it controls primarily, in a noninvestment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development.

II. Background

A. The Definition of Investment Company

Section 3 of the Act determines when an issuer is an investment company subject to regulation under the Act. General provisions for determining investment company status are set forth in sub-sections 3(a) and 3(b).

Section 3(a) has two definitions of investment company that may be relevant to R&D companies.[8] Section 3(a)(1)(A) defines an investment company as any issuer that is, holds itself out as, or proposes to be engaged primarily in the business of investing, reinvesting, or trading in securities.[9] Section 3(a)(1)(C) defines as an investment company 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 securities having a value exceeding 40 percent of the value of its total assets on an unconsolidated basis (exclusive of U.S. government securities and cash items).[10] Section 3(a)(2)

[2] *See* Certain Research and Development Companies, Investment Company Act Release No. 19566 (July 9, 1993) [58 FR 38095 (July 15, 1993)] (the ''1993 Proposal''). The Commission withdrew rule 3a–8 from the Unified Agenda on April 1, 1996, because the Commission did not expect to consider the item within the next 12 months. Regulatory Flexibility Agenda, Investment Company Act Release No. 21795 (Mar. 4, 1996) [61 FR 24066 (May 13, 1996)].

[3] ICOS Corp., Investment Company Act Release Nos. 19274 (Feb. 18, 1993) [58 FR 1426 (Feb. 25, 1993)] (notice) and 19334 [53 S.E.C. Docket 2965] (Mar. 23, 1993) [58 FR 15392 (Mar. 22, 1993)] (order) (the ''ICOS Order'').

[4] Petition for Investment Company Act of 1940 Rulemaking, submitted by Matthew A. Chambers and John C. Nagel, Wilmer, Cutler & Pickering, on behalf of the Biotechnology Industry Organization, File No. 4–457 (May 23, 2002) (''BIO Petition'') (available at *http://www.sec.gov/rules/petitions/petn4–457.htm*). BIO represents more than 950 biotechnology companies in the United States and 33 other countries. Its members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products.

[5] *See infra* note 14.

[6] *Id.* at 1, 7.

[7] R&D companies increasingly are recognized as making an important contribution in many areas. For example, the U.S. Senate recently passed a resolution designating a ''National Biotechnology Week'' in recognition of the importance of biotechnology to the U.S. economy and to an improved quality of life overall. *See* Senate Resolution 243 Designating The Week Of April 21 Through April 28, 2002, as ''National Biotechnology Week,'' 107th Cong., 2d Session, April 16, 2002. The resolution noted that the biotechnology industry is instrumental in the research and development of antibiotics and other drugs to treat and cure diseases and conditions such as cancer, diabetes, epilepsy, multiple sclerosis and Acquired Immune Deficiency Syndrome. It also develops products to improve agriculture, industrial processes, the environment, and national security. *Id.*

[8] Section 3(a)(1)(B) of the Act [15 U.S.C. 80a–3(a)(1)(B)] defines an investment company to include companies that issue face-amount certificates of the installment type and is not relevant for purposes of this release.

[9] 15 U.S.C. 80a–3(a)(1)(A).

[10] 15 U.S.C. 80a–3(a)(1)(C).

defines ''investment securities'' to include all securities except Government securities, securities issued by employees' securities companies, and securities issued by majority-owned subsidiaries of the owner which are not investment companies.[11]

An issuer that meets the definition of investment company in section 3(a)(1)(C) of the Act nevertheless may be deemed not to be an investment company under two provisions in section 3(b). Section 3(b)(1) provides that an issuer is not an investment company if it is primarily engaged, directly or through wholly-owned subsidiaries, in a business other than that of investing, reinvesting, owning, holding or trading in securities.[12] Section 3(b)(2) provides that an issuer is not an investment company if the Commission by order finds and declares it to be primarily engaged (directly, through majority-owned subsidiaries or controlled companies [13] conducting similar types of businesses) in a business other than that of investing, reinvesting, owning, holding or trading in securities.[14]

To receive an order from the Commission under section 3(b)(2), an issuer initially must establish that it is engaged in some non-investment business. If an identifiable non-investment business exists, the inquiry then shifts to whether that business is ''primary.'' In Tonopah Mining Co.,[15] the Commission stated that its determination of an issuer's primary business under section 3(b)(2) would be based on five principal factors: (a) the issuer's historical development; (b) its public representations of policy; (c) the activities of its officers and directors; (d) the nature of its present assets; and (e) the sources of its present income (the ''Tonopah factors,'' also referred to as the ''Tonopah test''). The two most important factors are the composition of the issuer's assets and the sources of its income.[16] The Tonopah factors also have been applied to determine whether an issuer satisfies the primary business standard under section 3(b)(1).[17] Rule 3a-1 under the Act, adopted in 1981, codified a series of Commission orders issued under section 3(b)(2).[18]

B. Certain R&D Companies

The Tonopah test, while well suited for most issuers, may not appropriately identify the primary business of certain R&D companies. For example, ''in the biotechnology industry, there is typically a significant time lag between research and development investments, and revenues produced by those investments.'' [19] Accordingly, biotechnology companies must obtain financing many years [20] before they offer their products for sale and invest the proceeds in liquid instruments [21] so the funds are readily accessible for research and development activities.[22] Some R&D companies also enter into strategic alliances with other R&D companies to conduct research and develop products jointly.[23] These alliances may involve a strategic investment whereby one R&D company purchases a non-controlling equity stake in another R&D company.[24]

Many of the instruments in which R&D companies invest their capital and most investments made as part of a strategic alliance are investment securities counted toward the 40 percent threshold in section 3(a)(1)(C). Moreover, research and development expenses,[25] including those associated with the development of ''intellectual capital,'' are not recognized as assets on balance sheets prepared in accordance

[11] 15 U.S.C. 80a–3(a)(2). ''Government security'' is defined in section 2(a)(16) of the Act [15 U.S.C. 80a–2(a)(16)] and generally includes any security issued or guaranteed as to the principal or interest by the United States. ''Employees'' securities company'' is defined in section 2(a)(13) of the Act [15 U.S.C. 80a–2(a)(13)] generally to mean an investment company owned by employees of a company. ''Majority-owned subsidiary'' of an issuer is defined in section 2(a)(24) of the Act [15 U.S.C. 80a–2(a)(24)] to mean a company 50 percent or more of the outstanding securities of which are owned by the issuer or by a majority-owned subsidiary of the issuer.

[12] 15 U.S.C. 80a–3(b)(1).

[13] Section 2(a)(9) of the Act [15 U.S.C. 80a–2(a)(9)] defines ''control'' as the power to exercise a controlling influence over the management or policies of a company. This section creates a rebuttable presumption that owners of 25 percent or more of a company's voting securities control the company, and that owners of less than 25 percent do not. Unless otherwise stated, ''control,'' when used in this release, refers to the section 2(a)(9) definition.

[14] 15 U.S.C. 80a–3(b)(2). Section 3(b)(2) allows issuers that are investment companies as defined by section 3(a)(1)(C) to apply to the Commission for an order. An exclusion pursuant to section 3(b)(1), on the other hand, is ''automatic'' in that it is determined by the issuer itself. A determination under either section 3(b)(2) or section 3(b)(1) that an issuer is engaged primarily in a noninvestment business also means that it is not an investment company under section 3(a)(1)(A). *See* M.A. Hanna Co., 10 S.E.C. 581 (1941).

