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Presto! Now It's an Investment Company, Now It's Not:
SEC v. National Presto Industries, Inc.

I. Summary

The unique set of facts which gave rise to *SEC v. National Presto Industries, Inc.*[1] provide an equally unique instance of the rendering of two completely opposite judicial applications of the law to those same set of facts. As discussed in this memorandum, a Federal District Court granted summary judgment to the Securities and Exchange Commission ("SEC") finding that National Presto Industries, Inc. ("Presto" or the "Company") was an investment company as defined in the Investment Company Act of 1940, as amended (the "Act"). The District Court's finding resulted from its application of the five factor analysis first set forth in 1947 in the *Tonopah* case.[2] Looking at the same facts and applying the same five factor analysis, the Seventh Circuit Court of Appeals reversed the District Court's finding and held that Presto was not an investment company as defined in the Act. Notwithstanding the *sui generis* nature of the case, it is instructive insofar as it provides an updated look at how at least one appellate court approaches a well established analytic approach that is frequently used by practitioners advising on a threshold question under the Act -- what is and what is not an "investment company."

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1 *SEC v. National Presto Industries, Inc.* (7th Cir. May 15, 2007), rev'g, *SEC v. National Presto Industries, Inc.*, Case No. 02 C 5057 (N.D. Ill October 31, 2005). Attached are copies of the opinion of the District Court (the "District Court Opinion") and the opinion of the Court of Appeals (the "Slip Opinion") at the end of this memorandum.

2 *In the Matter of The Tonopah Mining Company of Nevada* (File No. 812-241), 26 S.E.C. 426 (July 21, 1947).

II. Discussion

Background -- a Brief History of Presto[3]

Historical Development of Presto

Organized in 1905 as Northwestern Steel and Iron Works, Presto initially manufactured industrial sized pressure canners. The Company moved into the commercial pressure canner market in the early 1920s with a small canner for farms and ultimately invented the first pressure cooker for the urban market. The Company temporarily ceased producing pressure cookers during World War II to devote itself to the support of the war effort through the production of artillery and rocket fuzes. Thereafter, it became a stated goal of the Company to maintain a defense-related business to enable it to survive during times of war when, due to governmentally imposed "set asides," material for commercial production might not be available. The Company continues as a defense producer through to the present day with the U.S. Army being one of its major customers.

After World War II, the Company resumed the manufacture of pressure cookers, ultimately diversifying into portable electric appliances. It expanded its commercial production facilities both horizontally (with more plants) and vertically (with tool and die, printing, door to door sales and truck leasing companies) to locations both in and outside of Wisconsin. In 1953, it changed its name to National Presto Industries, Inc., after its famous Presto© Pressure Cooker. Over the next five decades, the Company introduced many new and significant products.

The vertical businesses, all of which were small, were sold in the late 1970s and early 1980s in recognition of the fact that the time and effort spent managing the small subsidiaries could be put to better use in managing business segments of substantial size. The Company focused considerable time, effort, and energy on locating acquisition candidates that ideally would be (1) contra-seasonal, (2) of substantial size, and (3) in a different industry. Internally generated funds, both from past profitability and the disposition of the vertical businesses, were maintained for the purposes of making such acquisitions. To ensure safety and liquidity, a majority of the funds were placed in cash-like instruments (categorized as cash equivalents on the Company's balance sheet) and most of the balance in short-term high-rated municipal bonds, many of which were pre-refunded with U.S. government bonds. It was following these transactions that investment securities came to exceed more than 40 percent of Presto's total assets (a critical threshold under the Act as discussed below), although Presto did not believe that to be the case at the time.

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[3] The following background is for the most part taken from Presto's application to deregister as an investment company, discussed below in the text accompanying note 12. It follows the *Tonopah* five factor analysis.

Dozens of businesses were explored as acquisition candidates and intensive due diligence was completed before final offers were made. In many instances, the Company was outbid; in others, the information secured during due diligence dictated a decision not to proceed. The Company ultimately selected the absorbent products industry as a prime target for Company acquisitions. In November 2001, the Company purchased the assets of RMED, a company that manufactured baby diapers. In October 2003, the Company acquired the assets of NCN Hygienic Products, Inc., a Georgia-based manufacturer of absorbent products for the adult incontinence market and puppy training pads, and renamed it Presto Absorbent Products — Atlanta. Major capital expenditures were made to purchase state-of-the-art equipment to expand the Company's absorbent products business ($31.5 million had been authorized as of December 31, 2004). With each new machine costing several million dollars, sizable amounts of capital are required for this business. During 2004, revenues from the Company's absorbent product segment totaled $28.2 million.

In 2001, the Company recognized that it could no longer competitively manufacture small appliances and pressure cookers in the United States due to cost and pricing pressures. It set up a sizable reserve to pay for the costs associated with closing down its manufacturing facilities in Alamogordo, New Mexico and Jackson, Mississippi, and moving production overseas. As a result of that reserve, 2001 was the only year in its long history in which the Company incurred an operating loss. By the end of 2002, the Company had shifted all significant manufacturing operations in its household appliance business to independent contractors in Asia.

At present, Company employees formerly responsible for both manufacturing small appliances and purchasing materials and component parts for manufacturing such appliances are responsible for purchasing finished products for the Company. The Eau Claire, Wisconsin staff performs the Company's engineering and product design functions. The Company purchases all tooling used to manufacture its products. Members of the Company's purchasing and engineering departments in Eau Claire, who closely supervise the manufacturing process, are in daily contact with vendors in Asia to oversee this process, and make numerous in-person visits annually. Once the products are manufactured and leave Asia, they are shipped to a variety of Company distribution centers, warehouses, and shipping facilities in the United States and Canada. Products are inspected to assure quality before shipment to retailers. The Company's national sales force is responsible for its relationships with retailers, and the Company supports retail sales with substantial national and cooperative advertising expenditures. During 2004, the Company's household appliance segment generated $106 million in sales. Further, the Company has actively pursued litigation, all of which has been successful, to protect and preserve the trademarks and patents associated with its products.

Public Representations

The Company has always held itself out as an operating company.

Activities of Officers and Directors

The activities of the officers and the members of the Company's Board are almost entirely devoted to the three core businesses. The Company's Board has adopted a clear and un-

ambiguous investment policy that mandates the preservation and liquidity of capital as opposed to total return or maximization of interest income. Consequently, little time is spent on investment related matters at meetings of the Board. Presto asserted that the Board spends the vast majority of its time reviewing the Company's consumer appliance, defense, and absorbent products operations, considering management's views regarding those business operations, discussing potential acquisitions, and analyzing other potentially significant issues (such as raw material costs, warehouse expansion, sales forecasts and planning reports, gross margin analysis, product advertising programs, and new product ideas). Little time is spent on investment-related matters; on average, only ten to fifteen minutes of every eight-hour Board meeting are spent discussing the Company's investments.

Just four of the Company's employees devote any time to the Company's investments. The Company's Vice President, Treasurer and CFO spends less than 3 percent of his time on the management and oversight of the Company's securities portfolios. The President and Chief Executive Officer devotes less than 1 percent of her time to such activities. None of the Company's other officers (Vice Presidents of Sales, Engineering, Purchasing, and Senior Vice President) have any involvement in investment activities and all of their time is devoted to operating matters. Only two Company employees are involved in investment activities on a day-to-day basis, but both only partially so: (i) the Company's cash and risk manager spends about 15 percent of his typical day tending to the Company's investment activities; and (ii) a clerk who works for the cash and risk manager performs limited cash management functions.

Nature of Assets[4]

National Presto had $301 million in total assets in 2003, $305 million in total assets in 2004 and $315 million in total assets in 2005. In each of those years it sold securities for proceeds of $40.7 million, $40.9 million and $54.4 million. It appears that the proceeds of these sales were invested in cash items or in properties for use in the Company's business.

Since 2003, the Company also has spent a significant amount of money on capital improvements and acquisitions and, thereby, has dedicated even more of its assets to its operating businesses. As a result of capital improvements, acquisitions, and new contracts, the fair value of the Company's assets has also increased significantly in value since 2003.

