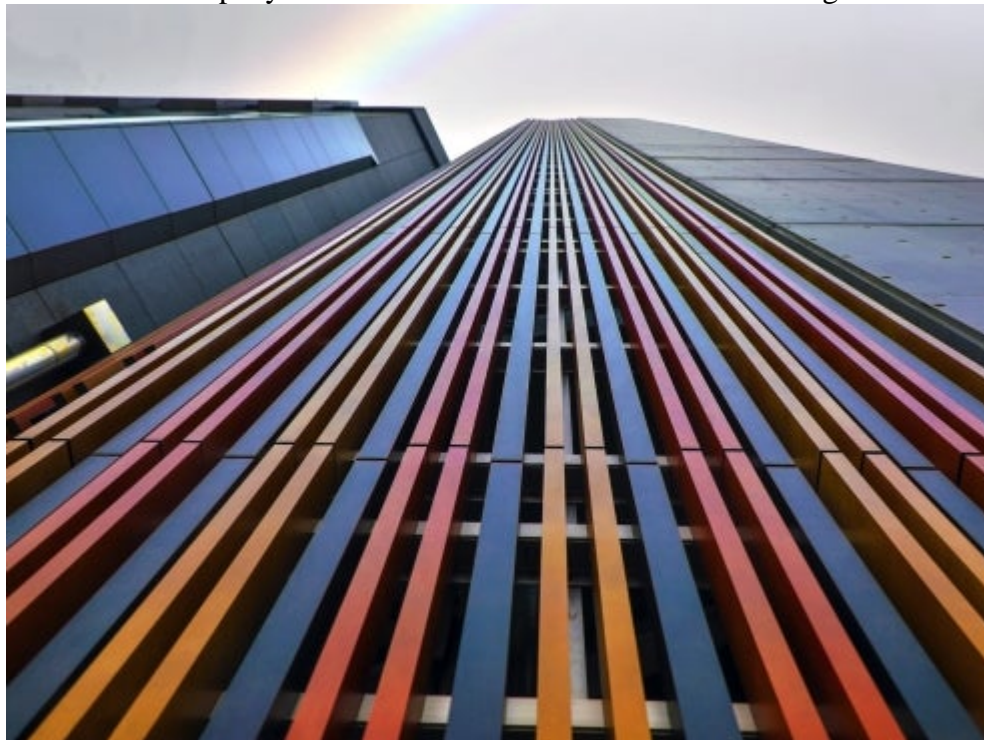


Updates

March 17, 2023

Investment Company Status Considerations for Cash Positioning in Wake of Bank Failures



Given this week's headlines, many emerging companies may be asking themselves: ***"Why am I holding so much cash?"***

The Investment Company Act of 1940 (the 1940 Act) may be to blame.

"But I don't have any intention of being an investment company. Aren't those mutual funds or hedge funds? I'm an operating company that produces goods or provides services."

The 1940 Act can apply to all companies, not just those with investment-related businesses. The term "[investment company](#)" under the 1940 Act has two primary meanings:

1. A company that is or holds itself out as primarily engaged in the business of investing or trading in securities, which describes many investment funds; or
2. A company whose total assets (exclusive of government securities and cash items) comprise at least 40% "[investment securities](#)" (which is more broadly defined under the 1940 Act than "securities" are defined under the Securities Act of 1933).

In other words, even if it doesn't consider itself as an investment-related business, an operating company that has 40% or more of its assets invested in stocks, bonds, or other securities (even conservative corporate bonds held for cash preservation purposes) is an "investment company" and is subject to the registration and other requirements of the 1940 Act unless it meets a conditional exemption under Section 3 of the 1940 Act or another relevant provision or rule under the 1940 Act. Intent is not an element of the second primary meaning of "investment company," and even a company that produces goods and services could inadvertently meet the definition simply by having a balance sheet comprising too high a percentage of "investment securities" in relation to its total assets (exclusive of government securities and cash items).

Importantly, along with government securities (as defined), federally regulated money market funds and "cash items," such as cash and bank deposits, are typically (but not always) removed from both the "investment securities" numerator and the total assets denominator when calculating the 40% test described above or similar tests under exemptive provisions. Holding corporate assets in cash as opposed to "investment securities" helps a company avoid investment company status if an exemption is not available. Even holding cash can complicate things, though, since excluding a large cash position from the 40% test can cause a company's "investment security" holdings to disproportionately affect the results of that calculation.

Many start-up companies find themselves in the position of holding proceeds from fundraising but with relatively few other offsetting assets. Seeking to avoid becoming an inadvertent investment company, they may choose to hold the proceeds in cash items or government securities. [Rule 3a-8](#) excludes certain research and development companies (and some other start-up companies) from the definition of an investment company if certain conditions are met, but many companies are not able to meet the conditions. This means that startups may be at particular risk from instability in the banking system as they may be limited in their choices to invest their fundraising proceeds.

"What should I do if I am worried about holding cash but want to avoid an investment company status issue?"

Even if a regulator does not approach a company, many significant deals require representation or even an outside legal opinion as to the company's status under the 1940 Act. Significant securities holdings could delay a deal or even require restructuring the business. So, while moving liquid holdings from bank accounts to securities or other assets may be tempting, in light of recent bank developments, careful planning can help prevent inadvertently jumping from the frying pan into the fire.

Contact a securities lawyer knowledgeable on investment company status issues with any questions or inquiries.

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