[15] Tonopah Mining Co., 26 S.E.C. 426 (1947)(''Tonopah Order'').

[16] *Id.* at 427, 430–431.

[17] *See* Moses v. Black, Fed. Sec. L. Rep. (CCH) P 97,866 (S.D.N.Y. 1981).

[18] 17 CFR 270.3a–1. The rule provides that a company that meets the definition of investment company in section 3(a)(1)(C) will not be deemed to be an investment company if it meets certain requirements. The rule essentially requires that the issuer derive no more than 45 percent of the value of its total assets, and no more than 45 percent of its net income for the last four fiscal quarters, from securities other than Government securities, securities issued by employees securities companies, securities issued by the issuer's majority-owned subsidiaries that are not investment companies, and securities issued by companies that are controlled primarily by the issuer through which the issuer engages in a non-investment business.

[19] BIO Petition, *supra* note 3, at I.B. BIO states that it takes approximately 10 to 14 years and costs approximately $300 million to $500 million to develop a new drug and obtain approval from the Food and Drug Administration (''FDA'') to market it. See also Ernst & Young, *Convergence: The Biotechnology Industry Report, Millenium Edition* (''Ernst & Young Report 2000'') at 6 (estimating that the average research and development cost of bringing a new drug to market is $400 million); Cynthia Robbins-Roth, *Magic Bullets: The Breakthroughs, the Business and the People of Biotechnology,* Forbes, May 31, 1999 at 42 (stating that new pharmaceutical products generally take more than 10 years from conception to approval by the FDA).

[20] Several cycles of equity offerings and depletions of the resulting investment pools can occur before an R&D company achieves profitable operations, if ever. *See* Financing the Biotech Industry: Can the Risks Be Reduced?, 4 B.U. J. SCI. & TECH. L. 1 (1998) (''Financing the Biotech Industry'') (noting that Chiron Corporation, a biotechnology company, ''came to market approximately six times * * * to get where it is today.''). *See also* Ernst & Young Report 2000, *supra* note 20 (indicating that at the end of 1999, 36 percent of public biotechnology companies had less than one year's worth of cash on hand).

[21] Biotechnology companies, for example, are traditionally financially conservative because they need to preserve cash for high research and development expenses. *See Biotech Firms Growing Up Fast,* Standard & Poors, April 10, 2002.

[22] On an industry-wide basis, research and development accounts for approximately 45 percent of all expenses incurred by U.S. biotechnology companies. *See* Ernst & Young, *Focus on Fundamentals, The Biotechnology Report* (Executive Summary) (Oct. 2001) (''Ernst & Young Report 2001'').

[23] In the biotechnology area, a very high risk business with few profitable companies, strategic alliances allow firms to share the risk and reduce fund-raising pressures. *See* Financing the Biotech Industry, *supra* note 20. Additionally, strategic alliances with pharmaceutical companies facilitate biotechnology companies' ability to raise additional funds in the market by providing confirmation of the company's prospects and tending to put a valuation on its products and technology. *See* Ernst & Young Report 2000, *supra* note 19, at 48.

[24] In addition to equity interests, strategic partnerships can also take the form of licensing agreements and other contractual partnerships. *See* Hagedoorn, John, ''*Inter-firm R&D Partnership—An Overview of Major Trends and Patterns Since 1960,*'' Strategic Research Partnerships: Proceedings from an NSF Workshop, August, 2001 (''Inter-Firm R&D Partnership'').

[25] Statement of Financial Accounting Standards No. 2 defines ''research'' as planned search or critical investigation aimed at discovery of new knowledge with hope that such knowledge will be useful in developing a new product or service or a new process or technique or in bringing about a significant improvement to an existing product or process. ''Development'' is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. *See* Accounting for Research and Development Costs, Statement of Financial Accounting Standards No. 2 (Fin. Accounting Standards Bd. 1974) at P 8 (''SFAS No. 2''). Research and development expenses generally include costs incurred for materials, equipment, facilities, personnel, intangibles, and indirect costs that are clearly related to research and development activities. *Id.* at 11.

with Generally Accepted Accounting Principles (''GAAP'').[26] R&D companies therefore may have few assets other than investment securities. As a result, a bona fide R&D company may fall within section 3(a)(1)(C)'s definition of investment company and fail to meet the traditional assets and income factors for determining a company's primary non-investment business. Becoming subject to regulation under the Act, however, typically is incompatible with how operating companies, including R&D companies, conduct their business.[27]

C. The ICOS Order

In the ICOS order, the Commission set forth an alternative test for determining the primary business of an R&D company under sections 3(b)(1) and 3(b)(2) of the Act. The ICOS order stated that, ''Given the unique nature of [R&D] companies, the Commission believes that it is appropriate to expand the traditional Tonopah analysis. If a company demonstrates that it is engaged actively in bona fide research and development activities, the Commission would consider the use, rather than simply the composition, of the company's assets and income.'' [28] Under the ICOS order, this consideration focuses on three factors: (1) Whether the company uses its securities and cash to finance its research and development activities; (2) whether the company has substantial research and development expenses and insignificant investment-related expenses; and (3) whether the company invests in securities in a manner that is consistent with the preservation of its assets until needed to finance operations. If a company satisfies these factors, the remaining factors of the traditional primary business test—the company's historical development, its public representations of policy, and the activities of its officers and directors—then should be examined to determine whether the company is engaged primarily in a noninvestment business.[29] Several months after issuing the ICOS order, the Commission proposed rule 3a–8 to codify the analysis that it set forth in the ICOS order. The rule was withdrawn from the Commission's rulemaking agenda in 1996.[30]

D. The BIO Petition

The BIO Petition requests that the Commission adopt a rule to address what BIO perceives as weaknesses in the tests used to determine its members' status under the Act. BIO asserts that with respect to the biotechnology industry today, the ICOS test is arbitrary and unduly limiting. The BIO Petition states that competition for skilled personnel and technology has increased the need for strategic collaborations and, without greater certainty about their investment company status, biotechnology companies forego these investments, or invest liquid assets solely in government securities, rather than those that may provide a higher return. BIO also argues that the increased duration of the drug development cycle, the nature of the capital markets, and biotechnology companies' ability to receive financing early in the product development cycle may cause companies to forego funding opportunities that may result in its income exceeding research and development expenses during some periods. To address these issues, the BIO Petition requests that the Commission adopt a rule that modifies the ICOS analysis to permit biotechnology companies to own more strategic investments and capital preservation investments (the ''BIO Proposal'').

III. Discussion

Today we are proposing rule 3a–8 to update and codify the primary business test for R&D companies set forth in the ICOS order. The proposed rule would serve as a nonexclusive safe harbor from the definition of investment company in sections 3(a)(1)(A) and 3(a)(1)(C) of the Act. The analysis set forth in the proposed rule generally focuses on an R&D company's use of its capital and other indicia of the company's primary engagement in a non-investment business. Rule 3a–8, as proposed, differs from the BIO Proposal in certain respects, which are noted below. We generally request comment on these differences.