The Board of Directors determined the fair value of the Company's assets as of July 13, 2005, October 2, 2005 and December 31, 2005. To calculate the Company's fair value on an unconsolidated basis, the Company's Board of Directors used conservative multiples of projected earnings before interest, taxes, depreciation and amortization to determine the fair value of each of its operating divisions.

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4 The financial information which follows derives from Presto's filing to deregister in March 2006. In that filing, Presto redacted certain information about the value of its assets which explains the absence of such information in the following summary. It is not known whether the SEC staff will ultimately permit those numbers to be redacted from the public record on this matter.

Sources of Income

Most of the Company's present income is derived from its operating assets, not its "investment securities." Over four fiscal quarters combined (ended October 2, 2005), only 23 percent of the Company's total consolidated net income was derived from "Other income, principally interest," which includes all income derived from "investment securities," as well as earnings from miscellaneous non-investment sources like rentals and royalties. Further, compared to operating income, the Company's investment security income was below 10% for an extended period of time.

The Litigation

In July 2002, the SEC filed a lawsuit in the Federal District Court in Chicago, Illinois, against Presto alleging that the Company operated as an unregistered investment company from 1994 through 2002. The SEC alleged that during the relevant period, investment securities comprised 69 percent to 93 percent of the total assets of the Company — well over the 40 percent threshold for companies coming within the definition of "investment company" in the Act.[5] The SEC complaint did not allege fraud, deceptive practices or questionable accounting methods.

In October 2005, the District Court granted the SEC's motion for summary judgment and ordered the Company to register under the Act. The Court rejected the Company's arguments that Variable Rate Demand Notes ("VRDNs") and Pre-refunded Municipal Bonds were cash items and found that they were "investment securities" for purposes the 40 percent test.[6] Since investment securities owned by Presto far exceeded 40 percent of the Company's total assets, it fell within one of the definitions of "investment company" in the Act.

The Company argued that it should not be deemed to be an investment company notwithstanding the composition of its assets. The Company's argument was based on Section 3(b)(1) of the Act which provides that

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5 Under the Act, an issuer that owns "investment securities" having a value in excess of 40 percent of its total assets (exclusive of Government securities and cash items) is an "investment company" unless some other provision of the Act exempts it from that definition. The term Government security, as defined in the Act, is a security issued or guaranteed as to principal and interest by the United States or a person controlled or supervised by and acting as an instrumentality of the United States. The term "cash items" is not defined in the Act. *See* Section 3(a)(1)(C) and Section 2(a)(16) of the Act.

6 The District Court's opinion is instructive on a technical level because it is not uncommon for corporate treasurers to view these types of instruments as cash items because, in the case of the VRDNs they can be put or remarketed at par whenever rates reset; and in the case of Pre-refunded Municipal Bonds, because they are pre-refunded with U.S. government bonds. The Court's conclusions about these instruments (which it did not have to strain the statute to reach) is a current reminder of the breadth to be accorded the term "investment securities" when doing a balance sheet analysis for purposes of the Act, and conversely, how narrowly the term "cash items" is interpreted for such purpose.

"none of the following persons is an investment company within the meaning of this title:

"(1) Any issuer *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. * * *" [emphasis added]

Following long standing precedent for analyzing the phrase "primarily engaged," the District Court applied the so-called five factor analysis that derives from the case of Tonopah Mining Company.[7] In that case, the SEC stated that for purposes of determining an issuer's primary business the following factors should be considered:

i. the issuer's historical development;
ii. the issuer's representations of its policy;
iii. the activities of the issuer's officers and directors;
iv. the nature of the issuer's present assets; and
v. the sources of the issuer's present income.[8]

Taking its cue from language in *Tonopah* "that the nature of the company's assets and the sources of its income are the most important of the five factors,"[9] the District Court briefly noted the other three *Tonopah* factors. The District Court noted that over time, the Company changed from a company "primarily engaged in manufacturing to a company primarily engaged in the business of investing in securities."[10] The District Court noted that the Company's SEC filings disclosed the closing of its manufacturing facilities and that it purchased securities with its excess cash. Finally, the District Court noted that Company treasurer purchased securities for the Company under the supervision of the Company Chairman Emeritus and the Company's CEO. Because more than 40 percent of the Company's assets were "investment securities" and because no other safe harbors or exemptions were available to the Company, the District Court granted summary judgment to the SEC holding that the Company was an investment company within the meaning of the Act.

Subsequent to the District Court's ruling, an injunction was entered requiring the Company to register as an investment company. In December 2005, the Company did register, noting

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7 *Supra* at note 2.

8 *Id.* at 427.

9 District Court Opinion at 13 citing 26 S.E.C. at 430-432. The full quote from *Tonopah* is:

"More important, however, as appears below, the nature of the assets and income of the company, disclosed in the annual reports filed with the Commission and in reports sent to stockholders, was such as to lead investors to believe that the principal activity of the company was trading and investing in securities."

This language played a pivotal role in the Court of Appeals' analysis as discussed below.

10 *Id.* at 14.

when it did so that it was only registering to comply with the terms of the injunction.[11] In March 2006, the Company filed an application to deregister arguing that under the five factor *Tonopah* analysis, it should not be deemed an investment company.[12] Deregistration requires action on the part of the SEC. To date, the SEC has not taken any action on the Company's application.

In addition to making the SEC filings noted, the Company appealed the District Court decision to the United States Circuit Court of Appeals for the Seventh Circuit. On May 15, 2007, the Court of Appeals, in a scathing opinion which included strong criticism of both the District Court and the SEC attorney who argued the case, reversed the judgment of the District Court.[13]

The Court of Appeals opinion applied the five factor *Tonopah* analysis with quite a different result from the District Court. The Court's decision is significant because it rejects the proposition generally asserted by the SEC and noted in the District Court opinion that the composition of an issuer's assets and the sources of its income are more significant factors than the other three elements of the *Tonopah* analysis. The Court of Appeals analysis gave full weight to the other *Tonopah* factors and concluded that the history, operations and investor information consistently published by Presto all convincingly presented the company as an operating company over its more than 100-year corporate life, including a period when more that 40 percent of its balance sheet assets were investment securities.

In its opinion, the Court rebuked the SEC counsel who argued that the 40 percent test was essentially the only *Tonopah* factor that should be considered. The Court noted that doing so would cut off analysis of other factors which should properly be taken into account in determining whether a company need not be subject to regulation under the Act notwithstanding the fact that the company may have exceeded the 40 percent asset threshold. Noting that the SEC had never issued an opinion or rule to that effect, the Court observed that the SEC could not change the ground rules for analysis "by filing briefs." The Court forcefully noted "what principally matters is the beliefs the company is likely to induce in investors."[14] Upon conclusion of its excoriation of the SEC and an analysis of all the *Tonopah* factors, the Court found that Presto was not an investment company, ordered that Presto could drop its registration under the Act and operate under the Securities and Exchange Act of 1934 "whether or not" the SEC gives its formal

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11 Form N-8A of National Presto Industries, Inc. dated December 23, 2005 available at http://www.sec.gov/Archives/edgar/data/80172/000089710106000617/presto061239_n-8a.htm

12 Application pursuant to Section 8(f) of the Investment Company Act of 1940, as amended, for an order declaring that National Presto Industries, Inc., has ceased to be an investment company, available at http://www.sec.gov/Archives/edgar/data/80172/000089710106000651/0000897101-06-000651-index.htm

13 The Court of Appeals did agree with the District Court's conclusions that VRDNs and Pre-refunded Municipal Bonds were "investment securities" for purposes of the Act.

14 Slip Opinion at 16 and note 9, *supra*.

approval to Presto's application to deregister.[15] At this point, it is not known what action, if any, the SEC will take or whether it will appeal the Seventh Circuit's judgment.

Impact on the Company

Throughout the litigation, the Company continued to operate. However, it encountered a variety of compliance issues as a result of the litigation. The Company's prior auditor, Grant Thornton, resigned because the SEC questioned its certification of the Company's financials as an operating company, not as an investment company. Grant Thornton, therefore refused to permit the Company to use the financials it had certified in further filings under the Exchange Act and thus the Company has been unable to file required periodic reports. The Company hired another auditor, but that triggered the expense of re-auditing prior years. In addition, the Company was threatened with the delisting of its securities although it has succeeded in maintaining its New York Stock Exchange listing.[16]

Throughout the period of the litigation, the Company continued to do business. In fact, its business seems to be doing well and the U.S. Army continues to be one of its more significant customers. The Company's business success has been reflected in its stock price which has stayed at consistently high levels.

