Investment Company “Status”: Presto Case Reduces Pressure on 40% Test Failures

On May 15, 2007, the Seventh Circuit Court of Appeals decided against the Securities and Exchange Commission in an important ruling that may impact the way investment company “status” is determined. Under Section 3(a)(1)(C) of the Investment Company Act of 1940 (the “Act”), a company that is engaged in the business of investing or holding securities with more than 40 percent of its total assets comprised of investment securities is required to register as an investment company if it does not qualify for an exception or exemption. An operating company that fails the 40 percent test risks being treated as an “inadvertent investment company.” A key, but previously hesitantly applied, exception is provided by another section of the Act, Section 3(b)(1), if the issuer can establish that it is “primarily engaged” in a business other than investing or holding securities.1 Lawyers have been hesitant to provide opinions relying on Section 3(b)(1) because of its heavily factual and arguably “subjective” nature – and because of the SEC’s strong emphasis on the asset test. In *SEC v. National Presto Industries*,2 the Seventh Circuit applied a broad-based analysis of Presto’s business to reverse a 2005 district court decision and in doing so shifted the focus of this “primarily engaged” test from the nature of the company’s assets to the beliefs the company is likely to induce in investors.

**Background**

National Presto Industries (“Presto”) is a Wisconsin-based manufacturer of pressure cookers and other consumer products and munitions that has been operating since 1905. After outsourcing much of its manufacturing business, Presto was retaining significant cash profits each year and holding that cash in the form of financial instruments to fund future acquisitions. Because of Presto’s business plan and the fact that it had leased office space and had substantial intellectual property assets that did not show up on its balance sheet, Presto failed to stay within the 40 percent threshold.

In 2005, the SEC sued on the basis that Presto was an inadvertent investment company under Section 3(a)(1)(C) of the Act. Presto lost in district court and was issued an injunction requiring it to register as an investment company, which it ultimately did. These events caused Presto’s auditor to resign, leaving the company unable to meet reporting deadlines as either an investment company or an operating firm.

1 Section 3(b)(1) of the Investment Company Act of 1940. The “non-investment company” operations must be conducted directly or through “wholly-owned subsidiaries” (meaning at least 95% of the subsidiary’s voting securities are owned by the parent). *Id.*

company and facing the prospect of being delisted by the New York Stock Exchange. Presto reconfigured its assets to reduce its investment securities below 40%, but its request for deregistration filed in 2006 was not acted on by the SEC.

Analyzing Presto’s Business

The SEC’s 1947 decision in *In re Tonopah Mining*[^3] established a five factor test for determining whether a company is primarily engaged in the business of investing in securities. The factors to be considered are:

- the company’s history;
- the way it presents itself to the public;
- the activities of its officers and directors;
- the nature of its assets; and
- the sources of its income.

Prior to the *Presto* ruling, the most important factor in the eyes of the SEC was the nature of the company’s assets. The Seventh Circuit, however, considered this focus to be too myopic. The court asked “[w]hat sense would it make to enact a law using 40 percent as a threshold in Section 3(a)(1)(C),” yet convert Section 3(b)(1) into still another purely numbers-based test?

The court weighed all five factors in the *Tonopah* test to conclude that Presto was not an investment company. Unlike other companies that had been found to be inadvertent investment companies, Presto still had active business operations and its managers spent roughly 95 percent of their time running the company’s consumer products and military-ordnance business.

In addition, although Presto’s balance sheet may have been heavily weighted with investment securities, its public representations and business focus were those of an operating company. The court’s analysis gave significant weight to this last point, looking closely at “the beliefs the company is likely to induce in investors.”

Impact

The primary impact of the ruling is that determinations of investment company status under Section 3(b)(1) may be less mechanical than in the past. If *Presto* is followed by other courts and the SEC, the totality of a company’s business and its representations to investors will be viewed with equal or greater importance than its asset mix. This would make it easier for operating companies to avoid becoming inadvertent investment companies by virtue of their balance sheets. On the other hand, the more subjective nature of the test set forth in *Presto* may make such determinations less predictable.

To be safe, a company that fails to meet the 40 percent threshold under Section 3(a)(1)(C) and seeks to avoid registration as an investment company should try not only to minimize the percentage of assets comprised of investment securities, but also be certain that all aspects of its business are structured in such a way that it would not be seen as primarily engaged in a securities holding or trading business. This would include considering the activities of officers and directors as well as public statements and presentations by the company and its interactions with customers and investors.