A. Use of Capital

As the Commission has recognized, an R&D company would not be expected to maintain perpetually a portfolio of investment securities, and the amounts earned on the company's investments should bear some reasonable relationship to its actual research and development costs.[31] A bona fide R&D company also would be expected to invest its capital in a manner designed to preserve it, rather than in a manner designed to produce speculative profits.[32] Finally, we recognize that there are circumstances where an R&D company may want to make a strategic investment to gain access to another company's intellectual property or for other reasons related to the company's non-investment business.[33] These strategic investments, however, should not be for speculative purposes and should not comprise an overly large portion of the company's assets (because, as non-controlling minority equity investments, they are not investments in companies through which the R&D company conducts its non-investment business).[34]

[26] *See id.* at 12. Under GAAP, costs of self-developed intangible assets generally, and research and development expenses for ''intellectual assets,'' in particular, are charged to expense when incurred.

[27] Section 18 of the Act [15 U.S.C. 80a–18], for example, places limits on a registered investment company's capital structure, and would significantly reduce the ability of an R&D company to raise capital. Section 18's restrictions on the issuance of warrants, options, and other rights also would limit the company's ability to attract scientific talent.

[28] The ICOS Order, *supra* note 3, at section II. ICOS, a development stage biopharmaceutical company, had no drug products approved for commercial use and, as a result, no revenues from product sales. It had, however, raised $90 million in public and private stock offerings that it had invested in short-term U.S. government and commercial debt securities pending the use of the proceeds in its research and development programs and for capital expenditures. As a result, most of ICOS' revenues were derived from securities. On the other hand, a substantial percentage of ICOS' total expenses were for research and development, its research and development expenses exceeded its investment revenues, and its investment-related expenses were insignificant. ICOS' historical development, its public representations of policy, and the activities of its officers and directors also all indicated that it was not engaged primarily in the investment company business. ICOS thus applied for an order under section 3(b)(2) declaring it to be engaged primarily in a business other than investing, reinvesting, or trading in securities. In the ICOS order, the Commission stated that, ''The Commission believes that ICOS may rely on the automatic exclusion provided by section 3(b)(1) * * * The Commission, however, believes an order is appropriate here to modify the analysis for determining the primary business of bona fide [R&D] companies.'' *Id.*

[29] *Id.* at sections II.A—II.C.

[30] *See supra* note 2. It appears that the Commission's analysis set forth in the ICOS Order provided R&D companies and their counsel with sufficient guidance for determining their status under the Act.

[31] *See* the ICOS Order, *supra* note 3, at section II.A and the 1993 Proposal, *supra* note 2, at section II.A.1.

[32] *See* the ICOS Order, *supra* note 3, at section II.C and the 1993 Proposal, *supra* note 2, at section II.A.4.

[33] *See* the 1993 Proposal, *supra* note 2, at section II.A.4. *See also* Inter-Firm R&D Partnership, *supra* note 24. Strategic alliances enable R&D companies to cross-fertilize technological disciplines, achieve technology synergies and complements as well as R&D economies of scale and scope, share R&D costs, utilize a partner's R&D expertise, and jointly cope with R&D uncertainty. *Id.*

[34] Both the framers of the Act and the Commission in administering the Act have viewed non-controlling minority equity interests as a type of investment security, which, if it comprises a significant portion of a company's assets, suggests that the company may in fact be an investment company. *See* sections 3(a)(1)(C) and 3(b)(2) of the Act; the Tonopah Order, *supra* note 14. The Act was an outgrowth of a Commission study of the investment company industry conducted between

We view these factors as important to the distinction that must be drawn between bona fide R&D companies that should not be subject to the Act and investment companies that should be. The provisions of proposed rule 3a–8 described below are designed to limit the rule's safe harbor to bona fide R&D companies.

1. Substantial Research and Development Expenses

Paragraph (a)(1) of proposed rule 3a–8 would require that research and development expenses [35] for an R&D company's last four fiscal quarters combined be a substantial percentage of its total expenses for that period. The proposed rule leaves the determination of ''substantial'' undefined in order to allow R&D companies to take into account fluctuations in the composition of their expenses over time. If an R&D company's research and development expenses are the majority of its expenses but for nonrecurring items or unusual fluctuations in recurring items, the research and development expenses certainly would be ''substantial'' for purposes of this provision. We request comment whether the rule should provide a more objective standard and if so, what that standard should be.

2. Revenues from Investments Compared to Research and

Development Expenses

Paragraph (a)(2) of proposed rule 3a–8 would require that the R&D company's revenues from investments in securities not exceed twice the amount of its research and development expenses.[36] As defined in paragraph (b)(6), ''investments in securities'' would include all securities owned by the R&D company other than securities issued by majority-owned subsidiaries and companies controlled by the R&D company that conduct similar types of businesses, through which the R&D company is engaged primarily in a business other than that of investing, reinvesting, owning, holding, or trading in securities.[37] Investment revenues, for purposes of the proposed rule, would include all investment returns, including amounts earned from dividends, interest on securities, and profits on securities (net of losses).

The requirement set forth in paragraph (a)(2) is designed to allow an R&D company to raise a significant amount of capital during favorable market conditions while precluding a situation in which the company's primary focus is its revenues from investments rather than its research and development activities. We note that the proposed rule would permit R&D companies to raise and hold more capital than the ICOS order currently permits. Under the ICOS order, an R&D company was expected to spend more on research and development than its gross investment income. R&D companies are spending an increasing amount on research and development. For example, between 1997 and 2000, total funds for industrial research and development in the U.S. increased over 26 percent.[38] Given these increased capital requirements and the lengthy product development phases faced by R&D companies, additional flexibility to raise and invest capital pending use in research and development would appear appropriate so long as the other requirements of the rule are met.

In the 1993 Proposal, the Commission noted that, if an R&D company did not deplete its invested funds over time to fund its research and development, a question would arise as to whether it was maintaining the value of its reserves for use in its operations or was running a perpetual investment program.[39]

- We request comment on whether the rule as proposed today sufficiently protects against that possibility.
- We also request comment on whether the rule should address an R&D company's other operational expenses as well.
- Would a requirement that an R&D company spend more on research and development and other operational expenses than its gross investment income be more appropriate?
- The Commission also requests comment on whether the rule should define ''investment revenues,'' and, if so, how that term should be defined.
- We also request comment on whether the proposed test unduly limits the ability of R&D companies to raise capital during favorable market conditions. If so, what would be an appropriate alternative test for determining whether a company's investment program is consistent with a primary engagement in research and development and related non-investment business activities?
- We also request comment on whether the holding of investments by an R&D company should be subject to custody, bonding or other requirements, similar to those contained in the Act, relating to the safekeeping of liquid securities.[40]

3. Insignificant Investment-Related Expenses

Paragraph (a)(3) of proposed rule 3a–8 would require that an R&D company devote no more than five percent of its total expenses for its last four fiscal quarters combined to investment advisory and management activities, investment research and selection, and supervisory and custodial fees.[41] Under paragraph (a)(4), as discussed more fully below, most of an R&D company's investments would be made to conserve capital and liquidity pending use of the funds in its operations. Consequently, its excess funds generally would be invested in instruments presenting limited investment risk. Accordingly,

1938 and 1940 pursuant to a Congressional mandate in the Public Utility Holding Company Act of 1935 [15 U.S.C. 79z–4]. When determining which companies to include in the study, the Commission distinguished between ''investment companies'' and ''holding companies'' on the basis of whether the company held a controlling interest in other companies, or instead smaller blocks of securities. SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1939–1942).