III. **Observations**

The Company observed in its 2006 proxy statement[17] that given the issues it faced under the Act, "the Company is operating under a cloud of uncertainty." However, the mere fact of registration under the Act and the SEC's lawsuit against the Company apparently had little noticeable effect on Presto's business. This may have been more a matter of luck on the part of Presto than any well thought out strategy. The Company happened to be in a clearly non-investment company business or businesses for more than 100 years. When it came into a large sum of cash from the sale of some of those businesses, it invested conservatively. As a result, it maintained sufficient liquid resources to conduct its business and make acquisitions of related businesses without the need for third party financing — and hence was not required to make representations as to its regulatory status and legal compliance to funding sources and their counsel. Presto did not appear to engage in transactions with affiliates which would have been prohibited once it was registered under the Act. In short, the particular circumstances of Presto were such that the Act had little noticeable practical effect on its operations. Lastly, throughout the years

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15 By the time the matter was decided by the Court of Appeals, Presto's application to deregister had been pending at the SEC for more than a year without any action. Hence the deregistration order and comment by the Court.

16 Even though Presto has been unable to file Exchange Act periodic reports, it has kept the investing public apprised of its financial results by issuing press releases containing capsule results and filing those press releases as exhibits to Form 8-Ks.

17 Available at http://www.sec.gov/Archives/edgar/data/80172/000089710106000689/nat061380_def14a.htm

under scrutiny, Presto's public disclosures have been clear and it has never been accused of engaging in any fraudulent or deceptive practices.

Suffice it to say, the *National Presto* case is *sui generis*. Generally, one would not advise another issuer to choose to navigate the issues Presto faced in a similar manner. Further, the experience of Presto should not be taken as illustrative of the operational market experience other types of companies might have or the approach an issuer should take *vis a vis* the SEC in the event of similar circumstances. Issuers which do not have long and continuing operating histories as companies clearly not in the business of investing in securities and companies that rely on outside financing sources for capital might be considerably less successful in surviving the regulatory assault to which Presto was subject.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com.

Court of Appeals Opinion

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District Court Opinion

National Presto Opinion

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,	)	Case No. 02 C 5027
Plaintiff,	)	Honorable Charles R. Norgle
v.	)	
NATIONAL PRESTO INDUSTRIES, INC.,	)	
Defendant.	)	

OPINION AND ORDER

CHARLES R. NORGLE, District Judge

Plaintiff United States Securities and Exchange Commission ("SEC," or the "Commission") and Defendant National Presto Industries, Inc. ("Presto") have filed cross Motions for Summary Judgment. For the following reasons, the SEC's Motion is granted, and Presto's Motion is denied.

I. INTRODUCTION[1]

A. Facts

Presto is a publicly traded company based in Eau Claire, Wisconsin. During the time period relevant to this case (1994-2003), Presto's common stock has been registered with the SEC, and traded on the New York Stock Exchange. The SEC is the federal agency responsible for enforcing federal securities laws, including the Investment Company Act (15 U.S.C. § 80a-1 et seq.).

[1] The facts are taken from the parties Local Rule 56.1 Statements, and Presto's website. Disputed facts are noted within the text. Details regarding certain types of securities are taken from the websites of various financial institutions.

Presto was founded in 1905 as Northwestern Steel and Iron Works, and initially manufactured pressure canners for commercial canneries, hotel use, and home canning. By 1917, Presto had expanded its manufacturing business to include cast aluminum cooking utensils. In 1939, Presto began to manufacture pressure cookers and other small household appliances. During World War II, Presto converted its production facilities so that it could produce war materials for the United States military. Following the War, Presto resumed production of its line of household appliances. In 1969, Presto was admitted to the New York Stock Exchange.

In the late 1970's, and the early 1980's, Presto had accumulated cash through the sale of a number of its subsidiaries. Presto then used this cash to purchase and hold securities. Presto did not distribute this cash to shareholders as dividends, reinvest in its manufacturing business, or acquire other operating businesses. In approximately 1979, Presto created the National Holding Investment Company ("Holding") as a subsidiary. Holding then proceeded to invest cash Presto held in excess of its operating needs. Holding receives its funding mostly from the sale of Presto subsidiaries, and the reinvestment of these funds. Holding is thus the investment arm of Presto.

The manufacturing and sales portion of Presto's business has steadily decreased since 1979. At the end of 1979, Presto had a sales force of approximately sixty employees, and over 1,300 total employees. By the end of 1994, Presto had a sales force of nineteen, and 674 total employees. In 2002, Presto closed its manufacturing facilities in Mississippi and Texas, and discontinued manufacturing small household appliances. At the conclusion of 2004, Presto had a sales force of nine, and only 551 total employees.

Presto presently holds assets in the form of cash, accounts receivable, inventory, property, equipment, and securities. Presto's securities portfolio consists mostly of Variable Rate Demand

Notes ("VRDNs") and Pre-refunded Municipal Bonds ("PRMBs").

> A Variable Rate Demand Note (VRDN), also called a "low-floater" or "seven day floater," is a long term, taxable, or tax-exempt bond issued on a variable rate basis that can be tendered for purchase at par whenever rates reset upon seven-day notice by the investor. The bonds tendered are then resold by the remarketing agent in the secondary market to other investors. VRDNs can be converted to a long term fixed rate security upon appropriate notice by the issuer. . . Bond maturity is up to 15 years.

Http://www.wachovia.com/corp_inst/page/printer/0,,7_26_252_932,00.html. VRDNs are typically "issued by a municipality or public agenc[y] or [other] authorit[y]," and have "[e]xcellent after tax yields," and "[h]igh credit quality." Http://corp.bankofamerica.com/public/products/investsolutions/taxadvantaged.jsp.

> Similar to the refinancing of a home mortgage, pre-refunded municipal bonds are created when municipalities borrow money at lower interest rates to refinance municipal bonds issued when interest rates were higher. Unlike home mortgages, however, the original municipal bond issue remains in existence according to the terms of its original issuance. Once the refinancing is completed, the municipality uses the proceeds to buy a portfolio of U.S. Treasury securities; the interest and principal of which are used to retire the original issue to its call or maturity date.

Http://www.morganstanleyindividual.com/markets/bondcenter/school/prere.pdf. "Pre-refunded municipal bonds are among the highest quality municipal bonds available." Id.

The SEC has examined Presto's and Holding's financial records for the years 1994-2003, in attempting to determine whether Presto must register with the Commission as an investment company. The SEC has examined, *inter alia*, Presto's consolidated financial statements, Presto's and Holding's details and summary of investments (F1-A Reports), Presto's and Holding's common stock holdings, and Presto's Annual Reports and Forms 10-K. The SEC's analysis of these records showed that the percentages of Presto's total assets represented by investment securities, exclusive of Government Securities and cash items on an unconsolidated basis, were

as follows: 86.30% (1994), 86.04% (1995), 90.58% (1996), 89.16% (1997), 92.21% (1998), 80.97% (1999), 74.18% (2000), 63.37% (2001), 61.75% (2002), and 62.23% (2003). The percentages of Holding's total assets represented by investment securities, exclusive of Government Securities and cash items on an unconsolidated basis, were as follows: 81.85% (1994), 80.09% (1995), 77.71% (1996), 77.74% (1997), 77.62% (1998), 76.99% (1999), 74.08% (2000), 70.35% (2001), 69.86% (2002), and 67.96% (2003).

B. Procedural History

The SEC filed its First Amended Complaint in the Northern District of Illinois on July 26, 2002. The Commission alleges that since at least 1994, Presto has been operating as an unregistered investment company in violation of Section 7(a) of the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.) (the "Act"). The SEC seeks a court Order requiring Presto to either register with the SEC as an investment company, restructure its securities holdings so as to come into compliance with the Act, or take any such other steps as may be required to come into compliance with the Act. The SEC also seeks a Permanent Injunction enjoining Presto from selling or purchasing any securities, controlling any investment company which does these things, or otherwise violating the Act.

