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The "Inadvertent" Investment Company Trap: Identifying Operating Companies Subject to the Investment Company Act

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The **Investment Company Act of 1940** (the "Act") was enacted by Congress to protect members of the U.S. public from potential abuses resulting from pooled investments in companies that are primarily engaged in the business of investing and trading in securities. Like other federal securities laws, the Act's regulation of investment companies is a disclosure based regime that, in the absence of an exception or exemption, requires registration with the **Securities Exchange Commission** and regular disclosures relating to the financial condition and investment policies of the investment company. Furthermore, the Act imposes various other substantive requirements and restrictions on investment companies, such as board independence requirements, limits on borrowing money and raising equity, and restrictions on the types and amounts of securities that can be acquired by investment companies.

While mutual funds are perhaps the most commonly recognized form of investment companies, legal practitioners and corporate executives should be aware that the Act also potentially applies to a variety of traditional operating companies that would not ordinarily be regarded as investment companies. Indeed, in the absence of an exemption or exclusion, a company will be deemed to be an investment company for purposes of the Act if forty percent (40%) or more of its total assets, excluding government securities and cash items, are comprised of "investment securities." Investment securities are generally defined to include all securities other than securities in majority owned subsidiaries that themselves are not investment companies.

This so-called "inadvertent" investment company definition is a rigid mathematical test that does not depend on a company's intent or business purpose. Moreover, the test is in effect a daily test and a company can unwittingly fall within the definition based merely on a change in the composition of its assets. Examples of traditional operating companies that may inadvertently become subject to the Act include without limitation:

- Operating companies that conduct business operations through minority owned subsidiaries, including, for example, companies that utilize special purpose entity and joint venture structures for the purpose of acquiring real estate or oil and gas interests;

- Operating companies with substantial working capital reserves invested in debt and equity securities;
- Operating companies that have sold one or more of their primary operating divisions and invested the sale proceeds temporarily in debt and equity securities;
- Operating companies that have invested significant capital into research and development activities and/or entered into minority owned strategic alliances with other research and development companies; and
- Newly formed operating companies that have raised money but have not yet devoted the capital to the underlying business operations.

Compliance with the Act is both costly and administratively burdensome. Furthermore, violation of the Act's requirements could expose an inadvertent investment company to civil and criminal suits and penalties, as well as invalidate contracts which involve conduct that violates the Act. Accordingly, legal practitioners and corporate executives should be aware of the inadvertent investment company trap created by the Act and put appropriate controls in place to identify potential investment company issues.

Fortunately, there are a number of statutory and regulatory exceptions and exemptions under the Act that provide relief to companies which may otherwise qualify as inadvertent investment companies and want to avoid compliance with the Act. The availability of these exceptions and exemptions will depend, in each case, on the specific facts involved and must be viewed within the context of a significant body of interpretative guidance. Our firm has experience with the exceptions and exemptions under the Act and is available to assist companies who may or have become inadvertent investment companies with strategic planning to avoid regulation under the Act.

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