[35] Research and development expenses are defined in paragraph (b)(5) by reference to SFAS No. 2, as currently in effect or as it may be subsequently revised.

[36] The Commission recognizes that bona fide R&D companies at times experience fluctuations in their research and development expenses and investment revenues. Consequently, the requirements in paragraphs (a)(1) and (a)(2) are calculated using the last four fiscal quarters combined.

[37] The BIO Proposal contains a similar requirement—that a company's investment income (excluding any income from strategic investments) be less than or equal to twice the amount the company spends on research and development. As proposed, paragraph (a)(2) would not exclude income from strategic investments. We request comment on our proposed approach. We ask commenters to discuss the types of income an R&D company receives from strategic investments and whether such income would be more properly viewed as indicative of research and development operations, rather than as investment income.

[38] *See* National Science Foundation, *Research and Development in Industry: 2000* (Early Release Tables), Table E–1 at *http://www.nsf.gov/sbe/srs/srs02403/tables/e1.xls* (last visited Nov. 26, 2002). Since 1993, research and development expenses for biotechnology companies alone more than doubled, *See Report on the State of the Industry,* presentation by Carl B. Feldbaum, President of the Biotechnology Industry Organization to Covance Senior Management, Washington, D.C. (April 29, 2002)(''Feldbaum Speech'') available at *http://www.bio.org/news/speeches/20020429.asp* (last visited Nov. 26, 2002). From 1999 to 2000 alone, these expenses rose from $10.7 billion to $13.8 billion, a 29.2 percent increase. *See* Ernst & Young Report 2001, *supra* note 22.

[39] *See* 1993 Proposal, *supra* note at section II.A.1.

[40] Under the Act, securities and similar investments of a registered investment company must be placed in the custody of a bank, a member of a national securities exchange, or the company itself in accordance with Commission rules. 15 U.S.C. 80a–17(f); *see also* 17 CFR 270.17f–1 and 2. As authorized by the Act, the Commission requires registered management investment companies to provide and maintain a fidelity bond against larceny and embezzlement that covers officers and employees of the company who have access to its securities or funds. 15 U.S.C. 80a–17(g); *see also* 17 CFR 270.17g–1.

[41] *See* 17 CFR 210.6–07.2(a) (Regulation S–X).

investment advisory, management, research, and similar expenses should be limited. In contrast, a high level of spending on these types of expenses may indicate that the company is more focused on its investment activities then its research and development activities, and should therefore be regulated as an investment company. We request comment on whether a different limitation on investment-related expenses would be more appropriate.

4. Investments to Conserve Capital and Liquidity

Paragraph (a)(4) of proposed rule 3a–8 would require that an R&D company's investments in securities be capital preservation investments, subject to two exceptions for ''other investments.'' The exceptions are designed to clarify the extent to which an R&D company may make investments that are not consistent with the preservation of capital and still remain within the safe harbor provided by the rule.

a. Definition of Capital Preservation Investments. ''Capital preservation investments'' are defined in paragraph (b)(3) as investments made to conserve an R&D company's capital and liquidity until the funds are used in its primary business or businesses. In general, capital preservation investments are liquid so that they can be readily sold to support the issuer's research and development activities as necessary and present limited credit risk. This requirement is intended to ensure that the investments are being used to support the company's research and development activities, rather than in a speculative manner that would be more characteristic of an investment company.

- We request comment on whether this definition provides sufficient guidance and, if more guidance would be appropriate, the types of issues any such guidance should address.
- We also request comment on whether the rule should require the board of directors of the company to adopt investment guidelines designed to assure that the company's funds are invested consistent with the goals of capital preservation and liquidity.[42]

Finally, the proposed rule, like the ICOS order, does not impose a limit on capital preservation investments relative to the company's total assets because R&D companies tend to have few tangible assets and large amounts of capital are needed to conduct research and development activities. We request comment on this approach.

b. Other Investments. In the 1993 Proposal, the Commission proposed a requirement that an R&D company's investment portfolio, viewed overall, present limited investment risk.[43] The Commission also stated that it would not view the acquisition of a limited amount of equity securities of a noncontrolled company, pursuant to a collaborative arrangement or ''strategic business relationship,'' as necessarily placing the issuer outside of this requirement, depending upon the facts and circumstances of that investment.[44] In recent years, companies are increasingly collaborating with other companies to conduct joint research and development.[45] Further, these collaborative arrangements appear to enhance research and development efforts.[46]

We believe that R&D companies should have some flexibility to obtain equity stakes that advance their strategic and business goals. The countervailing concern, however, remains that such investments, while being ''strategic,'' are nonetheless non-controlling minority equity interests which, if they constitute a significant portion of a company's assets, may indicate that the company's primary business is that of an investment company.[47] We also note that it is unclear why some collaborative research and development arrangements include the purchase of a non-controlling equity interest, while others do not.[48] We request comment on the specific reasons for including non-controlling interests in securities as part of collaborative research and development arrangements.[49]

Paragraph (a)(4) of proposed rule 3a–8 is designed to balance these considerations by drawing a distinction between investments made pursuant to a collaborative research and development arrangement and other investments that are not made to preserve capital and liquidity. Paragraph (a)(4)(i) would permit an R&D company to acquire investments that are not capital preservation investments (''other investments,'' defined in paragraph (b)(7) of the proposed rule), provided that immediately after the acquisition no more than 10 percent of its total assets consist of other investments. Alternatively, paragraph (a)(4)(ii) would permit a larger 20 percent ''basket'' of investments that are not capital preservation investments so long as at least 75 percent of those investments were made pursuant to collaborative research and development arrangements. These alternatives are designed both to ensure that an R&D company's investment portfolio, viewed overall, presents limited investment risk and to reflect the increased use of collaborative relationships to conduct research and development since the ICOS order was issued.

- We request comment on whether the proposed limits on other

[42] *See* the ICOS order, *supra* note 3, at section II.C.; *see also* BIO Petition, *supra* note 4, at 9.

[43] *See* the 1993 Proposal, *supra* note 2, at section II.A.2.

[44] *Id.*

[45] *See* Inter-Firm R&D Partnership *supra* note 24. The trend among biotechnology companies over the last 9 years, for example, has been a substantial increase in the number of strategic partnerships, including a six-fold increase between biotechnology and pharmaceutical companies, and a twelve-fold increase in partnerships between biotechnology companies. *See* Feldbaum Speech, *supra* note 38. Although the most common alliance remains between biotechnology and pharmaceutical companies, partnering between biotechnology companies is growing as smaller companies with narrow areas of expertise require other biotechnology companies to generate product candidates. *Id.*

[46] *See* Audretsch, David B., *Strategic Research Linkages and Small Firms, Strategic Research Partnerships: Proceedings from an NSF Workshop* (Aug. 2001) (noting that it has been argued that linkages and partnerships among R&D companies has ''contributed to a superior innovative performance''). *See also* Ernst and Young Report 2000, *supra* note 19, at 48 (noting that pharmaceutical companies rely on biotechnology companies to drive product development and to access cost-cutting technologies, which may increase the speed and efficiency of the drug discovery process).