On August 22, 2005, the SEC and Presto filed cross Motions for Summary Judgment. These Motions are fully briefed and before the court.

II. DISCUSSION

A. Standard for Summary Judgment

Summary judgment is permissible when "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." FED. R. CIV. P. 56(c). The

nonmoving party cannot rest on the pleadings alone, but must identify specific facts, see Cornfield v. Consolidated High Sch. Dist. No. 230, 991 F.2d 1316, 1320 (7th Cir. 1993), that raise more than a mere scintilla of evidence to show a genuine triable issue of material fact. See Murphy v. ITT Technical Services, Inc., 176 F.3d 934, 936 (7th Cir. 1999).

In deciding a motion for summary judgment, the court can only consider evidence that would be admissible at trial under the Federal Rules of Evidence. See Bombard v. Fort Wayne Newspapers, Inc., 92 F.3d 560, 562 (7th Cir. 1996). The court views the record and all reasonable inferences drawn therefrom in the light most favorable to the non-moving party. FED. R. CIV. P. 56(c); see also Perdomo v. Browner, 67 F.3d 140, 144 (7th Cir. 1995). "In the light most favorable" simply means that summary judgment is not appropriate if the court must make "a choice of inferences." See United States v. Diebold, Inc., 369 U.S. 654, 655 (1962); see also First Nat'l Bank of Ariz. v. Cities Service Co., 391 U.S. 253, 280 (1968); Wolf v. Buss (America) Inc., 77 F.3d 914, 922 (7th Cir. 1996). The choice between reasonable inferences from facts is a jury function. See Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255 (1986).

When a party moves for summary judgment, the court must view the record and all inferences in a light most favorable to the non-moving party. Ameritech Benefit Plan Comm. v. Communication Workers of Am., 220 F.3d 814, 821 (7th Cir. 2000). However, the inferences construed in the non-moving party's favor must be drawn from specific facts identified in the record that support that party's position. Waldridge v. Am. Hoechst Corp., 24 F.3d 918, 922-23 (7th Cir. 1994). Under this standard, "[c]onclusory allegations alone cannot defeat a motion for summary judgment." Thomas v. Christ Hospital and Medical Center, 328 F.3d, 890, 892-93 (7th Cir. 2003)(citing Lujan v. Nat'l Wildlife Federation, 497 U.S. 871, 888-89 (1990)).

B. The Statutory Definition of an Investment Company

1. A Brief Legislative History of the Investment Company Act

In 1935, Congress requested that the SEC undertake a study of investment trusts and investment companies to determine whether "federal oversight of these investment media" was needed, and what the "regulatory parameters for [such] legislation" might be. Sydney H. Mendelsohn, et al., *Status Seeking: Resolving the Status of Inadvertent Investment Companies*, 38 BUS. LAW 193, 196-97 (1982). In response to this request, the SEC submitted a five part report (with six supplemental reports) to Congress. Id. The Senate also held four weeks of hearings on investment company legislation. Thomas P. Lemke, et al., REGULATION OF INVESTMENT COMPANIES § 2.04 (Release 18, Sept. 2005). The Investment Company Act was signed into law on August 22, 1940. Id.

The Act is broadly intended to minimize conflicts of interest that can arise in complex securities investment operations. Http://www.sec.gov/about/laws.shtml. The Act requires, *inter alia*, that companies primarily engaged in securities investments (i.e. investment companies) disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis. Id. The Act also indicates that these companies may not engage in the purchasing or selling of securities unless they register as an investment company with the SEC. 15 U.S.C. § 80a-7(a); 15 U.S.C. § 80a-8.

2. The Orthodox Investment Company

Section 3(a)(1)(A) of the Act (15 U.S.C. § 80a-3(a)(1)(A)) defines what some commentators have called "orthodox" or "typical" investment companies. See Lemke, supra, at § 3.01-02. An "orthodox" investment company is defined as "any issuer which is or holds itself

out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 80a-3(a)(1)(A).

> This definition generally applies to traditional investment companies, i.e. companies engaged in the business of issuing securities and obtaining capital with the express purpose of purchasing securities - usually stocks and bonds - on behalf of their shareholders. To come within this definition, a company must be an "issuer," i.e., it must issue or propose to issue a security or have outstanding any security which it has issued.

Lemke, supra, at § 3.02.

In contrast to the inadvertent investment company, see Part II.B.3. below, the question of an orthodox investment company's primary business engagement is usually not complicated. Companies whose everyday business is "active portfolio management," and which have "no business other than acquiring and holding securities and actively promote [themselves] as [] *investment* vehicle[s]" fall under the rubric of § 80a-3(a)(1)(A). Id.

3. The Inadvertent Investment Company

Section 3(a)(1)(C) of the Act (15 U.S.C. § 80a-3(a)(1)(C)) defines what are sometimes called "inadvertent investment companies." Id. at § 3.03. An "inadvertent investment company" is defined as

> any issuer which 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 percentum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a)(1)(C).

By definition, no company intentionally sets out to become an inadvertent investment company. Events, however, may unfold so as to change an operating company into an

investment company without the intent of company management.

> The typical inadvertent investment company's problems begin when some or all of its operating properties are sold and the company cannot, or does not wish to invest the proceeds in its own business or a new operating business. For one reason or another . . . management does not want to distribute the money to security holders. It invests the surplus funds in securities. If the securities come to represent a substantial portion of the company's assets, the company may be required to register under the act.

Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STAN. L. REV. 29, 29 (1959-60).

To be an inadvertent investment company within the meaning of § 3(a)(1)(C), a company must satisfy two elements. "First, a company must be an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities." Lemke, supra, at § 3.03. The statutory language indicates that companies with both active and inactive portfolios satisfy this element. Id.; In the Matter of the Atlantic Coast Line Co., 11 S.E.C. 661, 667-668 (1942); Kerr, supra, at 34. "Second, the company must own or propose to acquire 'investment securities' with a value exceeding 40% of its total assets on an *unconsolidated* basis." Lemke, supra, § 3.03. The requirement that a company's assets be calculated on an unconsolidated basis means that the assets of majority owned subsidiaries are not to be considered an asset of the parent company. The following types of securities are excluded from the statutory definition of "investment securities": government securities, securities of employees' securities companies, and securities of non-investment company majority-owned subsidiaries. 15 U.S.C. § 80a-3(a)(2); see also Lemke, supra, § 3.03. Government securities and cash items are excluded from total assets. 15 U.S.C. § 80a-3(a)(1)(C). The key to the second element of § 3(a)(1)(C), however, is the 40% test. If over 40%

of an issuer's assets are investment securities, that issuer is an investment company (certain statutory exceptions to this general rule apply - see Part II.B.4.).

Companies generally will take steps to avoid becoming an inadvertent investment company, as these companies must register with the SEC, and comply with SEC regulations. Such companies must then "conform[] to a statute that demands strict adherence to structural and transactional limitations often not conducive to the efficient operations of a noninvestment company business, or risking a [SEC] enforcement action, as well as the invalidity of any contracts contravening the Act's pervasive regulatory scheme." Mendelsohn, supra, at 195; see also Kerrr, supra, at 30 (outlining some of the rules and regulations investment companies become subject to upon registration with the SEC).

4. Statutory Exceptions to the Inadvertent Investment Company Rule

Congress provided several statutory exemptions from Rule 3(a)(1)(C). 15 U.S.C. § 80a-3(b)(1) provides: "none of the following persons is an investment company within the meaning of this title: any issuer 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." 15 U.S.C. § 80a-3(b)(2) provides that "none of the following persons is an investment company within the meaning of this title: any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses."

Companies that fall under the statutory definition of an inadvertent investment company,

but who are "primarily engaged" in something other than the investment business, are thus not investment companies. The following five factor test is commonly used to determine a company's primary engagement: the company's historical development, its public representations of policy, the investment activities of its officers and directors, the nature of its assets, and the sources of its income. In the Matter of the Tonopah Mining Co., 26 S.E.C. 426 (1947); see also Lemke, supra, at § 3.05.

