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A legal update from Dechert's Financial Services Group

Court Rules Presto Not Required to Register as Investment Company

On May 15, 2007, the Court of Appeals for the Seventh Circuit ("Court") ruled that National Presto Industries Inc. ("Presto"), a company largely familiar to the general public as a purveyor of household items such as the "Salad Shooter," is not required to register as an investment company with the Securities and Exchange Commission ("SEC").[1]

The ruling provides some additional guidance with respect to the definition of an "investment company" in Section 3(a)(1)(C) of the Investment Company Act of 1940 (the "Act"),[2] and the application of that definition to certain operating companies that, due to various business and other reasons, may find themselves to be "inadvertent investment companies."

Inadvertent Investment Companies

Under Section 3(a)(1)(C) of the Act, 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 per centum of the value of [its] total assets (exclusive of Government securities and cash items) on an unconsolidated basis" is an investment company.[3] This definition creates a formula for determining whether or not an issuer may be an investment company (the "Forty Percent Test").[4] Operating companies that fail the Forty Percent Test are often referred to as "inadvertent investment companies." The impact of the Forty Percent Test has, in the past, led several potential "inadvertent investment companies" to seek exemptive relief from the SEC to avoid being subject to the registration and other provisions of the Act.

1 *SEC v. National Presto Industries, Inc.*, No. 05-4612 (7th Cir. May 15, 2007) ("*Presto*"). The case was heard before Judges Frank H. Easterbrook, Terence T. Evans, and Richard Posner, and the opinion was written by Judge Easterbrook.

2 There are other definitions of "investment company" under the Act. Section 3(a)(1)(A) of the Act defines an "investment company" as any company which holds itself out as an investment company, irrespective of the amount of investment securities it owns. Section 3(a)(1)(B) of the Act defines an "investment company" as any company which "is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificates outstanding."

3 The Act defines "investment securities" to include all securities except (a) Government securities, (b) securities issued by employees' securities companies, and (c) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company provided by Sections 3(c)(1) or 3(c)(7) of the Act.

4 Some courts hold that failing the Forty Percent Test is essentially just a "red flag" or warning sign that close analysis is required and that the "engaged in the business" component of the definition is ultimately the real test of investment company status. *See Allison Lynne Slimes v. Salvatore Giordano*, 1992 U.S. Dist. LEXIS 16340 (Dist. N.J. Oct. 8, 1992) ("*Giordano*"). A determination under the "engaged in the business" component depends upon the facts and circumstances of a particular issuer. However, where an issuer passes the Forty Percent Test (i.e., less than 40% of its total assets are held in investment securities), the issuer would not be classified as an investment company.

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Background of the *Presto* Case

In 2002, the SEC sued Presto, claiming that Presto held a sufficient amount of investment securities to bring its status as an investment company into question as a result of the Forty Percent Test and, therefore, would either need to apply for exemptive relief (as other inadvertent investment companies had done) or otherwise register as an investment company and comply with relevant provisions of the Act and related rules thereunder.[5] The SEC reached this conclusion, despite Presto's long history of operating as a consumer and defense goods manufacturer and seller, based predominantly on the composition of Presto's assets.

Historically, Presto engaged in the manufacture and sale of both consumer goods (cookware, diapers, and other household items) and munitions. According to the court's opinion, prior to the 1970s, Presto generally manufactured these goods itself. However, during the 1970s, Presto began to divest its manufacturing facilities and to contract production to third parties. Due to the sale of the physical assets associated with a manufacturing business, Presto held large quantities of cash and financial instruments and no longer held as many operating assets. Presto intended to use the cash to acquire other businesses over the long-term.

According to the facts presented in the Seventh Circuit's opinion, financial instruments comprised 86% of Presto's total assets by 1994 and 92% in 1998. Given these ratios, Presto's asset composition fell on the wrong side of the Forty Percent Test. In keeping with its long-term view, Presto had purchased two manufacturers of military supplies and two makers of diapers and puppy pads since 2000. However, in 2003, financial instruments still represented 62% of Presto's physical and financial assets.[6]

The Court's Ruling

In ruling that Presto is not an investment company, the Court looked to the composition of Presto's assets prior to the recent changes in Presto's portfolios (i.e., to the period during which the SEC claims Presto operated as an unregistered investment company). Presto had argued that certain of the securities that it held at that time were not "investment securities" for purposes of the Forty Percent Test.