[47] *See* the 1993 Proposal, *supra* note 2, at II.A.4.

[48] Although joint ventures and other equity partnerships previously dominated the alliances among R&D companies, recently R&D companies seem increasingly to prefer contractual partnerships. *See* Inter-Firm R&D Partnerships, *supra* note 24. *See also* Windhover's Pharmaceutical Strategic Alliances, Volume XIII (September 2002) (indicating that 98 of more than 650 strategic alliances signed between July 2001 and June 2002 included equity investments) (available at *http://www.windhover.net/pubs/psa/psa.asp*) (last visited Nov. 26, 2002).

[49] According to one commentator, the investing company may be motivated to make an investment more for strategic reasons than for the financial rewards. Mark A. Medearis & Michael W. Hall, *Minority Equity Investments In Connection With Strategic Alliances,* 1323 PLI/Corp 117, 119 (July-August 2002). These strategic reasons may include investment: (a) to obtain influence or control over the investee and its business plans; (b) to serve as a prelude to an ultimate acquisition of the investee by the investing company; (c) to provide a mechanism through which the investing company may provide development funding without incurring an expense for accounting purposes; and (d) to serve as a ''goodwill'' gesture to the investee. *Id.* According to a recent article, however, technology corporations that invested in other technology companies for strategic reasons in the late 1990's are now selling those interests as their value has declined. Ann Grimes, *Tech Companies Itch to Shed VC Portfolios in Tough Times,* Wall Street Journal, September 26, 2002. It is not clear that any of these motives are directly connected to the long, expensive research and development cycles experienced by R&D companies. We believe that understanding the reasons for structuring a strategic alliance to include an investment in a non-controlling interest in securities is important because, absent such an investment, a strategic alliance would not raise any issues under the Act.

investments set forth in paragraph (a)(4) are too restrictive or whether they may be too broad.

• We also request comment on whether other investments that were made pursuant to collaborative research and development arrangements should continue to be considered with respect the 75 percent calculation, if the collaborations are no longer ongoing.[50]

Under the proposed approach, the limits on other investments would be calculated only at the time other investments are acquired. If an R&D company's other investments increase in value due to market fluctuations, it would not be required to sell any other investments it already owns, but it would not be able to continue to acquire other investments.

• Is this approach appropriate?

• Should the rule provide a limit, applicable at any time, on the percentage of an R&D company's assets, valued in accordance with section 2(a)(41) of the Act, that may consist of other investments?

• Should the rule provide a period of time after a collaborative research and development arrangement ends during which securities obtained pursuant to it must be sold?

We also encourage commenters to suggest alternative tests. We note that the BIO Proposal would not impose any asset-based limit on investments that meet its definition of strategic investments.[51] The BIO Proposal would impose a cost-based limit on strategic investments, requiring that the cost of all strategic investments at any time be less than the total amount of the company's research and development expenses during the most recent four fiscal quarters.[52]

• We request comment on the approach advocated by BIO.

• We also request that commenters who propose tests alternative to that which we are proposing today address how their proposed test(s) would ensure that companies that should be regulated under the Act are not afforded the benefit of the rule's safe harbor.

c. CollaborativeResearch and Development Arrangements. ''Collaborative research and development arrangement'' is defined in paragraph (b)(4) as a business relationship which (i) is designed to achieve narrowly focused goals that are directly related to, and an integral part of, the issuer's research and development activities; (ii) calls for the issuer to conduct joint research and development activities with one or more other parties, and (iii) is not entered into for the purpose of avoiding regulation under the Act. Together, paragraphs (a)(4) and (b)(4) recognize that certain investments, while not interests in controlled companies through which the issuer engages in a non-investment business, nonetheless may be sufficiently related to an R&D company's primary business that their holding should be permitted by the rule's safe harbor.

• We request comment on the scope of the definition of collaborative research and development arrangement.[53]

• Does the proposed definition appropriately distinguish a ''strategic'' investment of an R&D company from one that primarily has an investment purpose?

• Should other relationships, such as a licensor-licensee relationship with respect to a patent or other intellectual property rights, be included in the definition?[54]

• Should activities other than research and development activities, such as manufacturing and joint marketing activities, be included?[55] In this regard, we ask commenters to address whether R&D companies face any unique challenges that are not faced by other operating companies seeking to produce and market their products.

We note that paragraph (b)(1) of the proposed rule provides that assets are to be valued for purposes of the rule in accordance with section 2(a)(41) of the Act.[56] Section 2(a)(41)(B) provides, in relevant part, that for purposes of section 3 of the Act the term ''value'' means, (i) with respect to securities for which market quotations are readily available, the market value of those securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors. We request comment on whether some other basis (for example, cost) would be more appropriate for investments made pursuant to collaborative research arrangements, and if so, why.

B. Conducting Business Through Primarily Controlled Companies

The rule's safe harbor would be available to any R&D company that conducts business directly, through majority-owned subsidiaries, ''or through one or more companies which it controls primarily.'' Paragraph (b)(5) of the rule provides that ''controlled primarily'' means that the issuer has control over the company within the meaning of section 2(a)(9) of the Act and that the degree of the issuer's control is greater than that of any other person. The ''controlled primarily'' standard, also found in rule 3a–1 under the Act, is designed to distinguish securities representing interests in operating companies through which an issuer engages in a non-investment business from mere investments in securities.[57] The Commission traditionally has viewed the fact that an issuer's degree of control over a company is greater than that of any other person as strong evidence that the issuer is engaged in a business through the other company.[58]

[50] Under the BIO Proposal, an investment would not qualify as strategic if the subject of the collaborative activity or contractual right is not ongoing (*i.e.*, once the collaboration or contractual right terminates, the investment would no longer be treated as a strategic investment.) *See* BIO Petition, *supra* note 4, at 8.

[51] *See id.* The BIO Proposal would allow a company to hold strategic investments, provided they are owned to achieve goals that are directly related to its research and development activities. *Id.*

[52] *Id.* Unlike the proposed rule, the approach suggested in the BIO Proposal would not limit an R&D company's ability to continue to acquire other investments when non-controlling strategic investments, valued in accordance with section 2(a)(41) of the Act, are a large portion of the company's assets.

[53] The BIO Proposal similarly would require that strategic investments be owned to achieve narrowly focused goals that are directly related to, and an integral part of, the issuer's research and development activities. *Id.*

[54] Under the BIO Proposal, an investment will qualify as ''strategic'' if, among other things, the investing company made the investment in connection with a strategic agreement with another company under which (1) the parties collaboratively will conduct research, development, manufacturing, or commercialization activities, *or* (2) the investing company provides or receives a license of, or similar contractual right to use (or an option to provide or receive a license of, or similar contractual right to use) patents, know-how, or other proprietary intellectual property to use in research, development, manufacturing, or commercialization activities. *Id.*

[55] The BIO Proposal also would permit an investment to qualify as strategic when the parties collaboratively conduct manufacturing or commercialization activities.

[56] 15 U.S.C. 80a–2(a)(41)(B).

[57] Rule 3a–1(a)(4) [17 CFR 270.3a–1(a)(4)]. *See, e.g.*, Standard Shares, Inc., Investment Company Act Release Nos. 10200 (Apr. 11, 1978) (notice) and 10234 (May 9, 1978) (order).

[58] *See* Health Communications Services Inc. (pub. avail. Apr. 26, 1985). To demonstrate control over a company for purposes of section 2(a)(9) under the Act, an issuer must show not only the ability to exercise control, but also that it is exercising it. *See id.* (ownership of more than 25 percent of the outstanding stock of affiliates, if ''outstanding stock'' is comprised of voting securities, constituted control over those entities for purposes of the rebuttable presumption established by section 2(a)(9) of the Act). *See also* In the Matter of ENERSIS S.A., Investment Company Act Release Nos. 20925 (Feb. 27, 1995) (notice) and 20965 (Mar. 24, 1995) (order); In the Matter of CITIC Pacific Limited, Investment Company Act Release Nos. 21282 (Aug. 15, 1995) (notice) and 21345 (Sept. 12, 1995) (order); In the Matter of Safeguard Scientifics,

Continued

We request comment on extending the rule's safe harbor to R&D companies that conduct their business in this manner.

C. Holding Out as Primarily Engaged in a Non-investment Business

Paragraph (a)(5) of the proposed rule would require that an R&D company not hold itself out as being engaged in the business of investing, reinvesting, or trading in securities. This requirement would ensure that any issuer that holds itself out as being an investment company could not rely on the rule. Paragraph (a)(5) further requires that the company not be a special situation investment company.[59]

D. Other Tonopah Factors

Paragraph (a)(6) of the proposed rule codifies the requirement in the ICOS order that the activities of an R&D company's officers, directors and employees,[60] its public representations of policies, and its historical development demonstrate that it is primarily engaged in a business or businesses other than investing, reinvesting, owning, holding, or trading in securities. Paragraph (a)(6) also requires that the board of directors of a company seeking to rely on the safe harbor adopt an appropriate resolution evidencing that the company is primarily engaged in a non-investment business.[61] We request comment on these provisions.

E. Consolidation With Financial Statements of Wholly-Owned Subsidiaries

Paragraph (b)(2) provides that, for purposes of the proposed rule, an R&D company's assets, expenses and revenues should be determined on an unconsolidated basis, except that the company shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries. This approach is consistent with rule 3a–1 under the Act.[62] We note that, under GAAP, the assets, income and expenses of majority-owned subsidiaries of an issuer also are consolidated with the issuer's statement of operations.[63] We request comment on whether it would be more appropriate for the proposed rule to require or permit consolidation of an R&D company's financial statements with those of its majority-owned subsidiaries.

An R&D company's investments in companies it controls primarily (but which are not majority-owned subsidiaries) may be accounted for using the equity method.[64] Statements of operations prepared on the basis of the equity method of accounting reflect, in a single amount, the parent's share of the controlled company's net income, but not the parent's share of its investment revenues, investment-related expenses, or research and development expenses. We request comment on whether an R&D company should be allowed or required to combine its pro rata share of the relevant expenses and revenues of any companies it controls primarily with its own when determining whether it meets the requirements of paragraphs (a)(1) through (a)(3) of the proposed rule.[65]

IV. General Request for Comment

The Commission requests comment on the rule proposed in this release, suggestions for other additions to the rule, and comment on other matters that might have an effect on the proposal contained in this release.

V. Cost-Benefit Analysis

The Commission is proposing a rule that would serve as a nonexclusive safe harbor from investment company status for certain R&D companies. The rule is designed primarily to benefit R&D companies that currently are relying on the ICOS Order. The rule primarily would address two aspects of the analysis in the ICOS Order. First, it would allow R&D companies greater flexibility to raise and invest capital pending its use in research, development and other operations by modifying the requirement that an R&D company generally spend more on research and development that it earns on its investments. Second, the proposed rule would clarify the extent to which an R&D company may make investments in other R&D companies pursuant to collaborative research and development arrangements.

The proposed rule generally would determine the primary business activity of a company based on how the company uses its assets and income. A company would be eligible to rely on the rule's nonexclusive safe harbor if it: (a) Has research and development expenses that are a substantial percentage of its total expenses for its last four fiscal quarters combined and that equal at least half of its investment revenues for that period; (b) has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined; (c) makes its investments to conserve capital and liquidity until it uses the funds in its primary business subject to certain exceptions; and (d) is primarily engaged, directly or through a company or companies that it controls, in a noninvestment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development.

As the proposed rule is exemptive, rather than prescriptive, R&D companies are not required to rely on it. Therefore, we assume that R&D companies will only rely on the provisions of the proposed rule if the anticipated benefits from such actions would exceed the anticipated costs.

A. Benefits

Proposed rule 3a–8 is intended to benefit R&D companies by reducing costs on an ongoing basis. When an R&D company's status under the Act is uncertain, it may experience higher costs when issuing securities or when borrowing. The proposed rule is

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Inc., Investment Company Act Release Nos. 24317 (Feb. 25, 2000) (notice) and 24345 (Mar. 22, 2000) (order).

[59] For a discussion of a special situation investment company, *see e.g.*, Certain Prima Facie Investment Companies, Investment Company Act Release No. 10937 at nn. 19–20 & accompanying text (Nov. 13, 1979).

[60] In the Tonopah Order, and subsequent Commission orders under section 3(b)(2) of the Act, the Commission considered the activities of a company's employees in determining a company's primary business. *See* Tonopah Order, *supra* note 14. *See also, e.g.*, Yahoo! Inc., Investment Company Act Release Nos. 24459 (May 18, 2000) (notice) and 24494 (June 13, 2000) (order); Airtouch Communications, Inc., Investment Company Act Release Nos. 24271 (Jan. 28, 2000) (notice) and 24294 (Feb. 23, 2000) (order); Internet Capital Group, Inc. Investment Company Act Release Nos. 23923 (July 28, 1999) (notice) and 23961 (Aug. 23, 1999) (order); and Extended Stay America, Inc., Investment Company Act Release Nos. 23167 (Apr. 30, 1998) (notice) and 23210 (May 27, 1998) (order).

[61] This requirement is modeled on the requirement in rule 3a–2 under the Act that provides a temporary exemption from the Act for transient investment companies. 17 CFR 270.3a–2.

[62] *See* rule 3a–1(c). Under section 3(a)(1)(C) of the Act, an issuer's status is determined by the composition of its assets on an unconsolidated basis.

[63] The consolidated statement reflects all income and expenses of these subsidiaries, whether the issuer/parent owns all or just a majority of the outstanding common stock of the subsidiary. The net income attributable to minority ownership of the subsidiaries is also deducted in arriving at consolidated net income on the consolidated income statement. 1993 Proposal, *supra* note , at n.31.

[64] *See* The Equity Method of Accounting, Accounting Principles Board Opinion No. 18 (American Institute of Certified Public Accountants 1971) (''APB No. 18''). APB No. 18 generally prescribes the equity method of accounting by investors for investments in investees when the investor owns more than 20 percent, but not more than 50 percent, of the investee's voting interests.

[65] This method of accounting, generally referred to as the pro rata consolidation method, currently is applied in certain industries in lieu of the equity method. *See* Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Securities and Exchange Commission Release No. 34–33139 (Nov. 3, 1993) [58 FR 60307 (Nov. 3, 1993)].

designed to assist R&D companies in determining their status under the Act by clarifying the applicable test. Clarification of the test should both reduce the costs that an R&D company may need to incur to determine its status under the Act and reduce any uncertainty in such determination, which may reduce costs when issuing securities or borrowing.

In addition, the rule is designed to afford R&D companies greater flexibility to both raise and invest capital. R&D companies may be forgoing opportunities to access the markets or reducing the amounts raised when accessing the markets because of limits contained in the current test. The current limits also may discourage investment in higher yielding capital preservation instruments. The rule should allow R&D companies to raise larger amounts of capital in a more cost-effective manner and to formulate more efficient asset allocations than would be permitted under the existing tests. Thus, the rule is expected to reduce any costs that may be associated with a lack of flexibility (1) to access fully the markets when conditions are favorable, and (2) to make capital preservation investments.

B. Costs

In addition to the benefits of the rule, the Commission is sensitive to the costs that may be associated with it. The proposed rule would require a company's board of directors to adopt and record a resolution that the company is primarily engaged in a non-investment business. The Commission believes the cost of this requirement, which generally would need to be fulfilled once, to be minimal relative to its benefits. We estimate that to comply with this requirement, an R&D company would need to have its in-house counsel spend 45 minutes preparing the resolution, and its board of directors spend 15 minutes adopting the resolution. Based on our estimate that 500 companies would rely on the rule, one hour per company at a blended hourly rate results in a total cost of $103,750.[66] The Commission requests comment on whether its estimates of the number of companies that may rely on the rule, the amount of time needed to adopt the required resolution and the costs of such time are appropriate. The Commission requests comment on the potential costs and benefits identified in the proposal and any other costs or benefits that may result from the proposal.

[66] The Commission's estimate concerning the weighted average hourly wage rate is based on salary information for the securities industry compiled by the Securities Industry Association. *See* Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry—2001. The weighted average hourly wage rate of $207.50 includes overhead costs and assumes that 75 percent of the time will be by in-house counsel at a rate of $110 per hour and 25 percent by the board of directors at a rate of $500 per hour.

VI. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, a rule is ''major'' if it results or is likely to result in an annual effect on the economy of $100 million or more; a major increase in costs or prices for consumers or individual industries; or significant adverse effects on competition, investment, or innovation. The Commission requests comment on the potential impact of the proposed rule on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

VII. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Act provides that whenever the Commission is engaged in rulemaking under the Act and is required to consider or determine whether an action is consistent with the public interest, the Commission also must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission has considered rule 3a–8 in light of these standards and believes that, by clarifying the status of certain R&D companies under the Act, and allowing R&D companies greater flexibility to raise and invest capital, the rule is consistent with the public interest and will positively affect capital formation. The Commission also believes that the proposed rule will promote efficiency and competition, and that the rule would not be unduly burdensome to those companies wishing to rely on it.

The Commission requests comment on whether the proposed rule, if adopted, would promote efficiency, competition, and capital formation. Will the proposed rule materially affect both the number of R&D companies and their ability to raise capital for their business? Comments will be considered by the Commission in satisfying its responsibilities under section 2(c) of the Act. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. Paperwork Reduction Act

R&D companies wishing to rely on the safe harbor provided by proposed rule 3a–8 must fulfill certain conditions set forth in the rule. One such condition requires that the board of directors of the company adopt an appropriate resolution evidencing that the company is primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities. The proposed rule would require that the resolution be recorded contemporaneously in the company's minute books or comparable documents. This requirement constitutes a ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501, *et seq.*], because adopting the resolution is necessary to meet the conditions of the rule. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information without display of a valid Office of Management and Budget (''OMB'') control number. Accordingly, the Commission has submitted the proposed rule to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is ''Rule 3a–8 under the Investment Company Act.''

The Commission has estimated the paperwork burden under the proposed rule. The total aggregate estimated annual reporting burden associated with the rule's requirements is 500 hours. The required board resolution would need to be adopted and recorded only once (unless relevant circumstances change). Thus, the Commission believes that the annual collection of information requirement will not be a significant burden.

The Commission estimates that of the 500 R&D companies that may take advantage of the proposed rule, the reporting burden imposed by rule 3a–8 is one hour per company, for a total aggregate reporting burden of 500 hours.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609 with reference to File No. S7–47–02. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB

is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–47–02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

IX. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding proposed rule 3a–8 under the Act. The IRFA explains that the proposed rule would provide a safe harbor to allow R&D companies more investment flexibility and the ability to hold and invest more capital without becoming subject to the Act. The IRFA also explains that in order to be eligible for the nonexclusive safe harbor the proposal would create, an R&D company must have research and development expenses that are a substantial percentage of its total expenses, have relatively small investment-related expenses, make its investments to conserve capital and liquidity until it uses the funds in its primary business, subject to certain exceptions, and be primarily engaged, directly or through a company or companies that it controls primarily, in a noninvestment business.

The IRFA states that proposed rule 3a–8 is designed to clarify, and provide greater certainty concerning, the status of an R&D company under the Act. Rule 3a–8 would have no reporting requirements, but the board of directors of a company seeking to rely on the rule would need to adopt a board resolution and record that resolution contemporaneously in its minute books or comparable documents. The IRFA states that the only significant alternative to the proposed rule would be for an R&D company to engage in its own analysis and application of existing statutory provisions, Commission orders and interpretations to determine the R&D company's status under the Act. The Commission therefore concluded that the proposal, although it could affect small entities, would be less burdensome than this alternative and, thus, would minimize any impact upon, or cost to, small businesses. Any company with net assets of $50 million would be a small entity for purposes of the proposed rule. The IRFA also states that the Commission believes that there are no duplicative, overlapping, or conflicting Federal rules with the proposed rule.

The Commission encourages comment with respect to any aspect of the IRFA. The Commission specifically requests comment on the number of small entities that would be affected by the proposed rule, and the likely impact of the proposal on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of the rule, and will be placed in the same public file as comments on the proposed rule itself. A copy of the IRFA may be obtained by contacting Karen L. Goldstein, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

X. Statutory Authority

We are proposing rule 3a–8 pursuant to our authority set forth in sections 6(c) and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a–6(c) and 80a–37(a)].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulation is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, 80a–39, unless otherwise noted;

* * * * *

2. Section 270.3a–8 is added to read as follows:

§ 270.3a–8 Certain research and development companies.

(a) Notwithstanding sections 3(a)(1)(A) and 3(a)(1)(C) of the Act (15 U.S.C. 80a–3(a)(1)(A) and 80a–3(a)(1)(C)), an issuer will be deemed not to be an investment company if:

(1) Its research and development expenses, for the last four fiscal quarters combined, are a substantial percentage of its total expenses for the same period;

(2) Its revenues from investments in securities, for the last four fiscal quarters combined, do not exceed twice the amount of its research and development expenses for the same period;

(3) Its expenses for investment advisory and management activities, investment research and custody, for the last four fiscal quarters combined, do not exceed five percent of its total expenses for the same period;

(4) Its investments in securities are capital preservation investments, except that the issuer may acquire other investments, provided that immediately after such acquisition:

(i) No more than 10 percent of its total assets consist of other investments; or

(ii) No more than 20 percent of its total assets consist of other investments and at least 75 percent of such other investments were made pursuant to collaborative research and development arrangements;

(5) It does not hold itself out as being engaged in the business of investing, reinvesting or trading in securities, and it is not a special situation investment company; and

(6) It is primarily engaged, directly, through majority-owned subsidiaries, or through one or more companies which it controls primarily, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, as evidenced by:

(i) The activities of its officers, directors and employees;

(ii) Its public representations of policies;

(iii) Its historical development; and

(iv) An appropriate resolution of its board of directors, or by an appropriate action of the person or persons performing similar functions for any issuer not having a board of directors, which resolution or action has been recorded contemporaneously in its minute books or comparable documents.

(b) For purposes of this section:

(1) All assets shall be valued in accordance with section 2(a)(41)(A) of the Act (15 U.S.C. 80a–2(a)(41)(A));

(2) The percentages described in this section are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries;

(3) *Capital preservation investments* means investments that are made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses;

(4) *Collaborative research and development arrangement* means a business relationship which:

(i) Is designed to achieve narrowly focused goals that are directly related to, and an integral part of, the issuer's research and development activities;

(ii) Calls for the issuer to conduct joint research and development activities with one or more other parties;

and (iii)Is not entered into for the purpose of avoiding regulation under the Act;

(5) *Controlled primarily* means the issuer has control over the company within the meaning of section 2(a)(9) of the Act (15 U.S.C. 80a–2(a)(9)) and the degree of the issuer's control is greater than that of any other person;

(6) *Investments in securities* means all securities other than securities issued by majority-owned subsidiaries and companies controlled primarily by the issuer that conduct similar types of businesses, through which the issuer is engaged primarily in a business other than that of investing, reinvesting, owning, holding, or trading in securities;

(7) *Other investments* means investments in securities that are not capital preservation investments; and

(8) *Research and development expenses* means research and development expenses as defined in the Statement of Financial Accounting Standards No. 2, as currently in effect or as it may be subsequently revised.

By the Commission.

Dated: November 26, 2002.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–30663 Filed 12–2–02; 8:45 am]

BILLING CODE 8010–01–P

FEDERAL COMMUNICATIONS COMMISSION

47 CFR Part 73

[DA No. 02–2721, MB Docket No. 02–335, RM–10545]

Radio Broadcasting Services; Coopersville, Hart & Pentwater, MI

AGENCY: Federal Communications Commission.

ACTION: Proposed rule.

SUMMARY: This document requests comments on a petition filed by Waters Broadcasting Corporation and Synergy Media, Inc. requesting the substitution of Channel 287B for Channel 287C2 at Hart, Michigan, and reallotment of Channel 287B from Hart, Michigan, to Coopersville, Michigan, and modification of the license for Station WCXT to specify operation on Channel 287B at Coopersville. The coordinates for Channel 287B at Coopersville are 43–20–36 and 85–52–16. To accommodate the proposal for Coopersville, we shall also propose the reallotment of Channel 231C3 from Pentwater to Hart, Michigan, and modification of the license for Station WWKR accordingly. The coordinates for Channel 231C3 at Hart are 43–51–33 and 86–18–27. In accordance with Section 1.420(i) of the Commission's Rules, we shall not accept competing expressions of interest in the use of Channel 287B at Coopersville or Channel 231C3 at Hart. Canadian concurrence will be requested for both allotments.

DATES: Comments must be filed on or before December 30, 2002, and reply comments on or before January 15, 2003.

ADDRESSES: Federal Communications Commission, 445 Twelfth Street, SW., Washington, DC 20554. In addition to filing comments with the FCC, interested parties should serve the petitioner's counsel, as follows: Matthew H. McCormick, Reddy, Begley & McCormick, LLP, 2175 K Street, NW., Suite 350, Washington, DC 20037–1845 and Robert L. Olender, Koerner & Olender, P.C., 5809 Nicholson Lane, Suite 124, North Bethesda, Maryland 20852–5706.

FOR FURTHER INFORMATION CONTACT: Kathleen Scheuerle, Media Bureau, (202) 418–2180.

SUPPLEMENTARY INFORMATION: This is a summary of the Commission's Notice of Proposed Rule Making, MB Docket No. 02–335, adopted October 23, 2002, and released November 8, 2002. The full text of this Commission decision is available for inspection and copying during normal business hours in the Commission's Reference Center, 445 Twelfth Street, SW, Washington, DC 20554. The complete text of this decision may also be purchased from the Commission's duplicating contractor, Qualex International, Portals II, 445 12th Street, SW, Room CY–B402, Washington, DC, 20554, telephone 202–863–2893, facsimile 202–863–2898, or via e-mail *qualexint@aol.com.*

Provisions of the Regulatory Flexibility Act of 1980 do not apply to this proceeding. Members of the public should note that from the time a Notice of Proposed Rule Making is issued until the matter is no longer subject to Commission consideration or court review, all *ex parte* contacts are prohibited in Commission proceedings, such as this one, which involve channel allotments. See 47 CFR 1.1204(b) for rules governing permissible *ex parte* contact.

For information regarding proper filing procedures for comments, see 47 CFR 1.415 and 1.420.

List of Subjects in 47 CFR Part 73

Radio, Radio broadcasting.

For the reasons discussed in the preamble, the Federal Communications Commission proposes to amend 47 CFR part 73 as follows:

PART 73—RADIO BROADCAST SERVICES

1.The authority citation for part 73 continues to read as follows:

Authority: 47 U.S.C §§ 154, 303, 334 and 336.

§ 73.202 [Amended]

2. Section 73.202(b), the Table of FM Allotments under Michigan, is amended by removing Channel 287C2 at Hart, by adding Coopersville, Channel 287B, and by removing Channel 231C3 at Pentwater and adding Channel 231C3 at Hart.

Federal Communications Commission.

John A. Karousos,

Assistant Chief, Audio Division, Media Bureau.

[FR Doc. 02–30508 Filed 12–2–02; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

47 CFR Part 73

[DA 02–2927; MB Docket No. 02–314 RM–10594]

Radio Broadcasting Services; Encino, Texas

AGENCY: Federal Communications Commission.

ACTION: Proposed rule.

SUMMARY: This document seeks comment on a petition for rulemaking filed by Charles Crawford proposing the allotment of Channel 283A at Encino, Texas, as the community's first local transmission service. Channel 283A can be allotted at Encino, Texas, with a site restriction of 6.4 kilometers (4.0 miles) west of the community. Coordinates for Channel 283A at Encino, Texas are 26–55–42 NL and 98–11–56 WL . Since this proposal is within 320 kilometers (199 miles) of the U.S.-Mexico border, concurrence of the Mexican government to the proposed allotment has been requested.

DATES: Comments must be filed on or before December 30, 2002, and reply comments must be filed on or before January 14, 2003.

FOR FURTHER INFORMATION CONTACT: Victoria M. McCauley, Media Bureau, (202) 418–2180.

SUPPLEMENTARY INFORMATION: This is a synopsis of the Commission's Report