In addition, Rule 3a-1 of the Act provides that a company that meets the statutory definition of an investment company, but has no more than 45% of its assets in securities, and receives no more than 45% of its income from investments, is not an investment company. 17 C.F.R. § 270.3a-1; see also Lemke, supra, at § 3.06 (noting that this exception provides a "safe harbor" for companies that might otherwise be forced to register with the SEC).

C. National Presto is an Inadvertent Investment Company

1. Presto fails the 40% test

By statute, an issuer is an investment company if it is in the business of, *inter alia*, investing, holding, or trading in securities, and the value of the securities it holds exceeds 40% of its total assets. 15 U.S.C. § 80a-3(a)(1)(C). The essential issue before the court is therefore whether the value of Presto's securities exceeds 40% of its total assets. Presto contends, however, that the majority of the securities it owns (VRDNs and PRMBs) do not meet the statutory definition of a "security," and should therefore be excluded from these calculations. Before reaching the essential issue in this case, the court must therefore determine whether the securities in question are in fact "securities" as defined by the Act.

The Act defines a "security" as, *inter alia*, "any note, stock, treasury stock, security

future, [or] bond . . . ." 15 U.S.C. § 80a-2(a)(36). "Investment securities" are defined as "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 in paragraph (1) or (7) of subsection (c)." 15 U.S.C. § 80a-3(a)(2).

VRDNs are long-term bonds that can take as long as fifteen years to mature. Presto asserts that because these bonds may be tendered for purchase at par whenever rates reset, they are liquid, or "cash-like," and are therefore not true "securities." However, VRDNs are clearly "bonds" under 15 U.S.C. § 80a-2(a)(36). In addition, VRDNs meet none of the statutory exceptions promulgated in § 80a-3(a)(2). VRDNs are therefore securities within the meaning of the Act.

PRMBs are municipal bonds. Although these bonds are issued by municipalities, they are neither issued by nor guaranteed as to principal by the United States government, a person acting as an instrumentality of the United States government, or a certificate of deposit for the United States government. <u>See</u> 15 U.S.C. § 80a-2(a)(16). PRMBs are thus not government securities, nor do they meet any of the other statutory exceptions outlined in 15 U.S.C. § 80a-3(a)(2). PRMBs are therefore also securities within the meaning of the Act. VRDNs and PRMBs must therefore be included in determining whether the value of Presto's securities exceeds 40% of its total assets.

Taking into account Presto's VRDNs and PRMBs, investment securities as a percentage of Presto's total assets, exclusive of government securities and cash items on an unconsolidated basis, <u>see</u> 15 U.S.C. § 80a-3(a)(1)(C), are as follows: 86.30% (1994), 86.04% (1995), 90.58%

(1996), 89.16% (1997), 92.21% (1998), 80.97% (1999), 74.18% (2000), 63.37% (2001), 61.75% (2002), 62.23% (2003). Investment securities as a percentage of Holding's total assets, exclusive of government securities and cash items on an unconsolidated basis, see 15 U.S.C. § 80a-3(a)(1)(C), are as follows: 81.85% (1994), 80.09% (1995), 77.71% (1996), 77.74% (1997), 77.62% (1998), 76.99% (1999), 74.08% (2000), 70.35% (2001), 69.86% (2002), 67.96%(2003). Investment securities as a percentage of Presto's total assets as adjusted for fair market value, exclusive of government securities and cash items on an unconsolidated basis, see 15 U.S.C. § 80a-3(a)(1)(C), are as follows: 85.84% (1994), 84.82% (1995), 89.71% (1996), 89.05% (1997), 92.74% (1998), 80.28% (1999), 72.07% (2000), 58.80% (2001), 58.07% (2002), 62.25% (2003). Investment securities as a percentage of Holding's total assets as adjusted for fair market value, exclusive of government securities and cash items on an unconsolidated basis, see 15 U.S.C. § 80a-3(a)(1)(C), are as follows: 85.08% (1994), 88.46% (1995), 87.03% (1996), 78.77% (1997), 71.36% (1998), 80.14% (1999), 83.32% (2000), 86.25% (2001), 81.98% (2002), 67.89% (2003). There therefore is no genuine issue of material fact as to whether investment securities account for more than 40% of both Presto's and Holding's total assets during the relevant period.

2. No statutory exception applies to Presto

Under Rule 3a-1 of the Act, a company that meets the statutory definition of an investment company, but has no more than 45% of its assets in securities, and receives no more than 45% of its income from investments, is not an investment company. 17 C.F.R. § 270.3a-1. By statute, the percentage of a company's assets that are securities is calculated on an unconsolidated basis, "except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries." Id. Since all of Presto's subsidiaries are

wholly-owned, these calculations are to be performed on a consolidated basis.

Investment securities as a percentage of Presto's total assets, exclusive of government securities and cash items on a consolidated basis, are as follows: 75.11% (1994), 71.45% (1995), 79.77% (1996), 79.19% (1997), 81.70% (1998), 79.28% (1999), 76.66% (2000), 66.15% (2001), 68.24% (2002), 67.32% (2003). Investment securities as a percentage of Holding's total assets, exclusive of government securities and cash items on a consolidated basis, are as follows: 77.71% (1994), 77.96% (1995), 75.65% (1996), 69.12% (1997), 75.58% (1998), 65.59% (1999), 55.36% (2000), 49.88% (2001), 50.75% (2002), 48.79% (2003). Investment securities as a percentage of Presto's total assets as adjusted for fair market value, exclusive of government securities and cash items on a consolidated basis, are as follows: 77.76% (1994), 65.90% (1995), 72.91% (1996), 78.25% (1997), 89.00% (1998), 76.41% (1999), 69.31% (2000), 56.69% (2001), 59.69% (2002), 67.39% (2003). Investment securities as a percentage of Holding's total assets as adjusted for fair market value, exclusive of government securities and cash items on a consolidated basis, are as follows: 77.76% (1994), 65.90% (1995), 72.91% (1996), 78.25% (1997), 89.00% (1998), 76.41% (1999), 69.31% (2000), 56.69% (2001), 59.69% (2002), 67.39% (2003). Presto therefore does not meet the statutory exemption identified in Rule 3a-1 of the Act.

Under Rule 3(b)(1) of the Act, issuers "primarily engaged" in a business other than investing are not investment companies. 15 U.S.C. § 80a-3(b)(1). A five factor test is used to determine a company's primary engagement: the company's historical development, its public representations of policy, the investment activities of its officers and directors, the nature of its assets, and the sources of its income. Tonopah, 26 S.E.C. at 426. The nature of the company's assets and the sources of its income are the most important of the five factors. Id. at 430-32.

As the court has already discussed, the nature of Presto's assets is that these assets are mostly investment securities. <u>See</u> II.C.1. Investment securities as a percentage of Presto's assets range from approximately 61% to 92% during the relevant time periods. <u>Id.</u> Presto's interest income from marketable securities and cash and cash equivalents ranges from 27% to 133% of Presto's net earnings during the relevant time periods. The nature of Presto's assets and income therefore strongly indicates that Presto's primary engagement is in investment securities.

The other three factors of the primary engagement test also indicate that Presto is an investment company. Presto's historic development shows that over time, Presto has changed from a company primarily engaged in manufacturing to a company primarily engaged in the business of investing in securities. Prior to World War II, Presto manufactured housewares and small appliances. Presto has ceased manufacturing these items, has closed manufacturing facilities, and has used its excess cash primarily to purchase and hold securities. Presto has publicly represented that it is primarily engaged in investing in securities in its Forms 10-K and Annual Reports. These Forms indicate that Presto buys and sells millions of dollars worth of securities every year, and that these securities make up a substantial percentage of its assets. Finally, Presto's officers and directors govern and closely monitor Presto's investment activities. Presto's treasurer Randy Lieble has routinely purchased and sold securities for Presto under the supervision of Melvin Cohen, Presto's Chairman Emeritus, and Maryjo Cohen, Presto's CEO.