Specifically, Presto argued that pre-funded municipal bonds ("refunded bonds") should be considered "Government securities" and that variable-rate demand notes should be treated as "cash items" for purposes of the Forty Percent Test. Both cash and government securities are excluded from the definition of an investment security. The court rejected this argument and, in fact, concluded that Presto would fall within the limits of the Forty Percent Test unless a statutory exception, exemption, or exclusion to its classification as an investment company applied.[7]

One such provision, Section 3(b)(1) of the Act, applies to issuers "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." In analyzing whether Presto could avail itself of this provision, the court noted that Presto is actively engaged in various non-investment-related businesses, including the cookware and munitions businesses. However, according to the Court, the question of whether or not Presto was an investment company turns on whether Presto was "primarily" engaged in such other businesses. As the court notes, the term "primarily" is not defined by the Act.

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5 *See* SEC's Complaint, *SEC v. National Presto Industries, Inc.*, 397 F. Supp. 2d 943 (N.D.Ill 2005).

6 Despite the SEC's conclusion that Presto was an investment company, Presto refused to register as such with the SEC or otherwise apply for an appropriate exemption. Consequently, the SEC filed suit to seek an injunction that would require compliance. In 2005, the U.S. District Court for the Northern District of Illinois granted summary judgment in the SEC's favor and issued an injunction requiring Presto to register under the Act. *SEC v. National Presto Industries, Inc.*, 397 F. Supp. 2d 943 (N.D.Ill 2005). Presto subsequently complied with the District Court's injunction pending appeal, although in the interim the company altered its asset mix such that the percentage of investment securities held by the firm no longer exceed the 40% trigger. In connection with this reorganization, Presto sought to de-register as an investment company with the SEC. However, up until the date of the Seventh Circuit's ruling, the SEC had not acted on Presto's de-registration application.

7 The Court did not classify pre-funded municipal bonds as Government securities or variable-rate demand notes as cash items on the grounds that, among other things, the instruments were not the economic equivalent of Government securities or cash, respectively.

The Court first turned to five factors that the SEC has historically considered in determining whether a company is an "inadvertent investment company" in order to analyze Presto's investment company status:

- the company's history;
- the way the company holds itself out to the public;
- the activities of its officers and directors;
- the nature of the company's assets; and
- the source of the company's income.[8]

According to the court, all but the fourth suggest that Presto was not, at the time in question, an investment company.

With respect to Presto's assets, the Court noted that more than 60% of Presto's assets were comprised of investment securities for each relevant year. The SEC had argued that the nature of Presto's assets was the "most important" factor in determining whether Presto is an investment company. The Court disagreed, and noted that, while the nature of a company's assets is an important factor, the Act precludes it from being the sole or "most important" factor.[9]

Additionally, the court stated that "what principally matters is the beliefs the company is likely to induce in investors. Will its portfolio and activities lead investors to treat a firm as an investment vehicle or as an operating enterprise?" In addition to the importance of the public's perception of Presto, the court lent significant weight to the source of Presto's income. Even though Presto held more than 60% of its assets in investment securities, the court noted that more than 90% of Presto's gross receipts were derived from the sale of its products and not from investment securities.[10]

Although *Moses v. Black* is not cited in the court's opinion, the Court's approach is supported by the opinion in that case.[11] In *Moses,* a shareholder derivative action against Chock Full O'Nuts Corporation ("Chock"), a coffee company, plaintiffs alleged that Chock had operated as an unregistered investment company. The court in that case applied the Tonopah test utilized by the Court in *Presto* and examined each of the five factors with respect to Chock. The court gave considerable weight to the historical pattern of the company's development and public statements despite its admitted investment activity.[12] It noted that, since its inception, Chock had followed a course of business development in the retail food and restaurant business and engaged in a pattern of acquisition that confirmed its intent to continue development in the retail food business.

Additionally, the court found that there were no public statements of policy in its annual reports or public filings that suggested Chock was anything other than a retail food business. The court also noted that, although Chock's investment assets arguably exceeded the 40% threshold, Chock's proportion of investment income to income from operations was less than 10%. The court took all of these factors into consideration and concluded that the company "was both histori-

8 *In re Tonopah Mining Co.*, 26 S.E.C. 426 (1947) ("*Tonopah*").

9 The Court's position rested on the availability of Section 3(b)(1) of the Act. The Court reasoned that if the composition of an issuer's assets was the "most important" consideration, the exclusion from the definition of "investment company" provided by Section 3(b)(1) would be "unavailable as a practical matter. The only reason one turns to this exclusion is that the [Forty Percent Test] has been satisfied."

10 The Court was careful to note that, when considering a company's income for purposes of determining investment company status, looking at both gross and net income "is essential; otherwise an operating loss, with negative net income, would turn a firm into an 'investment company.'"

11 1981 U.S. Dist. Lexis 10870 (S.D.N.Y. 1981).

12 Similarly, in *Giordano*, the court stated that it "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." The court, however, was not persuaded that the "in the business" requirement is controlled by a company's subjective intent; rather "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 [but extends to consideration of the company's] total activities of all sorts." *Giordano* at 11 (citing *SEC v. Fifth Ave. Coach Lines, Inc.* 289 F.Supp. 3 (S.D.N.Y. 1968) and *Dan River, Inc. v. Icahn*, 701 F.2d 278, 291 n. 14 (4th Cir. 1983)).

cally and during the time period at issue . . . a mercantile company engaged in the food purveying business" and not that of an investment company.

Similarly, the *Presto* court emphasized what it believed to be the public's perception of Presto as an operating company as well as the sources of its gross income. In ruling that Presto was not an investment company, the Court held that reasonable investors would regard Presto as an operating company rather than a closed-end investment company.

Implications of the Court's Ruling

The Seventh Circuit's ruling in *Presto* is significant in that it provides some comfort, at least in the context of private litigation as compared with SEC actions, for operating companies that might, due to the strict composition of their assets, find themselves captured by Section 3(a)(1)(C) and deemed to be "inadvertent investment companies."

For example, the AFL-CIO recently wrote to the SEC arguing that The Blackstone Group L.P.'s ("Blackstone") initial public offering runs afoul of the Act as, according to the AFL-CIO, the proposed structure of the IPO is an attempt to "avoid coverage under [the Act]."[13] According to the ALF-CIO, Blackstone is "a vehicle for offering interests in managed assets, assets which are securities."[14] As part of its argument, the AFL-CIO asserted that more than 40% of Blackstone's assets constitute investment securities (in the form of general partnership interests that the AFL-CIO believes should be deemed to be call options on various Blackstone investment funds).[15]

Even while the AFL-CIO's position seems tenuous with respect to the classification of Blackstone's interests in the various Blackstone funds as "investment securities," the *Presto* case is likely to lend support to Blackstone's assertion that shares of Blackstone offered to the public would provide interests in the income generated from operating an asset management business, rather than from movements in the value of "investment securities." That is, if investors perceive Blackstone to be an asset management business, it is less likely that the business will be characterized as an investment company.

In fact, at a hearing of the House Finance Committee on June 26, 2007, in response to questions, SEC Chairman Cox stated that the SEC's Division of Investment Management had considered the status of Blackstone, and concluded that it was not an investment company within the meaning of the Act.

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13 Letter from Richard L. Trumka, AFL-CIO, to Mr. John White, Director, Division of Corporate Finance, Securities and Exchange Commission, and Mr. Andrew Donohue, Director, Division of Investment Management, Securities and Exchange Commission (May 15, 2007). Section 48(a) of the Act provides that "it shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of [the Act] or any rule, regulation, or order thereunder."

14 These assets would include the various Blackstone investment funds that would be held by Blackstone through various intermediate holding companies.

15 The AFL-CIO argues that Blackstone's general partnership interests (through its wholly-owned subsidiaries) are direct interests in and call options on securities. In advancing its position, the AFL-CIO argues that the carried interests that Blackstone's various general partner entities are entitled to receive through the management of various investment funds are economically equivalent to call options on the pools of securities held by those funds. The AFL-CIO's argument does not address the management and other operational functions carried out by the Blackstone general partnership interests nor the liability incurred by such interests, factors that weigh heavily against the characterization of such interests as securities under the Act.

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