3. Presto is therefore an investment company under 15 U.S.C. § 80a-3(a)(1)(C)

The percentage of Presto's assets which are investment securities is clearly over 40% for the time period in question. Presto does not fall under the 45%, or "safe harbor" exception to 15 U.S.C. § 80a-3(a)(1)(C). Presto is not primarily engaged in a business other than investing so as

to fall under the statutory exception promulgated in 15 U.S.C. § 80a-3(b)(1). There is therefore no genuine issue of material fact as to whether Presto is an investment company under the provisions of 15 U.S.C. § 80a-3(a)(1)(C).

III. CONCLUSION

For the foregoing reasons, the SEC's Motion for Summary Judgment is granted, and Presto's Motion for Summary Judgment is denied. The SEC is directed to submit a proposed Order requiring Presto to comply with Section 7 of the Act, and a proposed Order of Permanent Injunction, by November 30, 2005.

IT IS SO ORDERED.

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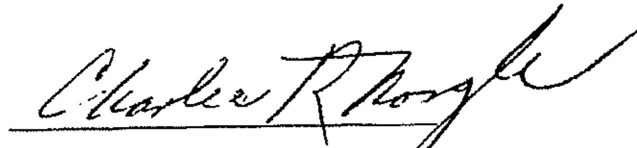

CHARLES RONALD NORGLE, Judge

United States District Court

DATED: October 31, 2005.

In the
United States Court of Appeals
For the Seventh Circuit

No. 05-4612

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

NATIONAL PRESTO INDUSTRIES, INC.,

Defendant-Appellant.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division.
No. 02 C 5027—**Charles R. Norgle**, *Judge.*

ARGUED SEPTEMBER 20, 2006—DECIDED MAY 15, 2007

Before EASTERBROOK, *Chief Judge*, and POSNER and EVANS, *Circuit Judges.*

EASTERBROOK, *Chief Judge.* Most mutual funds and other investment companies come within the scope of the Investment Company Act of 1940 because they hold themselves out "as being engaged primarily, or propos[ing] to engage primarily, in the business of investing, reinvesting, or trading in securities". 15 U.S.C. §80a-3(a)(1)(A). But firms can be dragged within the Act's coverage kicking and screaming, even though they depict themselves as operating businesses rather than as managing other people's money. Any issuer that owns "investment securities" worth 40% of its total assets is an investment com-

pany under §80a-3(a)(1)(C) unless some other provision of the Act takes it outside the definition. For this purpose, however, "Government securities and cash items" are omitted from both the numerator and the denominator.

National Presto Industries, a seller of both consumer goods (cookware, diapers, and other household items) and munitions, used to make everything it sold. During the 1970s it began to divest its manufacturing facilities and to contract production to third parties. In 1993 the Department of Defense closed a facility that Presto had used to make artillery shells. Presto was left with a pile of cash, most of which it retained with a long-term plan to acquire other businesses, and a shrunken book value of operating assets. Financial instruments were 86% of its total assets by 1994 and 92% in 1998. Since 2000 Presto has purchased two manufacturers of military supplies and two makers of diapers and puppy pads. But in 2003 financial instruments still represented 62% of its physical and financial assets. Intellectual property, although of considerable value to Presto, is not carried on corporate books at its full economic value, so this ratio overstates the significance of its portfolio of securities, but Presto does not argue that it could come under the 40% ratio by marking its patents and trademarks to current market value.

All of Presto's consumer products other than absorbent products are made by subcontractors, so although it has a substantial operating *income* it does not have operating *assets* to match—and the Investment Company Act's main test is asset-based. The SEC concluded that Presto was well past the 40% trigger. When the firm refused to register as an investment company—and make the changes to its corporate structure, management, and financial reporting required of investment companies—or request an administrative exemption, the SEC filed this suit to seek an injunction that would require compliance.

After preliminary maneuvering vindicated the SEC's choice of forum, see 347 F.3d 662 (7th Cir. 2003), the district court granted summary judgment in the agency's favor, 397 F. Supp. 2d 943 (N.D. Ill. 2005), and issued an injunction requiring Presto to register under the 1940 Act. The firm has complied pending appeal.

After suffering defeat on the merits, Presto replaced enough of its existing portfolio with "Government securities and cash items" to bring investment securities under the 40% threshold. The SEC had proposed an injunction that would have allowed Presto the opportunity to do this (or to seek an administrative exemption) in lieu of registration; the firm thought to avail itself of the opportunity even before the injunction was entered.

Without inviting comment from the parties, however, the district judge deleted these options from the SEC's draft and entered an injunction unconditionally requiring Presto to register as an investment company. The judge did not explain why. The result was a regulatory mismatch: a firm that is today required (by statute) to be organized and to report its financial position as an operating company is required (by injunction) to be organized and report its financial position as an investment company. Instead of doing this, the district court would have been well advised to craft an injunction commanding registration only if Presto should revert to its old portfolio design; obliging it to register as an investment company even when its investments do not require this is hard to fathom except as a form of punishment for Presto's conduct in past years, and civil injunctions are not supposed to punish litigants.

The unconditional injunction has caused considerable trouble. Investment companies are subject to many governance requirements that do not apply to operating companies. See, e.g., 15 U.S.C. §§ 80a-16, -17, -18, -19, -29,

-55, -56 (and the corresponding regulations). Presto's auditor, Grant Thornton, resigned because the SEC questioned its certification of Presto's financial statements as those of an operating company. Now that Presto is officially an investment company, Grant Thornton has refused to allow the statements it certified to be used for any purpose. This has disabled Presto from complying fully with *either* the Investment Company Act or the Securities Exchange Act of 1934. Without the financial statements, it is unable to file quarterly and annual reports. It has hired another auditor, but recreating and re-certifying financial statements for many past years is expensive and time consuming. Meanwhile stock exchanges have threatened to delist its stock because Presto is out of compliance with both statutory and exchange-based financial-reporting requirements.

At oral argument we inquired whether Presto's financial rearrangement has made the case moot. Now that it has complied with the injunction by registering as an investment company, can't it deregister and go back to its preferred status as an operating company, subject to registration under the Securities Exchange Act, no matter what happens on appeal? Deregistration requires the consent of the SEC, however, and although Presto filed the appropriate papers with the agency in January 2006 the SEC has failed to act on them.

One senses from this prolonged silence, and the tenor of the SEC's brief and oral argument, that the agency (or its senior staff) is in a snit because Presto declined to do what many other firms with excess liquid assets have done—apply to the agency for an exemption. See 15 U.S.C. §80a-3(b)(2). (Microsoft, for example, holds more than 40% of its assets in the form of investment securities but received permission to operate outside the 1940 Act.) The agency's counsel implied at oral argument that an exemption would have been forthcoming if sought. Yet a

firm's refusal to kowtow to an agency is not a good reason to force its investors to bear unnecessary costs—for it is the investors who must pay to recreate the financial statements, though *they* did not contribute to this imbroglio—and keep a firm inappropriately registered, as Presto now is. Why is the SEC bent on grinding down a corporation that it appears to acknowledge would not mislead or otherwise injure investors by using the governance and reporting devices appropriate to an operating company?

Because Presto remains registered as an investment company while the SEC sits on its hands, there is a live case or controversy, because a remedy is possible: we could end its registration forthwith. Moreover, if we hold that Presto's former portfolio does not bring it within the Investment Company Act, it will be free to rejigger its investments; the old investments likely had a higher rate of return, which is why Presto switched only after the district court's opinion.

Let us begin, then, with Presto's argument that even before the recent changes to its portfolio, enough of its investments were "Government securities and cash items" to keep its "investment securities" under the 40% trigger.

"Government securities" is a defined term. The phrase "means any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing." 15 U.S.C. §80a-2(a)(16). According to Presto, pre-refunded municipal bonds ("refunded bonds" for short) fit this definition. Presto held these instruments in quantity.

A refunded bond is a bond backed by U.S. securities as well as the credit of the issuer. Suppose that a municipal-

ity issues long-term bonds for a project (say, an airport) and that the market rate of interest later falls. The issuer would like to take advantage of the lower rate, but the bonds lack a call feature. The municipality can issue new bonds at the current lower rate and use the proceeds to buy Treasury bonds with the same maturity as the original issue of municipal bonds. The Treasury securities are held in trust to pay interest and principal on the original issue. The municipality pays the interest on the new issue; the Treasury securities may cover the old issue, and if not the municipality can chip in the difference. Refinancing in this way works because municipal bonds are not subject to federal taxes, so they often pay lower interest rates than Treasury securities. Bonds that can be bought with the proceeds of the new municipal issue may produce enough interest by themselves to cover the interest on the old issue.

The Treasury bonds held in trust lead Presto to call the refunded bonds themselves "Government securities." It should be apparent, however, that they do not fit the statutory definition. Refunded municipal bonds are still municipal bonds, exactly as they were before the refunding transaction. Municipal bonds are neither issued nor guaranteed by the national government or any federal instrumentality. If the municipality defaults, or a local employee reaches into the till and makes off with the Treasury securities, the national government will not cover the loss. The bonds in trust make the municipal bonds safer, but 15 U.S.C. §80a-2(a)(16) does not include in the category of "Government securities" everything that a company deems "almost as safe as" Treasury securities.

The argument "X has the same economic attributes as Y, so X must have the same legal attributes as Y" has a history in securities law. It was the basis of the sale-of-business doctrine that many courts accepted before *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). The

idea was that someone who bought all of the stock in a closely-held corporation was buying the corporation's assets, as an economic matter, so the transaction should not be governed by the securities laws. *Landreth Timber* held, however, that someone who wants the legal treatment of an asset acquisition must buy the assets rather than the stock; people may choose between transacting in securities and transacting in assets, and the law follows the form—not only because that is what the statute says, but also because trying to determine, one case at a time, when a transaction "really" has the economic attributes of a different form would lead to a great deal of uncertainty for little purpose. *Landreth Timber* represents the norm in securities law. Stock or bonds in a company that invests the proceeds in land, or gold, or art, are still regulated as securities rather than as land, or gold, or art. Pooled interests in orange groves are regulated as investment contracts rather than as oranges. See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). And municipal bonds issued by a city that plans to repay using U.S. bonds are still municipal bonds.

Securities laws regulate the form of financial transactions, rather than looking through form to substance. See *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (demand notes are regulated as securities even though they have many economic attributes of exempt instruments). True enough, §80a-2 begins, as several other definitional clauses in the securities laws do, with the phrase, "unless the context otherwise requires". The Supreme Court used this in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), to hold that a one-off transaction—a 50% interest in a neighbor's farm in exchange for a short-term loan, the sort of investment that could not even in principle be traded among anonymous investors—should not be treated as a security.

We know from *Rowland v. California Men's Colony*, 506 U.S. 194 (1993), however, as well as from *Landreth*

Timber, that this use of the context clause cannot be generalized into a norm that substance trumps form. *Rowland* holds that context clauses refer to *linguistic* rather than *economic* contexts, and even as so limited should be employed—as they say—only when the context of a phrase elsewhere in a statute "requires" a departure from the definitional clause. Neither the interest in the neighbor's farm nor the bank account involved in *Marine Bank* was a "security" under the Securities Exchange Act because neither fit the model of homogenous instruments that (at least potentially) could be traded among anonymous investors. The context clause prevented a need to jam a square peg into a round hole. See Scott FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 Minn. L. Rev. 893 (1980). But nothing in §80a-3(a)(1)(C) similarly "requires" a departure from the definition in §80a-2(a)(16). The definition of the phrase "Government securities" in the latter makes perfect sense when plugged into the former.

Judge Friendly once remarked, with respect to the definition of the term "note" in the securities laws: "So long as the statutes remain as they have been for over forty years, courts had better not depart from their words without strong support for the conviction that, under the authority vested in them by the 'context' clause, they are doing what Congress wanted when they refuse to do what it said." *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976). That high standard has not been met here. The Investment Company Act has been with us for 67 years without giving problems through the definition of "Government securities." And even if there were some wriggle room via the context clause, Presto has not established that refunded bonds are the economic equivalent of Treasury bonds. A report in the record from Morgan Stanley shows that the yield for Treasury bonds maturing in 2006 was 4.95%, while the

taxable equivalent yield for refunded bonds was 6.1% for taxpayers in the 38% bracket. That's a 23% premium over Treasuries, which must reflect extra risk. (The nominal interest rate for refunded bonds is below that for Treasury bonds, because of the tax subsidy for municipal securities; an adjustment must be made to find real returns and implicit risks.)

Mutual funds may treat refunded bonds as if they were "Government securities" for the purpose of 15 U.S.C. §80a-5, which says how an investment company's portfolio must be structured if it calls itself "diversified." See 17 C.F.R. §270.5b-3(b). How can refunded bonds be "Government securities" for one purpose but not the other?, Presto asks. Yet treating A as if it were B for one purpose does not imply that A *is* B for every purpose. The regulation on which Presto relies governs how investment companies describe their portfolios; that's a very different subject from whether something is an investment company in the first place. Equating refunded bonds with Treasury securities for the purpose of diversification allows mutual funds to offer tax advantages (which refunded bonds supply) without any change in the covariance of risk across a fund's assets. Denying investors that opportunity would injure them; it's sensible for the SEC to look at the economic attributes of instruments when determining what counts as diversification (another economic inquiry) while insisting that the statutory definition be used to determine what entities are covered by the statute in the first place.

"Cash items" also are excluded when calculating the 40% ratio, and Presto maintains that "variable-rate demand notes" should be treated as "cash items." A variable-rate demand note is an instrument (usually a bond or debenture) whose rate of interest is updated weekly (if not more often) based on some index, such as the London Interbank Offering Rate. Whenever the interest rate

changes, the note's holder is entitled to redeem at par. Usually this transaction is handled by a remarketing agent, who buys the note from the holder and resells it in the secondary market to another investor; the note's issuer is involved only if the note is trading for less than par.

In contrast to the detailed statutory definition of "Government securities," the Investment Company Act does not define "cash items." Presto maintains that variable-rate demand notes are equivalent to cash because of the weekly opportunity to sell the instruments at par for cash. If liquidity were enough, however, one would treat all shares of stock in large issuers, and many bonds, as "cash items" because they can be sold on liquid markets in a matter of minutes. The reason that such investments are not treated as cash or its equivalent, however, is that the market price the instrument will fetch when sold is variable. Presto thinks that the "redeem at par" feature of the variable-rate demand note insulates them from that sort of risk, but that's not true. The investor is entitled to *demand* redemption at par, but whether the issuer will comply depends on its financial health. A business reverse (or, for a municipal issuer, a shortfall of taxes) will mean no redemption, or redemption at a discount. That's a kind of risk an investor takes with any stock or bond—but does not take with cash.

Although the statute does not define "cash item," the SEC gave this definition when adopting a safe-harbor rule (17 C.F.R. §270.3a-1):

> For purposes of determining compliance with the proposed rule, cash, coins, paper currency, demand deposits with banks, timely checks of others (which are orders on banks to immediately supply funds), cashier checks, certified checks, bank drafts, money orders, traveler's checks and letters of credit generally would be considered cash items.

> Certificates of deposit and time deposits typically would not be considered cash items absent convincing evidence of no investment intent.

Certain Prima Facie Investment Companies, Investment Company Act Release No. IC-10937 (Nov. 13, 1979), at n.29; regulation adopted in final form 46 Fed. Reg. 6879 (Jan 22, 1981). This definition applies only to Rule 3a-1, but Presto does not contend that we should ignore it—or that it is arbitrary or capricious. Agencies are entitled to add detail to the statutes they administer, and their resolution of ambiguities is entitled to respect. See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

A variable-rate demand note does not fit this definition. Presto chose to invest in variable-rate demand notes rather than, say, money-market funds (which are diversified portfolios of safe and liquid investments) because the notes have higher rates of return. The higher return stems from higher risk, which explains why the notes differ from "cash items." (Presto does observe that many variable-rate demand notes are backed by letters of credit, which the SEC is willing to treat as "cash items," but that's a replay of the argument that refunded bonds are "Government securities" because they are secured by Treasury bonds.) Presto was making an *investment* in these notes, along the lines of "time deposits" (which are "cash items" only with "convincing evidence of no investment intent"), rather than holding them for liquidity.

Presto therefore comes within the 40% test and is an investment company unless one of the (many) statutory exceptions applies. The one on which Presto relies is §80a-3(b)(1): "Any issuer 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." Presto is actively

engaged in several businesses. A visitor to its web site for consumers (http://www.gopresto.com) will find sales promotions, warranty information, and instruction manuals for pizza ovens and coffee makers but nary a hint that someone would want to buy Presto's stock as a means to own a derivative interest in refunded municipal bonds or variable-rate demand notes. But is Presto "primarily" engaged in selling pressure cookers, deep fryers, popcorn poppers, diapers, and ordnance rather than the business of holding securities? The statute is unhelpful; "primarily" is not a defined term. No regulation fills the gap.

Sixty years ago the SEC announced that it would consider five factors to decide whether a firm that sold off its operating assets and chose not to distribute the proceeds to its stockholders had become what people today call an "inadvertent investment company." *In re Tonopah Mining Co.*, 26 S.E.C. 426 (1947). See also Sydney H. Mendelsohn, Mark B. Goldfus & Mark J. Mackey, *Status Seeking: Resolving the Status of Inadvertent Investment Companies*, 38 Bus. Law. 193 (1982); Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 Stan. L. Rev. 29 (1959).

According to *Tonopah*, what matter are the company's history, the way the company represents itself to the investing public today, the activities of its officers and directors, the nature of its assets, and the sources of its income. Of these, all but the fourth favor Presto. Founded in 1905, Presto was an active manufacturer of industrial, consumer, and military products until the 1980s, when it started to subcontract manufacturing activities. It remains an active manufacturer of absorbent goods and military ordnance and sells a line of kitchen goods under its own trademarks.

As far as we can see, this is the first time that the SEC has argued that a firm with such a substantial ongoing

presence in product markets is an inadvertent investment company. The model inadvertent investment company—of which Tonopah Mining is the initial exemplar and Fifth Avenue Coach Lines is perhaps the best-known, see *SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3 (S.D. N.Y. 1968), affirmed, 435 F.2d 510 (2d Cir. 1970)—is one in which the firm has sold all or almost all of its assets, reduced its operations to a skeleton staff (Tonopah Mining was down to one unprofitable mine and Fifth Avenue Coach Lines to no busses at all), and purports to be looking for acquisitions but never seems to find them. Perhaps one could have applied the "purports to be looking for acquisitions" label to Presto in the 1980s and 1990s, but one could *not* say that Presto had withdrawn from active business operations in the meantime. It continued selling both consumer and military products. It changed from a manufacturer to a firm that was (principally) a designer and marketer of products assembled by others, but this did not make Presto less an operating enterprise. Many other firms have made a similar transition (Apple comes to mind) without being thought to have evolved into mutual funds.

Presto presents itself to the public (and to investors) as an operating company. That's how its web site, its annual reports, and its publicity all depict it. The contrast with Tonopah Mining and Fifth Avenue Coach Lines is stark. An investor in the market for a mutual fund, a hedge fund, or any other investment pool would not dream of turning to Presto, whose net income can increase or decrease substantially as a result of business successes or reverses. The price of Presto's stock moves in response to changes in its operating profits rather than the slight annual changes in its investment income. The SEC has not identified even one confused investor who bought stock in Presto thinking that he was making an investment in a closed-end mutual fund whose assets were the securities that Presto holds.

"Activities of Officers and Directors," the third factor in *Tonopah*, likewise favors Presto. Directors and senior managers at Tonopah Mining and Fifth Avenue Coach Lines spent most of their time managing the firms' investment portfolios. Presto estimates that 95% of its managers' time is devoted to running its consumer-products and military-ordnance businesses. The SEC has not offered any contrary evidence. Cf. *First National Bank & Trust Co. v. Beach*, 301 U.S. 435 (1937) (a firm is "primarily engaged in farming" under the Bankruptcy Code if its officers and directors devote most of their time to farming).

As for the fifth factor, income, *Tonopah* looked at both gross and net figures, as well as at the firm's expenditures to produce income. (Looking at both gross and net is essential; otherwise an operating loss, with negative net income, would turn a firm into an "investment company".) Gross income at Presto is dominated by receipts from its consumer and military sales. More than 90% of Presto's gross receipts for every year covered by the record (1994 through 2003) comes from its sales of products. In 2003, for example, Presto recorded about $125 million in sales, yielding a net profit of $18.9 million; total receipts from investment securities that year were $4.2 million.

Only net income helps the SEC's position: the agency calculates that, over the decade covered by the record, 50.22% of Presto's net profits were derived from investments in securities. Presto's calculations show that operating profits exceed investment profits for the decade as a whole. The SEC acknowledges that, in each of the three years immediately preceding the district court's injunction requiring Presto to register as an investment company, investments produced less than 40% of Presto's net profit. So even if we take the view most favorable to the SEC, that a firm is "primarily" engaged in a business other than investment management only if more than half of its net profits come from non-investment sources,

Presto was "primarily" an operating business when the injunction issued. Whatever classification may have been appropriate in the 1990s (when more than half of net profits came from investments) cannot support an injunction issued in 2005, when at least 60% of net profit was coming from consumer and military sales. In *Tonopah*, by contrast, "the company's only source of net income consists of interest, dividends and profits on the sale of securities; and we find nothing to indicate that this situation will be changed substantially in the foreseeable future." 26 S.E.C. at 431.

This leaves the fourth *Tonopah* factor, the nature of Presto's assets. Here the picture at last favors the SEC, for more than 60% of Presto's assets were investment securities during every year covered by the record. In full flight from the Commission's multi-factor approach in *Tonopah*, the SEC's lawyer in this court urges us to give little weight to any consideration other than Presto's asset structure. Yet looking primarily at accounting assets has a potential to mislead. Imagine a firm that owns substantial assets such as patents and trademarks that do not show up on its balance sheet as assets, and that operates a business from a leased headquarters where it designs, contracts for, and sells products. Such a firm could have annual sales exceeding $100 million, and profits exceeding $10 million as Presto does, with book-value assets of only $1 million in office furniture. If that firm stored even 10% of two years' profits in refunded bonds, as a hedge against business reverses (or to finance expansion), instead of distributing all profits to investors in dividends, it would become an investment company under the approach the SEC urges in this litigation. Yet no investor would perceive such a firm as a substitute for a closed-end mutual fund; its stock returns would continue to depend on its operating profits and losses.

According to the SEC's brief, *Tonopah* deemed assets the "most important" of the five considerations. It would be surprising if that were so, because it would make the exclusion in §80a-3(b)(1) unavailable as a practical matter. The only reason one turns to this exclusion is that the 40% asset test has been satisfied. If subsection (b)(2) does nothing except raise the 40% test to 50% as a definition of the firm's "primary" engagement, it is an odd statutory provision indeed. What sense would it make to enact a law using 40% as the threshold in subsection (a)(1)(C), and convert the "real" rule to 50% in subsection (b)(1) by using words rather than numbers? Subsection (b)(1) has to be about considerations other than assets (or at least in addition to assets). And that's what the SEC said in *Tonopah*:

> More important . . . [is] the nature of the assets and income of the company, disclosed in the annual reports filed with the Commission and in reports sent to stockholders, was such as *to lead investors to believe* that the principal *activity* of the company was trading and investing in securities.

26 S.E.C. at 430 (emphasis added). In other words, the Commission thought in *Tonopah* 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? The Commission has never issued an opinion or rule taking a different view, and its lawyers cannot adopt a new approach by filing briefs. Only the Commission's members may change established norms, and they must do so by rulemaking or administrative adjudication. See *SEC v. Chenery Corp.*, 318 U.S. 80, 88-89 (1943); *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947).

Reasonable investors would treat Presto as an operating company rather than a competitor with a closed-end

mutual fund. The SEC has not tried to demonstrate anything different about investors' perceptions or behavior. It follows that Presto is not an investment company.

The judgment of the district court is reversed. Presto, which registered as an investment company only under judicial compulsion, now is free to drop that registration and operate under the Securities Exchange Act of 1934 whether or not the SEC gives its formal approach to that step.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit