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SMALL BUSINESS INVESTMENT

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 10717, H.R. 13032, H.R. 13765, and identical bills

BILLS TO AMEND THE SECURITIES ACT OF 1933 AND THE INVESTMENT COMPANY ACT OF 1940 TO ENCOURAGE INVESTMENT IN SMALL BUSINESS CONCERNS

SEPTEMBER 27 AND 28, 1978

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SMALL BUSINESS INVESTMENT

WEDNESDAY, SEPTEMBER 27, 1978

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 9:30 a.m., pursuant to notice, in room 2253, Rayburn House Office Building, Hon. Bob Eckhardt, chairman, presiding.

Mr. ECKHARDT. We will commence our hearings. Throughout the 1970's, the amount of capital flowing to small business ventures has been declining dramatically. Two reasons for this condition are relatively apparent: General economic conditions and investor disillusionment in the aftermath of the speculative bull market of the late sixties. Other reasons are more subtle. In 1975, the Small Business Administration appointed a task force, chaired by former SEC Chairman William Casey, to pinpoint the impediments to the raising of capital for small businesses.

The task force's report, issued in January 1977, made a number of findings and recommendations. They concerned, among other things, tax policy and securities laws and regulations.

The bills which the subcommittee will be considering in our hearings today and tomorrow propose to modify the securities laws to provide more incentive for investment in small business. The bills, H.R. 10717, H.R. 13032, and H.R. 13765, propose essentially four changes to the securities laws. First, they would allow the Commission to exempt from the full registration provisions of the Securities Act of 1933, offerings not exceeding $3 million. Second, they would increase the amounts of restricted securities which may be sold within specific periods of time. Third, they would restrict liability under the private offering exemption. And, finally, they would exempt small business investment companies from the provisions of the Investment Company Act of 1940.

Independently, the SEC has demonstrated a responsiveness to the capital access problems of small business. After holding hearings around the country on this issue, the SEC has recently adopted some rule changes and proposed others designed to eliminate some of the disincentives to small business investing.

Without objection the text of H.R. 10717, H.R. 13032, and H.R. 13765 will be printed at this point in the record.

[The text of the bills referred to follow:]

[H.R. 10717, introduced by Mr. Broyhill (for himself, Mr. Rinaldo, Mr. Krueger, and Mr. Luken) on February 2, 1978, and
H.R. 13032, introduced by Mr. Broyhill (for himself, Mr. Devine, Mr. Ketchum, Mr. Duncan of Tennessee, Mr. Dornan, Mr. Badham, Mr. Stockman, Mr. Madigan, Mr. Preyer, Mr. Neal, Mr. Watkins, Mr. Heftel, Mr. Kemp, Mr. Lent, Mr. Hollenbeck, and Mr. Scheuer) on June 8, 1978, and
H.R. 13765, introduced by Mr. Broyhill (for himself and Mr. Ottinger) on August 7, 1978,
are identical as follows:]

A BILL

To amend the Securities Act of 1933 and the Investment Company Act of 1940 to encourage investment in small business concerns.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 19 of the Securities Act of 1933 (15 U.S.C. 77s) is amended by adding at the end thereof the following new subsections:

"(c) In prescribing rules and regulations with respect to information required in a transaction by an issuer not involving any public offering pursuant to section 4(2), the Commission may not require that offerees (or their representa-

tives) have access to, or be furnished with, information other than material information.

"(d) (1) In prescribing rules and regulations pursuant to section 4 (1), describing a person who shall be deemed not to be engaged in a distribution of securities, the Commission may not require for exemption from registration—

"(A) in the case of a sale of securities by an affiliate of the issuer of such securities, that the amount of securities sold, together with all sales within the preceding three months of restricted and other securities of the same class for the account of such person, be less than—

"(i) if such securities are admitted to trading on a national securities exchange or are quoted on the automated quotation system of a registered securities association as well as traded on a national securities exchange, the greater of (I) 1 per centum of the shares or other units of the class outstanding, or (II) the average weekly reported volume of trading in such securities on all securities exchanges and reported through such automated quotation system during the four calendar weeks preceding the notice of sale, or, if no such notice is required, the receipt of the order to execute the transaction by the broker;

"(ii) if such securities are not traded on a national securities exchange, 1 per centum of the shares of other units of the class outstanding; and

"(B) in the case of a sale of restricted securities by any person other than an affiliate of the issuer, that the amount of restricted securities sold, together with all other sales within the preceding three months of restricted securities of the same class for the account of such person, be less than the greater of the amounts specified in subparagraphs (A) (i) and (ii).

"(2) In prescribing rules and regulations referred to in paragraph (1) of this subsection, the Commission may not impose any limitation on the amount of restricted securities which may be sold by a person after such person has been the beneficial owner of such securities for a period of five years or more.

"(3) As used in this subsection:

"(A) The term 'restricted securities' means securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering.

"(B) The term 'affiliate' of an issuer means a person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with such issuer.".

SEC. 2. Section 12 of the Securities Act of 1933 (15 U.S.C. 771) is amended by adding at the end thereof the following new sentence: "Notwithstanding the foregoing provisions of this section, a person who sells securities, in a transaction evincing a good faith attempt not to involve any public offering pursuant to section 4(2), shall not be liable to a purchaser of such securities in such transaction if all conditions prescribed in rules and regulations of the Commission concerning such a transaction have been met with respect to such purchaser, and such a purchaser may not bring a civil action for rescission of such a transaction on the grounds that all such conditions have not been met with respect to all purchasers of securities in such transaction.".

SEC. 3. Section 3(b) of the Securities Act of 1933 (15 U.S.C. 77c(b)) is amended by striking out "$500,000" and inserting in lieu thereof "$3,000,000".

SEC. 4. Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) is amended by adding at the end thereof the following new paragraph:

"(14) Any small business investment company licensed under the Small Business Investment Act of 1958.".

SEC. 5. (a) Except as provided in subsection (b) of this section, the amendments made by this Act shall take effect on the date of enactment of this Act.

(b) (1) The amendment made by the first section of this Act shall take effect one hundred and twenty days after the date of enactment of this Act.

(2) The Securities and Exchange Commission shall, within one hundred and twenty days after the date of enactment of this Act, prescribe such rules and regulations as may be necessary to carry out the amendment made by the first section of this Act.

Mr. ECKHARDT. I understand, Mr. Broyhill, that you have a statement.

Mr. BROYHILL. Just a very few comments, Mr. Chairman. I want to thank you very much for holding these hearings, and I think that it is good that the committee is addressing this particular problem. I believe that there is a need, as you have pointed out, to increase the flow of capital into small business enterprises. If the securities laws are in anyway impeding that flow of capital into small businesses, I think we need to examine it.

I want to commend the Commission for, on their own initiative, reexamining their rules and regulations in this regard, and for taking steps to change those rules and regulations.

The concepts that are found in the bill that we have presented for the consideration of the committee are not new concepts. The work on the bill was done by the SBA task force on venture equity capital for small business and also the work that was done in the Small Business Committees of both the House and the Senate. So, I am hopeful that these hearings will convince the majority of the members of the committee that this issue does deserve some early attention next year as a high priority item. I do realize that this late in the session we will not be able to act on the bill.

Mr. ECKHARDT. We are very pleased this morning to have Chairman Williams as our first witness. It is always a pleasure to have you here, Mr. Chairman. You may proceed as you desire.

STATEMENT OF HON. HAROLD M. WILLIAMS, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY RICHARD H. ROWE, DIRECTOR, DIVISION OF CORPORATE FINANCE; SIDNEY H. MENDELSOHN, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT

Mr. WILLIAMS. We appreciate this opportunity to appear before the subcommittee to testify on behalf of the Commission concerning the three bills, which are substantially identical, which would amend the Securities Act of 1933 and the Investment Company Act of 1940, in an attempt to increase the amount of venture capital available to small businesses, while reducing the administrative burdens otherwise imposed upon these firms by the Federal securities laws.

As one who has long recognized the vital importance to our economy of a strong small business sector, I am sympathetic to the adoption of legislation which encourages investment in small firms and creates a climate conducive to the growth of those firms. Your subcommittee of course recognizes the Commission's broad statutory responsibility to provide protection for investors. In addressing these bills I might point out that there are essentially two types of issues which are of some concern. One is the tradeoff between our responsibility to protect investors and the need to support the financing and growth of small business; and the second is the question of what can best be done by legislation as opposed to Commission action.

Now, as the subcommittee is aware, the Commission has previously submitted written comments on H.R. 13032. In those comments, which I have summarized in my prepared testimony, we set out in detail the problems raised by this legislation in its present

form. Rather than repeating those, I would like to describe some of the recent actions the Commission has taken to assist small business and which relate to the bill.

The Commission has recently concluded a series of hearings, held at various locations around the country, which dealt with the effects of the Commission's rules on the ability of small business to raise capital and the impact on small business of the disclosure requirements under the Federal securities laws.

As many of the commentators on these hearings pointed out, there are a number of factors which have a substantially greater impact on access to the public marketplace by small businesses than the costs and burdens of registration and reporting under the Federal securities laws. For example, a major obstacle is the Federal tax structure, which is perceived by investors as increasingly insensitive to the need to provide adequate incentives or rewards to induce them to forgo high interest rates, low risk returns on capital for the possibility of long-term capital growth. Special tax incentives, especially in the area of capital gains, are now necessary to induce investments in small businesses.

Additional factors affecting the ability of small business to raise capital include general economic conditions, including inflation; the institutionalization of the securities markets, and the cost of Government regulation, such as the fundamental safety laws which may have a disproportionate effect on small business.

But despite the preponderance of other factors affecting the viability of small business, the Commission is cognizant that there are ways in which the special needs of small businesses can be better accommodated within the Federal securities laws, consistent with our responsibility to protect investors.

Basically, two recent actions the Commission has taken in this area relate to the bill. Although several factors were cited during our small business hearings as contributing to the problem of secondary sales of small business securities, the most commonly identified factors were the resale restrictions imposed by rule 144.

At the time of our hearings, rule 144 provided that affiliates and others selling securities subject to the rule could sell, during a 6-month period, the lesser of 1 percent of the class outstanding, or the average weekly trading volume. Commentators were of the view that this provision severely restricted their ability to attract captial due to the long period of time before the investor could liquidate an investment. Thus, they believed that a relaxation of the provisions of the rule was essential to the ability of venture capitalists and other investors to recycle their investments into new enterprises.

The Commission responded by amending rule 144 to allow sales not to exceed the greater of 1 percent of the class outstanding or the average weekly trading volume during a 3-month period. In addition, the Commission proposed an amendment to rule 144 which would permit persons who have held securities covered by the rule for a 5-year period to sell such securities without any volume limitations, provided such persons are not affiliates of the issuer. The reason for this latter proposed restriction is that the Securities Act treats as issuers persons who control, are controlled by, or are under common control with the issuer. This present

statutory provision is necessary to prevent controlling persons who are in a position to cause the issuer to comply with the registration and disclosure provisions of the act from avoiding those provisions by buying or otherwise acquiring securities from the issuer, holding them for a period of time, and then distributing them to the public.

Now, the advantage of the Commission's approach in effecting these changes by the adoption of rules, rather than the enactment of additional statutory provisions—such as those in the bill—is that the Commission would retain its present flexibility to amend these rules in the future should conditions change and amendments become necessary either to protect the interests of public investors, or to further facilitate distributions by small issuers.

Consequently, while we do not oppose the substantive changes contained in section 1 of the bill, except for the provision which would allow persons affiliated with the issuer to resell securities after 5 years without limitation, we suggest that the better method of implementing these changes is by Commission rules.

Now, the Commission is authorized under section 3(b) of the Securities Act to exempt securities from registration if it finds that registration for these securities is not necessary to the public interest because of the small amount involved or the limited character of the public offering. Congress recently raised the ceiling in section 3(b) to $1,500,000 from $500,000, and just last week raised the ceiling to $2 million. The latter raise is awaiting signature by the President.

Pursuant to the authority of section 3(b), the Commission has adopted a number of rules and regulations, among which is regulation A. Following congressional action raising the ceiling, the Commission recently increased the offering price of securities which may be sold under regulation A to the new ceiling. This should assist the ability of small business to raise capital. While we have consistently endorsed the increase in the dollar limit ceiling contained in the bill—and we continue to do so—we would intend to carefully monitor the new $1,500,000 ceiling before raising the ceiling further, if given the authority.

I would also like to take a few moments this morning to discuss section 4 of the bill, which would amend the Investment Company Act of 1940, to exempt small business investment companies, or SBIC's, from the provisions of the Investment Company Act. The apparent purpose of this section is to eliminate the present dual jurisdiction exercised over SBIC's by the Commission and the Small Business Administration. It must be emphasized, however, that the purposes and protections provided by the statutes administered by the two agencies are very different.

The legislative intent in enacting the Investment Company Act was to eliminate the widespread abuses and failures to observe principles of fiduciary duties which were uncovered in unregulated investment companies. The Small Business Investment Act, on the other hand, was enacted to improve and stimulate the national economy in general and the small business segment thereof in particular. The primary concern of the SBA, therefore, is the stimulation of small businesses through additional financing; the protection of investors is at best a secondary concern. Morever, the SBA's position as a creditor of the SBIC's, and in many instances

as guarantor of their debt securities, may present conflicts of interest if the SBA were to assume the responsibility for investor protection.

Now, while we are concerned with the need to aid small businesses in their efforts to raise capital, this goal should not be accomplished in a manner which would cause substantial dilution of the statutory protections afforded investors who are expected to finance these investment companies. Our experience in enforcing the Federal securities laws has shown us that SBIC's are entitled to some special treatment, but that they should not be totally excluded from compliance with the Investment Company Act. The fact that compliance with the act entails some increased cost and inconvenience on the part of SBIC's does not in itself warrant completely excluding such companies from the regulatory scheme of the act. This increased cost and inconvenience engendered by the act must be weighed against the need to protect the investing public.

In our view, the remedy is not to eliminate all regulatory protections under the Investment Company Act, but rather to administratively reduce those costs and unnecessary regulations wherever feasible. We have the authority to reduce such costs under the act, and our earlier written statement sets forth some steps the Commission has taken to ease the regulatory burdens of the act on SBIC's.

The recent actions taken by the Commission are part of our continuing efforts to address the problems faced by small business, and the extent to which the Federal securities laws impact on their ability to raise capital. Over the next several months, we will be reviewing the summary of our small business hearings and we will explore what further steps the Commission can take to minimize the impact of the Federal securities laws on small firms wherever possible, consistent with our responsibility to protect the investing public. I am hopeful that with imaginative approaches we can find solutions that will fulfill both of these goals.

Mr. Chairman, we will be pleased to answer any questions which the committee might have.

[Testimony resumes on p. 20]

[Mr. Williams' prepared statement with attachment follows:]

STATEMENT OF HON. HAROLD M. WILLIAMS, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. Chairman and members of the subcommittee: I appreciate this opportunity to appear before the Subcommittee today to testify on behalf of the Securities and Exchange Commission concerning H.R. 10717, H.R. 13032 and H.R. 13765, substantially identical bills, which I shall refer to as the "Bill." The Bill would amend the Securities Act of 1933 and the Investment Company Act of 1940, in an attempt to increase the amount of venture capital available to small businesses, while reducing the administrative burdens otherwise imposed upon these firms by the federal securities laws.

As one who has long recognized the vital importance to our economy of a strong small business sector, I am sympathetic to the adoption of legislation which encourages investment in small firms and creates a climate conducive to the growth of these firms. The Committee should recognize, however, that the Commission's broad statutory mandate is to provide protection for investors. In that connection, I am concerned that parts of this Bill would amend the securities laws in ways which may be inconsistent with the Commission's responsibility.

As the Subcommittee is aware, the Commission has previously submitted written comments on H.R. 13032. In those comments, which I have attached to my prepared testimony and which I assume will be made a part of the record of this hearing, we

set forth in detail the problems raised by this legislation in its present form. Rather than taking up your time today with a repetition of all of those comments, I will attempt to highlight the Commission's comments and describe some of the recent actions the Commission has taken.

The Commission has recently concluded a series of hearings, held at various locations around the country, which dealt with the effects of the Commission's rules on the ability of small businesses to raise capital, and the impact on small businesses of the disclosure requirements under the federal securities laws. The staff presently is preparing a summary of the views expressed at the hearings, which I expect to send to the Subcommittee in the next several weeks.

While we have not completed our review of the voluminous testimony given at those hearings, a preliminary study of the record indicates that there are a number of factors which have a substantially greater impact on access to the public marketplace than the costs or burdens of registration and reporting under the federal securities laws. Insofar as the ability to raise capital is concerned, the existing tax structure and the state of the economy were reported to have the greatest impact. Thus, many witnesses expressed the view that if a favorable change occurred in either of these factors, small businesses would not be substantially impeded by the federal securities laws from obtaining the necessary capital. Despite the preponderance of other factors affecting the viability of small business, the Commission is presently reviewing its rules to determine if revision might be appropriate to further accommodate the needs of small businesses consistent with investor protection.

Turning now to a more specific discussion of the Bill, Section 1 would amend Section 19 of the Securities Act, which sets forth the general rulemaking and investigatory powers of the Commission under that statute, by the addition of four new provisions—subsections (c), (d), (e), and (f). These subsections, among other things, would:

1. Limit the information available to offerees or their representatives in a non-public offering, to material information;

2. Reduce the six-month waiting period during which securities can be sold under Rule 144(e), to three months, and change the test for determining the amount of securities which can be sold under the rule from the "lesser of" to the "greater of" one percent of the outstanding shares of a class or the average weekly trading volume;

3. Prevent the Commission from prescribing rules and regulations pursuant to Section 4(1) of the Securities Act, which would limit the amount of restricted securities that could be sold by a person after such person has been the beneficial owner of the securities for a period of five years or more.

These new provisions would do by statute what the Commission has the authority to do and, for the most part, has already done by rule.

Although several factors were cited during our small business hearings as contributing to the problem of secondary sales of small business securities, the most commonly identified factors were the resale restrictions imposed by Rule 144. The rule defines persons who are deemed not to be engaged in a distribution of securities, and therefore who are not underwriters for purposes of Section 4(1) of the Securities Act. Section 4(1) exempts from the registration provisions of Section 5 of the Act, all transactions by persons other than issuers, underwriters or dealers. It should be noted that Rule 144 is not the exclusive means for selling restricted securities without registration under the Securities Act. Rather, the Rule is intended as a safe harbor for establishing the availability of the exemption provided by Section 4(1).

At the time of our small business hearings, Rule 144 provided that affiliates and others selling securities subject to the Rule could sell, during a six month period, the lesser of one percent of the class outstanding or the average weekly trading volume. A majority of the witnesses that testified on this point at the hearings were of the view that this provision severely restricted their ability to attract capital due to the long period of time which was necessary to liquidate an investment. Thus, the witnesses believed that a relaxation of this provision of the Rule was essential to the ability of venture capitalists and other investors to recyle their investment into new enterprises.

The Commission has responded to these concerns by amending Rule 144 to allow sales not to exceed the greater of one percent of the class outstanding or the average weekly trading volume during a three month period. In addition, the Commission has proposed an amendment to Rule 144 which would permit persons who have held securities covered by the Rule for a five year period to sell such securities without any volume limitations, provided such persons are not affiliates of

the issuer. The reason for this latter proposed restriction is that the Securities Act treats as issuers persons who control, are controlled by, or are under common control with an issuer. This present statutory provision is necessary to prevent controlling persons who are in a position to cause the issuer to comply with the registration and disclosure provisions of the Act, from evading those provisions by buying or otherwise acquiring securities from the issuer, holding them for a period of time, and then distributing them to the public.

The advantage of the Commission's approach in effecting these changes by the adoption of rules, rather than the enactment of additional statutory provisions, is that the Commission would retain its present flexibility to amend these rules in the future should conditions change and amendments become necessary to protect the interests of public investors. Consequently, while we do not oppose the substantive changes contained in Section 1 of the Bill, except for the provision which would allow persons affiliated with the issuer to resell securities after five years without limitation, we suggest that the better method of implementing those changes is by Commission rule.

Section 2 of the Bill would amend Section 12 of the Securities Act, by adding a sentence which would deny recovery to a purchaser under that section where there has been a "good faith attempt not to involve any public offering * * *," and "all conditions prescribed in rules and regulations of the Commission concerning such a transaction have been met with respect to [the purchaser seeking recovery]."

Presently, there is absolute liability under Section 12(1) if an issuer offers or sells a security in violation of the registration requirements of Section 5. To establish a prima facie case under Section 12(1), all the purchaser need prove is: (1) The purchase of the security; (2) from the defendent or from a person controlled by the defendant; (3) the use directly or indirectly of the mails or the facilities of interstate commerce; (4) that no registration statement was in effect; and (5) that the action was brought within one year from the date of the violation.

In any suit against a seller of securities, the availability of the private offering exemption under Section 4(2) of the Securities Act is an affirmative defense, with the burden of proof resting upon the seller. It is important to note that this exemption is presently available only if the seller can show that there was no public offering to offerees who did not purchase as well as to actual purchasers. The reason for this is that Section 5, the general registration section of the Securities Act, covers offers as well as sales. Thus, under present law, the need for registration is viewed not only in terms of the particular purchaser, but also with respect to all offerees and purchasers, i.e., with respect to the offering itself. Therefore, if the requirments of Section 4(2) are not met, any purchaser has a right of rescission, thereby creating a strong prophylactic effect on sellers.

The approach taken in the Bill, on the other hand, would eliminate the present blanket effect and apply a good faith test as to each individual purchaser. This would result in a significant reduction in the prophylactic effect of the current requirements and result in a diminution in investor protection. In view of the volume of private placements, the limited staff of the Commission is not in a position to enforce the registration provisions of the Act with respect to such offerings without the aid of the prophylactic effect of liability under Section 12(1) as presently written.

Section 3 of the Bill would amend Section 3(b) of the Securities Act by raising the dollar limit ceiling for the small offering exemption from its present $1,500,000 to $3,000,000.

The Commission is authorized under Section 3(b) to exempt securities from registration if it finds that registration for these securities is not necessary to the public interest because of the small amount involved or the limited character of the public offering. Congress has recently raised the ceiling in Section 3(b) to $1,500,000 from $500,000, and just last week raised the ceiling to $2,000,000. The latter raise is awaiting signature by the President.

Pursuant to the authority of Section 3(b), the Commission has adopted a number of rules and regulations, among which is Regulation A. Regulation A is a conditional exemption from the full-scale registration requirements for offerings which do not exceed $1,500,000, and where the offering is made through the use of an offering circular containing disclosure which is somewhat less extensive than a registration statement. The Regulation A ceiling has just been raised to $1,500,000, and while the Commission has consistently endorsed the increase in the dollar limit ceiling contained in Section 3(b) of the Bill and we continue to do so, we would intend to carefully monitor the $1,500,000 ceiling before raising the ceiling further if given the authority.

The Bill would also make a substantial change in the Investment Company Act of 1940, which would result in a significant diminution in investor protection. Section 4 of the Bill would amend Section 3(c) of the Investment Company Act by adding a new subsection (14). This new subsection would exempt small business investment companies, or SBICs, from the provisions of the Investment Company Act, thereby denying public investors in these companies the regulatory protections provided by that Act.

The apparent purpose of this section is to eliminate the present dual jurisdiction exercised over SBICs by the Commission and the Small Business Administration. It must be emphasized, however, that the purposes and protections provided by the statutes administered by the two agencies are very different.

The legislative intent in enacting the Investment Company Act was to eliminate the widespread abuses and failures to observe principles of fiduciary duties which were uncovered in unregulated investment companies. As we discuss in more detail in our previous written comments, the Investment Company Act contains substantial investor protections beyond the disclosure and antifraud provisions of the other federal securities laws. The Small Business Investment Act, on the other hand, was enacted "to improve and stimulate the national economy in general and the small business segment thereof in particular * * *." The primary concern of the SBA, therefore, is with the stimulation of small businesses through additional financing; the protection of investors is, at best, a secondary concern. Moreover, the SBA's position as a creditor of the SBICs, and in many instances as guarantor of their debt securities, may present conflicts of interest if the SBA were to assume the responsibility for investor protection.

While we are concerned with the need to aid small businesses in their efforts to raise capital, this goal should not be accomplished in a manner which would cause substantial dilution of the protections afforded investors who are expected to finance these investment companies. Our experience in enforcing the federal securities laws has shown us that SBICs are entitled to some special treatment, but that they should not be totally excluded from compliance with the Investment Company Act. In fact, a number of the Commission's enforcement actions directed at SBICs have involved serious self-dealing and fraudulent conduct, and, in several cases, the Commission found it necessary to institute injunctive actions and seek the appointment of receivers in order to salvage some of the assets for the investors in such companies. The fact that compliance with the Investment Company Act entails some increased cost and inconvenience on the part of SBICs does not in itself warrant completely excluding such companies from the regulatory scheme of that Act. This increased cost and inconvenience engendered by the Investment Company Act must be weighed against the need to protect the investing public.

In our view, the remedy is not to eliminate all regulatory protections under the Investment Company Act, but rather to administratively reduce such costs and unnecessary regulations wherever feasible. We have the authority to reduce such costs under the Act, and our earlier written statement sets forth some steps the Commission has taken to ease the regulatory burdens of the Investment Company Act on SBICs. For example, the Commission has adopted rules under Section 17 of the Act to obviate the necessity for SBICs to file applications for exemption for certain joint transactions with affiliated persons. We shall continue to work towards easing these burdens where it is not inconsistent with appropriate investor protection.

The Commission is cognizant of the problems presently facing the small business sector of our nation's economy. As I stressed earlier, in many respects the problems of small businesses are rooted in broader economic factors which cannot be remedied solely by amending the federal securities laws. Nevertheless, the Commission is taking steps to minimize the impact of the federal securities laws on small firms wherever possible consistent with our mandate to protect the investing public. Over the next several months, we will be reviewing the summary of our small business hearings and will determine what further steps the Commission can take to enhance the capital raising ability of small business consistent with investor protection. I am hopeful that with imaginative approaches, we can find solutions that fulfill both of these goals.

I would be pleased to answer any questions that you might have.

Memorandum of the Securities and Exchange Commission on H.R. 13032

INTRODUCTION

H.R. 13032, a bill to amend the Securities Act of 1933 and the Investment Company Act of 1940, to encourage investment in small business concerns (the

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"Bill"), is similar, in many respects, to other recent legislation upon which the Commission has already commented,[1] and therefore, much of the following discussion reiterates comments which the Commission has previously made.

The Commission favors the adoption of legislation that would encourage investment in small business concerns and create a climate conducive to the growth of those firms, but, for the reasons set forth below, the Commission does not believe the enactment of the Bill, in its present form, would be in the public interest or consistent with the Commission's mandate to protect the investing public.

DISCUSSION AND SUMMARY

Past and current Commission activities to facilitate capital raising by small business

The Commission has for some time been examining steps which might be taken to facilitate capital raising by small businesses. In March, 1977, the Commission and the Department of Commerce jointly undertook the "Experimental Technology Incentives Program" (the "ETIP"). Under this project, the Commission and the National Bureau of Standards have combined resources to monitor the capital markets which supply financing to small, technology-based firms. The Commission's concern in this area stems from the fact that the funding sources available to small business concerns appear to have diminished during recent years. The ETIP study is intended to determine the extent to which these reductions may be the result of the Commission's administration of the securities laws and to establish an experimental monitoring system to obtain timely information on the impact of Commission regulations on small businesses.

The study will focus on existing regulations of primary concern to small businesses, including the exemptive provisions under the Securities Act of 1933 (15 U.S.C. 77a, et seq.) (the "Securities Act") which enable an issuer to raise capital without the need for the extensive registration statement otherwise required.[2]

Simultaneously, the Commission is reviewing its rules to determine if revision might be appropriate to further accommodate the needs of small business. For example, we are reviewing the narrative financial statement disclosure requirements for sales of securities not exceeding three million dollars.[3]

In addition, the Commission is presently reviewing Rule 146 (17 CFR 230.146)[4] with a view toward amending the rule to make it less burdensome on issuers for offerings not exceeding $500,000. The Commission's staff is also reconsidering Rule 144 (17 CFR 230.144).[5] In light of the 1977 report of the SBA Task Force on Venture and Equity Capital for Small Business which recommended relaxation of the rule.

Also under consideration are rules which would permit increased dollar amounts of securities to be sold without registration and ways to make the existing Regulation A exemption (17 CFR 230.251–230.263) more viable and readily available to small businesses.

In this connection, the Commission announced in December, 1977, that it would hold hearings for the purpose of determining the extent to which the burdens imposed on small issuers by the federal securities laws may be alleviated consistent with investor protection (Securities Act Release No. 5889, copy attached). The hearings, which were held in Washington, D.C., Los Angeles, Denver, Atlanta, Chicago and Boston, concerned the effects of the Commission's rules on the ability of small businesses to raise capital and the impact on small businesses of disclosure requirements under the federal securities laws. Testimony was taken for twenty-one days resulting in a transcript of approximately 5,000 pages. The hearings were completed on May 18, 1978, but the record for the submission of written statements was held open until June 1, 1978.

A preliminary study of the record developed at the hearings strongly indicates that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws. Insofar as the ability to raise capital is concerned, the state of the economy and the existing tax structure, particularly with respect to the capital gains tax, were reported to have the greatest impact. Thus, many witnesses expressed the view that if a favorable change occurred in either of these factors, small businesses would not be substantially impeded by the federal securities laws from obtaining necessary capital.

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[1] For example, H.R. 9549, which was the subject of our letter to the House Interstate and Foreign Commerce Committee, dated July 10, 1978; and S. 1815, and S. 2305. Also, the Bill is substantially identical to H.R. 10717.

[2] These provisions include Regulation A and Rules 144, 146, and 240 under the Securities Act.

[3] Enactment of Section 3 of the Bill might accomplish this same result by authorizing the increase to $3 million of the section 3(b) ceiling.

[4] See pages 4 and 5, infra.

[5] See pages 4 and 6, infra.

That is not to say that the witnesses believed that all of the current requirements under the federal securities laws were justified as applied to small businesses. We do not believe, however, that changes as drastic as those proposed in the Bill are necessary or that the attendant reduction in investor protection is justified by the amount of possible assistance which the Bill may provide. Moreover, the Commission should be allowed sufficient time to evaluate thoroughly the record which it has developed with a view to recommending legislation, where necessary, and taking other appropriate action to assist small business concerns.

Finally, with respect to small business investment companies ("SBICs"), which are the subject of Section 4 of the Bill, because the Commission has for many years been concerned with capital formation by small businesses, the Commission has adopted rules and regulations under Section 3(c) of the Securities Act (15 U.S.C. 77(c)[6] and under the Investment Company Act of 1940 (25 U.S.C. 80a. et seq.) (the "Investment Company Act"),[7] which provide specialized treatment for SBICs. In general, these rules relieve SBICs of requirements which apply to other registered investment companies. The adoption of these rules was prompted by consideration of the nature of SBICs, the inappropriateness of regulatory provisions otherwise applicable to investment companies, and, most significantly, the costs and other burdens of compliance which have to be borne by SBICs.

AMENDMENTS TO THE SECURITIES ACT OF 1933

Relevant provisions of the Securities Act of 1933 and rules and regulations thereunder

Present Section 3(b) (15 U.S.C. 77c(b)) of the Securities Act authorizes the Commission to exempt any class of securities from the full-scale regustration otherwise required by Section 5 of the Securities Act (15 U.S.C. 77e)[8] if it finds that such registration is not necessary in the public interest or for the protection of investors because of the small offering amount or the limited character of the public offering. Regulation A, adopted by the Commission under the authority of Section 3(b), permits a company to obtain capital up to $500,000 in any one year from a public offering of its securities without registration, if, among other things, (1) the company files a notification and offering circular with the Commission supplying basic information about the company and the securities, and (2) the circular is used in the offering.[9]

Also, Section 4(1) of the Securities Act exempts from the registration provisions of Section 5 of that Act "transactions by a person other than an issuer, underwriter or dealer." Rule 144, adopted under the Securities Act, defines certain persons who are deemed not to be engaged in a distribution of securities, and therefore, not underwriters for purposes of the Act.

Additionally, Section 4(2) of the Securities Act exempts transactions not involving a public offering from the provisions of Section 5. Rule 146 (17 CFR 230.146), promulgated under the Securities Act, sets forth non-exclusive conditions that would permit an issuer to qualify for an exemption under Section 4(2).

H.R. 13032

It is important to note, as a preliminary matter, that, while the Bill is intended to encourage investment in small business concerns, the relaxation in the securities laws which would result from the enactment of the Bill would not be confined to small businesses.

As mentioned above, a preliminary study of the record developed at our recent public hearings strongly indicates that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws. On the other hand, we believe that experience has shown that, over the past forty-five years, the full disclosure afforded investors and security holders by the federal securities laws has increased public confidence in the securities markets and facilitated capital-raising by larger business enterprises in a beneficial manner far outweighing the burdens imposed. Accordingly, we believe that the objective of

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[6] See regulation E (17 CFR 230.601, et seq.).

[7] See rules 3c-2, 3c-3, 14a-1, 17a-6, 17d-1(d), 17d-2, 18c-1 and 18c-2; 17 CFR 270.3c-2, 270.3c-3, 270.14a-1, 270.17a-6, 270.17d-1(d), 270.17d-2, 270.18c-1 and 270.18c-2.

[8] Section 5 of the Securities Act requires that all securities offered by the use of any means or instruments of transportation or communication in interstate commerce or the mails be registered with the Commission.

[9] Section 18 of Public Law 95-283 (May 21, 1978) increased the dollar limit ceiling in section 3(b) of the Securities Act from $500,000 to $1,500,000. Under the authority granted by section 3(b), the Commission has also adopted Regulation B (17 CFR 230.300—230.346) for fractional undivided interests in oil and gas rights, and Regulation F (17 CFR 230.651—230.656) for assessments on assessable stock and for assessable stock offered or sold to realize assessments.

assisting small businesses should be approached with appropriately circumscribed provisions which are specifically designed to accomplish that objective. Unfortunately, the Bill is not so restricted.

Section 1

Section 1 of the Bill would amend Section 19 of the Securities Act by the addition of four new provisions—Subsections (c), (d) (e) and (f), which would:

1. in Subsection (c), provide that, in the case of transactions not involving a public offering, the Commission shall not require that offerees or their representatives have access to or be furnished with information other than material information;

2. in Subsection (d), require that the six-month measuring period during which specified amounts of securities can be sold under Rule 144(e) be reduced to three months and that the test for determining the amount of securities which can be sold under the Rule be changed from the "lesser of" to the "greater of" one percent of the outstanding shares of a class or the average weekly trading volume;

3. in Subsection (e), prevent the Commission from prescribing rules and regulations, pursuant to Section 4(1) of the Securities Act, which would limit the amount of restricted securities that could be sold by a person after such person has been the beneficial owner of the securities for a period of five years or more.

4. in Subsection (f), define the terms "restricted securities" to be securities obtained in a transaction not involving a public offering, and "affiliate" to mean a person who directly or indirectly controls, is controlled by, or is under common control with an issuer.

As noted above, Rule 146 sets forth certain conditions which, if complied with, will result in an offering being deemed to be exempt from registration under Section 4(2) of the Securities Act. The Supreme Court has indicated that one of the standards for determining the availability of the exemption is whether the offerees have acess to the kind of information which registration would provide.[10] Accordingly, Rule 146 provides that if an offeree does not otherwise have access to such information, the offeror must provide it for him. The Rule expressly states that information which is not material need not be provided, and that information need not be provided if it is not reasonably available to the offeror.

Since neither the Securities Act nor Rule 146 purports to require the furnishing of information which is not material, proposed Section 19(c) is unnecessary and might be confusing in that it could lead to fruitless arguments about the provisions of a non-exclusive rule, rather than focusing attention on the basic question of whether investors had been adequately informed.

We are also concerned with the amendments contained in proposed Section 19(d). As mentioned above, Section 4(1) of the Securities Act exempts from registration securities in a transaction by a person other than an issurer, Underwriter or dealer. and, Rule 144, adopted under that Act, defines persons who are deemed not be engaged in a distribution of securities, and therefore, not underwriters for purposes of the Act. Rule 144(e) presently limits the amount of securities which may be sold in reliance upon Rule 144 during a given six-month period. Proposed Section 19(d) would decrease the six-month measuring period provided for in Rule 144(e) to three months and thus allow increased sales of securities of both large and small businesses without registration.

Similarly, increased sales of securities without registration could result from the change in the test for determining the amount of securities which can be sold under Rule 144—from the "lesser of" to the "greater of" one percent of the outstanding shares or the average weekly trading volume.

Some easing of present restrictions may well be appropriate. However, in view of the Commission's current intensive study, mentioned above, concerning possible rule changes and legislation to lessen the burdens on capital formation by small businesses, we believe that it would be inadvisable for Congress to amend present Commission rules by statute, thus prematurely and needlessly rigidifying the pattern of exemption from the present registration requirements.

Section 1 of the bill would also amend Section 19 of the Securities Act by adding a new sub-section (e). Proposed Section 19(e) would prevent the Commission from prescribing rules and regulations, pursuant to Section 4(1) of the Act, which would limit the amount of unregistered securities, purchased or otherwise acquired from an issuer or underwriter in a non-public offering, which could thereafter be sold where a person has been the beneficial owner of such securities for a period of five years or more.

Section 2(11) of the Securities Act defines "underwriter" to mean "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in

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[10] *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119, 127 (1953).

connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking * * *."[11]

There is nothing in the definition of an underwriter which places a time limit on a person's status as an underwriter. The public has the same need for the protection afforded by registration whether the securities are distributed shortly after their purchase or after some length of time. Accordingly, while the length of time which a person has been beneficial owner of restricted securities is obviously an important consideration in determining whether a person is an underwriter, it should not be decisive, as would be the case under proposed Section 19(e). Unless the Commission retains its present ability to impose such conditions as are necessary to govern the amount of restricted securities which can be resold by persons who have beneficially owned such securities for more than five years, there could be no assurance that the exemption from registration afforded by Section 4(1) would be used only for routine trading transactions, as opposed to distributions by persons who, under the present definition, are and should be considered underwriters.[12] The Commission, therefore, opposes the enactment of Section 19(e) as inconsistent with its mandate to protect the investing public.

We have no comments on Section 19(f), defining "restricted securities" and "affiliate."

Section 2

Section 2 would amend Section 12 of the Securities Act by adding a sentence which would, in the case of a transaction involving a "good faith attempt not to involve any public offering pursuant to section 4(2)," deny recovery under Section 12 to a purchaser of securities "if all conditions prescribed in rules and regulations of the Commission have been met with respect to such purchser." Enactment of Section 2 of the Bill would be contrary to the interests of investors, and the Commission, therefore, opposes this provision.

Presently, there is absolute liability under Section 12(1) if an issuer offers or sells a security in violation of Section 5.[13] To establish a prima facie case under Section 12(1) all the plaintiff need prove is (1) the purchase of the security, (2) from the defendant or from a person controlled by the defendant, (3) the use directly or indirectly of the required jurisdictional means, (4) that no registrtion statement was in effect, and (5) that the action was brought within one year from the date of the violation.[14] The availability of the private offering exemption is an affirmative defense as to which the defendant has the burden of proof.[15] Under present law that exemption is unavailable unless the defendant can show not only that the requirements of Section 4(2) have been met with respect to all purchasers but that they have also been met with respect to all offerees.[16] A contrary view would lose sight of whether the offering is in fact public or private inasmuch as Section 5 reaches both offers and sales. Thus, the fact that all the requirements of Section 4(2) have been met as to a particular plaintiff who is suing under Section 12(1) should be irrelevant

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[11] As used in the definition, the term "issuer" includes in addition to an issuer, "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

[12] It should be noted that rule 144 is not the exclusive means for selling restricted securities without registration under the act. Rather, the rule is intended to be a safe harbor for establishing the availability of the exemption provided by section 4(1). Thus, sales of restricted securities which do not constitute a distribution may be made by nonaffiliates directly under section 4(1), if they are made in accordance with the existing interpretations thereof. The Commission will not issue no-action letters relating to the resale of securities acquired after April 15, 1972, the effective date of rule 144. Securities Act Release No. 5223 (January 11, 1972) at 2. No-action letters, however, are issued with respect to the resale of securities acquired before that date.

With respect to restricted securities acquired after the effective date of the rule (April 15, 1978) but not sold thereunder, the Commission has taken the interpretative position that in deciding whether a person is an underwriter, the length of time the securities have been held will be considered, but the fact that securities have been held for a particular period of time does not by itself establish the availability of an exemption from registration. Securities Act Release No. 5223 (January 11, 1972) at 3. Nevertheless, restricted securities, which are not being sold by or for the account of an affiliate and which are not part of a distribution, may generally be sold directly under section 4(1) if they have been owned beneficially for a period of three years or more.

[13] See, e.g., *Woodward* v. *Wright,* 266 F.2d 108, 115 (C.A. 10, 1959).

[14] See, e.g., *Lively* v. *Hirschfield,* 440 F.2d 631 (C.A. 10, 1971).

[15] *Securities and Exchange Commission* v. *Ralston Purina Co., supra,* 346 U.S. at 126.

[16] *Henderson* v. *Hayden, Stone, Inc.,* 461 F.2d 1069 (C.A. 5, 1972); *Securites and Exchange Commission* v. *Continental Tobacco Co. of S.C., Inc.,* 463 F.2d 137 (C.A. 2, 1972); *Hill York Corp.* v. *American International Francises, Inc.,* 448 F.2d 680 (C.A. 5, 1971); *Lively* v. *Hirschfield, supra,* 440 F.2d at 632.

for the purpose of demonstrating that the issuer-defendant was exempt from the registration requirements by virtue of Section 4(2).

The importance of this approach was emphasized by the Court of Appeals for the 10th Circuit in *Lively* v. *Hirschfield.* In that case, the court stated:

"After the *Ralston Purina* case the emphasis in the decisions has been placed on the particular capabilities and information had by particular persons, buyers, plaintiffs or offerees. The *Ralston Purina* case required this examination of the individuals solicited to determine the nature of the offer, that is, to determine whether there was a public need for registration * * *.

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"The standard must apply to all the offerees if the *Ralston Purina* case is to be meaningfully applied, and if the artificial classification of "Plaintiffs" and the accidental classification of "buyers" is to be prevented from determining the nature of the offer in a private action such as this."[17]

Thus, under present law, the need for registration is viewed not only in terms of the particular private plaintiff but also with respect to all offerees and purchasers, i.e., with respect to the offering itself. Insofar as plaintiffs under Section 12(1) are concerned, the proposal to amend that section, in our view, erroneously shifts the emphasis on the need for registration by exempting any transaction by an issuer not involving a public offering to the particular purchaser, regardless of the fact that despite the asserted "good faith" of the issuer, the offering is public as to all other offerees and purchasers.

Moreover, even to the extent that provision of a right to recind or sue for damages to particular plaintiff who did not personally need the protections afforded by registration can be viewed as imposing a burden on the issuer, we believe that, from a policy standpoint, this burden may be justified as a necessary inducement to scrupulous adherence to the registration requirements. Of course, the Commission may sue to enforce violations of Section 5, but that is not a sufficient answer to this concern. Due in part to its recognition of the institutional limitations of the Commission in evaluating the volume of proxy statements which it received, the Supreme Court recognized a similar need under the Securities Exchange Act by recognizing that there is an implied cause of action under the Commission's proxy rules adopted under that Act.[18] The court noted that: "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages * * * serves as a most effective weapon in the enforcement of the proxy requirements."[19]

In view of the volume of private placements,[20] the limited staff of the Commission is not in a position to enforce the registration provisions of the Act with respect to such offerings without the aid of the prophylactic effect of liability under Section 12(1) as presently written.

The ability to maintain a class action under Rule 23 of the Federal Rules of Civil Procedure may also be impeded by the proposal. With the focus of Section 12(1) shifted to the determination of whether there has been a good faith attempt not to involve any public offering pursuant to Section 4(2) as to each purchaser, rather than whether there has been an unregistered public offering, a class of plaintiff-purchasers faces a substantial burden in persuading a court to find that "the questions of law or fact common to the members of the class predominate over any questions affecting only individual members * * *," as required by Rule 23(b)(3). This additional hurdle to the maintenance of private causes of action for failure to register may not only operate to leave an aggrieved class without an effective remedy but may also provide an incentive to issuers to gamble on avoiding the costs and burdens to registration.

An additional, although possibly unintended, effect of the proposal may be to reduce or eliminate the protection afforded by Section 12(2) as applied to private

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[17] 440 F. 2d at 632–633.

[18] *J. I. Case* v. *Borak,* 377 U.S. 426 (1964).

[19] *Id.* at 432.

[20] Commission statistics are not representative of the total volume of private placements since only institutional transactions are included. In spite of this limitations it is noteworthy that the Commission estimated that the securities in private placements in 1976 (the latest year for which complete statistics are available) was approximately $16.2 billion, approximately 31 percent of the gross proceeds from the sale of all corporate securities. 37 SEC Statistical Bulletin No. 1 (January, 1978). Private placements show no sign of abating; statistics through October, 1977, indicate approximately $11.8 billion in private placements, representing approximately 31 percent of sales of all corporate securities.

placements.[21] Thus, it is unclear to what extent "a good faith attempt not to involve any public offering pursuant to section 4(2)" will preclude a cause of action under Section 12(2) for an untrue statement of a material fact or for an omission of a material fact necessary in order to make statements made not misleading.[22] The Commission, of course, would be opposed to any reduction in the scope of liability under Section 12(2) under such circumstances.

Section 3

Section 3 of the Bill would amend Section 3(b) of the Securities Act by raising the dollar limit ceiling for the small offering exemption from $1,500,000 to $3,000,000.[23] The Commission recently expressed its support for this increase.[24] As noted above, the Commission is very sensitive to the burdens imposed by the requirements of the federal securities laws on capital formation by small businesses and is intensively considering means to lessen those burdens, consistent with investor protection. That protection, however, requires that the Commission carefully examine the exemption as it may apply in different situations, and therefore, we would not necessarily favor an across-the-board increase in the Regulation A exemption for all small offerings. In this regard, since the Bill would change only the dollar limit in Section 3(b), the Commission would retain its present flexibility to adopt rules classifying offerings under Regulation A, and otherwise, based on such factors as the size of the offering and the business and history of the issuer. This flexibility is necessary in order for the Commission to tailor the disclosure obligations and other safeguards, based on a balance between the protection of investors and the standards set forth in Section 3(b). In this connection, the Commission is actively considering raising the Regulation A limit to the new statutory ceiling of $1,500,000.

AMENDMENT TO THE INVESTMENT COMPANY ACT OF 1940

Section 4

Section 4 of the Bill would amend Section 3(c) of the Investment Company Act by adding a new subsection (14), which would exempt SBICs from the provisions of that Act. The apparent purpose of this section is to eliminate the present dual jurisdiction exercised over SBICs by the Commission and the Small Business Administration (the "SBA"). But, this would deny public investors in SBICs the protective umbrella of the Investment Company Act,[25] although SBICs would remain subject to certain provisions of the Securities Act and the Securities Exchange Act.[26]

The legislative intent in enacting the Investment Company Act was to eliminate the widespread abuses and failures to observe principles of fiduciary duties which were uncovered in unregulated investment companies. The Small Business Investment Act (the "SBIA"), on the other hand, was enacted "to improve and stimulate

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[21] Section 12(2) of the Securities Act imposes liability on any person who "offers or sells a security * * * by the use of any means or instruments of transportation or communication in interstate commerce or the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements * * * made not misleading."

[22] In this connection, we note that a condition for the application of the proposed additional sentence in Section 12 is that "all conditions prescribed in rules and regulations of the Commission have been met with respect to such purchaser." It is unclear to what extent antifraud rules adopted by the Commission under the Securities Exchange Act of 1934, such as Rule 10b–5, would be treated as rules of the Commission under the new sentence.

[23] As noted above, Public Law 95–283 (May 21, 1978), increased the dollar limit ceiling in section 3(b) to $1,500,000.

[24] Section 202 of H.R. 9549 is similar to this provision. As your Committee will recall, the Commission supported enactment of the section in its comments on that bill, transmitted July 10, 1978, but that bill contained a specific reference to regulation A in its heading. As we then noted, this reference might have reflected the drafter's intent that the Commission increase the maximum dollar amount of securities exempted under Regulation A to correspond to the proposed increase in the Section 3(b) limit. We note that this heading is absent from H.R. 13032.

[25] Those protections include: (1) prohibitions against change in the nature of an investment company's business or its investment policies without shareholder approval (Section 13(a)); (2) protection against management self-dealing (section 17); (3) restrictions on overly complex and unsound capital structures (section 18); (4) special requirements relating to the solicitation of proxies from shareholders (section 20(a) and rules 20a–1 and 20a–2); (5) restrictions on affiliations of directors (Section 10); (6) requirements for disclosure of the source of cash distributions (section 19) and financial condition (Section 30); and (7) provisions that contracts made in violation of the act shall be void (Section 47).

[26] Those requirements include the registration and antifraud provisions of the Securities Act, where applicable, and the antifraud, reporting, proxy solicitation provisions and insider trading restrictions under the Securities Exchange Act of 1934. The Securities Exchange Act provisions, other than those relating to fraud, would apply only where the SBIC had total assets exceeding $1,000,000 and a class of equity securities held by 500 or more persons; and even then such provisions would no longer apply where the number of security holders fell below 500.

the national economy in general and the small business segment thereof in particular * * *." [27] The primary concern of the SBA is with the stimulation of small business through additional financing; the protection of the investing public, if present as a concern, is only a secondary one. Moreover, the SBA's position as a creditor of the SBICs, and in many instances as guarantor of their debt securities, may cause conflicts of interest if the SBA were to assume the responsibility for investor protection.

While we are concerned with the need to aid small businesses in their efforts to raise capital, this goal should not be accomplished in a manner which would cause substantial dilution of the protections afforded investors who are expected to finance these investment companies. Our experience in enforcing the federal securities laws supports the conclusion that while SBICs are entitled to some special treatment,[28] they should not be excluded from compliance with the Investment Company Act. In fact, a number of the Commission's enforcement actions directed at SBICs have involved serious fraudulent conduct, and, in several cases, the Commission found it necessary to institute injunctive actions and seek the appointment of receivers in order to salvage some of the assets for the investors in such companies.[29] The fact that compliance with the Investment Company Act entails some increased cost and inconvience on the part of SBICs does not in itself warrant completely excluding such companies from the regulatory scheme of that Act. This increased cost and inconvenience engendered by the Investment Company Act must be weighed against the need for adequate means to protect the investing public. The remedy does not lie in the elimination of all regulatory protections under the Investment Company Act but rather in the administrative reduction of such costs and unnecessary regulations wherever feasible.

CONCLUSION

The Commission is cognizant of the problems of small businesses and, as mentioned above, is exploring ways to minimize the impact of the federal securities laws on those firms whenever possible, including legislative proposals. For the reasons set forth above, however, the Commission does not favor enactment of the Bill in its present form.

Mr. ECKHARDT. Thank you. Mr. Broyhill?

Mr. BROYHILL. Thank you, Mr. Chairman.

We appreciate the information that you have given to us. I am looking at the changes that you have made in rule 144. Now, as I understand it, the rule as unchanged limited the sales of securities in a 6-month period to the lesser of 1 percent of the class outstanding, or the average weekly volume. You have changed that to a volume in a 3-month period of the greater of the 1 percent of the class, or the average of the weekly volume. Is that a fair description?

Mr. WILLIAMS. Yes, sir.

Mr. BROYHILL. Plus, after 5 years there is no volume limitation.

Mr. WILLIAMS. That is a proposed rule.

Mr. BROYHILL. That is a proposed rule, there is no volume limitation. But that does not apply to affiliates of the issuer.

Can you give us some background on how you arrived at this particular market volume. Was it based upon some study, or based upon some other criteria that was developed?

Mr. ROWE. The 1 percent is a historical figure that was chosen by the Commission and has been used for some 24 years. There has been one study which the Commission's economic policy research staff did, which indicated that using that volume test, there did not appear to be any unusual market activity, and the Commission went to the greater standard because of that.

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[27] Section 12 of the SBIA (15 U.S.C. 661).

[28] See page 3, supra, and the rules cited in notes 6 and 7.

[29] See, e.g., *Securities and Exchange Commission* v. *Advance Growth Capital Corporation, et al.*, 470 F.2d 40 (C.A. 7, 1972).

Mr. WILLIAMS. We have to say to you, Mr. Broyhill, that there is no great science behind the 1 percent, there is history. In effect, what we have done at this point is, at a minimum, doubled it. We have gone beyond that in adopting the greater standard too. We will be pragmatic in trying to assess the results.

Mr. BROYHILL. It is possible, of course, under the rule, assuming it is finally adopted, that the average weekly volume could be higher than the 1 percent.

Mr. WILLIAMS. Yes.

Mr. BROYHILL. Has the average weekly volume, as a rule of thumb, or a rule indicated that you should not be disposing of any more stock than that, has that been based upon the other studies or criteria that have been developed by the Commission?

Mr. ROWE. That was not what was tested by the study, and it was not developed as a result of any empirical study. There was just some indication that if you sold the average weekly trading volume you would not have to engage in any unusual selling activity, or pay somebody more than the normal broker's commission to sell the securities. But it was not based on any hard and fast empirical study, it was based more on the experience of the Commission staff and the Commission itself as well as logic.

Mr. BROYHILL. Well, let me get into another area here quickly, we will have to leave here in a few minutes. With respect to section 4 of the bill that was introduced to exempt SBIC's from the 1940 act, you, of course, indicate that the missions of the SEC and the SBA are somewhat different. However, the SBA as the primary creditor of a SBIC does have the substantial responsibility of seeing that the SBIC investment is not only sound, but that it be reasonably broad.

It seems to me that the SBA's interests are compatible with the interests of investors, and that they can do a satisfactory job of monitoring the transactions. I wonder if you might comment further about this, as to what kinds of problems you had, and what information you might have developed that is different from that of the SBA.

Mr. WILLIAMS. Let me make some general observations about that and then ask Mr. Mendelsohn to comment on it.

Our experience has been in a number of areas of Commission activity that regulatory agencies or others who focus on creditor or solvency relationships typically show little concern directly for the interest of investors per se, especially that of equity investors. We have experienced that often in connection with the bankruptcy laws and reorganization activities where the focus of the trustee is on the creditors, and we have interceded to urge a restructuring of the arrangement—not to reduce the protection of creditors, but to recognize that there are some junior interests in there behind the creditors that the people seemed to have overlooked.

I might indicate that to some extent a similar criticism can be made, for instance, that a banking agency does not have a direct concern for the interest of investors in the banking institutions themselves. I think it is understandable in terms of the specifics relating to the SBIC's and our relationship with the SBA.

Would you comment on that?

Mr. MENDELSOHN. Yes. First, Mr. Broyhill, there are only now 42 registered SBIC's under the Investment Company Act. So, it is a miniscule number of situations where we have this so-called conflict with the SBA.

My experience has been that the SBA, looking toward the solvency in a particular transaction, particularly where the SBIC is in bad financial condition, will welcome, for example, the liquidation of a particular investment in order to pay off a debt that the SBA may be guaranteeing, or may be the principal creditor, and only secondarily—if at all—looking to the equities of the particular transaction—whether the SBIC could have gotten a better price; whether as a matter of fact it is an affiliated transaction and there is a bit of overreaching.

In addition I have found that our administration of the Investment Company Act has gone into an area which is totally—I say totally, at least to my knowledge—ignored by the SBA. For example, we have had at least two occasions that come to mind where a person and a company came in for a loan or an investment by the SBIC, the management would insist in one case that its president represent the small company as counsel when the deal is closed. This is something that would hardly come to the attention of the SBA. But in our inspections we have found that the president of the investment company, the SBIC, was also counsel for the borrower. On investigation we found that this was done by pressure. In effect, instead of helping small business, that kind of a transaction hindered it because I think it is a rather thinly vailed bribe that was being negotiated here.

We also have a variation on that theme, where a little company came in for a loan and the management of the SBIC said, "Well, you need financial consulting. Obviously, you are a new company, we cannot lend you any money because you just do not have any financial consulting."

Now, it just so happened that the president and vice president have a consulting firm, and they indicate that if you would take a contract with them, then of course they could see to lend you the money.

We have found several of those situations which my knowledge have never come up before the SBA. Now, as I say, the vast majority of SBIC's have no connection with the SEC because of the fact that they are private organizations, and they have raised their money in private and have less than a hundred investors. Consequently at the present, as of September 26, there are only 42 of these companies that have over a hundred investors, or have made a public offering, that are within the jurisdiction of the Investment Company Act of 1940.

Mr. BROYHILL. Well, of course the concern that I have, and what indicates the difficulty here is that only 42 firms that have registered under the 1940 act, that they take whatever steps necessary not to come under the 1940 act. That is why I think we should examine this to determine if there is any other way to regulate those SBIC's without overkill, so that we can encourage more capital to go into small businesses.

I can see if there were some way to encourage groups of investors that number over 100 that were able to form those organizations,

that it would be advantageous. But, they hesitate to do so because the act is cumbersome, and I suspect that we are going to hear testimony to that effect from witnesses later in these hearings.

Mr. MENDELSOHN. Well, obviously we have recognized that the act is not an easy act to comply with. In this connection the Commission, several years ago, promulgated what we call rule 17a-6. Now, this was done specifically for SBIC's. It was a rule which said with respect to affiliated transactions, particularly transactions dealing with the small company, refinancing and things of that sort, that there would be an exemption from section 17. That is, they would not have to file an application for exemption with the Commission provided that no officer, director, employee, or controlling person would have a specific financial interest in the transaction, other than his stock in the investment company. As a result of that rule we have had a tremendous downflow, if you will, of applications. Most of the transactions of an SBIC that formerly had to have approval by the Commission no longer have to be approved.

Mr. BROYHILL. I have no further questions at this time, Mr. Chairman.

Mr. ECKHARDT. Chairman Williams, as you recall, we permitted the raising of the regulation A exemption to $1.5 million in May. I believe that the Commission then proceeded in about July to provide for that increase.

Then, of course, recently the Senate passed the SEC authorization bill which would raise that to up to $2 million.

Have you had time to get any experience with the raised figure to $1.5 million, as to whether it has generated greater interest by issuers in the use of regulation A?

Mr. WILLIAMS. At this point, Mr. Chairman, the increase is not formally effective, not yet having been published by the Federal Register. We have submitted it for publication, but it has not phsyically happened as yet. We do have in the field an indication of a number of questions being asked, indicating at least an increased interest. But it is too early, of course, to tell whether it will make any substantive difference.

Mr. ECKHARDT. One of the attractions of regulation A for small issuers is that it does not require certified financial statements. On the other hand, it has been suggested that the proportionately large number of enforcement actions which the Commission has taken in connection with regulation A filings may be the result of unaudited financial statements.

I would like to ask some questions about such financial statements. First, could you tell us what the added increment of cost might be for certified financial statements?

Mr. ROWE. We do not have any exact figures on that. The Advisory Committee on Corporate Disclosure in their report to the Commission indicated that the cost of an audit for a company with less than $100 million assets—and they looked at a few companies—is something like $47,000. Accountants charge by the hour, so, depending on the complexity of the company, the size of its records, the number of years that they have to audit, the cost would vary. But the $47,000 figure is probably a little high for a company that is making a $500,000 offering. For a company that is

making a $1.5 million offering, a slightly larger company, it might be a fairly representative figure, but that is not based on any hard cost data. We do get the information from the companies' postfiling reports.

Mr. WILLIAMS. It would depend in part on the size and the type of the company. Typically, I think the kind of company we would be addressing here would be one that does not normally have audited financials, otherwise it would produce very little incremental cost. Which is, the, typically a small company, privately owned—or larger, privately owned—and they would be probably more toward the low end of the scale, which is still probably in the $30,000 to $50,000 range.

Mr. ECKHARDT. I have been told that it may be difficult to sell regulation A issues without such financial statements. Do you anticipate that this will be the case, with the new $1.5 million ceiling on regulation A.

Mr. WILLIAMS. probably, the larger the offering, the more likely an underwriter will be involved. If an underwriter is involved, the likelihood is they will require certified financial statements. Also, the greater the likelihood that the company ends up as a company, after the distribution, which then would require certified financial statements, independent of the offering itself.

Mr. ECKHARDT. What would you think of the possibility of exercising your discretion under the $2 million figure? And perhaps we might go higher in the future. What would you think about the conditioning the regulation A exemption with financial statements after a certain figure?

Mr. WILLIAMS. We considered that and discussed it at some length, even in the context of going to $1.5 million. I would say, there was some difference among the staff as to whether we should or should not do that. The Commsiion concluded that we should not.

The matter is complicated, there are what, 28 States?

Mr. ROWE. There are 31 States that have some sort of financial statement requirement.

Mr. WILLIAMS. Under their own "Blue Sky laws. So, we are not totally free on the requirements for certified financial statements, both because of State laws of underwriter activities and others. We are gaining some pretty good experience at this point in terms of under the million and-a-half limitation, and also how that integrates with our other filing alternatives like form S–18 offerings; and how it relates to section 12(g) of the Securities and Exchange Act. I think we need to gain more experience.

Certainly at that point, assuming we were to raise the ceiling again, we will be considering to what extent requiring financials would serve a constructive purpose, and to what extent it would be necessary.

Mr. ECKHARDT. I understand the Commission's reduction of quantitative restrictions under rule 144 seems to have been pretty generally favorably accepted. In addition, the Commission has proposed lifting any resale restrictions on the securities held more than 5 years by persons not affiliated with the issuer. I believe you touched on this in your testimony.

If this were adopted, might it not create some investor protection problems if a person were to buy a quantity of securities of Shell Corp., put them on the shelf for 5 years, and then sell them to the public?

Mr. WILLIAMS. It is possible. But essentially, all this proposed rule change would do would be to eliminate the volume limitation, all the other requirements would remain in effect. So, it would be a matter of degree in a sense. We just have an enforcement issue. Mr. Rowe, do you have any comments on that?

Mr. ROWE. It is conceivable, but the protections would still remain in the rule, and there would have to be public information available concerning the issue, it could only be sold in an ordinary broker's transaction without solicitation.

The Commission has indicated that the rule is not available for evasive schemes, so, you have that protection. The 5-year provision, if adopted, would not be available for affiliates. Generally, I think, when you get a situation—that is the one you described—the person who has a big block of securities controls the shell and is an affiliate. Although, conceivably, there are holes that somebody could slip through. I do not think the risk of that happening is terribly great.

Mr. ECKHARDT. I am wondering about rule 146. In your testimony you indicated the Commission's present disinclination to modify rule 146. I am wondering if you might agree that one of the reasons that rule 146 has been so unattractive is because of the quantitative limitations on secondary sales imposed by rule 144. Now the Commission has modified 144, perhaps there might not be so much attack on 146.

Mr. WILLIAMS. Possibly.

Mr. ROWE. It is too early to tell, 144 has only been in effect for 2 days. We do not know what the results will be. It is possible it will encourage more people to make private investments, and they can liquidate those investments more rapidly.

Mr. ECKHARDT. I am sort of anticipating some of the future testimony, and of course we do not have to guess much as to the future testimony on this committee. Some of the witnesses come after you, and I do not, therefore, otherwise have an opportunity to have you comment on his testimony.

Mr. Heizer, who will testify next, heads the largest independent venture capital firm in the United States with assets of some $200 million, and an impressive record of financing small companies.

That company has been in business for some time now and many of their initial investors would like to liquidate their positions. However, if they sell their shares they, without doubt, will end up with over 100 shareholders and therefore become a company subject to the Investment Company Act.

The restrictions of that act, Mr. Heizer suggests, are incompatible with the venture capital business. As a result, the Heizer Corp. will be forced to liquidate. Although I can appreciate the investor protection afforded by the Investment Company Act, it seems to me that the public interest is not served by forcing that kind of company to liquidate.

I am wondering what we might do to both protect public investors and keep the Heizer Corp. and other similar ventures in

business. Would you share your views, or do you have any thoughts about it?

Mr. WILLIAMS. Mr. Chairman, I have not seen Mr. Heizer's testimony. I have a great deal of respect for his firm and for his contribution to the financing of venutre capital in small business. If he feels that strongly about it, we ought to understand just why and what the problems are that he perceives, and respond more thoughtfully. I do not know what the crucial points of conflict are as far as he is concerned, but we ought to understand him and respond.

It would be unfortunate if we have that outright philosophical collision between two very worthwhile purposes. There ought to be some way we can reconcile them in the interest of all.

Mr. ECKHARDT. Well, thank you very much for your testimony, you have been very helpful.

Mr. WILLIAMS. Thank you.

Mr. BROYHILL. Mr. Chairman, would you answer a few questions in writing?

Mr. WILLIAMS. We will respond to any questions.

[Testimony resumes on p. 4.]

[The following questions from Congressman Broyhill to Chairman Williams and response thereto follow:]

Responses to Questions Asked by the Honorable James T. Broyhill in Connection With H.R. 10717, 95th Congress, 2d Sess.

Question #1: As we understand the history of Rule 144, the minimum holding period was required in order to prove investor intent. Since the Agency formerly granted "no-action" letters after a 2- or 3-year holding period and since that period of time certainly seems to be long enough to prove investor intent, why will the Agency not now support exempting all purchasers, including affiliates, from the sale provisions of Rule 144 after a 5-year holding period?

Answer: The minimum holding period was intended to preclude a distribution through a purchaser acting as a conduit, by placing the purchaser at risk for a reasonable period of time. As indicated recently in Release No. 33-5980 (September 20, 1978), the Commission believes there may be some basis for exempting persons who are not affiliates from the volume limitations of Rule 144 after such persons have held their securities for a period of five or more years. We believe, however, that exempting affiliates in a similar manner would not be consistent with Sections 2(11) and 4(1) of the Securities Act of 1933 to which Rule 144 directly relates.

Section 4(1) permits resales of securities to be made without registration under the Act "by any person other than an issuer, underwriter, or dealer." Since most persons are neither issuers nor dealers, the focus for purposes of Section 4(1) generally is on the term "underwriter." Section 2(11) defines an underwriter as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking..." In addition, the last sentence of Section 2(11) provides that the term "issuer", as used in the section, "shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

It is clear from Section 2(11) that a person will not be treated as an underwriter with respect to his securities if he meets two tests: (1) he did not buy the securities from the issuer with a view to distribution, and (2) he did not sell the securities in a distribution effected on behalf of the issuer or participate in such a distribution. In this context, if a person has held his securities for a period of five or more years, he would appear to satisfy the first test, since the length of his holding period would be an indication that he bought for purposes of investment rather than distribution. But if the person were an affiliate of the issuer, there necessarily would be some doubt whether he satisfied the second test. An affiliate by definition is a person who directly

or indirectly controls, or is controlled by, or is under common control with, the issuer. Because of an affiliate's control relationship to the issuer, there is always a significant possibility that he may seek to resell his securities in a distribution that is designed to benefit the issuer either directly or indirectly. Any such distribution would, of course, mean that the affiliate was an underwriter and that the exemption provided by Section 4(1) was not available, notwithstanding his lengthy holding period. Moreover, control persons generally can cause the issuer to file a registration statement to facilitate sale of their securities. Therefore, any limitation on their resales pursuant to Rule 144 would be less of a burden than it would be on a non-affiliate.

Because of the possibility that affiliates may sell their securities in distributions designed to benefit the issuer, the Commission believes it would be inappropriate to exempt such persons from the volume limitations of Rule 144 merely because they have held their securities for five or more years. The volume limitations are intended to limit sales under the rule to amounts that will not in the aggregate constitute distributions. If, however, affiliates are not required to adhere to such limitations, some might sell their shares in distributions effected, at least in part, on the issuer's behalf. Such a result under the rule clearly would be contrary to the purposes of Sections 4(1) and 2(11).

The Commission believes its view concerning the continued application of the volume limitations to affiliates is in accord with the last sentence of Section 2(11). That sentence, which is described in the second paragraph of this response, basically attempts to equate issuer sales with affiliate sales by stating in effect that a person who has a control relationship to the issuer (i.e., an affiliate) shall be treated as the issuer for purposes of Section 2(11). If carried to its logical extreme, this sentence could be interpreted to mean that the Section 4(1) exemption can never be available to affiliates, since such persons are deemed by Section 2(11) to be issuers and issuers are expressly prohibited from relying on it. Although the Commission has not adopted this extreme position, it nevertheless believes that the sentence indicates a basic concern on the part of Congress regarding sales by affiliates.

Although the Commission does not believe affiliates should be exempted from the volume limitations of Rule 144 after a five-year holding peroid, it has proposed to provide such an exemption for non-affiliates. The Commission's proposal in this regard is set forth in detail in Release No. 33-5980, a copy of which is attached. The comment period for the proposal expires on November 20, 1978, and it is anticipated that the Commission will take final action on the proposal no later than January 1979.

[17 CFR Part 230]

[Release No. 33-5980, File No. S7-755]

RESALES OF SECURITIES

Proposed Rulemaking

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rulemaking.

SUMMARY: The Commission is publishing for comment a proposal to amend two rules which provides safe harbors for the resale of securities to the public. The proposed amendments would permit persons who have held securities covered by the rules for a period of 5 years or more to sell such securities without any amount limitation, provided such persons are not affiliates of the issuer of the securities. The purpose of the amendments is to relax certain requirements of the rules which may be more burdensome than necessary.

DATE: Comments must be received on or before November 20, 1978.

ADDRESS: Comments should be submitted in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. Comment letters should refer to file No. S7-755 and will be available for public inspection.

FOR FURTHER INFORMATION CONTACT:

Peter J. Romeo, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 20549, 202-755-1240.

SUPPLEMENTARY INFORMATION: The Commission today published for comment proposed amendments to rule 144 (17 CFR 230.144) and rule 148 (17 CFR 230.148) under the Securities Act of 1933 ("1933 Act") (15 U.S.C. 77a et seq.) The amendments are being proposed for the purpose of relaxing certain requirements of the rule which may be unnecessarily burdensome. In a related action, the Commission previously announced in a separate release [1] the adoption of other amendments to rules 144 and 148 which similarly are designed to reduce the burdens of those rules.

[1] Release No. 33-5979 (September 19, 1978) (43 FR 43726).

BACKGROUND

Both rule 144 and rule 148 provide a safe harbor for the public resale of certain types of securities. Rule 144 applies to the resale of "restricted securities" [2] and securities held by affiliates [3] of an issuer, while rule 148 is applicable to the resale of securities acquired in bankruptcy proceedings. Both of these rules prescribe standards which, if met, permit persons who hold such securities to sell them publicly without the need for registration and without being deemed underwriters [4] under the 1933 Act.

Rule 144 was considered to be an experiment at the time of its adoption.[5] Accordingly, the Commission has monitored its operation to determine how well it is working and what changes, if any, are necessary to improve it. Generally, it is the Commission's view that the rule has operated well insofar as achieving its primary purpose, the protection of investors, is concerned. It has, however, been subject in recent years to the criticism that several of the requirements, particularly those limiting the amount of securities that can be sold under it, are more restrictive than necessary to achieve the purposes of the 1933 Act.

The Commission has given consideration to the critical comments concerning rule 144 and in the past several years has taken various steps to relax some of the rule's requirements.[6] It now proposes to take a further step in that direction by publishing for comment an amendment that would

[2] The term "restricted securities" includes securities acquired in nonpublic offerings, such as those under section 4(2) of the 1933 Act, as well as securities acquired in offerings made in reliance upon rule 240 (17 CFR 230.240) under the Act.

[3] An "affiliate" of an entity is defined in rule 405 (17 CFR 230.405) under the 1933 Act as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the (entity)."

[4] The term "underwriter" is broadly defined in section 2(11) of the 1933 Act and includes persons who acquire securities "with a view to * * * distribution" or who participate directly or indirectly in the distribution of a security.

[5] See in this regard the portion of Release No. 33-5223 (January 11, 1972) (37 FR 591) entitled "Operation of the Rule."

[6] For more information in this regard, see the release cited in footnote 1, infra.

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permit sales under the rule to be made without any volume restrictions: *Provided*, The seller is not an affiliate of the issuer and has held his securities for at least 5 years. A similar amendment to rule 148 also is being proposed for comment.

Discussion of the Proposal

Under the existing provisions of rule 144, a nonaffiliate who has held restricted securities for at least 2 years may commence selling specified amounts of those securities during periods of 3 months each.[7] If, however, such a person does not sell any securities during a particular 3-month period, he is not permited to cumulate the amount that could have been sold during the period with the amount permitted to be sold during a later 3-month period. Thus, for example, a person who has held restricted securities for 5 years without making any prior sales could not sell any greater number of securities during a 3-month period than a person who has held similar securities for only 2 years.

The inability to cumulate under the rule has fostered complaints that the rule is unnecessarily restrictive. For instance, it has been urged that a person who has held his securities for 5 years has demonstrated by his lengthy holding period that he is not an underwriter within the meaning of section 2(11) of the 1933 Act. According to this line of reasoning, the lenghty holding period is an ample indication that the person did not acquire his securities "with a view to distribution." Thus, under this rationale the person with the 5-year holding period should be free to resell his securities without restriction under section 4(1) of the 1933 Act, which exempts from registration sales of securities by any person who is not an "issuer, underwriter, or dealer." Adherents of this point of view therefore argue that rule 144 should not place limits on sales of securities which have been held for lengthy periods of time.[8]

While the Commission agrees that the length of one's holding period is a major consideration in determining whether a person is an underwriter, it is not the only one which bears upon that issue. As the Commission pointed out in the release [9] which announced the adoption of rule 144, the definition of "underwriter" in section 2(11) also includes any person who participates in a distribution and this requires that other factors also be examined. Included among these other factors, which all bear upon whether a person may be engaged in a distribution, are the availability of adequate current information about the issuer and the impact on the trading market of the sale transaction.

In an effort to take into consideration all of the factors that should be considered in determining whether a person is an underwriter, while at the same time attempting to provide appropriate relief to those who have held their securities for periods of considerable length, the Commission has decided to invite public comment on the proposal briefly referred to in the preceding section. As stated therein, the proposal would permit nonaffiliates of an issuer to sell their securities under rule 144 without any volume restrictions after they have held the securities for a period of 5 or more years. This proposal not only would give major recognition to the length of one's holding period, but also would continue to take into consideration the other elements involved in section 2(11) by applying certain other provisions of rule 144, such as the public information and manner of sale requirements, to transactions covered by the proposal.

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[7] In general, a person may sell during any 3-month period an amount equal to the greater of the average weekly trading volume (if available) or 1 percent of the outstanding securities of the class. See, in this regard, paragraph (e) of rule 144, as recently amended in the release cited in footnote 1, infra.

[8] It should be noted that rule 144 is not the exclusive means for selling restricted securities without registration under the Act. The rule is intended simply to be a safe harbor for establishing the availability of the exemption provided by section 4(1). Thus, sales of restricted securities which do not constitute a distribution may be made by nonaffiliates directly under section 4(1), provided they are in accordance with current interpretations of that section.

[9] Release No. 33-5223 (January 11, 1972) (37 FR 591).

The effect of the proposal outlined above would be to exempt nonaffiliates from the volume limitations of the rule after they have held their securities for at least 5 years. All other provisions of the rule would continue to apply to such persons. In this regard, however, the Commission is interested in receiving comments on whether the notice of sale requirement of paragraph (h) of the rule should continue to be applied to nonaffiliates who might wish to avail themselves of the provision.

With respect to the holding period of 5 years contained in the proposal, the Commission also invites comments on whether it would be appropriate to consider reducing the time period requirement, depending on whether the issuer files periodic reports with the Commission under sections 13 or 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78a, et seq.] (in which case the holding period might be reduced to 4 years) or whether the issuer's securities are listed on a national stock exchange (in which case the holding period might be reduced to 3 years).

The Commission wishes to emphasize that persons who are deemed to be affiliates of an issuer would not be able to avail themselves of the new provision. The control relationship which such persons have with the issuer of the securities would appear to increase the likelihood that they might attempt to utilize the provision for distributions rather than routine trading transactions. Accordingly, the Commission does not believe it would be appropriate to make the new provision available to persons who have such a relationship with the issuer.

TEXT OF THE PROPOSED AMENDMENTS

(Attention: Arrows are used to indicate additions. There are no deletions.)

I. It is proposed to amend 17 CFR Chapter II by revising § 230.144 to read as follows:

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

* * * * *

(e) * * *

(1) * * *

(2) *Sales by persons other than affiliates.* The amount of restricted securities sold for the account of any person other than an affiliate of the issuer, together with all other sales of restricted securities of the same class for the account of such person within the preceding 3 months, shall not exceed the amount specified in paragraphs (e)(1)(i), (1)(ii), or (1)(iii) of this section, whichever is applicable. ►The limitation in this paragraph (e)(2), however, shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer: *Provided* The securities have been beneficially owned by the person for a period of at least 5 years prior to the sale of such securities, except that in the event such securities were purchased, the full purchase price or other consideration shall have been paid or given at least 5 years prior to the sale.◄

* * * * *

II. It is proposed to amend 17 CFR Chapter II by revising § 230.148 to read as follows:

§ 230.148 Persons deemed not to be underwriters of securities issued or sold in connection with bankruptcy proceeding.

* * * * *

(b) *Securities issued under a plan.* A person or entity who acquires securities issued under a plan in a transaction exempt from the registration requirements of the Securities Act of 1933 shall not be deemed an underwriter within the meaning of section 2(11) of the Act with respect to resales of such securities if all of the following conditions are met:

(1) *Volume limitation.* The amount of securities sold for the account of such person or entity during any 3 month period shall not exceed the greater of (i) 1 percent of the sum of the number of shares or other units of the class issued and outstanding and the number of shares or units of the class reserved for future issuance in respect of claims and interests filed and allowed under the plan, as shown by the most recent report or statement published by the issuer, or (ii) the average weekly reported volume of trading in such securities on all national securities exchanges and reported through the automated quotation

system of a registered securities association during the 4 calendar weeks preceding the date of receipt of the order to execute the transaction by the broker or the date of execution of the transaction directly with a market maker, or (iii) the average weekly volume of trading in such securities reported through the consolidated transaction reporting system contemplated by rule 17a-15 under the Securities Exchange Act of 1934 during the 4-week period specified in paragraph (b)(1)(ii) of this section. For the purpose of determining the limitation on the amount of securities sold, all securities of the same class sold under this rule by persons or entities acting in concert shall be aggregated. ►The limitation in this paragraph (b)(1) on the amount of securities that may be sold, however, shall not apply to securities sold for the account of a person who is not an affiliate of the issuer, provided the securities have been beneficially owned by the person for a period of at least 5 years prior to the sale of such securities, except that in the event such securities were purchased, the full purchase price or other consideration shall have been paid or given at least 5 years prior to the sale.◄

* * * * *

(Secs. 2(11), 4(1), 4(4), 19(a), 48 Stat. 74, 77, 85; secs. 201, 203, 209, 210, 48 Stat. 905, 906, 908; secs. 1-4, 6, 68 Stat. 683, 684; sec. 12, 78 Stat. 580; (15 U.S.C. 77b(11), 77d(1), 77d(4), 77s(a)))

STATUTORY BASIS

The amendments to rules 144 and 148 are being proposed by the Commission pursuant to the Securities Act of 1933, particularly sections 2(11), 4(1), 4(4) and 19(a) thereof.

By the Commission.

GEORGE A. FITZSIMMONS,
Secretary.

SEPTEMBER 20, 1978.

[FR Doc. 78-27193 Filed 9-26-78; 8:45 am]

Question # 2: How many small business investment companies have been the subject of enforcement actions taken by the Agency? Please provide us with a summary of those actions and an explanation of why the relevant provisions of the Investment Company Act of 1940 ('40 Act) were necessary in order to take those actions.

Answer: Considering the fact there are only approximately 42 registered small business investment companies (SBICs") (as of June 30, 1978) there have been a disproportionately high number of cases involving SBICs. These cases are as follows:

1. Puerto Rico Capital Corporation (Litigation Release No. 3308, August 13, 1969)

   In 1965, the Commission initiated an action against Puerto Rico Capital Corporation ("PRCC"), its President, Quing Wong, its Vice President, Thomas Gomez, and a Director, Josiah Scott, alleged that the individual defendants had invested PRCC's monies in companies owned or controlled by Wong and Scott in violation of the affilated transaction provisions in Section 17 of the Investment Company Act. It was futher alleged that PRCC suffered substantial losses on these investments. In August, 1969, the Commission entered into a settlement with the individual defendants pursuant to which Wong and Scott agreed to pay PRCC $500,000 and the Commission obtained certain injunctive relief.

2. Illinois Capital Investment Corporation (Litigation Release No. 4777, October 9, 1970)

   On July 20, 1970, the Commission filed a complaint seeking an injunction against further violations of the Investment Company Act by Illinois Capital Investment Corporation ("ICIC"), and five other persons, including its President, Irving Berlin, and its Vice President, Dave Kurtz. The complaint alleged that Berlin and Kurtz had violated, among other things, the affiliated transaction provisions in Section 17 of the Investment Company Act. On October 6, 1970, Berlin and Kurtz consented to an injunction from further violations of the Investment Company Act.

3. Advance Growth Capital Corporation (470 F.2d 40 (1972)

   SEC v. Advance Growth Capital Corp. involved a number of transactions with affiliated persons for which Commission approval under Section 17 of the Investment Company was necessary but never sought. For example, in a particular joint real estate transaction, a company which was 49% owned by the investment company was forced

to purchase the least desirable lots and pay a disproportionate share of the expenses. Similarly, on various occasions, the investment company subordinated its security interest in particular collateral in favor of a bank which was under common control with the investment company. The Court in this case granted a permanent injuncton enjoining the investment company, its president and the chairman of its board of directors, from violating any provisions of the Investment Company Act.

4. Creative Capital Corporation (Investment Company Act Release No. 7791, April 26, 1973)

The Commission's administrative proceeding involving Creative Capital Corporation concerned allegations that: (1) Creative Capital had leased more office space than it could use so than an affiliate could sub-lease 80% of it; (2) the Company had assumed the responsibilities of a loan agreement made by an affiliate with the terms of such agreement being unfavorable to Creative Capital; and (3) the Company had paid a management fee without an adviser contract. The defendants were charged with violations of Sections 17(a), 17(d) 20(a) 34(b), 36 and 36(c) of the Investment Company Act and Rule 20a-1 thereunder. In 1974, the Commission accepted an offer of settlement in which one respondent was barred from association with any broker, dealer, investment adviser or registered investment company for a period of 60 days and the remaining respondents were permanently barred from such association.

It was necessary to rely on the provisions of the Investment Company Act to take the above actions because the types of abuses involved in these cases, including self-dealing and breaches of fiduciary duty by management, are not specifically covered by the provisions of the Securities Act of 1933 or the Securities Exchange Act of 1934, both of which primarily deal with disclosure. In our response to Question #3 we explain the purposes, structure and specific relevant provisions of the Investment Company Act in more detail.

Question 3: If venture capital companies which invest directly in the securities of small concerns were exempted from the '40 Act, the Agency would still have jurisdiction over those companies via the Securities Act of 1933 and the Securities Exchange Act of 1934 as well as through the private placement exemptions for securities purchased privately. What abuses could be committed then which could not be committed presently under the '40 Act?

Answer: Introduction and Summary. The Investment Company Act of 1940 ("Act") was designed to eliminate widespread abuses and failures to observe fiduciary responsibilities in unregulated investment companies which were uncovered during the Commission's massive study of the investment company industry. Operation of SBICs involves many of the same potential abuses and breaches of fiduciary duties which persuaded Congress to enact the Act, after it found that the investor protection provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 were not sufficient. Excluding SBICs from the coverage of the Act would, therefore, deprive investors of significant investor protections. Congress declined to do this in 1940 and in 1970 when the Act was amended. As is discussed in detail below, the Act protects investment company shareholders from management self-dealing (Sections 17 and 23), breaches of fiduciary duty by management (Section 36), overly complex and unsound capital structures (Section 18) and changes in the nature of an investment company's business or its investment policies without shareholder approval (Section 13). Also, in furtherance of the national public interest as expressed in Section 1(b) of the Act and the interest of investors, the Act prevents certain persons from serving as officers or directors of an investment company (Section 9 and 10), requires shareholder approval of advisory contracts (Section 15), specifies certain books and records which must be maintained and which are subject to Commission inspection (Section 31), contains certain reporting standards (Section 30(d)) and proxy solicitation requirements (Section 20(a) and Rule 20a-1 thereunder) that have no counterparts in the Securities Exchange Act of 1934, requires disclosures regarding cash distributions (Section 19), and provides that certain contracts are void (Section 47(b)). Finally , Section 12 prevents undue concentration of control of investment companies, and Section 16 requires that investment company directors not serve for extended periods unless they are elected by shareholders.

Detailed Discussion

(1) The purpose of Section 17 of the Act, sometimes referred to as the "self-dealing" section, is to prevent overreaching and unfair transactions betwen investment company insiders and the investment company. This is accomplished by requiring that transactions between investment companies and officers, directors and similar persons associated with investment companies be submitted for prior independent scrutiny by the Commission with a view solely toward investor protection.

Absent Section 17: (1) affiliated persons could buy property from, sell property to, or borrow money from the investment company without any finding by an impartial third person that that the transaction is fair and reasonable (Section 17(a)); (2) affiliated persons could enter into joint transactions with investment companies which were more advantageous to the affiliated persons than to the investment company (Section 17(d)). For example, affiliated persons of an SBIC could say, "the SBIC we manage will lend you money if you will retain our business advisory service"; (3) affiliated persons of an investment company could demand and be paid compensation for the purchase or sale of any property to or for such company, (Section 17(e)). For example, a finders fee might be demanded and paid to an officer of an investment company by another company to whom the investment company is making a loan, (4) affiliated persons could have custody of the SBIC's assets which may be highly liquid and transferable (Section 17(f)), (5) no adequate bonding would be required to protect the investment company against larceny and embezzlement by its officers or employees (Section 17(g);-and (6) there could be indemnity agreements under which directors or officers of investment companies would be protected against any liability to the company or its shareholders by reason of their willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of their offices (Section 17(h)). It should be emphasized that this lengthy litany of potential overreaching and unfair transactions is not hypothetical: such transactions are the subject of continuing inquiry, investigation, administrative proceedings, and enforcement action. Not all Section 17 transactions are, of course, unfair or involve overreaching, and many proposed transactions do receive favorable orders from the Commission after its careful review. The point is that Section 17 is not merely a caution against serious problems observed only in 1940--it has current relevance, and our experience under Section 17 clearly indicates that it presently provides substantial investor protections. 1/

(2) Absent the carefully drafted restrictions imposed by Section 23, shares of a closed-end investment company could be issued for securities for services or for property other than cash or securities, or sold to favored persons at prices below current net asset value, and shares could be repurchased only from favored shareholders.

1/ In recognition of the fact that SBICs are different from other investment companies in certain respects, the Commission has adopted several rules, e.g., Rules 17a-6 and 17d-1(d)(5), which exempt certain transactions from the provisions of Section 17, which otherwise would be prohibited absent a favorable Commission order for each such transaction. These rules, which were promulgated principally for and are frequently relied upon by SBICs, thus exempt certain transactions which, while literally within the ambit of Section 17, do not present the opportunities for abuse the section was designed to prevent.

(3) Section 36(a) of the Act authorizes the Commission to bring an action in the proper United States District Court if it believes that persons serving an investment company in certain capacities--including officer, director, investment adviser or principal underwriter--have engaged in the past five years or are about to engage in an act or practice constituting a breach of fiduciary duty involving personal misconduct. If the Commission's allegations are proven, the court may enjoin such person from serving an investment company in any or all capacities and award other appropriate relief. Section 36(b) explicitly provides that an investment company's investment adviser has a fiduciary duty with respect to the receipt of compensation for services and payments of a material nature. This section also authorizes the Commission or a shareholder of the investment company to bring a court action if it believes this duty has been breached. The provisions of Section 36 are very important since they codify in the Act the fiduciary obligations of an investment company's officials and authorize Commission and shareholder's actions if these obligations are breached. 2/ We believe that the existence of Section 36, amended in 1970 to provide shareholders as well as the Commission with a cause of action for excessive management fees, serves as a valuable deterrent to improper conduct by investment company officials.

(4) Excessive borrowings and the issuance of excessive amounts of senior securities can, for various reasons, be inimical to the best interests of an investment company's shareholders. 4/ To prevent such abuses, Section 18 of the Act prohibits open-end investment companies from issuing senior securities and permits closed-end investment companies to issue senior securities only where asset coverage is 300% (debt security) 200% (preferred stock).

(5) Section 13 of the Act prohibits an investment company from engaging in certain acts, including changing from an open-end company to a closed-end company or vice versa, and from a diversified company to a non-diversified company within the meaning of Section 5 of the Act, deviating from its stated policies in respect of certain types of activities, or ceasing

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2/ See e.g., Moses v. Burgin, 445 F. 2d 369 (1st Cir. 1971), cert, denied sub. nom. Johnson v. Moses, 404 U.S. 994 (1971); Fogel v. Chestnutt, 533 F. 2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976).

3/ For example, small changes in securities prices may result in disproportionate changes in net asset value. In addition, an investment company's investment adviser may be able to increase its advisory fee (typically calculated as a percentage of the net assets held by the company) by causing the investment company to unnecessarily borrow by issuing senior securities.

to be an investment company without a vote of a majority of its outstanding voting securities. This statutory arrangement prevents shareholder from having the fundamental nature of their investment or the company's investment policies changed drastically and unilaterally by insiders without their approval.

(6) Sections 9 and 10 of the Act afford investment company shareholders certain protections with respect to the persons who will occupy key positions with the investment company or its related entities. Section 9(a) prohibits persons who have, among other things, been convicted of any felony or misdeameanor involving the purchase or sale of a security or arising out of their conduct as a broker, dealer or investment adviser from serving in various capacities with an investment adviser, or as an employee. Section 9(b) authorizes the Commission to bar persons from serving in specified capacities with or for an investment company if they have, among other things, willfully violated or willfully aided or abetted willful violations of the federal securities laws. Moreover, in an effort to prevent an investment company from being dominated and perhaps operated in the interests of individuals who have a financial interest in the company's operation (beyond that held by an ordinary shareholder), Section 10 of the Act requires that at least 40% of the members of the board of directors of investment companies be persons who are not "interested persons" (as defined in Section 2(a)(19)) of the investment company, its investment adviser, or its principal underwriter.

(7) Section 15 of the Act provides investment company investors certain protections designed to ensure that the investment company is not overreached in connection with the negotiation of its underwriting and advisory contracts. The advisory agreement must be in writing, be approved initially by a majority of the investment company's shareholders and a majority of the disinterested directors (and, after the first two years, approved at least annually by shareholders and the disinterested directors), must describe precisely the adviser's compensation, provide for its termination without penalty on not more than sixty days notice and provide for its automatic termination upon assignment. Without these protections, contracts for investment advice could be entered into without shareholder approval, be extended indefinitely without approval of the board of directors, be terminable only upon payment of a penalty, and be transferred to a new advisory organization without shareholder knowledge or approval.

(8) Section 31 of the Act authorizes the Commission to require investment companies to maintain certain books and records relating to their activities. It also authorizes the Commission to inspect such records at any time. Improper or carelessly maintained records may deprive shareholders of their rights. These records also allow the Commission, in administering its inspection program to ascertain whether an investment company is complying with the Act. In addition, the knowledge that the Commission may inspect an investment company's records probably acts as a substantial deterrent to any person inclined to consider engaging in improper conduct.

(9) Rule 30d-1, promulgated under Section 30(d) of the Act, provides for a detailed semi-annual report to shareholders, including information such as a balance sheet, a list of the amounts and value of portfolio securities, and statements of (a) income itemized as to categories of income or expense in excess of 5% of the respective totals, (b) surplus itemized as to charges and credits in excess of 5% of the respective totals, (c) aggregate remuneration paid to specified insiders, and (d) aggregate dollar amounts of purchases and sales of securities by an investment company. Having such disclosures made to shareholders lessens significantly the likelihood that the investment company will be operated for the benefit of insiders without shareholder knowledge.

(10) In connection with the solicitation of proxies, the rules under the Securities Exchange Act of 1934 do not have a requirement comparable to Rule 20a-2, adopted under Section 20(a) of the Act, regarding information to be furnished to the solicited shareholder pertaining to the investment advisory contract.

(11) Section 19 of the Act makes it unlawful to pay certain cash distributions other than from certain sources without such payment being accompanied by a written statement which adequately discloses the source or sources of such payment. This thwarts any efforts to deceive investors as to the source of their income.

(12) Section 47(b) of the Act provides, in pertinent part, that contracts made in violation of the Act, shall be void as regards the rights of any persons who, in violation of the Act, shall have made or engaged in the performance of such contracts. Hence, those who participate in a wrong may be unable to retain the benefit of the bargain.

(13) Control of investment companies could be unduly concentrated through pyramiding or inequitable methods of control, absent Section 12 of the Act. In addition, but for Section 16 of the Act, persons could serve as investment company directors for extended periods without being elected by shareholders.

We believe the foregoing demonstrates that the investor protections of the Act are significant and material, and should not be dismissed lightly as unduly complex or burdensome in light of the Commission's experience in administering the Act. Moreover, while it may be true that, in some instances, if SBIC's were not subject to the Act, they would come under the reporting and proxy solicitation requirements of the Securities Exchange Act of 1934, such would be the case only where the SBIC has total assets exceeding $1 million and a class of equity securities held of record by 500 or more persons. However, even in such instances, these requirements would no longer apply if the number of such security holders fell below 300. On the other hand, the protections afforded by the Act apply once an SBIC has more than 100 shareholders or makes a public offering of its securities (regardless of the number of shareholders), so that wider coverage is afforded

under the Act for the protection of investors in SBICs.

In addition to these substantive protections which the Act provides while an SBIC is an active operating entity, we believe that the Act plays an important role in protecting the interests of SBIC shareholders in the event the SBIC encounters financial difficulties. The SBA generally has loans or loan guarantees outstanding to an SBIC. Consequently, the SBA will have a natural and understandable inclination to view and consider the SIBC's financial problems in the most positive manner possible, even if this results in a total elimination of the equity interest of the SBIC's shareholders. As was suggested during the hearings, this has been the experience of the Commission in its involvement under Chapter X and XI of the Bankruptcy Act where the economic influence of the debtholders substantially outweighed the equally important interests of the common stock holders. Furthermore, even if the SBA is able to avoid any loss of its own, it will have little additional incentive to inquire or determine whether the transactions which resolve the SBIC's financial difficulties themselves involve possible overreaching on the part of the SBIC's insiders, whereas the role of the Commission, particularly pursuant to Sections 17 and 36 of the Act, would be to analyze and focus carefully on the fairness of such transactions.

In conclusion, we believe that there are a number of significant abuses, as our discussion of enforcement cases in our answer to question #2 shows, which SBIC shareholders could and would become subject to if they were denied the protections of the Act and could rely only on the protections provided by the other federal securities laws.

Question 4: Would the SEC be willing to undertake a study with the SBA to determine ways in which the burdens imposed on SBIC's under the '40 Act can be minimized?

Answer: As our testimony and the Commission's earlier written statement on H.R. 10717 pointed out, the Commission has adopted Rules 3c-2, 3c-3, 14a-1, 17a-6, 17d(d), 17d-2, 18c-1, and 18c-2 under the Act to ease the regulatory burdens the Act imposes on SBICs.

At present, the Commission's Division of Investment Management is conducting a thorough study of the Act, particularly designed to determine whether any of its requirements are unnecessary and whether procedures which are still valuable can nevertheless be streamlined. Implementation of this study's recommendations should remove some of the remaining unnecessary burdens investment companies and SBICs may encounter in registering under and complying with the prophylactic regulatory provisions of the Act. In this connection, our Division of Investment Management stands ready to discuss with the SBA any recommendations to eliminate any duplicative or unnecessary regulatory requirements the two agencies may impose.

Mr. ECKHARDT. Mr. Heizer, Mr. Garrett, we are glad to have you here again.

I might say at the outset that Mr. Broyhill and I are sponsoring an amendment that comes up very soon on a bill that should be on the floor of the House in just a few minutes. If possible, we will shift the chairmanship of the committee and proceed on. If we are not able to do that, we might have to interrupt your testimony. That is that difficulty of our situation.

Mr. BROYHILL. By the way, it is an amendment that Chairman Williams is most interested in. So, maybe we can help to soften his heart a little bit.

Mr. ECKHARDT. That is correct. You may proceed, Mr. Heizer.

STATEMENT OF E. F. HEIZER, JR., DIRECTOR, NATIONAL VENTURE CAPITAL ASSOCIATION, ACCOMPANIED BY RAY GARRETT, JR., SPECIAL COUNSEL, AND JOHN McDERMOTT, MEMBER OF BOARD OF DIRECTORS AND GENERAL COUNSEL

Mr. HEIZER. First of all I would like to thank you for giving us the opportunity to address the committee. Ray Garrett is here, he has worked with us several years now on the 1940 act questions as our special counsel on that subject. John McDermott is a member of our board of directors and is our general legal counsel, and he has worked with me for some 9 or 10 years on the subject. So, we thought they could be helpful.

My name is Ned Heizer, and as you have already stated, I am chairman and founder of Heizer Corp. which is the largest business development firm in the United States.

Mr. ECKHARDT. You may proceed.

Mr. HEIZER. As a matter of introduction, we specialize in financing and startup of very early stage companies, which we then work with very closely and build them into major companies that in time become publicly traded stocks.

I have also been an active member of the venture capital community, having served as president and chairman of the National Venture Capital Association, and I am currently serving on the boards of both the National Venture Capital Association and the National Association of Small Business Investment Companies. National Venture Capital, as you probably know, represents the privately financed venture capital firms, and NASBIC represents the SBA-financed venture capital firms, NASBIC. I just mention that as background because we are speaking, I hope, from the standpoint of both those organizations and in the best interest of both publicly and privately financed venture capital firms.

We would like to thank the committee and the Securities and Exchange Commission for the work you have done to improve the security laws and regulations. Our industry, the venture capital industry, is pleased with the progress that has been made regarding regulation A, rule 144, and rule 146. Therefore, I will not comment on these provisions this morning since I know you will hear testimony from others.

Instead, I would like to address my remarks to a less well understood but serious problem, namely, the adverse effect of the 1940 act upon the new capital formation process. The reason you do not hear much about the 1940 act is that no venture capital firm has

been able to work successfully under it, therefore, there are no 1940 act venture capital firms to talk to you about their problems.

The approximately 40 SBIC's that were mentioned by Mr. Williams which are under the 1940 act are not really in the venture capital business. Although one or two are to one degree or another in our business, I am sure if you will ask them to testify they will tell you it is extremely difficult for them to conduct their business and be under that act.

Many members of the venture capital industry are equally concerned about the Investment Advisory Act. For purposes of clarity this morning I will address my remarks to the 1940 act, but we wish the members of the committee would remember that many of the same points I will make on the 1940 act, apply to the Investment Advisory Act.

This committee is well aware of the importance of new capital formation to our economy. You are also aware of the serious deterioration in our equity markets during the last 10 years. You are aware that large companies with substantial earnings can continue to expanded with costly debt financing even during difficult periods, such as the 1930's or the 1970's. You are aware that small companies and emerging companies cannot be formed or expanded with debt money alone. They must have equity capital to be founded and to grow. It is these young growth companies which have the greatest incremental impact upon our net new employment, rate of innovation, and balance of payments. They also represent the "American Dream" to millions of people.

What many people do not realize or have not focused on is the long-term deterioration in the flow of new business development capital to these young companies. One good thing about the 1970's is that Government and business leaders are now reexamining our basic structure and asking how is industry going to obtain the capital it needs to grow and provide jobs for our people.

The Steiger amendment and its counterparts are a reflection of a better understanding and appreciation of the vital importance of new capital formation. We cannot expect people to risk their capital over a long period of time and then be taxed cumulatively at ordinary income tax rates upon realization of their long-term gains. We urge the House of Representatives to continue to push for passage of the Steiger amendment or similar legislation.

But we want to emphasize that tax incentives alone will not solve our basic problem of grossly inadequate new capital formation—except perhaps for our larger more successful companies where the need is not as critical.

Our money in this country has been largely institutionalized in the form of checking accounts, savings accounts in banks and savings and loans, life insurance cash values, pension funds, mutual funds, et cetera. Very little of this money is or will become available for new company development. Our laws have become well established to prevent these institutions from risking the public's money in the new capital formation process.

On the other hand, the individuals are not a reliable source of risk capital. The security laws of the Federal Government and the States have understandably been steadily developed to protect the public from taking risks. Even if we had no security laws, it would

be very difficult to assemble the public funds in a meaningful way to develop new and growing companies at the early stage.

Thus, if our free enterprise system is to continue to prosper we must develop a new infrastructure for moving equity capital to new and growing companies.

What the country needs in our opinion is more professionally managed venture capital firms. Today the venture capital industry-SBIC's and privately financed firms—are basically noncompetitive with each other. For instance, in its 9 years, Heizer Corp. has only been able to finance 33 companies out of over 6,000 which have formally requested help, and has experienced no competition from any other venture capital firm in that process. Instead, it has been the others asking for help in their ventures and us asking for help with ours. All the members of National Venture Capital and NASBIC put together—which constitutes the bulk of all business development capital in the United States—have invested less money per day over the last 20 years than Amtrak currently loses per day. Although saving the passenger rail service may be a fully justified Government activity, we submit it is imperative for the Government to encourage a greatly expanded flow of capital to new and growing businesses.

Your committee can make a great contribution by working with the Securities and Exchange Commission to formulate new legislation which will exempt all firms which invest long-term capital, directly and privately, from the provisions of the 1940 act. By "all firms" we mean whether SBIC or privately financed companies.

The 1940 act was passed to stop a number of abuses by firms which used public money to invest in publicly traded securities. This was very worthwhile and effective legislation. That job has been well done by the SEC.

The protective provisions of the 1940 act are not needed in the case of venture capital firms which invest directly and privately in companies. Anyone who purchases directly and privately is subject to the 1933 and 1934 acts, as well as a wide range of other Federal and State laws and regulations.

The Securities and Exchange Commission has traditionally said—and has in fact implied this morning—that there is no reason that a well-managed venture capital firm cannot operate under the 1940 act, and therefore no change in the law is required. The testimony of all those who tried and failed to operate successfully under the 1940 act should be ample proof that exemption is necessary in the national interest, but even better proof is that after 38 years no successful venture capital firm is operating under the 1940 act and the National Venture Capital Association and NASBIC agree that exemption is absolutely critical to the future growth of the venture capital industry. There is one firm in Boston which is under the 1940 act, which thinks it is a terrible act, and they are doing their best to operate under it. They will probably say they are successful, but at the same time they say it is very difficult.

Without going into the details of the 1940 act, it calls for a series of reports to and prior approvals by the Securities and Exchange Commission intended to protect the independence in terms of ownership and control and transactions between the 1940 act compa-

nies and their investees, which may be fitting and proper for mutual funds, but which is totally inconsistent with the proper and effective relationship between venture capital firms and their investees.

The practical effect of the 1940 act is twofold:

First, to avoid the crippling effects of the 1940 act, venture capital firms must have less than 100 security holders and must typically plan to liquidate within a 7- to 10-year period. Thus, even the best firms rise and fall within a relatively short period of time. We submit that is not good for the economy.

The second impact of the 1940 act, which is equally interesting is, the public is denied the opportunity to invest in the future of America through diversified and professionally managed venture capital firms. Only wealthy families and a few venturesome institutions can participate in financing the future of America under current law.

We doubt that Congress intended these results when it passed the 1940 act, but the Securities and Exchange Commission must live with the words of Congress.

Now, so that there will be no misunderstanding as to my own motivation in being here, I would like to end with the following statement:

Heizer Corp. was founded in 1969 as a corporation to be a continuing business development firm supplying early stage growth capital and management support to young companies if the 1940 act problems could be solved.

Heizer Corp. has been successful in that the companies Heizer Corp. has financed which would not exist without us, now have over $1 billion in sales, $150 million in taxable income and have created over 20,000 jobs.

Now, if we add to this list those companies financed by Heizer Corp. to which we were not absolutely essential, but in which we played an important role, those figures would become $2 billion in sales, taxable income in excess of $286 million, and new jobs in excess of 36,000.

I think you would all agree that Heizer Corp. has made a major contribution to the economy and the Government should encourage the continuation of Heizer Corp. and the formation of more venture capital firms and their continuation.

Commonsense would say that Heizer Corp. should continue business. Our investors want Heizer Corp. to continue in business. Our investment bankers feel a successful public offering of Heizer Corp. common stock could be made.

Unfortunately, the 1940 act and the historical regulations of the SEC say Heizer Corp. must be liquidated. The reasons are, Mr. Chairman, as you stated earlier:

Heizer Corp. investors understandably want liquidity on all or part of their investment after 10 years of locked in investment.

Heizer Corp. cannot provide its investors with meaningful liquidity without having more than 100 shareholders.

Having more than 100 shareholders puts HC under the 1940 act and we, from talking with many people, know that we could not operate successfully under that act.

Heizer Corp. is very skeptical about obtaining a meaningful exemption from the Securities and Exchange Commission, although Heizer Corp. and the Securities and Exchange Commission are trying to work out a meaningful solution.

The only practical answer appears to be legislation. This is especially so when you consider the difficulty Heizer Corp. is having in obtaining relief despite its size, record, and able representation by Ray Garrett, former Chairman of the Securities and Exchange Commission. I think that the small firms, the smaller venture capital firms that cannot afford the hundreds of thousands of dollars in fees we have spent over the last 10 years, the 1940 act is an impossible barrier to most of those firms.

Thus, as far as Heizer Corp. is concerned, this is a life-or-death matter. Speaking for the venture capital industry after 20 years of experience, this is a matter of vital concern. Speaking as a citizen, this is a matter of great national importance. I perhaps should not read this to you in such a serious session, but we read it to the SEC a few months ago:

Like Humpty Dumpty, Heizer Corporation Built a Success—Now it Faces Liquidation Stress. Once it has been Liquidated, all the Government Agencies and all Heizer Corporation's Men cannot put it Together Again.

Thus, we stand ready as a firm with our legal counsel, the National Venture Capital Association stands ready, and NASBIC stands ready to work with this committee, the Senate committee, and the SEC to work out an effective solution to this problem. It is in the public interest on both sides of the coin.

Thank you.

Mr. BROYHILL [presiding]. I apologize for all the coming and going here, but with going into session early today, of course we have to respond to bells and to votes as they occur.

Of course, as you know, I have been concerned over the situation that you have described here, and that is one reason that prompted me to introduce the bill, H.R. 10717 some time back.

I wonder if we could get a little more specific here. You have, of course, referred to some of the crippling effect of the 1940 act—particularly on page 5 here. I wonder if you could be more specific, to give the committee a more specific example of what you are talking about, what type of effects. Specifically what in the act is hindering your company and hindering the development of other companies like yours.

Mr. HEIZER. Well, we are somewhat handicapped in answering your question because, having talked to many other people who tried to operate under the act and gave up. We have had excellent legal counsel advising us on how to stay out from under it, and we have stayed successfully out from under it. Now, at this point in our history we do not have much choice, we have to liquidate or go under the act.

From what we hear from others—in other words, we cannot speak from personal experience—the problem with the 1940 act is, if you fall under it, then you and anyone else that is under it, or any associate of yours—and an "associate" is a very complex legal question—has to make filings. These filings are not just informational filings which are made under the 1934 act, they are not just full disclosure filings, they are filings to get SEC permission to do

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what you are doing. They were drawn up with a very good purpose in mind, namely protecting the public, but they are totally inconsistent with the needs of our industry.

Mr. BROYHILL. Let me back up a minute. You say that to make any transaction you have to file?

Mr. HEIZER. No, You can make an initial investment and have no problems as long as there is full disclosure and so forth. The difficulty comes in when you make a follow-on or subsequent investment in a particular investee which you already control, either directly or indirectly. The nature of our business is, in the early stages these firms are financed by one or a few investment capital funds, and you find yourself technically in control. Then, under the 1940 act you find that the various provisions that were intended to create independence when applied to our industry created a spiderweb, as we call it, of filings and permissions. Mr. Ray Garrett can probably speak to that point much better than I can.

Mr. GARRETT. I think it might be helpful, Mr. Broyhill, we are working on developing a more specific response to your very question, but we do not have it ready. It did not get cranked up in time to have. Obviously, it is essential to come up with a specific answer in order to make a convincing case.

We do know this much, there are descending degrees of objection to the various impositions of the 1940 act upon companies, some of which would attract more sympathy than others. It does affect stock option plans; it affects parallel investment in investee companies by officers and directors of the venture capital company; it affects senior securities issued by the venture capital company. Things of this sort, depending on who you talk to, are either great problems or are zero problems.

On the other hand, the fact that it would prevent the president of the venture capital company from holding up the investee to a legal fee in order to get a loan is nothing anybody can have any sympathy with, and that is not part of our program.

The most sympathetic problems center upon section 17 of the act which, as far as it has been able to persuade itself, the Commission has attempted to alleviate through the rule 17(a)(6) that Mr. Mendelsohn spoke to. It is based upon the fact that if the venture capital company acquires 5 percent or more of the voting securities of the investee company, they become affiliates. Transactons between affiliates require advanced approval by the Commission, unless exempted by rule. The rule that Mr. Mendelsohn referred to covers a lot of cases, but not all.

The more troublesome than the section 17(b) which reaches all transactions, or joint ventures, or joint participations between an affiliate, an investment company, and an affiliate of an affiliate of an investment company. This affiliation of affiliation concept plus the idea what may or may not be a joint venture, plus the absence of any helpful SEC rule can drive otherwise modest people up the wall. They do not know when they are going to run into it. If they do run into it too late and discover, "My God, we have a joint venture with an affiliate of an affiliate," the whole thing has become unlawful.

If they worry too much and go in and get exemptive orders in advance, it can kill the kinds of transactions we are talking about. You cannot wait 3 to 6 months to do something.

Mr. BROYHILL. How long does it usually take to get these orders?

Mr. GARRETT. It varies a great deal. If the case is obviously good and the staff can see it is obviously good, you can get an order within the 30-day notice period under the Administrative Procedure Act, plus the time it takes the staff to draft the appropriate documents. If it is troublesome, it can run to many months. If it is troublesome or very complex you have to persuade the staff that it is good, otherwise the staff will think they need to set it down for hearing. If they set it down for hearing you do not really know how long it is going to take.

Mr. BROYHILL. Of course, if there is a need for capital I can understand why people would not go this route. They would go elsewhere, perhaps, and find another source of capital, or, maybe they will just throw up their hands and not further pursue the expansion—they just forgo that need for capital.

Mr. GARRETT. The fact is that the companies that want to engage in venture capital business development financing stay away from the 1940 act, for one or more of the reasons that we are speaking of.

Mr. BROYHILL. Do you ever go abroad for capital, do you ever go into the Eurodollar market?

Mr. HEIZER. You mean for the capital for the venture capital firm?

Mr. BROYHILL. For you, or for the venture capital firm.

Mr. HEIZER. I think that a few venture capital firms have raised money overseas for their venture capital firms, privately. Some venture capital firms, privately. Some venture capital firms such as ourselves have been forced overseas and, although we have had excellent relationships with some of our overseas sources of money, we would not have those relationships at all if there was a freer flow of capital in the United States.

Our present structure for flowing capital and our tax laws, and everything else is, without any question, forcing, in my opinion the sale of an important percentage of our technology and stockholdings of our companies because the foreign countries support the capital flow within their society much better than our Government does. Those companies are very aggressive, and they are coming in here more and more. They are doing it very quietly, they do not talk about it much and it is not publicized much. But something has to be done to free up the flow of capital in a major way in this country for young and growing companies, or this foreign situation is going to become a serious problem.

Mr. BROYHILL. Let me get back to this question that Mr. Garrett was talking about, the problems in the 1940 act. Now, the companies that are basically regulated under the 1940 act are the mutual funds?

Mr. GARRETT. Yes, in terms of dollar-amount investment they are by far the largest component. There are also so-called closed in investment companies, those that do not stand open to redeem their shares, which a company like Heizer Corp. would be, were it

not exempt. There are many of those that have nothing to do with venture capital investments.

Mr. BROYHILL. I mean, there is a real difference between a mutual fund and a venture capital firm like this.

Mr. GARRETT. Indeed, there is.

Mr. BROYHILL. Perhaps you would want to expand on that a bit, so we are sure of the basic differences here that we are talking about.

Mr. GARRETT. Well, the major abuses at which the act is aimed actually, historically at the time of 1940, looking back to the experience of the 1930's and the late 1920's, curiously enough there were more closed-investment companies than mutual funds because mutual funds were a fairly new thing at that time. But, the basic abuses were those of the misuse of a very liquid and mobile pool of capital that could be used to benefit the persons that control the company in various ways, either in complete disregard or with unequal regard for the interest of the investors in the company, the stockholders in the company.

For that reason those various impositions upon dealings with affiliates, and affiliates of affiliates, and various other things, protection against excessive leverage to accumulate debt security, were all put into the act and they have done their job.

But when it comes to venture capital, depending upon the policy and the practice of the particular company, you move much closer to another concept the act recognizes, and that is that a holding company is distinct from an investment company. Somebody that has bought securities for the purpose of engaging in the business of the other company.

Well, a venture capital company falls somewhere in the middle, it is not trading in the marketplace like a classical investment company, so to speak; on the other hand, it perhaps does not have the same business purpose of stability and involvement in its investee companies that a true holding company or a conglomerate might have.

But we think the combination of direct investment, that is the providing of capital to companies in terms of which you buy predominantly nonmarketable securities to begin with because you are buying in the private place presumably a very small company, a long-term involvement in the affairs in that company, a lack of history of wheeling and dealing, fast trading in and out stuff, and some other protections could develop into a statutory exemption which would permit the legitimate transactions to occur in a timely and efficient way, and avoid the kinds of abuses that the Congress saw in the investment company business in 1940—and still does, and rightly so because the dangers are there.

Mr. BROYHILL. Thank you, Mr. Chairman, those are all the questions I have.

Mr. METCALFE [presiding]. Counsel has some questions.

Mr. OPPER. I think the issue we are most concerned about in connection with your statement, Mr. Heizer, are the precise disabilities imposed on the operations of venture capital companies by the Investment Company Act of 1940. Mr. Garrett indicated that you are working on a memorandum concerning this. I was wondering if you would be willing to submit that memorandum for the record.

Mr. HEIZER. Certainly, we will be glad to.

Mr. OPPER. Thank you.

[Testimony resumes on p. 127.]

[The following information was received for the record:]

VENTURE CAPITAL COMPANIES

AND

THE INVESTMENT COMPANY ACT OF 1940

Introduction

In his recent testimony before the House Subcommittee on Consumer Protection and Finance, E. F. Heizer, Jr., of Heizer Corporation[1], observed that no venture capital companies today are trying to do business as investment companies registered under the Investment Company Act of 1940 (the "Act"). The only exceptions are a few that are also qualified with the Small Business Administration as Small Business Investment Companies ("SBICs"). This fact is the best evidence that the Act is an effective impediment to the furnishing of financial assistance to small and developing business through venture capital companies.

At the request of Subcommittee Chairman Bob Eckhardt and Ranking Minority Member James T. Broyhill, Mr. Heizer agreed to furnish information giving further detail demonstrating why Heizer Corporation and other venture capital companies have accepted severe limitations, often including the programming of their own demise, rather than trying to operate as registered investment companies.

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1 E. F. Heizer, Jr., Chairman of the Board and President of Heizer Corporation, testified before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce of the United States House of Representatives on September 27, 1978.

This memorandum is in response to that request. It is based upon the experiences of Heizer Corporation, upon legal research done on its behalf and upon interviews with others now or previously engaged in venture capital financing, plus our experience in professional practice.

It is widely agreed that there is not as much capital available for venture capital financing as our economy could use or should have.2 While improved direct access to public equity markets would be beneficial to many small and promising businesses, venture capital financing also has a vital role to play, especially in helping to develop high-technology, high-risk enterprises before they have acquired sufficient substance and stability to be attractive for public distribution of their securities.

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2 There are differences of opinion as to what constitutes "true" venture capital financing. In the view of Heizer Corporation, it involves much more than simply the holding of securities of small companies. In particular, venture capital financing is characterized by more intensive participation in the affairs of the companies to which capital is provided than is typical of most SBICs and, indeed, of other companies holding themselves out as venture capital companies. Irrespective of semantics, however, the problems discussed herein are common to them all. See text following note 6 for an enumeration of what we think are the principal characteristics of venture capital companies.

Major reasons for the shortage of venture capital are the inability of venture capital companies to have public markets for their own equity securities without registering under the Act and the unwillingness of venture capital businessmen to try any longer to operate under the Act as it presently exists. This unwillingness has been dramatically demonstrated, and it must be accepted as a fact. The purpose of this memorandum is to show that this unwillingness is not unreasonable; it is not derived from any desire to engage in transactions or procedures, or establish capital structures, which are contrary to the public interest and the interests of investors. It is derived from direct or observed experience in trying to do necessary and desirable things under the constraints of the Act, which was not enacted with an adequate understanding of venture capital financing. Moreover, it is derived from fear, fear of the unknown, because the intricacies of the Act and the rules and interpretations are such that businessmen and their counsel cannot be confident of sensing danger areas.

Efforts in the past to explain why venture capital companies seek relief from some or all provisions of the Act have tended to become mired in debates over whether specific transactions were or were not commendable, whether certain forbidden capital

structures were or were not in the interests of investors, and, especially, over the reasonableness of SEC staff behavior in specific instances. In some areas the debates have been over whether or not, as to SBICs, SBA regulation is, or can be made to be, an adequate substitute for the Act as administered by the Commission. This memorandum seeks to avoid these quagmires by emphasizing why venture capital businessmen have avoided the Act and will continue to do so unless changes are made. It is fruitless to argue over whether certain transactions will or will not be permitted under the Act when the entire legal apparatus that raises the question to begin with makes it moot by keeping such companies away.

This memorandum does not address itself to proposed solutions. There are many that are worth considering of an administrative as well as a legislative nature. Those to be recommended will be the subject of a later communication.

The Investment Company Act of 1940

The Act rightfully has been called "the most complex" of the federal securities laws.[3] In the words of a former Chief

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3 Loss, 1 Securities Regulation 152 (1961): "Perhaps because the statute was the result of a compromise--but, in greater measure, probably, because of the different types of companies it covers and the intricacies of the problems it presents--the Investment Company Act is the most complex of the entire SEC series. It contains fifty-three sections and covers fifty-eight pages of the Statutes at Large."

Counsel and a present Associate Director of the Division of Investment Management of the SEC, the "unique characteristics of the investment company industry have led to an unusual regulatory framework. A fund's assets, usually consisting of a large pool of cash and securities, are highly liquid and highly vulnerable."[4] In attempting to remove the opportunities for self-dealing in these assets by the potentially unscrupulous management of traditional investment companies, Congress painted with a very broad brush. The result is a quite technical, restrictive statute that is "unlike other federal securities laws in going beyond minimum disclosure requirements to establish a comprehensive scheme for the sale of shares and management of assets."[5]

In large measure, the Act has worked. Abuses by traditional investment companies with substantial amounts of liquid assets and a significant degree of portfolio turnover, typified by today's mutual funds, are relatively rare. Moreover, such companies have been able to live, and in many cases thrive, under the Act.

While the fact that venture capital companies have not been able to thrive under the Act may not be an indication that Congress was unaware of their existence or did not intend the Act to apply to them, it is an indication that Congress did not under-

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4 Rosenblat and Lybecker, "Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project," 124 U. Pa. L. Rev. 587, 593 (1976) (hereinafter cited as "Rosenblat & Lybecker").

5 Id. at 594.

stand the business exigencies peculiar to venture capital companies. They did not foresee that proscriptive provisions that are beneficial to shareholders of mutual funds or traditional closed-end investment companies and not crippling to the operations of those funds or companies could have so devastating an effect on the operations of venture capital companies.

Furthermore, Congress did not foresee the major changes in this country's capital markets since it passed the Act, changes that have sharply increased the need for publicly-held venture capital companies. In 1940 there were few venture capital entities that raised money from public or private investors. Indeed, most of the venture capital at that time appears to have been provided directly by wealthy families and individuals. This situation, of course, no longer prevails today. Instead, the capital markets now are dominated by immense institutional investors, such as insurance companies and pension trusts, whose investment policies are restricted by legal and practical impediments such as prudent man standards, investment committees and the lack of personnel with sufficient expertise and incentive to engage in developmental financing. These impediments were not generally applicable to the main providers of venture capital in 1940. Venture capital companies can help fill today's need for venture capital by providing a mechanism by which capital can flow from investors to emerging enterprises.

Venture Capital Companies and the Legislative History

The definition of "investment company" under the Act is broad enough to include other entities that are very different from traditional investment companies. Among these other entities are so-called "venture capital companies," whose only real similarity to traditional investment companies is that both hold securities issued by other companies. While not precisely defined in the Act or anywhere else,[6] a venture capital company is distinguished from traditional investment companies by the following characteristics:

1. It furnishes capital directly to emerging enterprises which, in most instances, cannot obtain this capital elsewhere.

2. There is seldom a ready market for the securities held by the venture capital company, especially in the initial phases of investment, which means that its investments are largely illiquid. These securities are usually acquired in "private placement" transactions.

3. The venture capital company takes a substantial, and often a controlling, position in the companies to which it furnishes capital. The result is that, unlike the traditional investment company, the venture capital company's so-called "downstream" investee companies are "affiliated persons" under the Act.

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6 The sole reference to venture capital companies in the Act is in Section 12 which, while generally prohibiting the "pyramiding" of investment companies, grants in subsection (e) a limited exception where the second-tier company is

> engaged . . . in the business of underwriting, furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, and reorganizing companies or similar activities . . . .

This language is repeated in Rule 17a-6, discussed following note 41 below.

4. The venture capital company is compelled by the nature of its involvement with these investee companies frequently to enter into transactions with them.

5. Because of the size of its capital commitments and because the personnel of the emerging enterprises are typically entrepreneurs unskilled in essential phases of corporate management, the venture capital company actively participates in the operations of these enterprises; officers of the venture capital company often sit on the boards of directors of these enterprises.

6. The venture capital company generally has a relatively small number of security holders, often institutional investors or wealthy individuals, and, in turn, holds interests in only a small number of companies. This is not an inherent characteristic of a venture capital company, but a practical necessity caused by impediments which are posed by the Act.

7. The venture capital company typically retains its interests in these developing companies for a relatively long period, sometimes many years, with the result that its rate of portfolio turnover is quite low.

8. In order to attract and retain highly motivated personnel to assist in the development and operation of its portfolio companies, the venture capital company frequently provides such personnel with financial incentives, such as performance bonuses and options to purchase securities of the portfolio companies.

9. Most venture capital companies rely on internal management, rather than an investment adviser.

It is significant that, at the time of the studies conducted by the SEC prior to the adoption of the Act, the Commission found that investment companies investing in new or small businesses were so rare as to cause their contribution to financing such businesses to be "comparatively negligible."[7] Yet the

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7 Report of the Securities and Exchange Commission, Investment Trusts and Companies, Parts Four and Five, especially at 367-70 (hereinafter cited as "SEC Report"). One plausible explanation for this finding is that in 1940 there were few corporate venture capital entities that raised money from public or private investors. See discussion following note 5 above.

Commission did recognize that venture capital companies are different in certain material respects from the traditional investment companies at which the Act was primarily aimed:

> [T]he business of financing small enterprises and new ventures differs most markedly from the traditional business of investment companies. Because the investment in a small industry or new venture is necessarily illiquid, . . . it is almost inevitable that the investment company engaging in such a piece of financing should insist upon voting or working control of the enterprise in order to protect itself in respect of management.[8] (Emphasis supplied.)

The Commission concluded that it is important for venture capital companies to disclose to their shareholders the nature of their investment policies.[9]

Had Congress stopped there, the problems to which this memorandum is addressed would not have been created. Venture capital businessmen can have no fundamental quarrel with compelled disclosure, and it is not worth quibbling over the suggestion that more disclosure is more important for venture capital companies than for others.

But Congress went beyond disclosure to enact an intricate regulatory scheme from which venture capital companies were not exempted as a class, "the heart (and perhaps the principal roadblock)"[10] of which is flatly to ban all transactions between affiliated parties. In doing so, Congress and the Commission (at that time) failed to recognize that venture capital companies

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8 SEC Report at 369.

9 Id.

10 Rosenblat & Lybecker at 598.

cannot, as a practical matter, operate under the same restrictions that are applicable to traditional investment companies.

The unforeseen, and surely unintended, result is that today there are no venture capital companies that are able to function under the Investment Company Act of 1940, save perhaps for a small number of SBICs.[11] The few non-SBIC venture capital companies that once tried to operate under the Act have given up and liquidated or merged into something else.[12] As we will show, it

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11 In the view of Heizer Corporation, there is no SBIC registered under the Act that is a "true" venture capital company. See note 2 and text following note 6 above. No doubt this is caused in significant part by the fact to which this memorandum is addressed, namely, that the type of activities required for venture capital financing raise too many problems under the Act. As a consequence, publicly-held (and therefore registered) SBICs have limited themselves to more static roles, largely providing investment loans to "small" businesses. This has resulted in a substantial frustration of the intent of Congress in creating SBICs. In any event, the National Venture Capital Association reports that no non-SBIC venture capital company currently operates as a registered investment company. A listing of significant public issues of venture capital companies since World War II and the current status of those companies is attached hereto as Exhibit A.

12 For years the nation's preeminent venture capital company was American Research and Development Corporation ("ARD"). Organized in 1946 by the legendary General Georges F. Doriot, ARD grew to nearly $400 million in net assets, with its common stock being held by more than 6,000 stockholders and listed on the New York Stock Exchange. After years of frustrating experience trying to operate under the Act, ARD gave up and merged with Textron in 1972. General Doriot leaves no doubt as to the reason for ARD's demise: "I had to terminate ARD because it could not exist under the '40 Act. That is the sole reason it does not exist today as an independent company." Interview of General Georges F. Doriot by Paul H. Dykstra on November 9, 1978, in Boston, Massachusetts.

is simply not practically possible for a non-SBIC venture capital company to function under the Act and the rules adopted by the Commission.

On the other side of the coin, though, as we will also show, no substantial venture capital company can function successfully for more than a few years without becoming subject to the Act. Thus the reality, both for venture capital companies and for a nation seriously short of the capital needed to nurture its emerging enterprises,[13] is this: the Investment Company Act of 1940 as presently applied eliminates the venture capital company as a viable long-term form of business organization.

The emphasis here must be on practical possibility. As will be discussed below, the Commission has extensive exemptive powers, by rule or order. One could argue that if the Commission

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13 A recent article in Business Week paints a bleak picture of the availability of venture capital for emerging enterprises:

> The shortage of risk capital has had a tremendous impact on small, technology-oriented companies trying to arrange new public financing. According to a Commerce Dept. survey, 698 such companies found $1.367 billion in public financing in 1969. In 1975, only four such companies were able to raise money publicly, and their numbers rose to just 30 in 1977. Equally ominous is the experience at Union Carbide, which, according to Tinsley [Sam W. Tinsley, director of corporate technology, Union Carbide Corp.], has not been able to compete for venture capital and has thus cancelled plans to start operations built around interesting new technology. Years ago, says Tinsley, Carbide was reasonably successful at getting such funding. "And you must remember that these ideas are perishable," he says. "They don't have much shelf life." Business Week, July 3, 1978, at 52.

cannot be persuaded of the desirability and fairness of a particular transaction or arrangement, then perhaps it should not be permitted. Such an argument may be satisfying to some lawyers, but it is not satisfying to businessmen, especially when combined with the manifold intricacies of the Act. It is important, thus, to show as clearly as possible why venture capital enterprises have found the Act intolerable, although managers of mutual funds, for example, have not. The difference lies in the business need for frequent transactions which might raise problems under the Act, whereas, for mutual funds, such transactions are relatively few and seldom pressing. Given a choice, businessmen will elect, and obviously have elected, not to subject themselves and their enterprises to an environment where legal analysis is required so often, and so often produces inconclusive advice. In no other business environment are the legal danger areas so many, so often hidden, and so often unrelated to those natural instincts of fairness and propriety that ordinarily alert one to the nearness of danger.

Definition of an "Investment Company"

A venture capital company actively participates in the management of emerging enterprises on a regular basis. Arguably, its activities may constitute engaging in the business of its investee companies to such a degree that it is not engaging "primarily . . . in the business of investing, reinvesting, or trading in securities," so that it may not be an "investment company" under Section 3(a)(1) of the Act. But such a company

may be caught by the definition of an "investment company" in Section 3(a)(3), which does not have the qualification of "primarily" and includes the "business" of holding securities.[14] A venture capital company almost always has 40% or more of its assets in "investment securities" (i.e., securities of issuers in which it has less than a majority interest), so that it

14 Sections 3(a)(1) and 3(a)(3) provide:

> SEC.3.(a) When used in this title, "investment company" means any issuer which --
>
> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
>
> * * * * * *
>
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.
>
> As used in this section, "investment securities" includes 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 are not investment companies.

So broad is the definition of "investment company" under Section 3(a)(3) that an industrial corporation that finds itself with 40% or more of its assets in "investment securities" comes within the definition. See, e.g., Atlantic Coast Line Co., 11 S.E.C. 661 (1942). This expansiveness of Section 3(a)(3) to include the so-called "inadvertent investment company" has suggested to some that "the Investment Company Act of 1940 has been expanded beyond the proper boundaries of a statute designed, fundamentally, to provide regulation for those entrusted with control of large liquid pools of capital belonging to other people." Kerr & Appelbaum, "Inadvertent Investment Companies--Ten Years After," 25 Bus. Law. 887, 905 (1970).

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meets the so-called "objective test" for being an investment company.[15]

To be sure, Section 3(b)(2) provides for exceptions from the definition of an "investment company" by Commission order, but this requires a finding that the venture capital company is "primarily engaged" in some business "other than 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 business."

This exemption is practically unavailable to most venture capital companies because it requires a showing that the company is primarily engaged in the daily operations of the enterprises

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15 The Commission has held, and the staff has stated, that even though a company has invested most of its assets in majority-owned situations and is not an "investment company" under 3(a)(3), it is nonetheless a so-called "special situations" company, and thus a species of investment company, because its business plan or practice is to buy companies, improve them and resell them. Bankers Securities Corporation, 15 S.E.C. 695 (1944); Entrepreneurial Assistance Group, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79, 410 (May 16, 1973).

in which it invests.[16] Perhaps a venture capital company could make such a case, but in doing so, it would be required to change its business to that of a holding company. The successful applicant under Section 3(b)(2) must be prepared to exist in a largely static situation and thus in large measure cease functioning as a source for venture capital.

Exemption from the Act under Section 6(c)

Although venture capital companies probably cannot obtain relief under Section 3(b)(2), they would appear to have a case for exemption under Section 6(c). Under this Section the Commission may, by rule or order, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision . . . of [the Act]." Exercise of this authority is governed only by the following standard: "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]."

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16 The Commission has required applicants under Section 3(b)(2) to prove that they are "primarily engaged" in the operations of these enterprises by an analysis of: (1) the applicant's historical development; (2) its public representations of policy; (3) the activities of its officers and directors; (4) the nature of its present assets; and (5) the sources of its present income. Tonopah Mining Co. of Nevada, 26 S.E.C. 426, 427 (1947); Newmont Mining Corporation, 36 S.E.C. 429, 431 (1955).

Professor Loss refers to Section 6(c) as conferring upon the Commission the "broadest authority" to grant exemptions.[17] The Commission itself has characterized the purpose of Section 6(c) in the following terms:

> The broad exemptive power provided in Section 6(c) was designed to permit the exemption of persons "who are not within the intent of the proposed legislation," even though such persons come within the scope of the Act by virtue of its specific provisions, and to enable the Commission to deal equitably with situations which could not be foreseen at the time the legislation was enacted . . . . (emphasis supplied and citations omitted.) [18]

It is clear, then, that Section 6(c) empowers the Commission to define "venture capital companies" and by rule exempt them as a class from all or some of the provisions of the Act. Even though the peculiar nature of venture capital companies was not considered in several crucial aspects by the framers of the Act[19]

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17 1 Loss, Securities Regulation 149 (1961). The Commission likewise has suggested that its authority under Section 6(c) is virtually unlimited:

> [S]ection 6(c) contains no qualification or limitation as to the sections of the Act from which an exemption may be granted, or as to the types of prohibited transactions which may be exempted. Nor is there anything in the legislative history of that section that indicates a Congressional intent that its application be so limited. Transit Investment Corp., 28 S.E.C. 10, 14-15 (1948).

18 The Great American Life Underwriters, Inc., 41 S.E.C. 1, 9 (1960), aff'd sub nom Hennessey v. S.E.C., 293 F.2d 48 (3d Cir. 1961).

19 See text at and following note 7 above.

and even though the public interest now appears to require the formation of massive amounts of additional venture capital,[20] the Commission has in the past shown little disposition to make any concessions to venture capital companies, by way of an exemption under Section 6(c) or otherwise.[21] To be sure, the Commission has attempted, in Rules 17a-6 and 17d-1(d)(5), to provide SBICs and other venture capital companies with some relief from the restrictions on transactions with affiliated persons where a so-called "upstream" affiliated person has no "financial interest" in a party to the transaction; still, as will be shown later, these Rules provide only sparse relief from situations that the Act was not even intended to cover.[22]

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20 See note 13 above.

21 See, e.g., In the Matter of the National Association of Small Business Investment Companies, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,076 (May 14, 1971), where the Commission, by a 3-to-2 vote reversing the decision of the Hearing Examiner, refused to grant SBICs a blanket exemption from Sections 17(a) and 17(d) under Section 6(c). In that proceeding the Commission staff argued that "findings of hardship or difficulty incidental to compliance with the [Act] are not material or germane to proceedings under Section 6(c) to determine whether exemptions from any or all of its provisions should be granted." Decision of Hearing Examiner, Admin. Pro. File No. 3-1825 (1969), at 10. See also authorities cited at note 15 above.

22 See text following notes 40 and 47 below.

Operation of a Venture Capital Company Outside of the Act

Under the present law, it is possible for a venture capital company to exist for a few years without having to register under the Act. This requires initial and continuing compliance with the conditions for exemption under Section 3(c)(1), meaning that the venture capital company must be and remain an "issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering."

If a company holds 10% or more of the venture capital company's outstanding voting securities, then all of the holders of that company's securities must be included in computing whether there are more than 100 holders of the venture capital company's securities.

In effect, then, Section 3(c)(1) carries the following conditions: (1) the funds necessary to finance the venture capital business must be obtained from 100 or fewer investors, (2) no investor that is a company with a significant number of shareholders may hold 10% or more of the venture capital company's voting securities, and (3) the investors must be sophisticated or otherwise such that the offering will qualify as "private" under Section 4(2) of the Securities Act of 1933. As a result, a venture capital company cannot raise its own capital from the public and remain exempt from the Act.

Section 3(c)(1), then, can pose a problem for a venture capital company at several stages, thereby cutting off a substantial amount of potential funds. It precludes such a company from raising its initial capital from 100 or more persons without its prior registration under the Act. It can also compel such a company to register under the Act later, if the number of its shareholders expands due to factors over which it has no control (for example, if a shareholder dies and leaves his interest in the company to several different parties). The difficulty for a venture capital company under Section 3(c)(1), however, usually comes after several years of operation, when some means must be found to enable its investors to realize on their investment.

Investors in a venture capital company cannot be expected, and should not be asked, to invest for yield (that is, interest and ordinary dividends on their investment). The risk is high, and the embryonic enterprises to which the venture capital company furnishes funds will not be a productive source of cash dividends. If those enterprises have any earnings, they usually should retain them for their own growth. The primary incentive for investment in the venture capital company's securities must be the hope for long-term capital gain. This gain, though, if it occurs, remains only "paper profit" until it can be realized. Yet such realization can be accomplished only through one of two very unhappy alternatives for the venture capital company--complete or partial termination (through liquidation, other dis-

posal of the venture capital company or some of its assets, or transformation to an operating company by means of the acquisition of operating company assets) or the creation of a public market for the venture capital company's securities, which means registration under the Act.

An example of a venture capital company currently placed in such a situation is Heizer Corporation, believed to be the nation's largest non-SBIC venture capital company. After nearly ten years of effort, Heizer has experienced a degree of success in its operations. The present fair value of its assets is now approximately $200,000,000 as compared with the original investment of $81,100,000.[23] Heizer's investors, after a decade of patience, would prefer that Heizer adopt a program whereby they can realize on these gains. Indefinite prolongation of life under Section 3(c)(1) is inconsistent with such a program.

Heizer has two choices for meeting the needs of its investors. It may embark upon a program of liquidation, whereby portfolio values are transferred directly to the investors in cash or kind, or it may create a public market for its shares.

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23 As of June 30, 1978, the fair value of Heizer's assets was $205,597,650. A descriptive summary of the history of Heizer is attached hereto as Exhibit B.

The latter alternative would, of course, be more attractive to Heizer and more in the public interest, for the reason that Heizer could remain in business to develop more companies and even raise additional capital.[24] Yet, in so doing, Heizer would lose its Section 3(c)(1) exemption and would have to register under the Act. For the reasons described below, Heizer has reached the same conclusion as has every other non-SBIC venture capital company--life under the Investment Company Act of 1940 is impossible. Without legislative or administrative relief, therefore, the Act may once again compel the nation's largest venture capital company to cease functioning as an independent entity.[25]

The Act as a Minefield

Familiar to only a relatively small band of experienced securities lawyers, the Investment Company Act of 1940 and the rules thereunder can be terrifying to the uninitiated. It is no exaggeration to suggest that the Act, in some areas, is at once so intricate

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24 Heizer's management estimates that Heizer's venture capital activities are directly responsible for the existence of companies with over $1 billion in sales, $150 million in taxable income, and more than 20,000 new jobs. Further, Heizer is partly responsible for an additional $1 billion in sales, $136 million in taxable income, and 16,500 new jobs. Testimony of E. F. Heizer, Jr., Before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce of the United States House of Representatives, September 27, 1978.

25 ARD, believed to be the largest independent venture capital company of its time, was forced to merge with Textron in 1972. See note 12 above.

and so amorphous that it defies comprehension by virtually anyone.

A prime example is Section 17, which prohibits transactions between investment companies and affiliated persons and thus works a particular hardship on venture capital companies. This Section has been described by the Commission as the "keystone" of the Act.[26] Yet, referring to Section 17(d), Commissioner Loomis has frankly admitted that it is "a rather peculiar section. I'm not sure that I understand it."[27] A leading practitioner under the Act, Milton Kroll, has called the same provision "a morass of unascertainable depth"[28] (Mr. Kroll has characterized Section 17 as a whole as merely "bewildering"[29]). Another with broad experience in the area, Peter Van Oosterhout, submitted to Congress this year: "I have worked with the '40 Act in one form or another for 18 years and have had legal training, and I am still not sure just what Section 17 does or does not cover."[30]

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26 In the Matter of the National Association of Small Business Investment Companies, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,076 (May 14, 1971).

27 Kroll, "The Portfolio Affiliate Problem," Third Annual Institute on Securities Regulation 261, 286 (R. Mundheim & A. Fleischer, Jr., eds. 1972) (hereinafter cited as "Kroll").

28 Id. at 283.

29 Id. at 262.

30 Submission for the record to the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce of the United States House of Representatives (September 28, 1978). Mr. Van Oosterhout has been the Chairman of the Publicly-Owned Section of the National Association of Small Business Investment Companies and the Chairman of Clarion Capital Corporation, an SBIC.

The Commission itself has conceded (referring to Rule 17d-1) that "it is in some circumstances unclear whether an application [for exemption] should or should not be filed . . . ."[31] Even Congress had trouble coming to grips with the meaning of the statute that it enacted.[32]

It is important to place this extraordinary situation in perspective. On the one hand, there is an enormously complicated

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31 Investment Co. Act Rel. 5128 (October 13, 1967).

32 Senator Taft at the 1940 Senate hearings confessed understandable confusion:

> Frankly, it would take all afternoon to study Section 17 to find out what it means, before I begin to criticize it. You define what would be an affiliated person, or any affiliated person of such a person acting as principal; and then you say that no affiliated person of an affiliated person of a registered investment company shall sell any stock to the company. Is that the English of it? It is certainly pretty hard to understand what this section does prohibit and what it does not.

Hearings on S.3580 Before a Subcomm. of the Senate Comm. on Banking & Currency, 76th Cong., 3d. Sess., pt. 2, at 345 (1940) (Investment Trusts & Investment Companies).

David Schenker, Chief Counsel for the SEC's study of investment trusts and the principal draftsman of the Act, was willing to attempt an explanation:

> What we tried to say--and it is a little complicated--is that no officer, director, or controlling person, no partner of his in a firm in which he is a partner, and no company which he controls, shall have the right to sell property to the investment trust.
>
> * * * * *
>
> The use of the term "affiliated person" is an attempt in a shorthand way to spell out those situations that I have enumerated. Maybe we have not said it, but I think we have. (Emphasis supplied.) Id.

Act comprised of fifty-three sections, at least one section of which seems to be fully understood by almost no one. On the other hand, there are venture capital companies, the essence of whose business is to risk continuous exposure to that very section. Underlying all this is Section 47(b) of the Act, which provides flatly that "[e]very contract made in violation of any provision of the Act is void." There can be little wonder that the managements of venture capital companies consider the Investment Company Act of 1940 to be a minefield, a "trap for the unwary,"[33] a fate to be avoided "almost at all costs."[34] It should not be surprising that no non-SBIC venture capital companies are registered under the Act.

Section 17(a): The Prohibition of Transactions Between Investment Companies and Their Affiliates

The most critical impediments to the successful operation under the Act by venture capital companies reside in that particularly perplexing provision, Section 17. Briefly stated, the purpose of Section 17 was "the prohibition of self-dealing, whether direct or indirect, on the part of investment companies'

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33 See Comments on Behalf of Midland Capital Corporation on Proposed Rule 17a-6 Submitted by Cleary, Gottlieb, Steen & Hamilton, October 30, 1963, at 29 (SEC File No. S7-240).

34 See Decision of Hearing Examiner, In the Matter of the National Association of Small Business Investment Companies, Admin. Pro. File No. 3-1825 (1969), at 8.

insiders, and the protection of investment company shareholders from any loss in the value of their shares that might be caused by such dealing."[35] Section 17(a) broadly bans, with only very limited exceptions, any transaction between a registered investment company or a company controlled by the investment company and an "affiliated person" or an "affiliated person" of an "affiliated person" of the investment company:

> It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12(d)(3)(A) and (B)) [involving underwriters owned entirely by investment companies--an exception not relevant for our purposes], or any affiliated person of such a person, promoter or principal underwriter acting as principal--
>
> (1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;
>
> (2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

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35 Note, "The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates," 120 U. Pa. L. Rev. 983 (1972). Section 17(b) provides a means for obtaining a prior exemptive order from the Commission for any transaction that would otherwise be in violation of Section 17(a). See text following note 50 below.

> (3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 21(b) of this title.

The breadth of Section 17(a), in turn, stems from its use of the term "affiliated person," which is defined in Section 2(a)(3) as follows:

> "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Finally, the term "control" is defined in Section 2(a)(9), which provides in pertinent part:

> (9) "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.
>
> Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of voting securities of any company shall be presumed not to con-

> trol such company. A natural person shall be presumed not to be a controlled person within the meaning of this title. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person.

Thus "control" under this definition is determined by a presumption based on percentage of ownership, unless a factual inquiry and an order of the Commission prove otherwise.[36]

Application of Section 17(a) to Venture Capital Companies

It is helpful to attempt to discuss the ramifications of Section 17(a) for a venture capital company by reference to visual aids. Accordingly, we have prepared a chart (Exhibit C hereto)[37] illustrating the application of Section 17(a) to VCC Corporation ("VCC"), a hypothetical closed-end venture capital company registered under the Act.

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36 See, e.g., colloquy between Milton Kroll and Solomon S. Freedman, then the SEC's Director of the Division of Corporate Regulation. Kroll at 267-69.

37 The complexity of the attached charts strikingly confirm that the following remarks of Milton Kroll are not so facetious:

> [T]he problems that can arise under the Act for such portfolio affiliates or companies which, in turn, are affiliated with them should be of interest not only to 1940 Act buffs, but to any lawyer for an operating company the shares of which are the object of the affections of any mutual fund. The topic also should appeal to double-crostic fans. Kroll at 262.

VCC is a typical venture capital company. It relies on internal management for its investment decisions; there is no outside investment adviser to complicate the situation. VCC's shareholders, comprised of both institutions and individuals, hold VCC's common stock in amounts ranging from less than 5% to more than 25%. VCC is not under common control with any other entity. VCC owns securities in other companies in amounts ranging from less than 5% to more than 25% of the voting securities of those other companies. It actively participates in the management of its portfolio companies and its officers sit on their boards of directors.

Following the definitions of Section 2(a)(3), the attached chart divides the "affiliated persons" of VCC into two groups: "upstream" (those that control or are otherwise in a position to influence VCC) and "downstream" (those that VCC controls or is otherwise in a position to influence). Thus the "upstream" affiliated persons of VCC are (1) each of its directors, (2) each of its officers and employees, and (3) each shareholder of VCC owning 5% or more of its common stock. VCC's "downstream" affiliated persons (sometimes called "portfolio affiliates") consist of all companies of which it owns 5% or more of the voting securities.

But we are not done yet, for Section 17(a) also prohibits transactions between VCC or companies it controls and affiliated persons of its underwriter or affiliated persons. These so-called

"second-tier" affiliated persons consist of the following persons with specified relationships to each corporate affiliated person of VCC: (1) each director of each corporate affiliated person of VCC, (2) each officer or employee of each corporate affiliated person of VCC, (3) each person owning 5% or more of the voting securities of each corporate affiliated person of VCC, and (4) each company, 5% or more of whose voting securities are owned by such corporate affiliated person of VCC. For each natural person who is an affiliated person of VCC, the list of second-tier affiliated persons is comprised of each partner or employee of each natural affiliated person of VCC, and each company, 5% or more of whose voting securities are owned by each natural affiliated person of VCC.[38]

The result of all this is that, under Section 17(a), a transaction involving the purchase or sale of securities or other

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38 For purposes of our illustration, we have assumed, in accordance with the presumptions of Section 2(a)(9), that VCC "controls" each company of which it owns more than 25% of the voting securities. Companies which are controlled by affiliated persons of VCC are in the category of companies which are affiliated persons of affiliated persons of VCC due to the ownership of 5% or more of the second-tier affiliated person's voting securities by the affiliated person of VCC. This inclusion is proper because the set of companies, 25% or more of whose securities are owned by affiliated persons of VCC, is a subset of the companies, 5% or more of whose securities are owned by affiliated persons of VCC. It is not necessary, under Section 17(a) or 17(d), to identify companies controlled by affiliated persons of VCC as a separate category.

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property between an entity marked on the chart in RED and an entity marked in BLUE is prohibited.[39]

One part of the statutory scheme becomes puzzling almost at once. How can a "downstream" affiliate (a party controlled or influenced by VCC) be in a position to deal with VCC to the detriment of the shareholders of VCC? The answer is that in almost all instances it cannot; indeed, the clear prohibition on dealings between VCC and its downstream affiliated persons "does not appear to have been anticipated or intended."[40] Nonetheless, Section 17(a) in effect prohibits VCC from engaging in any follow-up transactions with its downstream affiliated persons no matter how small, how urgent, or how vital to the survival of the portfolio affiliate. Although it could be corrected in a few words (simply by making clause (B) of the definition of affiliated person in Section 2(a)(3) inapplicable in the context of Section 17(a)), Congress has not done so, nor has the SEC encouraged it to do so.[41]

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39 While Section 17(a)(3), in that it implies that a company controlled by VCC can borrow from VCC, creates a limited exception to our generalization, this exception is of no practical significance. Since virtually all borrowing involves the purchase or sale of a security, the transaction would be barred by subsection (a)(1) or (a)(2).

40 Rosenblat & Lybecker at 653. They also point out that a "second-level portfolio affiliate is even less likely to be susceptible to any attempt by the investment company to affect the independence of its decision-making." Id.

41 However, proposed §1411 of the Proposed Official Draft of the Federal Securities Code (March 15, 1978) does adopt essentially this change.

The Commission has attempted to alleviate this situation by promulgating Rule 17a-6. Although this Rule applies specifically to SBICs and venture capital companies and was intended to exempt their transactions with affiliated persons where no upstream affiliated persons (GREEN on the chart) have a "financial interest" in a party to the transaction, it is so vague and prolix as to be of minimal practical value.

In essence, Rule 17a-6 provides that a transaction between an investment company such as VCC and an affiliated person of VCC (or an affiliated person of that affiliated person) is exempt from Section 17(a), provided that (a) none of the following is a party to the transaction:

> (1) An officer, director, employee, investment adviser, member of an advisory board, depositor, promoter of or principal underwriter for the registered investment company, or
> (2) A person directly or indirectly controlling the registered investment company, or
> (3) A person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding securities of the registered investment company, or
> (4) A person directly or indirectly under common control with the registered investment company, or
> (5) An affiliated person of any of the foregoing,

and (b) none of the foregoing "has, or within six months prior to the transaction had, or pursuant to an arrangement will acquire a direct or indirect financial interest in a party (except the registered investment company) to the transaction."[42]

Rule 17a-6, then, is even more convoluted than the statute itself. Businessmen are understandably reluctant to enter into transactions when they cannot readily determine whether those transactions are permissible. For example, even though the availability of the exemption is critically dependent on the meaning of the term "financial interest," this term is conspicuously left undefined in the Rule, the Act

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42 Paragraph (c)(2) of Rule 17a-6 also excludes from item (4) of the list of prohibited persons any person who, if it were not directly or indirectly controlled by the registered investment company, would not be directly or indirectly under the control of the person who controls the registered investment company. Finally, paragraph (c)(3) of Rule 17a-6 excludes from item (5) of the list of prohibited persons a registered investment company and a person who (a) if it were not directly or indirectly controlled by a registered investment company, or (b) if 5% or more of its outstanding voting securities were not directly or indirectly owned, controlled or held with power to vote by the registered investment company, would not be an affiliated person of a person described in items (2) or (3) of the list of prohibited persons.

or anywhere else.[43] Perhaps worse still, the "financial interest" concept neglects to employ any kind of a de minimis standard.

Specific Impediments to Venture Capital Companies Posed by Section 17(a) and Rule 17a-6

It has been stressed that venture capital companies, unlike traditional investment companies, are compelled to deal regularly with affiliated persons in the ordinary course of their doing business. Virtually any transaction of this kind that is effected by a venture capital company such as VCC is therefore potentially

43 However, Rule 17a-6(c)(1) does tell us what a "financial interest" is not:

> (i) any interest through ownership of securities issued by the registered investment company;
> (ii) any interest of a wholly-owned subsidiary of the registered investment company;
> (iii) usual and ordinary fees for services as a director;
> (iv) an interest of a nonexecutive employee;
> (v) an interest of an insurance company arising from a loan or policy made or issued by it in the ordinary course of business to a natural person;
> (vi) an interest of a bank arising from a loan or account made or maintained by it in the ordinary course of business to or with a natural person, unless it arises from a loan to a person who is an officer, director or executive of a company which is a party to the transaction, or from a loan to a person who directly or indirectly owns, controls, or holds with power to vote, 5 per centum or more of the outstanding voting securities of a company which is a party to the transaction; or
> (vii) an interest acquired in a transaction described in paragraph (d)(3) of Rule 17d-1 under the Act [applies only to SBICs].

in violation of Section 17(a). Due to limits of both space and imagination, we shall limit our discussion to only the following representative examples of impediments that Section 17(a) might reasonably pose for VCC:

1. Suppose that a major bank owns (through its trust department or a nominee, as will be the case in the examples hereinafter discussed) more than 5% of the voting securities of VCC. The bank, then, is an "upstream" affiliated person of VCC. Section 17(a) not only bars it from further dealings with VCC, but bars all of the affiliated persons of the bank from dealing with VCC as well. As Exhibit C illustrates, this group of second-tier affiliated persons includes all of the directors, officers and employees of the bank and all of the companies of which the bank owns 5% or more of the outstanding voting securities. It is likely that, through trust accounts and other vehicles, the bank holds with the power to vote 5% or more of the outstanding voting securities of hundreds of small companies. If VCC were to provide venture capital financing to Company A, one of these small companies, Section 17(a) would be violated and the transaction would be potentially void under Section 47(b). Rule 17a-6 would not provide relief for VCC's financing of Company A because the bank would have a prohibited financial interest in Company A.

2. Assume again that a bank owns more than 5% of the voting securities of VCC. Assume further that VCC owns more than 5% of the voting securities of Company B and that the bank has made a $1,000 home improvement loan to an assistant secretary of Company B. Suppose then that Company B, fledgling enterprise that it is, suddenly develops a critical need for additional funds and that VCC is eager to provide these funds in order to save Company B. There is plainly no danger here that VCC can be overreached by Company B--VCC has made an independent business judgment that furnishing Company B with the additional funds is in VCC's best interests. Nor is there a danger that the bank could, or would want to, influence VCC to VCC's detriment solely because of the loan to the Company B officer. Yet, because the bank has made a loan to an officer of Company B, an affiliated person of VCC (the bank) probably has an indirect financial interest in a party to the transaction (Company B). Thus the exemption under Rule 17a-6 is lost and the additional financing is prohibited by

Section 17(a).[44] If Company B goes bankrupt as a result, the shareholders of VCC will see the value of their investment decline through the perverse operation of a statute purportedly adopted for their protection.

3. Assume that VCC owns 25% of the voting securities of Company C, a controlling interest under Section 2(a)(9), and that these securities are publicly traded. One of VCC's investors is an insurance company that owns 5% of VCC's securities. An employee of the insurance company purchases a used desk from Company C. Even this purchase, without more, is void under Sections 17(a) and 47(b), and there is no reasonable way for the employee, the insurance company or VCC to know it.

Section 17(d): The Prohibition of Joint Transactions Between Investment Companies and Their Affiliates

This section is viewed as the bête noire of the Act in the experience of venture capital company management. In

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44 As a practical matter, it may be more likely that no one would discover that the loan to the employee poisoned the exemption of Rule 17a-6, so that the additional financing would be allowed to proceed. In that event, there would exist, unbeknownst to any of the parties, a continuing cloud on the transaction under Section 47(b), thereby risking its being voided long afterwards.

A prohibited financial interest also can arise from the ownership of Company B's securities by an affiliated person of the bank (i.e., any director, officer, employee or company of which the bank owns more than 5% of the outstanding voting securities). If so, neither VCC nor Company B would have any reasonable means of knowing that such a prohibited financial interest exists. It is no answer to suggest that VCC could have prevented the violation by checking the Schedule 13G filed by the bank pursuant to the Securities Exchange Act of 1934 to reflect the beneficial ownership by affiliated persons of the bank of the securities of Company B. The reasons for this are: (a) since the filing of Schedule 13G is required only with respect to securities registered under Section 12 of the Exchange Act, it is extremely unlikely that the Schedule would be required for the securities of a small corporation like Company B, (b) copies of the Schedule need be sent only to the issuer (i.e., Company B), not VCC, so that VCC would not have actual knowledge of the information and Company B would very likely be unaware of its significance under Section 17(a), and (c) the Schedule is required to be filed only once a year, so that it would not necessarily reflect the current ownership by any of the bank's affiliated persons of the securities of Company B, notwithstanding the prohibition of Section 17(a). Moreover, it is obviously impractical for the bank regularly to provide VCC with a list of all of its affiliated persons.

adopting the Act, Congress was aware of a host of subtle ways in which persons in a position to take advantage of a registered investment company might do so through means that did not come within Section 17(a) as direct principal transactions. Rather than try to identify all of these possible devices in the Act, Congress defined the potential trouble area very broadly and left it to the Commission to specify by rule what types of transactions should be prohibited.

Section 17(d) makes it

> unlawful for any affiliated person of or principal underwriter for a registered investment company . . . or any affiliated person of such a person or principal underwriter, acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person, principal underwriter, or affiliated person, in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant.

It is significant that this provision is not self-executing; no joint transaction is unlawful unless the SEC makes it so.

The Commission's response has been the promulgation of Rule 17d-1, which provides in part:

> (a) No affiliated person of or principal underwriter for any registered investment company (other than a company of the character described in Section 12(d)(3)(A) and (B) of the Act) and no affiliated person of such a person or principal underwriter, acting as

> principal, shall participate in, or effect any transaction in connection with, any joint enterprise or other joint arrangement or profit sharing plan in which any such registered company, or a company controlled by such registered company, is a participant, and which is entered into, adopted or modified subsequent to the effective date of this rule, unless an application regarding such joint enterprise or profit sharing plan has been filed with the Commission and has been granted by an order entered prior to the submission of such plan or modification to security holders for approval . . . .

The Commission has defined joint transaction in Rule 17d-1(c) to include virtually every conceivable type of transaction:

> (c) "Joint enterprise or other joint arrangement or profit-sharing plan" as used in this rule, shall mean any written or oral plan, contract, authorization or arrangement or any practice or undertaking concerning an enterprise or undertaking whereby a registered investment company or a controlled company thereof and any affiliated person of or a principal underwriter for such registered investment company, or any affiliated person of such a person or principal underwriter, have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking, including, but not limited to, any stock option or stock purchase plan, but shall not include an investment advisory contract subject to Section 15 of the Act.

Thus the Commission's exercise of the authority granted by Section 17(d) effectively turns upside down the legislative approach--instead of selectively prohibiting certain specified transactions, the Rule says that <u>everything</u> within the trouble area is unlawful unless it is the subject of an application filed with the Commission that is granted by order, as discussed later. Considering the unparalleled breadth of Section 17(d) and

Rule 17d-1, replete as they are with such open-ended terms as "affiliated person," "affiliated person of an affiliated person" and "other joint arrangement," the need for an order to legalize anything within the trouble area, the dire consequences of guessing wrong or overlooking the possible reach of these terms, and the potentially destructive delay in obtaining an order,[45] it may readily be seen why Section 17(d) and Rule 17d-1 loom as a foreboding trap for the luckless and have led to exasperation and despair.[46]

Application of Section 17(d) to Venture Capital Companies

Rule 17d-1(a) prohibits, without the SEC's prior approval, joint enterprises between VCC or one of its controlled companies and (1) any affiliated person of VCC, (2) any underwriter for VCC and (3) any affiliated person of such affiliated person of or such underwriter for VCC. On the chart attached as Exhibit

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45 The practical problems in obtaining an order from the Commission under the Act are discussed in the text following note 50 below.

46 The draftsmen of the proposed Federal Securities Code have observed that "Section 17(d) has been, because of its generality, perhaps the single most troublesome provision in the entire statute." Comment to proposed §1111A, Proposed Offical Draft of the Federal Securities Code (April 1, 1977). Mr. Kroll advises that "the only solution to the problem [of Section 17(d)] is prayer consistently applied." Kroll at 291.

D, the former category is marked in RED and the latter group in BLUE. Thus joint transactions involving any person in the RED group and any person in the BLUE group are prohibited.

The only exception to this broad prohibition applicable to VCC is provided by Rule 17d-1(d)(5), the substance of which is virtually identical to Rule 17a-6 and applicable to all investment companies, not just SBICs and venture capital companies. Unfortunately, it is equally convoluted.[47] Like Rule 17a-6, then, Rule 17d-1(d)(5) represents the Commission's unsuccessful attempt to provide some relief from the statute for transactions in which no "upstream" affiliated persons of the investment company have the ubiquitous, but undefined, "financial interest" in a party to the transaction.

Specific Impediments to Venture Capital Companies Posed by Section 17(d) and Rule 17d-1

There is little authority construing the terms "joint transaction" and "joint enterprise,"[48] but examples of all of the potential difficulties that await venture capital companies under Section 17(d) and Rule 17d-1 are unbounded. The following

47 Rule 17d-1(d)(5) is further qualified by the restriction that the investment company may not commit in excess of 5% of its paid-in capital (20% for SBICs) and surplus to a transaction for which exemption is claimed under the Rule which is not a merger of one of its controlled companies with another controlled company or affiliated person.

48 See, e.g., SEC v. Midwest Technical Development Corp., [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶91, 252 (D. Minn. 1963); and SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972).

illustrations, however, will serve to highlight some typical problems:

1. Suppose that VCC and a venture capital limited partnership, VCP, each own 5% of Company A's voting securities. Suppose further that VCC and VCP each wish to purchase 5% of the securities of Company B and that an insurance company holding 5% of VCC's stock has a "financial interest" in a partner of VCP (e.g., an insurance policy to a corporate partner of VCP). The new venture is prohibited by Rule 17d-1, and Rule 17d-1(d)(5) offers no relief because the insurance company (an affiliated person of VCC) has a prohibited "financial interest" in a party to the transaction. The effect of Rule 17d-1, then, is to prevent venture capital companies from entering into more than one simultaneous investment whenever such an indirect financial interest exists, which can be very frequently, given the large universe of "upstream" affiliated persons and affiliated persons of affiliated persons. For this reason, venture capital companies are reluctant to provide financing to any entity that has been financed by a registered investment company. Because of the limited number of venture capital companies, this prohibition dramatically restricts the availability of such financing.

2. Suppose that VCC owns 5% of the voting securities of Company B and that Company B proposes to make a public offering of its securities. Suppose further that, pursuant to a registration covenant negotiated at the time that VCC acquired its Company B securities, VCC desires to sell its Company B securities in a secondary offering as part of the same registration statement that Company B is using for the primary offering. Finally, suppose that VCC is currently offering its own shares to the public in an underwritten offering and that XYZ investment banking firm is a member of the underwriting syndicate for the VCC offering and will be a member of the syndicate for the Company B offering. Regardless of the facts that VCC will receive the same price per share as Company B, that the expenses of the Company B offering will be allocated on a pro rata basis, and that (as discussed in the next section) having to wait a minimum of two months for an SEC order to approve the transaction might well jeopardize the Company B offering and thereby disadvantage VCC's shareholders, VCC cannot exercise its registration covenant to sell its Company B shares without prior SEC approval. The reason is that XYZ (a "principal underwriter" for VCC even though only one of many firms in the underwriting syndicate) is deemed to have a "financial

interest" in the Company B offering that poisons the exemption under Rule 17d-1(d)(5). 49

3. Suppose that VCC has decided to implement a pension plan, so as to attract and retain qualified personnel. The plan is a joint enterprise under Rule 17d-1(c), 50 and relief under Rule 17d-1(d)(5) is unavailable because the employees have an obvious "financial interest" in the transaction. Thus, unlike virtually any other business, VCC would have to apply to the Commission for an order approving its pension plan.

Obtaining Exemptions from Section 17

When a transaction is otherwise barred by Section 17(a) or 17(d), it is, as we have mentioned, possible to obtain an order from the Commission exempting the transaction from the applicable prohibition. The suggestion has been made that, if it is unclear whether a contemplated transaction is within Sections 17(a) and 17(d) and the rules thereunder, the filing of an

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49 In a closely analogous situation, when the First Provident Co., a portfolio affiliate, and the George Putnam Fund of Boston applied for an SEC exemptive order to sell jointly shares of First Provident's common stock, the Commission scrutinized the total number of shares to be offered and the allocation of that number among the parties, the allocation of expenses among the parties, and the advantage to the Fund of having a public market for the First Provident stock it would retain. First Provident Co., Investment Company Act Release No. 6400 (March 4, 1971). Few other businesses, of course, are ever subject to such an ordeal.

50 The Commission has so held. Release No. 40-1598, March 20, 1951.

application for exemption is prudent.[51] Assuming that the venture capital company and its counsel are lucky enough to spot the potential problem in the first place, this is doubtless a fine suggestion for mutual funds (which seldom need to have dealings with affiliated parties anyway, other than advisory or underwriting arrangements), because time is ordinarily not a critical factor. However, for venture capital companies, which regularly must deal with a whole panoply of affiliated persons, often under severe time constraints, the Commission's exemption procedure is so time-consuming, expensive and otherwise unwieldly as to be of virtually no practical value.

A former Chief Counsel and a present Associate Director of the Division of Investment Management have recognized that Section 17(b), for example, "forces all transactions covered by Section 17(a), regardless of size or importance, into a cumbersome application procedure, preventing timely execution and, in some cases, entirely precluding consummation of the proposed transaction."[52] They are exactly right. Indeed, this procedure sometimes can be the difference between profit and bankruptcy for a venture capital company's portfolio affiliate. To illustrate, let us borrow again from an earlier typical hypothetical example.

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51 See remarks of Solomon Freedman (then the Director of the SEC's Division of Corporate Regulation), quoted in Kroll at 280-81.

52 Rosenblat & Lybecker at 639.

Suppose VCC, a venture capital company registered as an investment company under the Act, owns 5% or more of the common stock of Company B. Company B has an emergency need for additional funds, which VCC is eager to provide, but this will involve VCC's purchasing securities (notes or additional stock) from Company B. Since VCC's ownership of 5% of Company B stock makes Company B an affiliated person of VCC, and vice versa, the purchase by VCC of Company B's securities from Company B is unlawful under Section 17(a) unless the transaction is one of a class of transactions exempted by rule or VCC obtains an order of exemption from the Commission. The only exemptive rule that might be applicable is Rule 17a-6, but that rule is not available here because an employee of VCC or of an "upstream" affiliated person of VCC within the past six months had a "financial interest" in Company B (Rule 17a-6(ii)), although he has no such interest now. VCC must therefore obtain an exemptive order under Section 17(b) to save Company B. The problem is that Company B may be beyond saving by the time the exemption is obtained.

Section 17(b) provides that the Commission shall grant the exemptive order if the evidence establishes that

> (1) the terms of the transaction . . .are reasonable and fair and do not involve overreaching on the part of any person concerned;
> (2) the proposed transaction is consistent with the policy of each registered investment company concerned. . .; and
> (3) the proposed transaction is consistent with the general purposes of [the Act].

While it might be possible to have some exploratory discussions with the Commission staff based upon the tentative terms of the transaction, the process of obtaining the order cannot really begin until those terms are definite enough so that the staff can arrive at a preliminary conclusion as to fairness. However, by the time this degree of definiteness has been reached, the businessmen are ready to consummate the transaction, and, what is more, the need for the transaction is often critical.

If the staff can quickly grasp the terms of the transaction and promptly concludes that it meets the standards of Section 17(b), VCC might receive the most expeditious treatment available--it might receive its order in two months. This time would be consumed by counsel's drafting and filing the application; the staff's drafting the required notice of opportunity for hearing and supporting memorandum to submit to the Commission; getting the matter on the Commission's calendar; publishing the notice upon Commission authorization, which notice would give interested persons thirty days in which to request a hearing on the application; and, if no such request is received during those thirty days, drafting and getting the order issued, again by the Commission.

Certainly the consumption of time is inherent in the process of obtaining exemptions by formal Commission order. As we have seen, the question of whether an exemptive order is necessary because of Section 17(a) or (d), despite Rules 17a-6 and 17d-1(d)(5), may not be obvious and susceptible to quick answer. If

it is decided to seek an order because Section 17(a) or (d) does, or might, apply, the staff's attitude on the merits becomes critical. If the staff concludes that it will recommend the granting of the exemption and will not demand a formal, evidentiary hearing, there is hope of obtaining the order within a few months from the time of the decision to apply for it. If a hearing is required because the staff is unwilling to support the application, or if it is clearly opposed, the prospective time span moves from a few to many months or a year or more. But the proposed transaction may not lead itself to ready comprehension. So weeks or months may pass in the process of preparing and furnishing to the staff the necessary information and waiting for its decision.

All too often, of course, conclusion of this process is too late for the transaction to serve the purpose for which it was intended. By the time the order is finally available, the parties in desperation may have resorted to some less desirable alternative, the business opportunity for Company B may have been lost or Company B may be in bankruptcy.[53] Furthermore, because a company

53 This is by no means a new complaint. In a letter dated March 24, 1954, to then SEC Chairman Ralph H. Demmler, General Georges F. Doriot, then the President of American Research and Development Corporation (see note 12 above), made the same point:

> [I]f one of our [portfolio] companies is suddenly in need of $25,000, we can do nothing about it, even though the company needs it badly. We have to go to our lawyers, who prepare an application, this application goes to Washington, and it may be sixty days or more before we get an answer. By that time a small company, as you know, can become very very dead, and I am sure that the SEC does not plan to have that kind of thing happen, particularly in the case of a company like American Research, which is supported by some rather good people. (Emphasis supplied.)

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such as VCC doubtless would find it frequently necessary to seek exemptions from Section 17, the out-of-pocket costs (for outside counsel as well as unquantifiable internal costs) can be prohibitive to all but the largest venture capital companies.[54]

The fact is that the time alone, plus the expense, consumed in this process can be excruciating and wholly inconsistent with the business needs of venture capital companies. In our inquiries we have heard many "horror stories" of indecision and delay on the part of the Commission staff, as well as a penchant for excessive imagination and ingenuity in spinning webs to stretch the reach of the Act. In order to accept the business realities of this process it is not necessary to accept criticism of staff performance, especially relative to the merits of any given proposed transaction and the skill and diligence of counsel. The problem is inherent in the statutory scheme and would still be fully present were the staff always to perform in the most ideal fashion. We cannot put upon government officials the responsibility of interpreting intricate laws as applied often to intricate facts and reach conclusions on the merits of intricate transactions and expect them always to answer by return mail. This memorandum is not addressed to

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54 See, e.g., letter dated September 15, 1978, from Mr. William P. Lane, Vice President and Controller of Narragansett Capital Corporation, to Mr. Peter F. McNeish, Deputy Associate Administrator for Investment, Small Business Administration. Mr. Lane notes that, with respect to Section 17 matters alone, Narragansett expended $38,000 to special counsel for its fiscal year ended March 31, 1978, and $24,000 during the three months ended June 30, 1978.

staff deficiencies, real or imagined, but to legal deficiencies. The solution must be legislative, which might include administrative rulemaking by the Commission.

Section 18(d): The Prohibition of Stock Options and Convertible Securities

As disastrous as it is for venture capital companies, Section 17 is not the sole impediment to their successful operation under the Act. Section 18(d) is very nearly as bad. With a limited exception intended to permit a typical rights offering to shareholders, Section 18(d) flatly prohibits the issuance of any rights, options, warrants or conversion privileges.[55]

As in any business, stock options are an important element in the ability of venture capital companies to attract top-level

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55 Section 18(d) provides as follows:

> It shall be unlawful for any registered management company to issue any warrant or right to subscribe to or purchase a security of which such company is the issuer, except in the form of warrants or rights to subscribe expiring no later than one hundred and twenty days after their issuance and issued exclusively and ratably to a class or classes of such company's security holders; except that any warrant may be issued in exchange for outstanding warrants in connection with a plan of reorganization.

management. Highly motivated and involved personnel are especially vital in the development and operation of emerging enterprises. Indeed, in permitting the granting of qualified stock options to officers of SBICs in 1971, the SEC itself recognized that "[i]t cannot be disputed that stock options are today extensively employed as an element in management compensation, and we see no basis in the record for disagreeing with the SBA's view that the ability to issue such options would assist in alleviating personnel problems." The Commission noted in that opinion that "assertions that stock options tend to encourage speculative portfolio investments and to introduce complexity and uncertainty into the capital structure are not particularly applicable to SBICs."[56] The same arguments apply equally to venture capital companies.

Yet the ban on all employee stock options for non-SBIC venture capital companies continues. Moreover, exempting only qualified stock options is virtually no relief at all, even for SBICs, considering the limits placed on such options by the Tax Reform Act of 1976.[57] As a result, a venture capital

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56 In the Matter of the National Association of Small Business Investment Companies, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,076 (May 14, 1971).

57 Section 422 of the Internal Revenue Code has severely limited qualified options for pre-existing plans, and such options are no longer valid after May 21, 1981.

company registered under the Act must operate under a severe handicap in the recruitment of qualified personnel.[58]

Section 18(d) also prohibits the issuance of warrants or convertible securities. Thus a venture capital company subject to the Act may not raise capital by offering senior securities with an equity feature (a so-called "equity kicker"). Such a feature is usually essential to attracting capital from institutional investors in the formative stages of the venture capital company. These investors often demand a senior position through a note or preferred stock, so as to be protected in hard times, together with the right to participate in gains, should they come to pass, by converting the note or preferred stock into common stock or by exercising warrants to purchase common stock at a favorable price. The bulk of the capital of Heizer Corporation, for example, was raised by the use of both of these devices and could not have been attracted without them. Obviously enough, a venture capital company can scarcely begin, much less survive, if it cannot raise its own capital. Yet this is essentially the result mandated by Section 18(d).[59]

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58 General Doriot has strongly observed that a major factor in the demise of ARD was its inability to attract and retain qualified personnel because of the SEC's refusal to allow stock options. Interview of General Georges F. Doriot by Paul H. Dykstra on November 9, 1978, in Boston, Massachusetts.

59 Because Section 18(d) prohibits only the issuance (and not the existence) of options, warrants, rights, etc., it would appear that a company that had such securities outstanding prior to registering under the Act should be able to continue to have those securities outstanding and to honor their terms after registration. Yet the SEC staff is not sure, having advised that it can resolve the matter only in a formal proceeding.

Section 18(a): Limitations on Senior Securities

Section 18(a) prohibits an investment company from issuing a senior security unless the company can meet an asset coverage test of 300% if the senior security is debt and 200% if it is equity.[60]

Because venture capital companies invest in emerging enterprises whose securities are both speculative and illiquid, there may be wide fluctuations in the value of these portfolio securities in the early years. As a result, under Section 18(a), a venture capital company registered under the Act and intending to issue

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60 Section 18(a) provides in part:

> It shall be unlawful for any registered closed-end company to issue any class of senior security, or to sell any such security of which it is the issuer, unless--
>
> (1) if such class of senior security represents an indebtedness--
>
> (A) immediately after such issuance or sale, it will have an asset coverage of at least 300 per centum. . . .
>
> (2) if such class of senior security is a stock--
>
> (A) immediately after such issuance or sale it will have an asset coverage of at least 200 per centum . . . .

"Senior security" is defined in Section 18(g) and the method for computing "asset coverage" in Section 18(h).

senior securities would be compelled to retain large amounts of liquid assets (which could otherwise be used to finance developing industry) to avoid a violation in the event of a sudden downward fluctuation in the value of its portfolio securities. This is true even though Section 18(a), much like Section 18(d), prohibits only the issuance, not the existence, of securities that do not meet the asset coverage test.[61]

Although Congress apparently has recognized this reality by exempting SBICs from subsections 18(a)(1)(A) and (B)[62] through its enactment of Section 18(k) in 1972, this relief was not extended to non-SBIC venture capital companies.

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61 Here, too, the ban is on the issuance of the prohibited security, and the staff of the Commission is unsure whether a company that had such securities outstanding prior to registering under the Act would be able to continue to have those securities outstanding and to honor their terms after registration. The answer probably has to be affirmative if only because of the absence of any provision in the Act for compulsory recapitalization or reorganization, but it remains in doubt.

62 These subsections apply to senior securities that represent indebtedness.

Section 18(c) has similar restrictions in that it prohibits registered closed-end investment companies from having multiple classes of senior securities.[63] Since venture capital companies often must issue such securities in order to attract investors, this can be a severe impediment to their operations. The Commission has conditionally exempted SBICs from this Section.[64] Yet, although no logical distinctions can be made, the restrictions of Section 18(c) continue to apply to non-SBIC venture capital companies.

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63 Section 18(c) provides:

> (c) Notwithstanding the provisions of subsection (a) it shall be unlawful for any registered closed-end investment company to issue or sell any senior security representing indebtedness if immediately thereafter such company will have outstanding more than one class of senior security representing indebtedness, or to issue or sell any senior security which is a stock if immediately thereafter such company will have outstanding more than one class of senior security which is a stock, except that (1) any such class of indebtedness or stock may be issued in one or more series; provided, that no such series shall have a preference or priority over any other series upon the distribution of the assets of such registered closed-end company or in respect of the payment of interest or dividends, and (2) promissory notes or other evidences of indebtedness issued in consideration of any loan, extension, or renewal thereof, made in a bank or other person and privately arranged, and not intended to be publicly distributed, shall not be deemed to be a separate class of senior securities representing indebtedness within the meaning of this subsection(c).

64 Rules 18c-1 and 18c-2.

Section 23(b): Sale of Common Stock at Net Asset Value

Section 23(b) prohibits a registered closed-end investment company, and therefore a registered venture capital company, from issuing its common stock at a price per share that is below its net asset value per share, with an exception for typical rights offerings. The problem is that virtually all closed-end companies (not just venture capital companies) trade in the market at a price that is less than their net asset value. The result of Section 23(b) is to foreclose venture capital companies from raising their own capital in the public securities markets through additional offerings of their common stock to additional investors, even if that stock were sold at the prevailing market price. To be sure, a venture capital company could attempt to obtain an exemption from the prohibition by applying for a formal order from the Commission or it could ask a majority of its common stockholders to approve the proposed offering, but either of these procedures can consume so much time as to cause the company to miss a favorable selling opportunity.

Other Impediments under the Act

We have summarized the major impediments under the Act that preclude the successful operation of venture capital companies thereunder. Other provisions of the Act, even though applicable to all investment companies, pose disincentives to registration under the Act by all but the largest venture capital companies

because of the costs of compliance.[65] Among these provisions are Section 17(f) (relating to the custody of securities), Section 17(g) and Rule 17g-1 (requiring a fidelity bond covering all persons with access to cash or securities), Section 30 (prescribing reports more complex than those required of most other industries), Section 19 (reporting sources of dividends), and Section 32 (imposing additional requirements as to auditors and financial statements).

Conclusion

The quest to rationalize the Investment Company Act of 1940 so as to create at least a neutral environment for venture capital companies is not a new one--it has been going on, with an obvious lack of success, almost since the Act's passage. Meanwhile, the business of furnishing venture capital to developing industry continues to decline, as the Act has caused one venture capital company after another to close its doors and has discouraged others from even beginning.

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65 See, e.g., letter dated September 15, 1978, from William P. Lane, Vice President and Controller of Narragansett Capital Corporation to Mr. Peter F. McNeish, Deputy Associate Administrator for Investment of the Small Business Administration, and submission for the record to Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce of the United House of Representatives of Peter Van Oosterhout, September 28, 1978.

Whatever arguments may be raised in support of imposing these myriad restraints, history has demonstrated that they have not worked. They have not served to protect investors in venture capital companies. They have served only to prevent there being any such investors to be protected. Nor is it constructive to argue that businessmen ought not to object to these "protections" and would not if their motives were honorable. They do object to these for good reasons quite irrelevant to honor and fairness. If it is in the public interest to encourage more venture capital investing, something obviously must be done to make the legal and regulatory environment, if not attractive, at least bearable, for publicly-held and financed venture capital companies.

SIGNIFICANT PUBLIC ISSUES OF VENTURE CAPITAL COMPANIES SINCE WORLD WAR II

Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS: No Longer Registered Under 1940 Act: Registered Under 1940 Act	Merged with Operating Company	Converted to Operating Company	Liquidated	Current Venture Capital Activity
1.	American Research & Development Corp. Boston, Massachusetts (Textron, Inc.)	1946-1951 4/-/59 8/9/60	300 B.E. 100 350	$25 40 24.70	$ 7,500 4,000 8,645		X			Venture Capital Subsidiary
2.	Midwest Technical Development Corp. Minneapolis, Minnesota (Midtex, Inc.)	5/-/59 7/-/60	500 561	3.75 4.75	1,875 2,667			X		None
3.	*Electronics Capital Corp. San Diego, California (Shelter Resources, Inc.)	6/8/59 7/6/61	1,800 612	10 27	18,000 16,537			X		None
4.	*Allied Small Business Investment Co. Washington, D.C. (Allied Capital Corp.)	1/5/60	100 B.E.	11	1,100	X				SBIC Subsidiary
5.	*Greater Washington Industrial Investments, Inc. Washington, D.C. (Greater Washington Investors, Inc.)	4/27/60 2/14/69	500 147	10 27.50	5,000 4,046	X				SBIC
6.	*First Midwest Small Business Investment Co. Minneapolis, Minnesota (First Midwest Corporation)	5/-/60 1/29/69	110 150	7.50 17	825 2,550			X		SBIC Subsidiary
7.	*Growth Capital, Inc. Cleveland, Ohio (Park-Ohio Industries, Inc.)	6/8/60	500	20	10,000			X		None
8.	*Continental Capital Corp. San Francisco, California (Same)	6/21/60 8/24/69	235 175	14 15	3,290 2,625	X				SBIC

EXHIBIT A

* Went public as licensed SBIC
B.E. = Best efforts or non-underwritten issue

Significant Public Issues of Venture Capital Companies Since World War II
Page Two

Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS: No Longer Registered Under 1940 Act: Registered Under 1940 Act	Merged with Operating Company	Converted to Operating Company	Liquidated	Current Venture Capital Activity
9.	*The Franklin Corporation New York, New York (Same)	6/29/60	1,000	$ 10	$10,000	X				SBIC
10.	*Texas Capital Corp. Georgetown, Texas (Telecom Corp., Houston)	7/14/60 9/14/61	475 1,000	6 7.75	2,850 7.750			X		SBIC Subsidiary
11.	*Florida Capital Corp. Palm Beach, Florida (Same)	7/29/60 8/23/61	950 488	8 7.75	7,600 3,785			X		None
12.	*Techno-Fund, Inc. Columbus, Ohio (-)	8/18/60	450	12.50	5,625				X	None
13.	*Narragansett Capital Corp. Providence, Rhode Island (Same)	9/8/60	500	11	5,500	X				SBIC
14.	*Boston Capital Corp. Boston, Massachusetts (BCC Industries, Inc., Cleveland, Ohio)	9/13/60	1,500	15	22,500			X **		None
15.	*Venture Capital Corp. of America New York, New York (Royal Business Funds, Inc. - merged in and took control)	9/15/60	325	7.5	2,438	X				SBIC
16.	*Capital Investments, Inc. Milwaukee, Wisconsin (Same)	9/9/60 7/-/69	60 ?	11 ?	660 ?	X				SBIC

* Went public as licensed SBIC
** SBIC investments not retained in operating company but sold to Schooner Capital Corp., a privately-held SBIC.

Significant Public Issues of Venture Capital Companies Since World War II
Page Three

Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS Registered Under 1940 Act	No Longer Registered Under 1940 Act Merged with Operating Company	Converted to Operating Company	Liquidated	Current Venture Capital Activity
17.	*Virginia Capital Corp. Richmond, Virginia (Same)	10/19/60	60	$10.50	$ 630	X				SBIC
18.	*Electro-Science Investors, Inc. Dallas, Texas (LTV Ling Altec, Inc. ?)	10/27/60	772	11	8,492		X			None
19.	*Mid-States Business Capital Corp. (-)	11/2/60	225	11	2,475				X	-
20.	*First Connecticut Small Business Investment Co. Bridgeport, Connecticut (Same)	12/8/60 B.E. 12/11/62 3/15/65	110 75 80	10 7.50 12	1,100 563 965	X				SBIC
21.	*Midland Capital Corp. New York, New York (Same)	2/2/61	1,300	12.50	16,250	X				Inactive SBIC
22.	*Business Capital Corp. Chicago, Illinois (Dallas Business Capital Corp., Dallas, Texas)	2/9/61	500	10	5,000	X				SBIC
23.	*Citizens & Southern Capital Corp. Atlanta, Georgia (C & S Bank Corp.)	3/23/61 11/30/67	300 390	5.50 7.50	1,650 2,925		X			None
24.	*Marine Capital Corp. Milwaukee, Wisconsin (-)	4/5/61	717	15	10,755				X	-

* Went public as licensed SBIC
B.E. = Best efforts or non-underwritten issue

Significant Public Issues of Venture Capital Companies Since World War II
Page Four

Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS: No Longer Registered Under 1940 Act: Registered Under 1940 Act	Merged with Operating Company	Converted to Operating Company	Liquidated	Current Venture Capital Activity
25.	*St. Louis Capital, Inc. St. Louis, Missouri (Westgate California, San Diego, California)	6/8/61	750	$10	$7,500		X			None
26.	*Southwestern Capital Corp. San Diego, California (Intermark Investing Co.)	6/-/61	1,500	3	4,500			X		None
27.	*Capital for Technical Industries, Inc. Los Angeles, California (Cap Tech, Inc.)	6/22/61	800	10	8,000			X		None
28.	*Southeastern Capital Corp. Nashville, Tennessee (Same, Atlanta, Georgia)	7/12/61	530	12.50	6,630	X				SBIC Subsidiary
29.	*First SBIC of New Jersey Newark, New Jersey (Same)	7/12/61	300	12.50	3,750	X				SBIC
30.	*Capital Southwest Corporation Dallas, Texas (Same)	7/17/61	1,300	11	14,300	X				SBIC Subsidiary
31.	*Science Capital Corporation Philadelphia, Pennsylvania (Abacus Fund, Inc., New York)	7/20/61	500	8	4,000	X				None
32.	*Gulf-Southwest Capital Corp. Houston, Texas (-)	8/8/61	1,350	12	16,200				X	-

* Went public as licensed SBIC

Significant Public Issues of Venture Capital Companies Since World War II
Page Five

Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS No Longer Registered Under 1940 Act Registered Under 1940 Act	Merged with Operating Company	Converted to Operating Company	Liquidation	Current Venture Capital Activity
33.	*Business Funds, Inc. Houston, Texas (Marathon Manufacturing Co.)	8/23/61	1,750	$11	$19,250		X			None
34.	*Central Investment Corporation of Denver Denver, Colorado (Northwest Growth Fund)	9/5/61	1,700	3.75	6,375		X			SBIC Subsidiary
35.	*Food & Drug Capital Corp. Chicago, Illinois (Advance Growth Capital, Maywood, Illinois)	9/26/61	400	10	4,000	X				SBIC
36.	*California Growth Capital San Francisco, California (First Southern Corporation)	10/11/61	200	12.50	2,500				X?	?
37.	*Water Industries Capital Corp. New York, New York	10/16/61	500	11	5,500				X	-
38.	*Anderson New England Capital Corp. Boston, Massachusetts	10/26/61	175	15	2,625				X?	-
39.	*Small Business Investment Company of New York New York, New York split (SBIC - N.Y., Washington, D.C.) into (Creative Capital Corp., New York, N.Y.) (name changed to Clarion Capital Corp. in 1973)	11/8/61	875	20	17,500	X X				SBIC SBIC
40.	*Monmouth Capital Corporation Freehold, New Jersey (Same)	11/14/61 4/-/65 6/30/66 3/-/68	100 B.E. 38 38 B.E. 49	10 8.50 6.50	1,000 326 321	X				SBIC

* Went public as licensed SBIC
B.E. = Best efforts or non-underwritten issue

Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS: No Longer Registered Under 1940 Act: Registered Under 1940 Act	Merged with Operating Company	Converted to Operating Company	Liquidated	Current Venture Capital Activity
41.	*Sierra Capital Corporation San Francisco, California (Same, Los Angeles, California)	1/3/62	$1,000	$10	10,000				X	-
42.	*Illinois Capital Investment Corp. Chicago, Illinois	1/4/62	135	10	1,350				X?	-
43.	*Westland Capital Corporation Beverly Hills, California (Same, Minneapolis, Minnesota)	1/23/62	971	11	10,681		X(10%)		X(90%)	SBIC
44.	*Delta Capital Corporation New Orleans, Louisiana	3/-/62	155	11	1,701				X	-
45.	*Developers Small Business Investment Corp. Englewood, New Jersey (Struthers Capital Corp.)	3/-/62	600	5	3,000		X			SBIC Subsidiary
46.	*Puerto Rico Capital Corporation San Juan, Puerto Rico (-)	4/-/62	300	10	3,000				X	-
47.	*La Salle Street Capital Corp. Chicago, Illinois (Atlanta-La Salle Corp.)	4/24/62 3/25/69	250 100	9 13.75	2,250 1,375			X**		SBIC Subsidiary
48.	*Carolinas Capital Corporation Charlotte, North Carolina	5/8/62	250	10	2,500				X	-

* Went public as licensed SBIC
** SBIC presently in process of liquidation.

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Sequence	Original Name of Company Location (Current Name)	Date	Number of Shares (000)	Price per Share	Amount of Offering ($000)	CURRENT STATUS No Longer Registered Under 1940 Act Registered Under 1940 Act	Merged with Operating Company	Converted to Operating Company	Liquidated	Current Venture Capital Activity
49.	*Commerce Capital Corporation Milwaukee, Wisconsin (Commerce Group Corp.)	1/1/68 11/-/69	160 B.E. 246	$ 8.25 9.50	$1,320 2,335		X			SBIC Subsidiary
50.	Value Line Development Capital Corp. New York, New York	2/1/68	2,105	12	25,260	X				Inactive Venture Capital
51.	Diebold Technology Venture Fund, Inc. New York, New York (Diebold Venture Capital Corporation) (Claremont Capital, San Francisco, Calif.)	7/12/68	1,500	20	30,000	X				None
52.	Inventure Capital Corporation Boston, Massachusetts (Steadman Fund, Washington, D.C.)	5/-/69	621	20	12,411	X				None
53.	*Capital Corporation of America Philadelphia, Pennsylvania	9/17/70	100	6	600	X				SBIC
54.	Rand Capital Corporation Buffalo, New York	9/22/71	250	6.85	1,713	X				SBIC Subsidiary ?
55.	*Invesat Corporation Jackson, Mississippi	2/20/74	1,189 B.E.	N/A	1,280	X				SBIC

* Went public as licensed SBIC
B.E. = Best efforts or non-underwritten issue

HEIZER CORPORATION
AND
THE INVESTMENT COMPANY ACT OF 1940*

The purpose of this memorandum is to describe in summary form the principal legal problems which Heizer Corporation (including its wholly owned subsidiary Heizer Capital Corporation, jointly referred to herein as "Heizer") would have encountered if it had been formed originally as an investment company registered under the Investment Company Act of 1940 (the "Act"), as well as the principal problems which it could reasonably anticipate as a result of such status if it were to register under the Act at this time.

Background

Heizer Corporation was organized in 1969 to finance the equity capital requirements of major new growth companies. It was funded with $81,100,000 of capital provided by a group of 35 sophisticated institutional and individual investors. Heizer Capital Corporation, a wholly owned subsidiary and licensed SBIC, was organized in 1974. In 1977, the interests

*This memorandum was prepared in December, 1978 by McDermott, Will & Emery who have been corporate legal counsel to Heizer Corporation since it was incorporated in December, 1968. John H. McDermott, a partner in this firm, is also a director and stockholder of Heizer Corporation.

EXHIBIT B

of certain investors were repurchased by Heizer Corporation in connection with a recapitalization. It currently has 29 investors in addition to its management (see list of investors attached). Since 1969, Heizer's funds have been invested in a diversified portfolio of 32 companies. Some of these investments have been sold or written off. At June 30, 1978, Heizer had investments in 20 of these companies (see attached list of companies financed). Its financial position on that date and that of its SBIC subsidiary were as follows:

	Heizer Corporation	Heizer Capital Corporation
Total Assets	$205,597,650	$12,039,460
Investments	178,421,176	10,737,891
Debt	25,000,000	-
Equity	142,692,918	11,723,174

Pursuant to agreements with its investors, Heizer has been prohibited from investing at cost more than 15% of its assets in any single investee. At June 30, 1978, due to appreciation of certain investments, the fair value of its investments in Amdahl Corporation, Fotomat Corporation and NCR Corporation (resulting from an acquisition by NCR of Data Pathing, Inc.) constituted approximately 70% of its total assets. If the needs of its investors for liquidity in their investments can

be met otherwise than through liquidation of Heizer's portfolio, thereby permitting Heizer to continue to remain in its business, Heizer's management believes that it will continue to develop companies of substantial value.

Transactions with Affiliates

Looking at its investment transactions both historically and prospectively, Section 17 of the Act clearly would present the most significant legal problems to Heizer if it were registered under the Act. The whole philosophy underlying this section which with few exceptions effectively prohibits all transactions, including joint transactions, involving a registered investment company and affiliates, is essentially inconsistent with the realities of the business world within which Heizer has operated and must operate in the future, if it is to continue in its business.

Depending upon the degree to which investments in Heizer by related investors may be aggregated, Heizer currently has eight corporate investors who could be deemed to be its affiliates, based solely upon their ownership of 5% or more of Heizer's voting securities (Citibank, Bankers Trust, St. Paul Companies, University of Rochester, Manufacturers Hanover, Employers Mutual, First National Bank of Minneapolis and Robert Barker/Wm. A.M. Burden Company). On a pro forma basis, depending upon when outstanding warrants are exercised, it would have other

investors who could be deemed to be affiliates based upon their percentage stock ownership (Northwestern University, Northwestern Mutual and Prudential). As noted on the attached list of companies being financed, and again based solely upon its percentage stock ownership, Heizer is, or on a pro forma basis assuming exercise of presently held warrants and conversion privileges, would become an affiliate of practically all of its significant investees except NCR. In many cases, including Amdahl and Fotomat where less than 25% of the investee's voting securities are owned, Heizer clearly controls the investee or shares control with another party.

Investing in new and young companies is a risky business. The number of institutions and individuals willing to invest substantial money in such businesses is quite limited. No sensible and prudent investor parts with his money unless he can control its application or knows and has confidence in someone else who will be controlling the investee. The whole venture capital industry is based upon personal contact, the people with whom the venture capitalist has worked in the past, and the people in whom the venture capitalist has confidence. In the venture capital business, knowing and having confidence in another party to control an investee is not based upon the other party's name but rather upon knowledge of and experience with the individuals involved,

and that knowledge and experience can be acquired only by working with them. Accordingly, as a leading venture capital firm, Heizer has been a party to numerous investment transactions with companies with whom it is affiliated or has had past investment experience, which would have been prohibited under Section 17 of the Act if Heizer had been a registered investment company. Further, Heizer and companies with whom it is affiliated have been involved in many transactions which, because of the extreme complexity and vagueness of the language of Section 17 and the rules and regulations thereunder, may have been prohibited.

By way of illustration, Heizer frequently makes follow-on investments in companies with which it is affiliated. Between 1970 and 1975, Heizer invested over $11 million and acquired a 24% ownership position in Amdahl in a series of 43 transactions. Seriatim investments of this nature are not unusual. In connection with its investments in Fotomat, Heizer was a party to five transactions between 1969 and 1974. Its investments in IDC Services, Nortec and Omex each involved more than 40 transactions.

In order to attract and motivate highly skilled personnel needed to manage its investments and supervise the affairs of investee companies, Heizer from the time of its formation has employed a number of incentive compensation programs, including an investment participation plan whereby

officers of Heizer have made parallel investments in investees at the same time and upon the same terms as Heizer. Investment participations constitute a financial interest by an officer of Heizer such that the relief from Section 17(a) afforded by Rule 17a-6 would not have been available to Heizer.

Directors and investors in Heizer have also made parallel investments in investees affiliated with Heizer. For example, in 1972 when Amdahl had an offering of convertible subordinated notes, one part of the issue was purchased by Heizer and some of the other parts were purchased on exactly the same terms by a director of Heizer and by four other investors in Heizer. Citibank, Employers Mutual, Northwestern University, Prudential and other Heizer investors independently have made or are considering investments in companies affiliated with Heizer. Several of them have also made substantial purchases of products or services from Heizer's investees. Two investment bankers who are investors in Heizer (William Blair and First Boston) have managed or co-managed public offerings of securities by Heizer's investees.

To trace the relationships involving Heizer's affiliates and the affiliates of those affiliates produces patterns which are extremely complex and in many cases depend upon information which is not available to Heizer. For example, Chase Manhattan Bank is not an affiliate of Heizer

but is an affiliate of Omex which is Heizer's affiliate. Heizer cannot possibly know the relationships between Chase Manhattan Bank and all of its affiliates. Similarly, Heizer shares control of Fotomat with Bessemer Securities which has affiliates and affiliates of affiliates, some of whom are affiliates, or are affiliates of affiliates of Heizer. If Heizer were a registered investment company, it would have great difficulty sorting out all of these types of relationships in order to comply with Section 17 of the Act.

* * *

Apart from its problems in complying with Section 17 of the Act with respect to investment transactions, Heizer would have had significant problems at the corporate level in complying with other sections of the Act if it had been a registered investment company.

Capital Structure

Heizer was organized to provide investors with a means for participation in the venture capital field. Its capital structure was carefully designed to meet different tax and legal requirements and varying risk-reward preferences of potential investors. That structure included senior notes and preferred stock, both of which were convertible into and carried warrants to purchase common stock. Heizer's initial

offering was successful and its capital was raised through sale of $31,500,000 of notes and $49,600,000 of preferred stock. If Heizer Corporation had been a registered investment company, its capital structure clearly would not have complied with the requirements of Section 18(a) of the Act relating to asset coverage and the terms of senior securities, nor would it have complied with Section 18(d) of the Act prohibiting the issuance of warrants and convertible securities. It is quite possible that Heizer could not have been successfully financed. This has little bearing on Heizer today but is relevant to the question of whether other firms like Heizer could be formed today.

If Heizer were to register under the Act, its presently authorized securities would have to be modified to meet the provisions of §18(a)(2) and it is unclear whether the continued existence of warrants, convertibility of Class B Common Stock into Common Stock and the status of Common Stock as a senior security would comply with §18 of the Act.

Compensation of Key Personnel

Heizer has utilized qualified and non-qualified stock options as incentives for key members of its management, including its Board of Directors. These options would have been issued in violation of Section 18(d) of the Act.

Change in Investment Company Classification

If it had been registered under the Act, Heizer initially would have been classified as a "diversified company," as defined in Section 5(b)(1) of the Act. To continue its classification as a diversified company, no more than 25% in value of its total assets could have been invested in securities which, as to any one issuer, had a value greater than 5% of Heizer's total assets or constitute more than 10% of the outstanding voting securities of such issuer. Within three years from its formation, Heizer would have ceased to be a diversified company as defined and would have done so without approval of its stockholders as required by Section 13(a) of the Act. At June 30, 1972, Heizer's balance sheet reflected total assets of $93.7 million, including investments in 3 issuers (Amdahl, Fotomat, and IDC), each of which were valued at more than 5% of Heizer's total assets and in the aggregate were valued at 26% of total assets. Subsequently, Heizer made additional investments in each of these companies.

Dividends

To date Heizer has not paid any dividends and therefore would not have encountered problems in this area if it had been a registered investment company. Prospectively, Heizer could have some difficulty living with Section 19 of the Act which regulates payment of dividends by registered investment companies.

Heizer is subject to federal income taxes in the same manner as most other corporations. If it were registered under the Act, it would not qualify currently for tax treatment as a "regulated investment company" because its portfolio does not meet the diversification requirements of Section 851 of the Internal Revenue Code. The recapitalization which occurred in 1977 was designed, among other things, to permit continuation of a company's business development program, provide financial flexibility by eliminating senior securities with their sinking fund, interest and preferred dividend requirements, enhance the company's ability to use all tax losses, and create a foundation for paying dividends in cash or securities. It is contemplated that substantial dividends of securities will be paid in the future. The timing of such dividends in kind will depend upon many factors, including market conditions relating to the particular security to be distributed and, of course, these will vary from time to time with respect to different securities. Accordingly, it may be advantageous to distribute different securities as dividends at different times within a taxable year. Section 19(b) of the Act makes it unlawful for a registered investment company to distribute long term capital gains more often than once a year, subject to such rules, regulations or orders as the Commission may proscribe. Although the Commission has adopted

Regulation 270.19b-1(c) which permits a registered investment company to request permission to pay dividends of long term capital gains in a taxable year which would otherwise be prohibited, this provision is predicated upon there being "unforeseen circumstances in a particular taxable year" and Heizer could have difficulty justifying a request for exemption on this basis.

Sale and Repurchase of Heizer Securities

As further incentive for its key personnel, Heizer historically has sold Class B common stock to its directors and certain of its employees and for many years has repurchased such stock upon termination of employment. These transactions were based upon values determined monthly by Heizer's valuation committee employing valuation procedures approved by the Board of Directors. The valuation process results in substantial discounts being taken from quoted market values of publicly traded securities and additional discounts from underlying market value in determining the fair value of Heizer securities. Absent a favorable order by the Securities and Exchange Commission, it would appear that these transactions would have violated provisions of Section 23 of the Act, because among other things the prices at which they took place were less than current net asset value per share.

In 1977, Heizer repurchased approximately $15 million of its securities from certain investors and sold a portion of those securities after the recapitalization to First

Boston Corporation. These transactions were based upon a negotiated price which also would appear to have been in violation of Section 23 of the Act.

Heizer expects that in the future it may again repurchase some of its securities from employees or other investors. For Heizer to operate as a registered investment company would seem to require that it adopt some form of mutual fund accounting and buy and sell its own securities at current net asset value. This could be very troublesome in view of the fact that historically shares of closed end funds have traded in the market at a discount from their underlying market value.

Administration

Heizer has not but presumably could comply at considerable expense with the administrative provisions of the Act.

HEIZER CORPORATION

INVESTORS

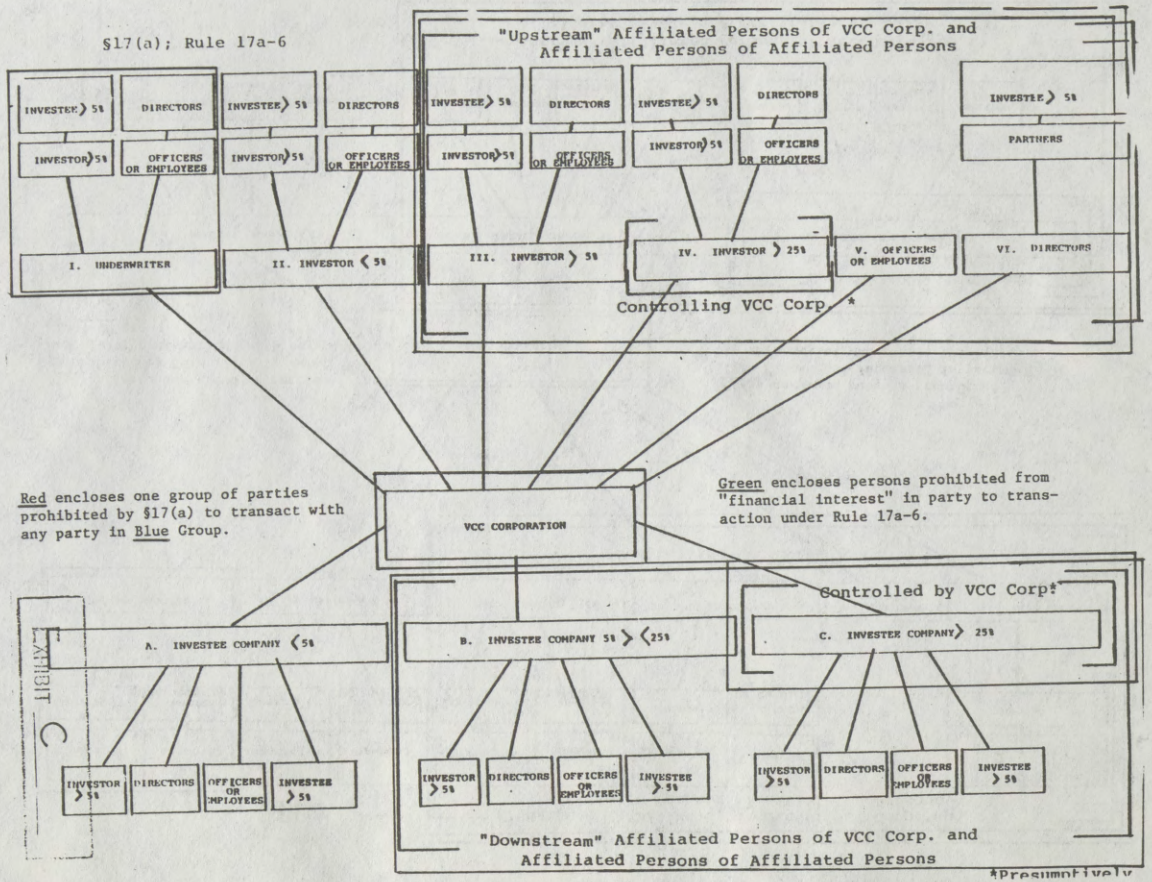
The American Museum of Natural History	New York, New York
The Art Institute of Chicago	Chicago, Illinois
Bankers Trust Company	New York, New York
Robert R. Barker & Co.	New York, New York
William Blair & Co.	Chicago, Illinois
William A. M. Burden & Company	New York, New York
Citibank, N. A.	New York, New York
The Citizens and Southern National Bank	Atlanta, Georgia
Donald F. Eldridge	Atherton, California
Employers Mutual Liability Insurance Company of Wisconsin	Wausau, Wisconsin
Employers Mutual Retirement Trust	Wausau, Wisconsin
The First Boston Corporation	New York, New York
First National Bank of Minneapolis	Minneapolis, Minnesota
Dr. George Kozmetsky	Austin, Texas
Manufacturers Hanover Trust as Trustee:	New York, New York
Chrysler Corporation Pension Plan	
Chrysler Corporation UAW Pension Plan	
Union Carbide Corporation Pension Plan	
John H. McDermott	Chicago, Illinois
Minnesota Mutual Life Insurance Company	St. Paul, Minnesota
North American Company	Ft. Lauderdale, Florida
The Northwestern Mutual Life Insurance Company	Milwaukee, Wisconsin
Northwestern National Life Insurance Company	Minneapolis, Minnesota
Northwestern University	Evanston, Illinois
The Ohio National Life Insurance Company	Cincinnati, Ohio
The Prudential Insurance Company of America	Newark, New Jersey
The St. Paul Companies, Inc.	St. Paul, Minnesota
The Board of Trustees of Stanford University	Stanford, California
The Regents of the University of California	Berkeley, California
University of Rochester	Rochester, New York

HEIZER CORPORATION HEIZER CAPITAL CORPORATION*

COMPANIES FINANCED

AS OF 6/30/78

COMPANY	Investment at Cost ($Millions)	Present Pro Forma Ownership	DESCRIPTION
AMDAHL CORPORATION Sunnyvale, California	11.2	24%	Developer, manufacturer and marketer of large scale fourth generation computer systems. System advantages include cost/performance benefits and IBM compatibility. (ASE)
CARDIASSIST CORPORATION Hoffman Estates, Illinois	.5	61%	Developer of Cardiassist®, a new device for non-invasive treatment of coronary heart disease. (Private)
COMMODITIES CORPORATION Princeton, New Jersey	1.3	28%	Trades and invests in commodities. (Private)
THE COMMODORE CORPORATION Danville, Virginia	2.2	44%	Manufacturer of mobile homes. (ASE)
COMPUTER CONSOLES, INC. Rochester, New York	2.7	66%	Manufacturer of data base systems used primarily by the telephone industry. Applications include directory assistance, intercept and various inventory files. (OTC)
COMPUTERIZED PRODUCTS CORPORATION Edina, Minnesota	1.8	59%	Computerized patient record keeping, billing services and insurance claims preparation for medical and dental practices. (Private)
DATA 100 CORPORATION Minnetonka, Minnesota	1.8	8%	Manufacturer of IBM compatible remote computer terminals for large-scale computer users. (OTC)
FEDERAL EXPRESS CORPORATION* Memphis, Tennessee	.4	1%	Provides overnight delivery of small packages (under 80 lbs.) throughout the U.S. (OTC)
FOTOMAT CORPORATION Stamford, Connecticut	4.9	24%	Retailer of photo processing service and film. (NYSE)
IDC SERVICES, INC. Chicago, Illinois	10.3	62%	Provides financial services to the advertising, motion picture and television industries. (Private)
INTERNATIONAL CAPITAL EQUIPMENT LTD. Chicago, Illinois	.1	75%	Lease financing services which provide a means for banks, insurance companies, lessors or other lenders of financing institutions to be assured of a future residual value of specific capital equipment. (Private)
MATERIAL SCIENCES CORPORATION Elk Grove Village, Illinois	6.2	87%	Manufacturer of advanced materials including pre-finished metals, diffusion alloyed steel and carbon graphite fiber products. (Private)
NCR CORPORATION Dayton, Ohio	2.8	1%	A major manufacturer of computer and terminal systems. (NYSE) (Position results from acquisition by NCR of investee company.)
NORTEC ELECTRONICS CORPORATION* Santa Clara, California	.6	65%	Manufacturer of integrated circuits and subsystems. (Private)
OMEX (Formerly Precision Instrument Co.)* Santa Clara, California	5.7	54%	Developer of laser mass memory systems used in data processing applications and in document storage and retrieval systems. (OTC)
PARADYNE CORPORATION Largo, Florida	2.0	13%	Developer of high performance data communication equipment, including high-speed modems and remote communications processors. (OTC)
RED CARPET INNS, INC. Daytona Beach, Florida	.1	4%	Operates a chain of motels in southern U.S. (Private)
SPECTRA-PHYSICS, INC. Mountain View, California	.6	3%	Manufacturer of lasers, laser systems and automated instrumentation products. (OTC)
STRATFORD OF TEXAS, INC. Houston, Texas	3.0	13%	Major grower and distributor of indoor tropical plants. (OTC)
VILCOR, INC./* VACATION RESORTS, INC. Aspen and Vail, Colorado	2.6	94/ 100%	Provides management of destination resort hotel and condominiums and related travel services/ Operates a resort hotel in Vail, Colorado.(Private)
INACTIVE COMPANIES (Information Management International, Inc.)			


§17(a); Rule 17a-6
"Upstream" Affiliated Persons of VCC Corp. and Affiliated Persons of Affiliated Persons
INVESTEE > 5%
DIRECTORS
INVESTOR > 5%
OFFICERS OR EMPLOYEES
PARTNERS
I. UNDERWRITER
II. INVESTOR < 5%
III. INVESTOR > 5%
IV. INVESTOR > 25%
V. OFFICERS OR EMPLOYEES
VI. DIRECTORS
Controlling VCC Corp. *
Red encloses one group of parties prohibited by §17(a) to transact with any party in Blue Group.
Green encloses persons prohibited from "financial interest" in party to transaction under Rule 17a-6.
VCC CORPORATION
Controlled by VCC Corp.*
A. INVESTEE COMPANY < 5%
B. INVESTEE COMPANY 5% > < 25%
C. INVESTER COMPANY > 25%
INVESTEE > 5%
"Downstream" Affiliated Persons of VCC Corp. and Affiliated Persons of Affiliated Persons
*Presumptively
EXHIBIT C

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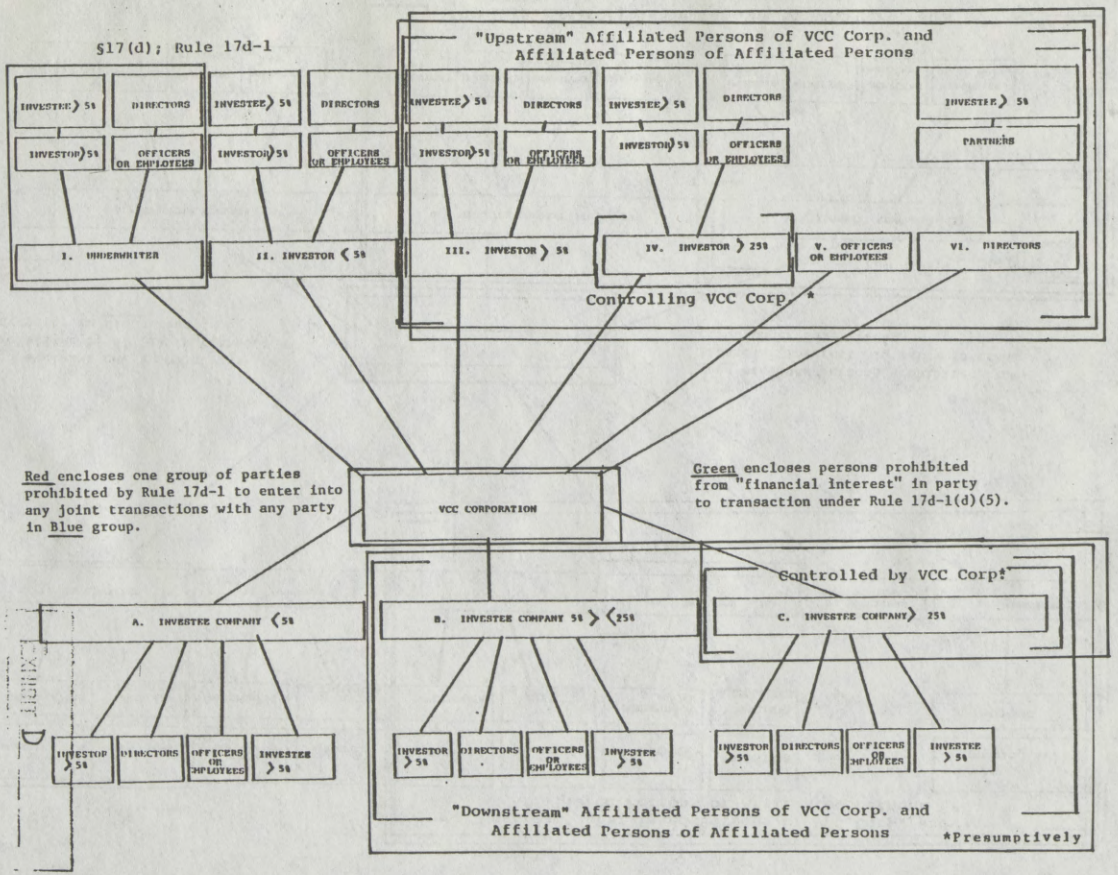
§17(d); Rule 17d-1
"Upstream" Affiliated Persons of VCC Corp. and Affiliated Persons of Affiliated Persons
INVESTEE > 5%
DIRECTORS
INVESTOR > 5%
OFFICERS OR EMPLOYEES
PARTNERS
I. UNDERWRITER
II. INVESTOR < 5%
III. INVESTOR > 5%
IV. INVESTOR > 25%
V. OFFICERS OR EMPLOYEES
VI. DIRECTORS
Controlling VCC Corp. *
Red encloses one group of parties prohibited by Rule 17d-1 to enter into any joint transactions with any party in Blue group.
VCC CORPORATION
Green encloses persons prohibited from "financial interest" in party to transaction under Rule 17d-1(d)(5).
Controlled by VCC Corp.*
A. INVESTEE COMPANY < 5%
B. INVESTEE COMPANY 5% > < 25%
C. INVESTEE COMPANY > 25%
INVESTOR > 5%
DIRECTORS
OFFICERS OR EMPLOYEES
INVESTEE > 5%
"Downstream" Affiliated Persons of VCC Corp. and Affiliated Persons of Affiliated Persons
*Presumptively

Mr. METCALFE. Thank you.

Mr. HEIZER. Thank you very much.

Mr. METCALFE. Our next witness will be Mr. Russell Carson. Mr. Carson is the secretary of the National Association of Small Business. Would you proceed with your statement, Mr. Carson?

STATEMENT OF RUSSELL L. CARSON, SECRETARY, NATIONAL ASSOCIATION OF SMALL BUSINESS, ACCOMPANIED BY WALTER B. STULTS, EXECUTIVE VICE PRESIDENT, AND JIM WATTS, ASSOCIATE DIRECTOR

Mr. CARSON. Good morning, Mr. Chairman. I am Russell Carson, chairman of Citicorp Venture Capital, Ltd., a wholly owned subsidiary of Citicorp, and of FNCB Capital Corp., a wholly owned subsidiary of Citibank, both of which are located in New York City. FNCB Capital Corp. is the largest active bank-related SBIC in the United States with assets in excess of $50 million. I am here today representing NASBIC, the trade association for SBIC's which has in its membership the vast majority of companies and assets in the SBIC industry.

With me today is NASBIC's executive vice president, Walter Stults, and its associate director, Jim Watts.

I am here today to deliver testimony on behalf of NASBIC's entire membership. Tomorrow you will hear from Peter Van Oosterhout, chairman of Clarion Capital in Cleveland, Ohio, who will appear specifically on behalf of NASBIC's members who are regulated under the Investment Company Act of 1940.

Our association is in strong support of H.R. 10717, a bill to provide relief for small business investment companies and others from certain provisions of the Federal securities laws and the Commission's rules thereunder. H.R. 17017 has the unanimous support of the board of governors of our association, and we applaud this subcommittee for holding these hearings and calling attention to some very serious flaws in the securities laws and regulations which are severely impeding the flow of venture capital to small and growing firms.

In my remarks today I would like to concentrate on the two aspects of H.R. 10717 with which I have the most personal familiarity, rules 144 and 146. Over the past 10 years my organization has invested in excess of $100 million in small- to medium-sized companies through private placement transactions. So, I feel fully qualified to talk on this subject.

I would like to thank the members of this subcommittee for supporting H.R. 10717 which, if it accomplishes nothing else, has caused the SEC to come to grips with some key issues it has avoided for the past several years.

The Commission, in a September 15 action, decreasing the rule 144 selling period from 6 months to 3 will provide much needed liquidity for venture capital investors, and encourage capital formation for smaller companies. I do not however feel that the SEC has gone far enough in changing rule 144 until it eliminates all selling restrictions on securities held for over 5 years, as proposed by H.R. 10717.

The SEC has announced that they will invite public comment on this issue, but being somewhat cynical about the incentive of regulatory agencies to voluntarily surrender some of their regulatory domain, it may take pressure from Congress to make anything happen on this point.

I would like to give you some personal observations on rule 144. First of all, it is very important to understand that the imposition of restrictions on the ability of a holder to resell his securities has significant economic implications for both the issuer of the securities and the purchaser. Because the securities are not immediately marketable, the issuer is almost always forced to sell them at a discount from their market value, assuming that the issuer is a public corporation.

In my experience this discounting has ranged from 10 percent to 50 percent below market price, with a median range somewhere around 25 percent. Obviously, a lessening of restrictions on resale would enable the issuer to sell his securities at a higher price because of their enhanced marketability.

The purchaser of restricted securities, on the other hand, is faced with three alternatives when he wishes to sell. He can either dribble them out into the market pursuant to rule 144; he can request that the company register them and sell them at an underwritten public offering; or he can encourage the company to merge with a larger company for cash or nonrestricted securities.

Rule 144 has the disadvantage of taking a long time to liquidate for anyone who owns a large bloc of securities, which is almost always the case of a venture capital investor.

Registration is a very expensive means of selling because the combination of commissions and registration expenses will typically equal or exceed 10 percent of the value of the securities being sold. If one were to sell a $1 million bloc of stock, the cost would be $100,000 or more.

It also puts the issuer to the inconvenience of having to prepare a full registration statement at a time when he may not wish to do so.

Finally, forcing a merger with a larger company as an avenue to liquidity has obvious implications for the competitiveness and productivity of our economy.

Second, in my experience, I am not aware of any instance in which the sale of restricted securities pursuant to rule 144 has had a disruptive effect on the company's public market. Our investment portfolio currently contains approximately 50 companies which are publicly traded. So, I think we have fairly extensive experience with this situation.

Simple logic dictates that a seller will want to get the best price for his shares and will not dump a large bloc of shares on the market if it depresses the price which he will get for that bloc. The SEC's rules against insider trading and the use of nondisclosed corporate information provides sufficient protection to the public, such that rule 144 will not be abused if its provisions are liberalized.

Third, many small companies have the problem of not having enough shares publicly traded to create a viable public market for their stocks, and thus interest intitutional investors. The sale of

restricted securities into the public market often performs a very valuable function of expanding the tradable flow and providing a much more meaningful and efficient market.

For all of these reasons I feel that Congress should keep pressure on the SEC to liberalize the resale restrictions of rule 144. I believe that this will be helpful in creating more efficient securities markets, and in aiding ther capital formation process for smaller companies.

My extensive experience with rule 146 leads me to the conclusion that this has generally been a very effective rule, which has created certainty as to what constitutes private placement of securities. The one area in which I feel rule 146 should be amended is in the rescission right of purchasers in an offering which deliberately or inadvertently contained an unsophisticated investor. Under the current rule all investors will have the right of rescission, even if only one small investor was wrongfully included in the group. H.R. 10717 would remedy this problem by giving recourse to a rescission only to the one investor, not to the entire group.

This amendment would be of considerable benefit to both purchasers and to issuers.

In closing I would again like to thank the sponsors of H.R. 10717 for introducing a piece of legislation which has focused attention on some issues which have been badly neglected in the past. Thank you.

[Testimony resumes on p. 228.]

[Mr. Carson's prepared statement with attachments follows:]

STATEMENT OF RUSSELL L. CARSON, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Good morning Mr. Chairman, I am Russell L. Carson Chairman of Citicorp Venture Capital, Ltd., a wholly-owned subsidiary of Citicorp, and of FNCB Capital Corp., a wholly-owned subsidiary of Citibank, FNCB Capital Corp. is the largest active, bank-related SBIC in the U.S. with assets in excess of $50-million. I am here today representing NASBIC, the trade association for SBICs which has in its membership the vast majority of companies and assets in the SBIC Industry. With me today is NASBIC's Executive Vice President, Walter Stults and Associate Director, Jim Watts.

I am here today to deliver testimony on behalf of NASBIC's entire membership. Tomorrow you will hear from Peter VanOosterhout, Chairman of Clarion Capital in Cleveland, Ohio, who will appear specially on behalf of NASBIC's members who are regulated under the Investment Company Act of 1940.

Our Association strongly supports H.R. 10717, a bill to provide relief for small business investment companies and others from certain provisions of the federal securities law and the Commission's rules thereunder. H.R. 10717 has the unanimous support of the Board of Governors of our Association, and we applaud this subcommittee for holding these hearings and calling attention to some very serious flaws in the securities laws and regulations which are severely impeding the flow of venture capital to small and growing firms.

Before becoming involved in the details of legislation before us, I would like to briefly explain what SBICs are and how they are formed as well as to mention how the venture capital industry works and what it does for the economy. Many of the benefits of venture capital investing are not readily recognized when they are melded into the macroeconomic variables upon which analysts of our economy are so prone to focus.

SBIC's are creatures of the Congress, licensed and regulated by the Small Business Administration pursuant to the Small Business Investment Act of 1958. Simply stated, the function of an SBIC is to supply long-term loan funds and equity capital to eligible small business concerns and to render management assistance to them.

SBIC'S are formed by private and public investors who provide capitalization which is then leveraged by federal funds up to a maximum of four-to-one. All private capital is at risk (i.e. is subordinated to the government leverage) so the discipline of the private sector is strictly imposed—to date, the SBA has lost less

than $25 million on the program. Also, leverage funds are provided through the Federal Financing Bank at a rate equal to the cost of money to the Treasury plus one-eighth of one percent so that the federal government does not incur an operating loss on funds it lends to the SBICs.

At the present time, there are close to 300 active SBIC's licensed and in operation. They have total assets slightly in excess of 1 billion dollars, approximately one half of that being private capital and the balance being borrowed funds guaranteed by the Small Business Administration. Since the first SBIC's were licensed early in 1959, they have provided over 3 billion dollars in financing to more than 40,000 small business concerns.

Of the 300 licensed SBIC's, 32 are currently registered under the Investment Company Act of 1940 as publicly owned companies. Those 32 companies account in the aggregate for one fourth of all industry assets.

Venture capitalists, through SBIC's and venture capital corporations and partnerships, invest in small companies with better than average growth potentials in return for a share of the ownership of those companies. The ultimate rewards to both entrepreneur and venture capitalist come generally in the form of capital gains. The rewards those individuals reap, however, are not as important as are the economic benefits which the small, growing companies bestow.

Various studies have shown how these small companies grow faster and generate greater economic activity than mature corporations. One such study was done by the Massachusetts Institute of Technology Development Foundation and compared the performance of six mature companies, five innovative companies and five young, high-technology companies. From 1969 to 1974, the average annual contribution of these companies in jobs and revenues shaped up as follows:

[In percent]

Type of companies	Sales Growth	Job Growth
Mature	11.4	0.6
Innovative	13.2	4.3
Young high-technology	42.5	40.7

Another study, conducted by the SBA, sampled SBIC-financed small businesses and found that those companies achieved annual growth rates of 25 percent for employment, 27 percent for revenues, 27 percent for profits and 35 percent for assets.

The most recent study and one of the most dramatic to which I would wish to call your attention is that done by the American Electronics Association. It showed that among the AEA members, which included young, intermediate and mature corporations, the employment growth rate for companies between 5 and 10 years old was 55 times the rate in mature companies. It also found that for every $100 of equity capital invested in young companies founded between 1971 and 1975, those companies generated, spent or paid in 1976 alone: $70 in exports; $33 dollars on research and development; $15 in federal corporate income taxes; $5 in state and local taxes; and $15 of personal income tax revenues.

Because we feel that the results of the AEA survey are so exciting, I am submitting with my statement a copy of Dr. Ed Zschau's testimony before the Senate Finance Committee which contains the results of that survey originally released on February 8 of this year.

While it is an established and documented fact that growth companies are labor intensive, competitive and innovative, it is not as widely known that there is an insufficient number of such companies being financed today.

And of those which are being financed, many are receiving dollars from foreign sources in cases where they are unable to obtain favorable financing from U.S. concerns. The Senate Small Business Committee has been investigating the activity of foreign venture investors in the United States and I might refer you to the 28th Annual Report of that Committee for further information on that phenomenon.

The obvious question is 'what can be done to improve the venture capital investing climate in the country?' Tax laws have a great impact. But certainly we cannot blame the tax laws for all of the problems which plague venture capital. Other less obvious laws such as the Employee Retirement Income Security Act of 1974 have had a significant impact. And securities laws and regulations have had an enormous impact. Changing or amending them will certainly do a very great deal to help channel more venture capital dollars into the companies which need them. Accordingly, we urge this Subcommittee and the SEC to work together to help eliminate or

reduce securities law-related impediments to venture capital formation which currently exist.

Regulation A

Section 3. of H.R. 10717 would amend the Securities Act of 1933 so as to raise the Regulation A ceiling from $500,000 to $3 million. The Regulation A ceiling was, of course, raised to $1.5-million with the enactment of Public Law 95-283 (H.R. 8333). We wish to thank the members of the Subcommittee for the role they played in raising that statutory ceiling as well as the SEC for its prompt action in allowing the regulatory maximum to be raised also to $1,500,000.

The Regulation A ceiling is one of the reasons that small concerns today turn to foreign sources of capital, or sell-out to public corporations, or choose not to grow as fast as they could. In the past, the Regulation A limited offering exemption had a statutory ceiling which proved to be a number that grew uneconomic. The following table of Regulation A offerings during fiscal years 1973 to 1977 shows a dramatic drop-off in the use of the Reg A option.

REGULATION A STOCK OFFERING FILINGS, FISCAL YEARS 1973-77

Fiscal year	Number of filings	Amount (millions)
1973	817	$298.6
1974	438	147.8
1975	264	91.3
1976	240	83.5
1977 (1st 11 mo)	215	71.1

Although the Reg A offering ceiling was recently raised to $1.5 million, knowledgable individuals in the industry do not feel that $1.5-million is sufficient. The Report of the SBA Task Force on Venture and Equity Capital for Small Business, chaired by former SEC Chairman William Casey and released in January of 1977, recommended raising the Reg A ceiling to $3 million. That is the recommended minimum which is being supported by small business concerns and venture capitalists as well as securities brokers. The reason for the higher ceiling is to accommodate increased costs of public offerings and to provide underwriters with compensation commensurate with their own risks.

In 1977, the average size of a first time securities offering was $7.6 million. Of that offering 10.4 percent went for the underwriters take-down and costs in excess of that underwriting take-down. That meant that the average commission and costs totalled almost $800,000 per offering. At the same time, a sampling of 38 firmly underwritten Reg A offerings showed that 17.7 percent of the offering went for costs and underwriters take-down. That percentage is unappealing to small business managers since almost one-fifth of the proceeds of the offering go for overhead. The total number of dollars on the other hand is unappealing to a broker since he can rarely look to make more than a fraction of that which can be made by doing a full blown underwriting.

Since raising the Reg A ceiling to $3 million is reasonably non-controversial, and is supported by nearly everyone familiar with the issue, NASBIC urges the Committee to raise the ceiling to $3 million.

Rule 144

Section 2 of H.R. 10717 would double the amount of stock which may be sold under the current provisions of SEC Rule 144. We were pleased with the September 15th action of the SEC in proposing amendments to Rule 144 which would accomplish all of the purposes intended by Section 2 of H.R. 10717 except with respect to restricted securities held more than 5 years.

Section 2 of the Bill would permit the unlimited sale of restricted securities held more than 5 years. The Commission proposal would continue the limitations on sales of restricted securities held by "affiliates" and "control persons" even after they had held the restricted securities more than 5 years. While we recognize the Commission's concern with respect to trading in securities of an issuer by its affiliates and control persons, we do believe that there should be some relaxation of the resale restrictions for these investors after they have held such securities for five years. If the Subcommittee feels that the lifting of all restrictions on resales of restricted securities by such persons after 5 years would be too liberal, then we would suggest as a compromise that such persons be permitted to least to sell their

securities at a rate greater than 1 percent very three months, after a five year holding period.

Althought the recent SEC liberalization helps venture capital investors considerably, it still does not go quite far enough. The reason is because investors in risky, growth firms tend to invest up to levels where they become affiliates and sometimes control persons as defined by the SEC. If then, for example, a venture investor purchases 49 percent of the common stock of a small concern, it would take him 25 years to sell under the old Rule 144, but it still could take more than 12 under the new Rule 144. And since most venture investments are held 7 to 10 years before the stock is at a point where sales can reasonably begin, the end result even under the new Rule 144 is still an unreasonably long holding period. If Rule 144 is amended according to the language in H.R. 10717, that lock-in effect would be significantly reduced and the sales would be treated by the SEC as they were before Rule 144 was created. For a brief discussion of the issue, see William Casey's "SEC Rules 144 and 146 revisited", Brooklyn Law Review, Spring, 1977, pages 584 to 588.

Finally, it is important to understand that the lock-in effects of Rule 144 are of concern not only to the venture capitalist, but also to the small business concern. Because of the illiquidity features imposed on private sales of securities, investors insist upon a discount from market when purchasing unregistered securities which will have to be disposed of either through private sales or through 144 sales. Because of that discount, the entrepreneur receives fewer dollar for his securities that their intrinsic value would otherwise command.

Rule 146

In enacting the Securities Act of 1933, Congress provided a private offering exemption under Section 4(2). The SEC promulgated Rule 146 in order to clarify the scope of the private offering exemption and to provide a safe harbor for issuers wishing to make such an offering under section 4(2). Administrative and court interpretations, however, have so strictly applied the rescission rules under Rule 146 that investors are sometimes afraid to use the rule.

The problem under Rule 146 arises when an unsophisticated investor or a person with unsubstantial net worth purchases securities offered in a private offering. Such person can later sue for his money back. Such action, however, opens the offering and all purchasers of securities are granted standing to sue for rescission.

NASBIC strongly believes that the burden of proof should be on the offeror to make certain that he offers securities to persons qualified under the private offering exemption to purchase those securities and that the offeror should have the burden of making all material information available to those purchasers. We do feel, however, that the courts have gone too far in allowing total rescission of an offering if even one unqualified person is later found out to have participated. For the protection of other investors, we only might suggest that if persons qualified for rescission under the redefined Rule have purchased a majority of the securities or have purchased an amount whereby their recission will materially effect value of the securities held by the other purchasers, then and only then should granting of the right of rescission be extended to all purchasers.

The Investment Company Act of 1940

The final provision in H.R. 10717 which NASBIC strongly supports is the amendment to the Investment Company Act of 1940 which would exempt SBICs caught under that Act from its privisions—provisions which were certainly not intended to regulate companies such as SBICs. Exemption from that Act would not leave the public unprotected since the full and active regulation of the SBA would still apply to every SBIC exempted from 1940 Act jurisdiction. In addition, all the shareholder protection provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 would still apply to public SBICs.

Since the first SBICs were licensed in the Spring of 1959, more than 100 of them have registered under the Investment Company Act of 1940 and raised many millions of dollars through public offerings of their securities. In the 1960–62 period alone, some thirty-five SBICs raised over $350 million in the public markets.

Today there are just thirty-two SBICs registered under the 1940 Act, and less than a dozen of them have securities which are publicly traded. What happened to all of those other registered companies? Admittedly, some of them got into financial difficulties, but the overriding reason for their leaving the SBIC program or getting out from under the Act was their inability to operate viably under that Act.

The early publicly-owned SBIC's encountered a number of problems under the 1940 Act, particularly in matters falling within the purview of Section 17 of the Act, relating to transactions with affiliates, and Section 18, relating to capital formation.

The result was that many of the public-owned SBIC's deliberately converted to operating companies in order to get out from under the 1940 Act. Others simply gave up, surrendered their SBIC licenses and liquidated.

These difficulties were documented in hearings before Congress in the early 1960's where NASBIC sought exemptions for publicly-owned SBIC's from the Investment Company Act of 1940, pointed out that the Act and the dual regulation of publicly-owned companies by SEC and SBA were hobbling the efforts of publicly-owned SBIC's to operate viably and effectively.

While the Congressional committees were sympathetic to our problem, representatives of the Commission insisted that no new legislation was necessary and that administrative relief could be granted under Section 6(c) of the 1940 Act which gives the SEC authority to "* * * conditionally or unconditionally exempt any person, * * * or class of persons * * *" from the Act or any of its provisions.

Accordingly, in March 1968, NASBIC filed an application with SEC pursuant to Section 6(c). In January, 1969, the Commission ordered administrative proceedings on that application. In an extensive series of hearings beginning in February 1969, representatives of NASBIC member companies and others testified on the need for relief. They stressed particularly the need for relief from Sections 17 and 18 of the 1940 Act, a number of the witnesses testifying that their companies had convented to operating companies or left the SBIC program entirely for reasons directly related to difficulties encountered under those sections of the 1940 Act.

In an initial decision favorable to the industry, the Hearing Examiner agreed that matters coming within the purview of Section 17 of the 1940 Act should be administered by SBA rather than SEC. In an Order finally handed down in May 1971, more than three years following the filing of the NASBIC application, however, the Commission declined in a 3-2 vote to transfer jurisdiction over Section 17 to SBA.

For the benefit of those SBIC's still registered under the Investment Company ACt of 1940 and still others which might "go public" except for the 1940 Act, we urge the Subcommittee to approve Section 4 of the Bill.

We are confident that had SBIC's been in existence when the 1940 Act was being considered by the Congress, they would have been exempted from the definition of "investment company". NASBIC feels strongly that the merits of the case are on our side, and we must necessarily now look to Congress for relief following the exhaustion of our administrative remedies. For a fuller treatment of the issues I am submitting with my statement a copy of the NASBIC "Application for Exemption from Provisions of the Investment Company Act of 1940" as submitted to the SEC in 1968, as well as copies of the Hearing Examiner's Initial decision and the Commission's final order. An additional discussion of 1940 Act problems as well as some of the economic effects of 1940 Act regulation can also be gleaned from the November 30, 1977 NASBIC Memo to Dr. Al Osborne of the SEC, also included with this statement.

Our final comment pertains to the status of SBIC's regulated under the 1940 Act which also qualify and elect to be taxed as regulated investment companies under Subchapter M of the Internal Revenue Code. Although the IRS has on a previous occasion given an opinion that it would continue to allow SBIC's to qualify for RIC status even if exempted from the 1940 Act, NASBIC feels that a statutory arrangement or clarification should be provided so as to guaranty the preservation of that status.

Conclusion

In summary, NASBIC believes in investor protection and efficient regulation. We also believe, however, that certain of the securities laws and regulations have swung too far to the side of investor protection to the extent that they are a detriment to the economy. We feel, therefore, that H.R. 10717 is a step in the right direction and that the provisions contained therein, if enacted into law, would help re-establish a healthy balance between investor protection and venture capital formation.

It is important that we distinguish between the public investor trading in securities in the public market and the sophisticated venture capitalist investing large sums in the fast-growing young businesses. This subcommittee has the heavy responsibility of seeing that such a differentiation is made and that a healthy balance is struck.

We close with a quote from the Introduction to the report of the SBA Task Force on Venture and Equity Capital for Small Business:

"It is alarming that venture and expansion capital for new and growing small businesses. In 1972 there were 418 underwritings for companies with a net worth of less than $5 million. In 1975 there were four such underwritings. The 1972 offerings raised $918 million. The 1975 offerings brought in $16 million. Over that same period of time, smaller offerings under the Securities and Exchange Commission's

Regulation A fell from $256 million to $49 million and many of them were unsuccessful. While this catastrophic decline was occurring, new money raised for all corporations in the public security markets increased almost 50 percent from $28 billion to over $41 billion.

"A public policy that discourages the public from investing approximately $1 billion a year of its savings in economic innovation, growth, and the creation of jobs while it encourages the public to risk $17 billion a year in Government-sponsored lotteries, requires close and serious re-examination."

Securities and Exchange Commission

Washington, D. C.

Application

For

Exemption from Provisions of the

Investment Company Act of 1940

of

National Association of Small Business Investment Companies

537 Washington Building

Washington, D. C. 20005

Dated: March 15, 1968

APPLICATION

Applicant

The National Association of Small Business Investment Companies ("NASBIC") is a trade association the active membership of which consists of 230 small business investment companies ("SBICs") licensed by the Small Business Administration ("SBA") pursuant to the provisions of the Small Business Investment Act of 1958, as amended ("1958 Act").

Of the 230 active members of NASBIC, 29 are registered as closed-end management investment companies under the Investment Company Act of 1940 ("1940 Act").

While the 230 SBICs belonging to NASBIC represent only half of the 462 SBICs whose licenses remain outstanding, it is estimated that the assets of NASBIC member companies account for 80% of the assets currently committed to the SBIC program.

Purpose of Application

The purpose of this Application is to secure an exemption for SBICs from those provisions of the 1940 Act not applicable to SBICs and to transfer to SBA the administration of those provisions of the 1940 Act deemed applicable to SBICs. The Application is submitted pursuant to the provisions of Section 6(c) of the 1940 Act on behalf of member companies of NASBIC registered under the 1940 Act.

Statutory Basis For Requested Exemption

Section 6(c) of the 1940 Act provides as follows:

> "The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or

transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

Statement of Grounds for Application

We submit that the requested exemption is "necessary" and "appropriate in the public interest", as required by Section 6(c), for the following reasons:

1. It is recognized that the thrust of the 1940 Act is investor protection. The thrust of the 1958 Act, as set forth in Section 102 of that Act (15 U.S.C. § 661 (1964)), is the establishment of "a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization..."

   The administration of the 1940 Act by the Commission and the administration of the 1958 Act by SBA has resulted in conflicting and dual regulation which in our view impedes the ability of SBICs to accomplish their statutory mission. We submit therefore that the investor protection goal of the 1940 Act and the financing mission of SBICs under the 1958 Act must be accommodated in such a fashion as to eliminate the present system of dual regulation. This can best be accomplished by transferring to SBA, the agency with the primary responsibility for the administration of the SBIC

program, responsibility for administering those provisions of the 1940 Act deemed applicable to SBICs, thereafter exempting SBICs from SEC regulation under the 1940 Act so long as and to the extent that they comply with applicable SBA regulations. We explain below why we believe this can be done without compromising the Commission's responsibility for investor protection.

2. In the calendar year 1967, SBICs accounting for approximately one hundred million dollars of paid-in capital and surplus, nearly one-third of the total paid-in capital and surplus of the entire industry, announced their intention to leave the SBIC program. While this mass exodus can be attributed to a variety of factors, it is clear to NASBIC that a dominant factor was and is the great difficulty of attempting to operate an SBIC subject to dual regulation by SEC and SBA. Such dual regulation inhibits the proper operation of an SBIC, and the continued failure to eliminate the dual regulation could well bring an end to the SBIC program. Such an end would benefit no one. The small business concerns of the nation who are the intended beneficiaries of the 1958 Act would clearly be the losers. The responsible regulatory agencies clearly have a duty to reverse the recent trend toward contraction of the SBIC program and to encourage its growth.

3. By virtue of Section 308(g)(2) of the 1958 Act as enacted in 1967 (Public Law 104, 90th Cong., 1st Sess (Oct. 11, 1967)), SBA is now required to submit to the Congress in its annual report "full and detailed accounts" relating to certain matters including the following:

> "(H) A report from the Securities and Exchange Commission enumerating actions undertaken by that agency to simplify and minimize the regulatory requirements governing small business investment companies under the Federal securities laws and to eliminate overlapping regulation and jurisdiction as between the Securities and Exchange Commission, the Administration, and other agencies of the executive branch."

The granting of the exemptions from the 1940 Act requested herein would be responsive to the foregoing statutory directive.

We likewise submit that the requested exemption would be "consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title", as required by Section 6(c) of the 1940 Act, for the following reasons:

1. As proposed hereinafter, we submit that the "protection of investors" in SBICs is already subject to administration by SBA. Implicit in SBA's statutory authority to license and regulate SBICs is its authority to ensure the protection of investors in SBICs. In addition, SBA Reg. 107.1004 (33 Fed.Reg. 334(1968)) specifically provides, "Self-dealing to the prejudice of a small business concern, or of a Licensee or its shareholders, or of SBA, is prohibited." (emphasis added).

To the extent the Commission feels SBA regulations need modification to ensure additional protection for investors in SBICs, Section 6(c) of the 1940 Act vests in the Commission adequate authority to support its cooperation with SBA to that end.

2. SBICs are the only Federally licensed and regulated entities subject to regulation under the 1940 Act. Indeed, Section 3(c) of that Act specifically exempts from its operations a number of financial institutions not dissimilar from SBICs. For example, Section 3(c)(3) exempts "Any bank or insurance company; any saving and loan association, building and loan association, cooperative bank, homestead association, or similar institution...", and Section 3(c)(5) exempts "Any persons substantially all of whose business is confined to making small loans, industrial banking, or similar businesses." (emphasis added).

We submit that had SBICs been in being when the legislation leading to the enactment of the 1940 Act was in Congress, SBICs would likewise have been expressly exempted from the provisions of the 1940 Act.

In short, it is our position that the regulation of SBICs under the 1940 Act was not and is not now one of the "purposes fairly intended by the policy and provisions of this title" as specified in Section 6(c) of the 1940 Act, and that certainly it was never intended that SBICs be subject to dual regulation by the Commission and SBA.

Applicability of 1940 Act to SBICs

The 1940 Act contains 53 sections. It deals with five types of investment companies and contains sections intended to regulate each of such types. For purposes of the 1940 Act, an SBIC falls within the type of company designated as a "closed-end management investment company." Relatively few sections of the Act are applicable to this type of company, and thus the vast majority of the sections of the 1940 Act have no applicability whatever to SBICs. Where sections of the 1940 Act are applicable to SBICs, as hereinafter noted, SBA has promulgated regulations which in our view are either sufficient in their present form or adaptable to meet 1940 Act requirements.

As previously noted, the thrust of the 1940 Act is investor protection. The companies which the 1940 Act was intended to regulate are mutual funds which invest almost exclusively in outstanding securities of well-known companies. As a group, mutual funds have contributed little new capital to industry. Their purpose is solely to provide an investment medium in outstanding securities for relatively small investors. In contrast, SBICs are required by law to make direct investments in small business concerns. They perform largely the functions of investment bankers, the difference being largely the fact that they retain the securities underwritten by them for longer periods than the usual investment banker. The 1940 Act was not enacted to deal with the operations of investment banking firms. As previously noted, Sections 3(c)(2) and (5) of the 1940 Act specifically exempt companies whose business is of a character approaching that of SBICs.

A detailed analysis of the 1940 Act makes it clear that a substantial number of the sections have no regulatory impact upon SBICs. Sections 1, 2 and 3, dealing respectively with Findings and

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Declaration of Policy, General Definitions and Definition of Investment Company, are not needed for regulation of SBICs. Sections 4 and 5, titled respectively Classification of Investment Companies and Subclassification of Management Companies, are inapplicable. The 1958 Act and SBA's regulations thereunder specify very precisely the requirements with respect to the organization, operation, authorities and limitations of SBICs. Section 6 of the 1940 Act, titled Exemptions, is likewise irrelevant for purposes of the 1958 Act.

Section 7 of the 1940 Act, dealing with Transactions by Unregistered Investment Companies, has no bearing upon an SBIC, the 1958 Act and SBA's regulations again specifically limiting the organization and operation of SBICs.

Section 8 of the 1940 Act, relating to Registration of Investment Companies, requires every company subject to the Act to file a registration statement reciting its proposed investment policy. While we have no objection to such registration by SBICs, and indeed would continue this requirement to accommodate SBICS electing to be taxed as regulated investment companies under Section 851 of the Internal Revenue Code of 1954, it should be noted that SBA regulations require each SBIC to set forth in its Proposal (SBA Form 414, Part I, Item 11(a)) a precise and detailed statement of its investment policy.

Section 9 of the 1940 Act, titled Ineligibility of Certain Affiliated Persons and Underwriters, makes it unlawful for persons who have been convicted of a crime involving securities or has been enjoined by a court for a similar offense within a 10-year period to serve as affiliated persons of an investment company unless exempted by the Commission. Comparable and even more stringent restrictions on

such persons serving in SBICs are now contained in Section 314(c) of the 1958 Act (15 U.S.C. § 687f(Supp.II, 1965-66)). In addition, pursuant to its licensing authority, SBA now conducts extensive investigations and personal interviews with the proposed management of all new SBICs. Thus, it is our view that Section 9 of the 1940 Act is not necessary for the regulation of SBICs.

Section 10 of the 1940 Act inhibits certain affiliations of directors of an investment company with brokers, investment advisors or investment bankers. These strictures have a degree of merit in the case of the usual investment company engaged solely in the purchase of outstanding securities and are clearly intended to reduce business biases in the administration of the investment company. In our view, they are not applicable to SBICs which ordinarily have no brokerage business to distribute. Indeed, the presence of bankers and investment bankers on the board of directors of an SBIC is highly desirable and therefore should be encouraged rather than discouraged.

Sections 11 and 12 of the 1940 Act, titled respectively Offers of Exchange and Functions and Activities of Investment Companies, deal with matters which are of no regulatory importance insofar as SBICs are concerned.

Section 13 of the 1940 Act, providing that the investment policies established in the registration statement cannot be changed except by a vote of the majority of the company's shareholders, corresponds to SBA Reg. 107.1105(a) (33 Fed. Reg. 336(1968)) which provides among other things that any change in an SBIC's investment policy must be reported to SBA within thirty days and that any such change "shall be subject to SBA post-approval as a condition for the continuance of the license." Thus, it would be our view that Section 13 of the

1940 Act is not necessary to the proper regulation of SBICs.

Section 14 of the 1940 Act, relating to Size of Investment Companies, finds its counterpart in Section 301(b) (15 U.S.C. § 681 (1964)) of the 1958 Act which vests in SBA the authority to approve "the amount and classes of its shares of capital stock" which an SBIC might issue. By Reg. 107.1105(a) (33 Fed. Reg. 336 (1968)), relating to post-licensing changes in an SBIC's activities, SBA also reserves the right to pass on any "increase in capitalization". Accordingly, Section 14 of the 1940 Act does not appear to be necessary to the administration of the SBIC program.

Section 15 of the 1940 Act, dealing with investment advisory contracts, finds its counterpart in SBA Reg. 107.809(a)(33 Fed. Reg. 332 (1968)), wherein SBA requires the filing of any contract entered into by the Licensee for investment advisory services and, where the SBIC is indebted to SBA, "reserves the right to approve the compensation of the investment adviser". The provisions in Section 15 of the 1940 Act dealing with underwriting contracts are in any event inapplicable to SBICs.

The thrust of Section 16 of the 1940 Act, governing changes in a company's board of directors, is implicit in SBA's statutory authority to license SBICs, incident to which it conducts investigations relating to the character and qualifications of proposed directors, and in its Reg. 107.1105(a) (33 Fed. Reg. 336 (1968)) requiring notification of changes in directors, specifying that such "changes shall be subject to SBA post-approval as a condition for the continuance of the license." Thus, Section 16 of the 1940 Act does not appear necessary to the proper regulation of SBICs.

Section 17 of the 1940 Act, relating to Transactions of Certain Affiliated Persons and Underwriters, presents particularly troublesome problems for SBICs registered under the 1940 Act. SBA's Reg. 107.3 (33 Fed. Reg. 327-28 (1968)), defining "Associate of a Licensee", when taken together with its Reg. 107.1004 (33 Fed. Reg. 334 (1968)), relating to Conflicts of Interest, deals adequately, in our view, with the matters encompassed within Section 17 of the 1940 Act. While the SBA regulations in this area are stringent, they are at least clear and susceptible of application to SBICs. The very nature of the operations of SBICs, involving as they do intimate and continuing association with their portfolio companies, constantly present the risk of inadvertently falling within the purview of Section 17 of the 1940 Act and the Commission's rules promulgated thereunder.

The Commission's Investment Company Act Release No. 5128 issued October 13, 1967 invited comments on the proposed revision of Rule 17d-1 under the 1940 Act. Attached hereto (Exhibit A) for incorporation herein by reference is the letter of November 21, 1967 from the President of NASBIC to the Commission commenting on the proposed revision. For the reasons outlined in said letter of November 21, 1967, we renew herewith our application for exemption for SBICs from the application of Section 17 of the 1940 Act.

Section 18 of the 1940 Act, titled Capital Structure, is generally speaking inapplicable to SBICs. In fact, Section 18(a)(1) is specifically made inapplicable to SBICs by Section 307(c) of the 1958 Act.

Section 18(a)(2) of the 1940 Act, dealing with permissible issues of preferred stock, finds its counterpart in SBA Reg. 107.1401

(33 Fed. Reg. 337(1968)) which provides that where the capitalization of an SBIC is to consist of more than one class of stock, "the voting rights and other rights and remedies may not be inequitable or discriminatory, and may not unduly concentrate control or management of the Licensee through pyramiding, inequitable methods, or inequitable distribution." The same regulation further requires "Full disclosure of all voting rights and other rights and remedies of all classes of stock" to all shareholders prior to their purchase of stock.

Section 18(d) of the 1940 Act has been construed by the Commission to prohibit the issuance of stock options by registered investment companies. SBA Reg. 107.805 (33 Fed. Reg. 332(1968)) specifically permits an SBIC to issue stock options to management and employees. We submit that SBICs now subject to the 1940 Act should likewise be permitted to issue stock options.

The success of the SBIC program will undoubtedly stand or fall on the capabilities of the management of the SBICs. With the present stress on more venture capital financing by SBICs and their continuing need to "plow back" earnings into additional investments and loans, the likelihood of SBICs having sufficient income to warrant salaries necessary to attract and hold qualified talents is not promising. Even if such income were available to pay higher salaries, the income tax applicable to such salaries would make them unattractive to the type of person ideally qualified to serve in an executive capacity with a venture capital institution such as an SBIC.

Stock options do serve as an attractive inducement to qualified managerial talent. This is attested to by the fact that the vast

majority of companies traded on the national securities exchanges employ stock options extensively in compensating their executives.

Just within the past six months, two of the best executives in the SBIC industry, both employed by companies registered under the 1940 Act, left their SBICs to accept employment with other companies offering them stock options. In both instances, the executives made it clear that the availability of stock options outside the SBIC program was the deciding factor in their leaving their companies. This program, hard pressed at best to find persons possessing the unique talents necessary to the successful operation of an SBIC, can ill afford to lose proven managerial talent to other industries simply by virtue of its inability to utilize stock options in compensating the people responsible for ensuring the success of their companies.

On February 20, 1962, NASBIC submitted a Proposed Rule 18d-1 to permit the issuance of "restricted stock options". Attached hereto (Exhibit B) is the text of the Proposed Rule 18d-1 as previously filed with the Commission. We request herewith that the Commission now exempt SBICs from those provisions of the 1940 Act which the Commission regards as prohibiting the issuance of stock options, or, in the alternative, that the Commission reconsider the Proposed Rule 18d-1 as submitted by NASBIC under date of February 20, 1962.

Sections 19 and 20 of the 1940 Act, relating respectively to Dividends and Proxies, could, if deemed necessary by the Commission, be incorporated in suitable SBA regulations.

The restrictions of Section 21 of the 1940 Act, relating to Loans, are now, in our view, adequately covered by SBA Reg. 107.1004 (33 Fed.Reg. 334 (1968)) relating to conflicts of interest and thus the

need for applying Section 21 of the 1940 Act to SBICs is obviated.

Section 22 of the 1940 Act, titled Distribution, Redemption, and Repurchase of Redeemable Securities, deals with matters which are of no regulatory importance insofar as SBICs are concerned.

Section 23 of the 1940 Act, titled Distribution and Repurchase of Securities: Closed-End Companies, forbids such a company to issue any of its securities for services. With respect to the implied prohibition against stock options in this section, we incorporate herewith by reference our previous comments relating to Section 18 of the 1940 Act.

The same section also regulates the manner in which closed-end companies may repurchase their shares. SBA provides controls in this area under its Reg. 107.902 (33 Fed. Reg. 333 (1968)) governing voluntary capital decreases, and thus again, in our view, Section 23 of the 1940 Act need not be applied to SBICs.

Section 24 of the 1940 Act relates to the Registration of Securities Under Securities Act of 1933. We do not propose to exempt SBICs from the requirements of the Securities Act of 1933 and are of the view that the provisions of this section otherwise applicable to SBICs are now adequately treated under the 1958 Act and SBA's regulations thereunder.

Section 25 of the 1940 Act, relating to Plans of Reorganization, covers the same matters now subject to stringent regulation by SBA under its Reg. 107.701 (33 Fed. Reg. 331(1968)) relating to changes in ownership or control of an SBIC. Accordingly, we see no need for the duplicative application of Section 25 of the 1940 Act to SBICs.

Sections 26, 27, 28 and 29, relating respectively to Unit Investment Trusts, Periodic Payment Plans, Face-Amount Certificate Companies and Bankruptcy of Face-Amount Certificate Companies, all deal with matters which are of no regulatory importance insofar as SBICs are concerned.

Sections 30, 31 and 32 of the 1940 Act, relating respectively to Periodic and Other Reports, Accounts and Records and Accountants and Auditors, are all extensively covered by Section 310 of the 1958 Act (15 U.S.C. § 687b (Supp.II, 1965-66)) and by SBA Regs. 107.1101 and 107.1102 (33 Fed. Reg. 335-36 (1968)). Thus, in our view, the application of Sections 30, 31 and 32 of the 1940 Act to SBICs is not necessary.

Section 33 of the 1940 Act, titled Settlement of Civil Actions, requires certain reports relative to litigation, a subject expressly and adequately covered under SBA Reg. 107.1102(g) (33 Fed. Reg. 335-35 (1968)). Accordingly, the application of Section 33 of the 1940 Act to SBICs would appear to be unnecessary.

Sections 34, 35, 36 and 37 of the 1940 Act, relating respectively to Destruction and Falsification of Reports and Records, Unlawful Representations and Names, Injunctions Against Gross Abuse and Larceny and Embezzlement, are now adequately covered, in our view, by Sections 313, 314, 315 and 316 of the 1958 Act, all by virtue of the Small Business Investment Act Amendments of 1966 (80 Stat. 1359-65 (1966); 15 U.S.C. §§ 687e-h (Supp. II, 1965-66)). Accordingly, the application of the cited sections of the 1940 Act to SBICs is clearly unnecessary.

Sections 38, 39, 40 and 41 of the 1940 Act, relating respectively to (i) Rules, Regulations, and Orders; General Powers of

Commission; (ii) Rules and Regulations; Proceedure for Issuance; (iii) Orders; Proceedure for Issuance; and (iv) Hearings by Commission, all basically relating to internal procedural matters relative to the administration of the 1940 Act, would no longer be applicable to SBICs under our proposal.

Sections 42, 43 and 44 of the 1940 Act, relating respectively to Enforcement of Title, Court Review of Orders and Jurisdiction of Offenses and Suits, find their counterparts in Sections 315 and 316 of the 1958 Act as amended by Public Law 89-779 (15 U.S.C. § § 687g and h (Supp. II, 1965-66)). Accordingly, the application of the cited sections of the 1940 Act to SBICs would not appear to be necessary.

The balance of the 1940 Act, namely Sections 45 through 53, being largely of a housekeeping and procedural nature, would likewise appear not to be applicable to SBICs in light of SBA's existing statutory authority and regulations governing the same matters.

With respect to Section 47(b) of the 1940 Act, however, specific comment is in order. In light of SBA's enlarged regulatory authority pursuant to the Small Business Investment Act Amendments of 1966 (80 Stat. 1359-65 (1966)), the application of this section of the 1940 Act to SBICs would not appear to be necessary or desirable.

Conclusion and Recommendation

As noted at the outset, it is our view that the attainment of the Congressional goals laid down for the SBIC program in the 1958 Act can best be accomplished by eliminating any and all regulatory obstacles in the path to those goals. On the basis of nearly ten years

of close study of the SBIC program, the officers and Executive Committee of NASBIC and member companies registered under the Investment Company Act of 1940 are of the common view that the dual regulation by the Commission and SBA over the SBIC program constitutes a substantial obstacle to the proper functioning of the program.

SBA has the primary responsibility under the 1958 Act to license and regulate SBICs. By virtue of Congressional action in every Congress since the enactment of the 1958 Act, and in particular the enactment of the Small Business Investment Act Amendments of 1966, SBA now has adequate statutory tools to permit its regulation of the SBIC program in the interests of small business concerns, SBICs and their investors. In addition, the personnel of the Investment Division of SBA, where the administration of the SBIC program is centered, now includes many personnel who formerly served with the Commission and thus are conversant with its policies and goals.

It is our further view that Section 6(c) of the 1940 Act vests in the Commission adequate statutory authority to grant exemptions to the extent necessary to permit the proper accommodation of the goals of the 1958 Act as well as those of the 1940 Act.

Accordingly, NASBIC recommends that the Commission delegate to SBA the authority to regulate SBICs now subject to registration under the Investment Company Act of 1940 in those areas where present provisions of the 1940 Act are deemed to be applicable to SBICs and that the Commission thereafter exempt SBICs from the application of the 1940 Act to the extent that SBA regulations deal with the applicable provisions of the 1940 Act in a satisfactory manner.

Consent to Use of this Document in Evidence

Pursuant to Rule 0-2(f), NASBIC hereby offers this application and all exhibits hereto and all Amendments hereof hereafter made, in evidence at any hearing with respect to the action herein sought, and requests that the original, a duplicate original, or a photocopy of this Application and any and all Amendments thereto, whether executed hereafter or concurrently herewith, be offered in evidence on behalf of NASBIC and be received in evidence as an exhibit of NASBIC in any such proceeding before the Securities and Exchange Commission, or any officer thereof or any trial examiner designated thereby, and that the verification of this Application and any Amendment hereof be considered as if the person signing such verification had personally appeared and testified orally under oath, duly administered, in any such proceeding to the statements contained in such verification.

Exhibits

A. Copy of letter to the Commission dated November 21, 1967 relating to proposed revision of Rule 17d-1 under the Investment Company Act of 1940.

B. Copy of Proposed Rule 18d-1 under the Investment Company Act of 1940 as submitted to the Commission by NASBIC under date of February 20, 1962.

Signature

NASBIC has duly caused this Application to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Washington, District of Columbia, on the 15th day of March, 1968.

NATIONAL ASSOCIATION OF SMALL
BUSINESS INVESTMENT COMPANIES

By _____

Verification

DISTRICT OF COLUMBIA) SS:

The undersigned, being duly sworn, deposes and says that he has duly executed the attached Application dated March 15, 1968, for and on behalf of the National Association of Small Business Investment Companies, that he is the President of said Association, and that all action by the Executive Committee and other bodies necessary to authorize deponent to execute and file such Application has been taken. Deponent further says that he is familiar with said Application and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.

Elliott Davis

SUBSCRIBED and SWORN to before me, a Notary Public, this 15th day of March, 1968.

Notary Public

My Commission Expires 1/4/71

ADMINISTRATIVE PROCEEDING
FILE NO. 3-1825

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	
THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ET AL.	INITIAL DECISION
537 Washington Building Washington, D. C. 20005	
(812-2297)	
Investment Company Act of 1940	

APPEARANCES: Charles M. Noone, for The National Association of Small Business Investment Companies and for individual small business investment companies appearing as parties.

William T. Genetti, Eric W. Weinmann, Jerome Garfinkel and John J. Sharp, for The Small Business Administration.

Sydney H. Mendelsohn, David M. Butowsky, Herbert E. Milstein, Raymond J. Klapinsky and Paul R. Huard, for the Division of Corporate Regulation.

BEFORE: Sidney Ullman, Hearing Examiner

NATURE OF THE PROCEEDINGS.

These proceedings were instituted by an order of the Commission dated January 14, 1969 ("Order"), issued pursuant to Section 40(a) of the Investment Company Act of 1940 ("'40 Act"), which directed that a hearing commence on February 19, 1969, on an application filed by The National Association of Small Business Investment Companies ("Applicant") on behalf of member companies. (Investment Company Act Release No. 5581). Applicant is a trade association with an active membership of 230 small business investment companies ("SBICs") licensed by the Small Business Administration ("SBA") pursuant to the Small Business Investment Act of 1958, as amended ("SBI Act"). Of the 230 active members, 29 are public companies which have registered with the Commission under the '40 Act as management, closed-end, non-diversified investment companies.[1/]

The application was filed on March 15, 1968, pursuant to Section 6(c) of the '40 Act, which reads as follows:

> "The Commission . . . may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this title . . . if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

Thereafter, informal conferences were held by counsel for the Applicant and counsel for the Division of Corporate Regulation ("Division")

1/ The application states: "While the 230 SBICs belonging to NASBIC represent only half of the 462 SBICs whose licenses remain outstanding it is estimated that the licenses of NASBIC member companies account for 80% of the assets currently committed to the SBIC program."

with the view toward narrowing the issues in the proceedings and discussing the possibility of reaching a settlement. As amended at the hearing and as treated in the post-hearing documents of the parties, the application seeks a Commission order exempting those SBICs which are subject to registration under the '40 Act from virtually all provisions of that Act.[2/] Applicant's position is that the exemptions can be conditional, as discussed below, and that as a practical matter Commission oversight for the protection of investors can continue. Joining in the application and urging that it be granted are 24 SBICs which are members of the Applicant. They have been made parties to these proceedings. Also a party is the Small Business Administration ("SBA"), which participated actively throughout the proceedings and supports the application, urging that it be granted unconditionally.

Exemption is not sought by Applicant from Sections 8 and 24 of the '40 Act, which pertain to the registration of investment companies with the Commission.[3/] Continuation of such registration is desired in order to accommodate SBICs electing to be taxed as regulated investment companies under Section 851 of the Internal Revenue Code of 1954.

2/ As filed, the application requested exemption of the SBICs from those provisions of the '40 Act allegedly not applicable or "not of regulatory importance" to SBICs; from other sections which, if deemed necessary, could be incorporated in suitable Small Business Administration regulations; and as to other sections it requested either Commission exemption, adoption of a new Rule, or delegation to the Small Business Administration of authority to regulate SBICs. As indicated in the text, infra, during the course of the proceedings the requested delegation to the Small Business Administration was withdrawn in favor of an expanded request for exemption.

3/ Certain other SBIC parties indicated they did not request exemption from particular sections of the '40 Act, but these are minor departures from the norm.

In connection with its opposition to the application, counsel for the Division questioned whether the exemptions might not preclude the tax advantages otherwise available to SBICs under Section 851 of the Internal Revenue Code. However, following the conclusion of the hearings and in their post-hearing filings of documents, both Applicant and the SBA attached for the record a copy of a letter dated July 15, 1969 from the Department of the Treasury to the Associate Administrator for Investment of the SBA. The letter stated that the granting of the exemptions would not affect the status of an SBIC under Section 851(a)(1), the pertinent provision of the Code, so long as the SBIC became and continued to be registered with the Commission as an investment company under Section 8(a) of the '40 Act.

In its Order providing for the hearing, the Commission directed that attention be given to the following matters and questions which the Division had advised are presented for consideration by the application:

"a. Whether the Commission has authority to grant the requested relief, i.e. exempt SBICs from substantially all provisions of the Act and delegate its regulatory authority over SBICs registered pursuant to Section 8 of the Act to the SBA. (With respect to Applicant's withdrawal of the request for delegation, see footnote 2 in the margin supra, p. 2).

b. Whether the granting of the requested exemptions and orders under the Act is (a) necessary or appropriate in the public interest, (b) consistent with the protection of investors and (c) consistent with the purposes fairly intended by the policy and provisions of the

Act; and

c. If the requested exemptions and orders are to be granted, what conditions, if any, should be imposed in the public interest and for the protection of investors."

In a subsequent order the Commission designated the undersigned to preside at the hearing, and on February 14, 1969 at the request of counsel for the Division a prehearing conference was held, during which certain procedures were adopted with respect to the manner of introduction of evidence on Applicant's case-in-chief, including the use of direct evidence in the form of prepared statements to be served on Division's counsel in advance of the appearance of the witnesses for cross-examination.

In accordance with an agreed schedule, the hearing commenced on March 17, 1969 and continued intermittently until May 6, 1969. Substantial testimony and voluminous documentary evidence were presented in support of the application by persons either currently engaged in or having prior experience in the industry, and official notice was taken of Commission files and documents at the request of one or more parties. Following the hearing the parties submitted proposed findings of fact, conclusions of law and briefs in support thereof in simultaneous filings, and reply briefs were filed in response to the initial filings. I have made the findings of fact and conclusions of law discussed herein on the basis of the record in these proceedings, after observing the witnesses who appeared before

me and with particular regard for the issues specified by the Commission in the Order.

At the outset I point out that it would be naive not to recognize that representatives of a regulated industry such as that in which the registered SBICs are engaged would wish to mitigate the burden of regulations to the extent practicable: and where the regulations are deemed excessive and also are imposed by more than a single regulatory authority, both consciously and unconsciously the burden of such regulations might be exaggerated. In evaluating the evidence I have kept this in mind.

Here the emphasis in support of the application has been on the burden of "dual regulation" by both SBA and the Commission. That term is used broadly herein to include not only current requirements of both agencies for filing reports, documents, and exemptive requests, whether such requirements duplicate or differ as between the agencies, but also to include regulations which prohibit or restrict activities of SBICs where they are imposed only by the '40 Act and its implementing regulations issued by the Commission, even though not also imposed by the SBA.

The thrust of the arguments in support of the application, and these are also urged by the SBA, is that the SBA, either under its current regulations implementing the SBI Act or under regulations which it can promulgate under that Act, can and will effectively supervise the SBICs in a manner consistent with the protection of investors and the purposes of the '40 Act. Counsel for the SBA assert

that an unconditional exemption from all '40 Act provisions is necessary and appropriate in the public interest. The one side, consisting of Applicant and SBA, concedes that the main thrust or essential purpose of the SBI Act is the effective utilization of funds to assist small business companies through the SBICs whereas the main thrust or purpose of the '40 Act is the protection of investors. But the SBA insists that it has had sufficient experience under the SBI Act and has sufficiently competent personnel who can accommodate and reconcile both the effective protection of investors and also the effective assistance to small business with which SBA is charged by the Congress. This one side contends, therefore, that the burdens imposed upon the small business investment company program and the consequent danger to that program and to small business as a result of dual regulation must now be considered, and that these considerations support the argument that the Commission can and should cease to exercise its authority in those areas in which SBA can and will supervise the SBICs with appropriate regard for the protection of their public investors.

The record is replete with testimony persuading me that dual regulation is a serious burden upon and inhibits to a material extent the viability of the SBIC industry. The burden falls upon all registered SBICs: on the larger ones, which can or should be able to furnish to small business concerns the significant long-term debt and equity capital essential to a successful program under the SBI Act, as well as on the smaller ones, where the expense of compliance with dual regulation is inordinately high when measured against the size of the operations and proposed transactions.

The record shows, with respect to the small business investment industry, that the registered SBICs are substantially larger than the non-registered. SBA figures as of September 30, 1968 show that of total assets of $638.5 million of all of the SBICs reporting to SBA, the assets of 44 registered SBICs which reported were approximately $260.8 million, or just over 40%, while the 378 reporting non-registered SBICs had assets of $377.7 million, or approximately 60%. But the trend is for the registered SBICs to pull assets out of the program, frequently by forming parent-subsidiary corporations and transferring assets from the program into comparable activities which are not subject to Commission supervision under the '40 Act. 4/ Conversely, there is no trend toward entry into or expansion of the

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4/ For example, Boston Capital Corporation in 1967 decided to surrender its SBIC license; in 1968 Greater Washington Investors, Inc. formed a subsidiary corporation to accomplish purposes mentioned in the text. Cf. In the Matter of Capital Southwest Corporation, Investment Company Act Release No. 5827, September 30, 1969.

The testimony also disclosed that the management of Delta Capital Corporation, which was licensed in 1961, has decided to liquidate the SBIC, primarily because of dual regulation. The prepared statement of John C. Laslie, Vice President, reads in part:

> ". . . investing risk capital in small and untried businesses while at the same time attempting to comply with the rules and regulations of two different federal agencies has proven impossible." On cross-examination, however, it was clear that regulations of SBA and its restrictive rules concerning real estate were in no small measure also accountable for management's decision.

Growth Capital Corporation formed a subsidiary, Growth International Corporation, and it, also, withdrew substantial assets from the program in 1967.

program, either by non-public SBICs going public and thus increasing the funds available for assistance to small business or by the creation of SBICs by persons not now in the program. The testimony indicates not only that dual regulation is a prime reason for refusal of non-public companies to go public but also that officials of companies now subject to dual regulation advise others to avoid it, almost at all costs.[5/]

I have no doubt that the representatives of the industry who testified, despite some exaggeration or misunderstanding of difficulties and delays previously encountered in connection with Commission supervision, sincerely believe that the industry is excessively and unduly burdened by dual regulation and that relief is required if the industry is to survive. The testimony with regard to the need for the filing of numerous reports with both agencies, some of the reports differing in content or format despite Commission efforts at accommodation; the testimony with respect to necessary delay when speedy action is essential; with respect to the expense involved, especially onerous for SBICs with small and limited capitalization, in studying the need for exemptive authority in order to consider or to accomplish potential transactions; with respect to the danger of entering into a void contract because of inadvertent violation of a complex Commission regulation; and the testimony with respect to time

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5/ The record also contains hearsay testimony on the limitation of the volume of assets in the program, some of which is extremely difficult to evaluate. Witnesses testified, for example, that officials of non-public companies have stated that they would be willing to go public if it were not for dual regulation. (Whether this would be conditioned upon or subject to total exemption from the '40 Act is not indicated: and whether these are resolute statements of company position is doubtful). While I credit the witnesses, I ascribe little weight to such hearsay testimony.

and expense of management, attorneys, and other personnel who are involved in filing dual applications for exemptive authority, frequently in situations where exemption is doubtful, are among the factors which convince me that serious effort should be made by the Commission to mitigate the burdens imposed upon the industry by dual regulation, provided that this can be done within the standards and limitations of the Commission's exemptive authority and responsibility under Section 6(c).[6/] The above problems relate particularly to Section 17 and the Rules thereunder.

While concentrating their attack on the problem areas which the application seeks to change, the industry representatives concede that even total and unconditional exemption from the '40 Act would be no panacea. The stringent federal budgetary limitations recently and currently imposed upon the lending power of the SBA are a severe handicap to the performance of the functions of the SBICs. And for reasons discussed below, total and unconditional exemption is neither possible nor practical. The extent and measure of the help which would be afforded by the exemptions suggested below is problematical, but steps in the direction are necessary and will afford some relief and encouragement to persons now in the industry and may afford some

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6/ Even though a few of the "problems" with respect to which testimony for Applicant was received are illusory or imagined, the very fact that representatives of the SBIC industry are under the impression that they exist militates somewhat against the potential growth, if not the survival of the industry. By way of example only, it was not recognized by all witnesses that adoption of a Commission rule under Section 17(d)(6) of the '40 Act had materially diminished the need for certain exemptive applications. (The complexity of Section 17 and the rules thereunder was the subject of much testimony by past and present representatives of the industry.)

Conversely, however, it is recognized that the testimony describes

(continued on following page)

encouragement and stimulus to potential entrants. I believe it is an imperative obligation that the Government which created the program should not, without purpose or plan to do so, stifle it or frustrate its development.

Counsel have expressed opposing arguments with respect to the somewhat vague term "public interest" as it is used in Section 6(c). Applicant and SBA argue that public interest embraces a regard for the success of the SBI program and for the Congressional and national concern for the success of small business. But the Division insists that a narrow construction of the term is required by Section 6(c); that the SBIC program is not to be considered by the Commission in weighing an application for exemption under that Section; and that protection of investors rather than national problems should be the concern of the Commission.[7/] The Division also argues that "findings of hardship or difficulty incidental to compliance with the ['40 Act] are not material or germane to proceedings under Section 6(c) to determine whether exemptions from any or all of its provisions should be granted."

6/ (continued)
typical problem areas of dual regulation, and that the testimony could not purport to disclose all situations where SBICs were precluded from entering into transactions because speedy decisions were required but were not possible; where investment opportunities had to be abandoned with or without consideration of Section 17 problems; or where expenses or delay were considered insuperable under the circumstances of dual regulation.

7/ The Division's argument goes further and denies that there is ". . . assurance that the program will succeed even if the proposed exemptions are granted, especially in light of the fact that the record does not establish that the Investment Company Act has impeded the success of SBICs."

Both of these positions seem narrow. I believe that the Commission must consider public interest broadly, as it has done in the past,[8/] and that in considering the requested exemptions it cannot disregard the Congressional intent to facilitate the formation and growth of SBICs. I believe, also, that hardship and difficulty incidental to compliance with the '40 Act are germane to the Commission's consideration of public interest under Section 6(c), and that if, as witnesses testified, these factors have induced withdrawals of registered SBICs from the program, and if, again as witnesses testified, these factors have impeded and continue to impede entries into and endanger the program, such hardships and difficulties are problems

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8/ See In the Matter of J.D. Gillespie, Trustee, 13 S.E.C. 470, 480-481 (1943), where the Commission discussed the possible encouragement of the purchase of government bonds to aid in the war effort as a matter of public interest under Section 6(c).

Cf. Investment Company Act Release No. 1945, January 28, 1954, (to be found in 19 F.R. 754, February 9, 1954), where the Commission's notice of proposed rule-making which eventually resulted in current Rule 7d-1 under the '40 Act, under which Canadian management investment companies may request orders permitting registration, read in part:

> "In line with the policy of this government to facilitate and encourage foreign investments, the Commission directed its staff to endeavor to formulate the 'special arrangements' which would meet the standards of Section 7(d)."

Cf. American-South African Investment Co., Inc., 38 S.E.C. 546 (1958).

In Investment Company Act Release No. 3361, November 17, 1961, the Commission deemed it appropriate under Sections 6(c) and 38(a) to exempt SBICs from certain requirements of Section 17(a), 17(d) and 18(c) of the '40 Act ". . . in view of the public interest to be served as expressed in the Small Business Investment Act of 1958 (SBI Act)."

It would also seem that unless "public interest" were broader than the Division suggests, many exemptions heretofore ordered by the Commission, either on specific application or in broader Rules, would have been neither appropriate nor necessary in the public interest.

which must concern us at this time as matters of public interest.[9/]

In this connection the Division contends that the testimony of the president of one of the non-public SBICs "shows only that his company prefers not to subject itself to compliance with the Investment Company Act by 'going public' and that the testimony fails to establish that the company could not function successfully as an SBIC if it chose to make a public offering and became registered under the Investment Company Act." This argument is hardly an answer, for if the persons in the program and those potentially available to the program are refusing to continue in it or are failing to enter it to a significant extent, as the evidence indicates, then the viability of the program is in danger, whether or not the reasons for such attitudes are entirely well-founded. Expense, delay, and also hardship in complying with the requirements of dual regulation are among the burdens which must be evaluated, and even if some of these burdens, after these many years of SBIC operation are unfortunately exaggerated in the minds of the interested persons upon whom the industry must rely, they cannot be ignored.

Nor is it an answer to the application that, as the Division points out, certain SBICs have grown dramatically despite dual regulation. The evidence does not, of course, disclose whether such growth has

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9/ American Participations, Inc., et al., 10 S.E.C. 430 (1941) does not hold to the contrary. Where, as here, hardship and difficulty are part of a serious threat to a program established by Congress and important to the nation's economy, they constitute more than mere "inconveniences or impediments". Of course, if it were found, as in American Participations, that the factual evidence presents "no substantial basis for a conclusion by us that compliance with the provisions of the Act will destroy these applicants or that the grant of the proposed exemption will preserve them", exemption under Section 6(c) would be inexpedient and inappropriate. I do not reach such a conclusion here.

resulted from especially fortunate or wise investments, from superior management or exceptional opportunities, or from other causes. The more important consideration is that although the program itself has been helped by such successes, if it is nevertheless endangered by Commission regulation, reasonable efforts to mitigate the dangers must be made.

Part of the background of the filing of the application includes a long history of efforts to obtain both Commission and Congressional action exempting SBICs from Commission regulation. Apart from the many applications to the Commission by individual SBICs for the exemption of specific transactions, some of the efforts of Applicant and the SBA to obtain broader Commission action have been in the form of proposed exemptive rules; others have been made at meetings with Commission staff, including conferences and submissions in connection with the instant application. Some of these efforts have produced results which Applicant insists are inadequate, and it asserts that broader exemption is necessary to the survival of the program.

Applicant and SBA stress the significant difference between the investments of an SBIC and those of an open-end management company or mutual fund, some of which differences were discussed in the testimony. For example, the SBIC is required by law to make direct investments in small business concerns, and it generally holds its equity investments in newly-created and speculative ventures rather than in the securities of well-established companies. Its securities are generally unregistered and unmarketable: they are held for long period of time in portfolio

companies which sometimes need almost complete supervision by the SBIC, including accounting, engineering and administrative counselling. Such portfolio companies frequently have required the infusion of additional funds by the SBIC without delay, but speedy decisions have been prevented by the complexities of Section 17 and rules thereunder relating to transactions of affiliated persons.[10/] The mutual fund, conversely, usually invests in well-established listed companies and is not committed to long term or risk capital ventures: its investment opportunities are broader, and its assets and income generally are much more substantial.

Efforts to obtain relief from dual regulation by Congressional action have been only partially successful. Commission representatives have generally opposed broad exemptions in testimony before various committees, and despite committee reports and recommendations frequently favorable to relaxation of Commission oversight, Congress has been reluctant to enact broad exemptive legislation. So the Division argues that exemption by the Commission not only would jeopardize investments which the '40 Act was designed to protect but also would abrogate the expressed policies of Congress. Conversely, Applicant contends that if SBICs had been in existence at the time of the enactment

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10/ From time to time the Commission has assisted with broad exemptions relating to possible conflicts of interest and arising from the prohibitions of Section 17 and rules thereunder. For example, Rule 17a(6), promulgated in Investment Company Act Release No. 3968, April 29, 1964, exempted from the prohibitions of Section 17, investments by SBICs in small business concerns which are affiliates of an SBIC by reason of a prior investment or investments therein. This Rule obviated the need to apply for a Commission order permitting a proposed investment where an earlier investment in the business concern had been made.

of the '40 Act, Congress would have expressly recognized the difference between SBICs and the typical investment company or mutual fund which had created and presented the serious abuses and problems toward which the provisions of the '40 Act were aimed, 11/ and would have exempted SBICs in Section 3(c) along with the financial institutions of a "similar type" such as banks, savings and loan companies and finance companies.

Whether the differences between SBICs and other investment companies or mutual funds is as significant as Applicant and the SBA suggest, or whether the resemblance is as close as the Division urges throws little light on what the legislative intent in 1940 would have been if SBICs had then existed. The failure of Congress to exempt public SBICs from the overall coverage of the '40 Act at the time the SBI Act became law in 1958 is more meaningful and reflects the view of Congress at that time. 12/ This, of course, is part of the picture. So, too, is the failure of Congress on several occasions to take favorable action on bills which would exempt SBICs from Commission supervision with respect to certain activities or transactions. As pointed out by Applicant, Congressional committees have expressed concern about dual regulation, and Commission officials, including former Chairmen, have at times suggested to such committees, among other bodies, that because the Commission has authority to exempt SBICS to the

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11/ The abuses of investment companies at which the '40 Act was directed were broad. They were "particularly detrimental to public investors" and included self-dealing by insiders in the form of unfair sales and purchases of securities and other properties to and from investment companies. See Report of the Securities and Exchange Commission, Part Three, Chapter VII, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies.

12/ Congress was mindful of the problem in 1958. For example, Section 307(c) of the SBI Act provides limited exemptions for SBICs from the '40 Act requirements as to the capital structure of an investment company.

extent appropriate, specific legislation was unnecessary.[13/] I do not speculate on the effect such statements may have had on proposed legislation; but it would appear that further and perhaps more intensive efforts on behalf of SBICs to obtain exemption through legislation have been to some extent aborted by such statements.[14/] The testimony and statements before committees also reveal strong objections to some of the proposed changes,[15/] and some of these objections are now urged or suggested in the briefs of Division counsel in this proceedings.

Applicant's reply brief (to which the Division in the normal course of these proceedings could not respond) states that:

> "NASBIC's most recent effort to obtain statutory exemptions from the Investment Company Act of 1940 came in 1963 with the introduction of S. 1427, a bill which would have transferred SEC regulatory authority over

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13/ For example, Chairman Gadsby stated to the American Management Association on December 1, 1958, that ". . . what with the exemptive powers granted . . . by section 6(c) of the Investment Company Act . . . the SEC is given authority to apply with very great elasticity its regulation in the field opened up by the Small Business Investment Act. I have no doubts whatever but that the Small Business Administration and the Securities and Exchange Commission, working together, will be able to lay out a clear, simple, and safe course for these new enterprises to follow with the minimum of governmental interference consistent with the general public and investor interest." Briefing on the Investment Act, Committee Print, Senate Committee on Banking and Currency, 85th Cong., 2d Sess., p. 29 (1958).

14/ In 1961 Chairman Cary said, concerning proposed legislation and with reference to the conflicting views of SBA and the Commission: "We have worked very closely with the SBA, and indeed at the present time, as you can note, on three major points we are working with them in the belief that through our exemptive powers we can work out something that seems generally agreeable to them."

15/ In hearings in 1961 before Subcommittee No. 2 of the House Committee on Banking and Currency on H.R. 6672, 87th Cong., 1st Sess., Chairman Cary detailed objections to proposed amendments of the SBI Act which would exempt SBICs from certain prohibitions of the '40 Act. See, for example, page 92. See also Chairman Cary's testimony in 1961 on S. 902, 87th Cong., 1st Sess., at pp. 127-128.

> SBICs to SBA. The bill was introduced in the Senate at the request of NASBIC by Senator Harrison Williams, Chairman of the Securities Subcommittee of the Senate Banking and Currency Committee. The scheduling of hearings on that bill was deferred on receipt of informal assurances from the Commission that problems encountered by SBICs under the Investment Company Act of 1940 were under active review by the Commission."

As indicated above, Applicant and SBA contend that subsequent relief has been inadequate.

While the effort to divine the intent of Congress is important with respect to the issues before us, it is something of a speculative project. In this effort we are not confined to a study of the '40 Act and its legislative history and amendments, but the spectrum includes other legislation such as the SBIC Act and its amendments. In 1967 Congress amended the SBI Act to require that SBA annual reports should thereafter include

> "A report from the Securities and Exchange Commission enumerating actions undertaken by that agency to simplify and minimize the regulatory requirements governing small business investment companies under the Federal securities laws and to eliminate overlapping regulation and jurisdiction as between the Securities and Exchange Commission, the Administration, and other agencies of the executive branch." 15 U.S.C.A. 687(g)(1)(H).
>
> * * * *
>
> "(J) Actions undertaken by the Securities and Exchange Commission to simplify compliance by small business investment companies with the requirements of the Investment Company Act of 1940 and to facilitate the election to be taxed as regulated investment companies pursuant to section 851 of Title 26." 15 U.S.C.A. 687(g)(1)(J).

Such legislation signifies that as recently as 1967 Congress recognized that dual regulation existed and did not intend that SBICs be totally

exempt from Commission supervision or control. But it also indicates a Congressional concern for the problems that dual regulation imposes on SBICs.

As pointed out by the Investment Company Institute, an association of mutual funds, in a letter to the Commission dated February 12, 1969, commenting on the subject application,[16/] the language in (H) above "simplify and minimize" should not be equated with "wholesale and indistriminate abdication of responsibility" and the intent of Congress to reduce "overlapping jurisdiction" does not purport to preclude concurrent regulation by two agencies representing different aspects of public interest. The Division's brief also urges that the statutory language does not suggest a relinquishment of jurisdiction.

I believe it is a fair conclusion, from the legislative enactments and committee reports, that Congress intends that dual regulation should be minimized by the Commission to the extent practical, within the limitations and standards of Section 6(c), and that Congress would prefer, if it can do so, to defer to the expertise of the Commission in determining the extent to which exemptions can be granted in accordance with those limitations and standards.

16/ The Institute's letter was written to indicate its opposition to the request for "delegation" of authority to SBA, as originally stated in the application. The letter expressed the view that the Commission has no authority to delegate its responsibility to another agency, that "such delegation would be contrary to the will of Congress, and that it would be inconsistent with the public interest in the protection of investors."

The Institute's letter was in response to an invitation in the Order to persons desiring to be heard or otherwise participate in these proceedings. No other comments or requests for participation were received, apart from the communications of other SBIC members of Applicant who joined in the application.

Commission decisions and Congressional testimony by former Chairmen reflect that the Commission has never doubted its authority to grant broad exemptions from the '40 Act under Section 6(c), but it has regarded this authority as one which should be cautiously exercised. As stated in American Participations, Inc., et al., 10 SEC 430 (1941) at 437 in the margin:

> "We may assume that our powers under Section 6(c) are ample to authorize the type of relief sought. But the wisdom of the exercise of such powers is another matter. The very breadth of a power to exempt any person, security, or transaction from any provision of the Act places upon us a grave responsibility that such power be exercised with the greatest circumspection. We must be alert to guard against the possibility that this Commission, established to implement the legislative will to protect investors, become the instrument through which the expressed policies of Congress are thwarted in case by case grants of exemption to any applicant who files and presses an application."

In Transit Investment Corporation, 28 S.E.C. 10 (1948), the Commission said, at 14, 15:

> "The argument of the staff is that Section 17 as a whole sets forth the powers of this Commission with respect to dealings between affiliated persons and registered investment companies; that Section 17 contains within itself certain exceptions; and that these self-contained exceptions exclude the possibility of other exceptions under Section 6(c).
>
> Section(6)(c) contains no qualification or limitation as to the sections of the Act from which an exemption may be granted or as to the types of prohibited transactions which may be exempted. Nor is there anything in the legislative history of that section which indicates a Congressional intent that its application be so limited. The exemption may of course be granted only where it satisfies the conditions stated in Section 6(c), and we recognize our responsibility to exercise with circumspection the broad power conferred, but we find no basis express or implied for any further restriction of the nature contended for by the staff."

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More recently, in Matter of First National City Bank, Investment Company Act Release No. 4538, March 9, 1966, aff'd sub nom. National Association of Securities Dealers v. Securities and Exchange Commission (D.C. Cir., July 1, 1969, reh. den. August 15, 1969), CCH Fed. Sec. L. Rep. ¶92438 at 98065, the Commission granted certain exemptions from sections of the '40 Act pursuant to Section 6(c), thereby permitting the applicant bank to act as investment adviser to and supervisor of a collective investment fund operated as an open-end investment company. After reaffirming, by quoting from The Prudential Insurance Company of America, Investment Company Act Release No. 3620 at p. 8 (January 20, 1963), that Section 6(c) was put into the '40 Act

> ". . . for the purpose, among others, of permitting the exemption of persons 'who are not within the intent of the proposed legislation [citing Sen. Rep. No. 1775 (76th Cong., 3rd Sess.) at p. 13] even though such persons come within the scope of the Act by virtue of its specific provisions . . . ."'

the Commission, now quoting from Transit Investment Corporation, supra, continued,

> ". . . that the 'purposes fairly intended by the policy and provisions' of the Act obviously means something more than a literal reading only of the provision from which an exception is desired. Otherwise, the existence of a provision prohibiting a transaction, which in every case under Section 6(c) is the very reason why an application for exemption is necessary, would also be the very reason for denying the application, thus making it impossible to resort to Section 6(c) to exempt a transaction from any provision of the Act."

Thus in considering the purposes and policy of the '40 Act, Section 6(c) must be recognized as one provision which, along with all other

provisions, expresses the views of Congress, and it follows that changes in the scope of the literal language by Commission exemption in proper cases was intended and provided for in the Act and is a part not only of its provisions but also of its policy. The exercise of this prerogative to exempt is a matter within the judgment and expertise of the Commission. Congress did not intend that the responsibility and authority to exercise it should be renounced in deference to Congressional authority, where the standards of Section 6(c) can be met.

It is my view that in certain respects these standards are reasonably met, and that under the evidence presented at the hearing Applicant has sustained its burden of proving that it is appropriate in the public interest that some exemptions from provisions of the '40 Act should be granted, subject to appropriate conditions. Section 17 of the '40 Act has borne the brunt of Applicant's evidentiary attack. The applicability and effect of Section 17 which pertains, as the title indicates, to "Transactions of Certain Affiliated Persons and Underwriters" have become extremely complex, primarily by reason of the nature of the subject matter but also as a result of the Commission rules thereunder, both exemptive and prohibitive.[17/] Section 312 of

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17/ Rules 17a-1 through 17a-7 are exemptive under conditions and circumstances described therein, as amended from time to time.

Section 17(d) is not self-operating, but authorizes the Commission to adopt rules designed to protect investment companies and their investors from overreaching by affiliated persons where the investment company and the affiliated person have a joint or a joint and several participation in a transaction. Rule 17d-1 is prohibitive in nature, but now contains an exemption with respect to certain transactions, including loans made to a small business concern by a bank and a licensed SBIC. The Rule requires reports to the Commission with details of transactions "at such time, on such forms and by such persons as the Commission may from time to time prescribe."

the SBI Act, as amended,[18/] "Conflicts of Interest," relates to the same area as Section 17, and provides in part that the SBA shall adopt regulations "controlling conflicts of interest which may be detrimental to small business concerns, to small business investment companies, to the shareholders of either, or to the purposes of this Act. . . ." In implementation of this Section, SBA adopted its Regulation 107.1004 (13 CFR 107.1004). This Regulation, together with a broadly inclusive definition of the term "associate of a licensee" in Regulation 107.3, and the limitations on "Sale of portfolio securities" in Regulation 107.1005 appears to afford, subject to competent administration by SBA, reasonably adequate protection against potential conflicts of interest, although the coverage is narrower than that of Section 17 and Commission rules thereunder.

Counsel for SBA announced at the hearing that he was authorized to read into the record a statement by SBA strongly supporting the application, and asserting that the SBA now has the experience and expertise to carry out its responsibilities under the mandate of Congress in the SBI Act. As indicated above, that mandate is concerned with the success of the program, and it includes, by necessary implication and also expressly, the protection of investors in SBICs.

No convincing testimony or evidence, pro or con, reflects upon the ability of the SBA to administer and supervise with adequate care

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18/ 15 U.S.C. 67d, added February 28, 1964, (78 Stat. 147).

and competence the areas of potential conflicts of interest.[19] If the SBA does not have and does not continue to maintain a staff in sufficient numbers and with adequate expertise, alertness, imagination, and integrity, moral and political, to supervise the industry with competence, the program cannot succeed. Necessarily, its staff must be able to frustrate the efforts of persons who may attempt to profit by questionable or dishonorable activities -- attempts which will take the form of efforts at self-dealing by some, as well as attempts by questionable persons to enter the program, an administrative area over which SBA has had and continues to have jurisdiction perhaps primary to that of the Commission.[20] If the SBA cannot or does not adequately supervise the program, investors in SBICs will be defrauded, the '40 Act to the contrary notwithstanding. If it supervises adequately, the purposes of Section 17 will be accomplished.

The Division delicately raises some question concerning the ability of the SBA to administer investor protection regulations "with the same impartiality as the Commission", and expresses doubt concerning the adequacy of the SBA staff's "size and expertise to administer investor protection regulations in an SBIC industry which may well be expanded in numbers by the granting of the subject application."[21]

19/ This is stated as a fact and not in derogation of any party. I recognize the difficulty, if not the impossibility of proving the competence or incompetence of an agency's supervision in a hearing of this nature, assuming such matter is germane. But I do not accept the position urged by SBA that testimony which is not controverted must be adopted by me as the trier of the facts. And more specifically, I do not feel bound to the position of industry officials who expressed opinions that SBA now adequately protects SBIC investors and that no Commission oversight is necessary.

20/ Cf. Section 314(c) of the SBI Act (15 U.S.C. 687f) and Section 9 of the '40 Act.

21/ The Division did not request that official notice be taken of a (continued on following page)

No agency within the Government has a monopoly on talent, ability, or integrity, and if the SBA now lacks the personnel necessary to administer the program successfully, this should be apparent to those who must take remedial steps. I see no reason to doubt adequate administration and under the conditions of exemption which I suggest below with regard to continuation of SEC oversight, I believe that both the protection of investors and the relief required by SBICs from the burdens of dual regulation can be accommodated. 22/

On November 17, 1961, in Investment Company Act Release 3361 the Commission adopted certain rules exempting SBICs from some of the prohibitions of Sections 17(a), 17(d) and 18(c) of the '40 Act, stating, in part:

> "The SBIC program is too recent for the accumulation of any substantial experience which would demonstrate the desirability of complete exemptions in the respects indicated, as has been requested, from these provisions of the Act. However, in view of the public interest to be served as expressed in the Small Business Investment Act of 1958 (SBI Act), the Commission believes it is appropriate for an experimental period to grant exemptions with certain protective conditions. This approach will afford the Commission and all other interested persons an opportunity to examine the operation of SBICs and to reconsider the exemptions if that should appear necessary."

21/ (continued from preceding page)
Senate Committee document reflecting adversely on SBA's administration of the program, and no argument on the contents of the document is in the record. The document is now almost 2 years old, and speaks of still an earlier period. To the extent that it may accurately point out pre-existing deficiencies I believe we must assume that they have been or will be corrected. See Senate Report No. 958, 90th Cong., 2nd Sess., Investigation into Small Business Investment Companies, Report of the Committee on Government Operations, by its Permanent Subcommittee on Investigations.

22/ Counsel for Applicant and SBA also point out that apart from SBA's regulations on conflicts of interest it has other regulations and procedures which serve the purposes of investor protection. These include the audits and examinations conducted by SBA staff. In Matter of First National City Bank, supra, the Commission seems to have placed some measure of reliance on the periodic examinations of national banks by the staff of the Comptroller of the Currency.

Now, eight years later, the Commission with understandable hesitation is evaluating the further relinquishment of control. The Division urges that it would be unwise to relinquish any control, but evidence supporting its negative position is lacking. I do not suggest that further relief from dual regulation is as important to the success of the program as would be a favorable change in business conditions, or that it would be as dramatic as a loosening of the "tight money" situation now disturbing the economy generally and the SBIC program in particular. But given a reasonably favorable business climate and Government cooperation, I believe it would be a meaningful contribution to the program's success.

Although the SBA urges that the Commission relinquish totally its responsibility over SBICs and that all of the requested exemptions be granted unconditionally, a more radical position than that urged by Applicant, I do not find that such grant is either necessary or appropriate in the public interest at this time. It is my opinion that the registered SBICs should be exempted from Section 17 for reasons stated above, subject, however, to the following conditions:

> That for a period of one year,[23/] beginning with the effective date of the exemption under any order issued on the subject application, copies of all applications by registered SBICs for exemption pursuant to SBA

23/ The period of one year should be subject to further extension by order of the Commission issued prior to the expiration of the year, either after hearing ordered by the Commission or by ex parte order, within the sole discretion of the Commission.

Regulation 107.1004(b) or Regulation 107.1301 "Exemptions" shall be furnished for informational purposes to the Commission, and the SBA shall furnish to the Commission, contemporaneously with the issuance thereof, copies of all exemptions issued under said Regulations.

In my view ~~that~~ Applicant also has sustained its burden of proof that exemption is appropriate in the public interest and "consistent with the protection of investors and the purposes fairly intended by the policy and provisions "of the '40 Act with regard to the prohibitions in Section 18(d), and perhaps in Sections 19 and 23, against the issuance of stock options by an investment company. Here, too, I believe that accommodation should be made to the exigencies of the situation.[24/]

The evidence discloses that because of these prohibitions in the '40 Act several registered SBICs have suffered a loss of top management personnel and that several have been unable to attract the competent high-level officials essential to efficient operation. Expertise in such areas as finance and marketing, among others, are essential at the SBIC management level. But defections from employment and disinterest in accepting such employment with registered SBICs have resulted in part from the prohibitions against the issuance of stock options.[25/] With respect to several instances

24/ Cf. The Prudential Insurance Company of America, 41 S.E.C. 335 (1963), at 341-2: "The essential problem presented is the accommodation of two schemes of regulation - insurance and investment company." And at 353: "The Commission is not doctrinaire in providing some flexibility through exemptions."

25/ Some of the departures of high-level personnel from SBICs have followed offers by small business concerns which they have shepherded to success.

specified in the testimony, as well as in other instances not specifically described, I credit the evidence that this disability to compete with non-registered SBICs and with industry generally has been a serious burden to the registered SBICs and hence to the program. Now, perhaps more than ever, because of the monetary situation in the nation an SBIC must keep its funds to the extent that retention is possible, with a "promise" that if and when money becomes more freely available the reward for high calibre management will be forthcoming. One of the promises or inducements to good management in lieu of higher salaries is the stock option.

According to the testimony, some of the SBICs mentioned in fn. 4, page 7, supra, which have withdrawn funds from the SBIC program did so as a result, in part, of their inability to issue stock options. Moreover, an officer of one, Greater Washington Investors, Inc., testified with respect to stock options:

> "If, for example, SBIC's [sic] who are also registered under the 1940 Act would be permitted to grant stock options, we would merge our parent into our subsidiary and operate solely as a SBIC."

Whether this testimony refers to the release of all restrictions on stock options, and whether it reflects more than an ephemeral view of one man while testifying is not clear, but it does reflect the importance of the problem to many persons operating registered SBICs. There is additional credible testimony in the record to the effect that some unregistered SBICs have failed or refused to go public partly because of the restrictions on stock options.

Neither the SBI Act nor SBA regulations prohibit the issuance of stock options and among SBICs only the registered are competitively disadvantaged. I believe that the ability to issue restricted stock options would alleviate the personnel problems of these SBICs and that relaxation of the prohibitions should permit them at least to approach a competitive position with non-public SBICs and with operating companies seeking the same high-level management. The record contains no evidence relating to or reflecting the extent to which non-registered SBICs have issued such options, or the consequences of the issuance of options by such companies or by operating companies in industry.[26/] Nor does it contain evidence or argument by the parties concerning reasonable restrictions which might be imposed upon their issuance by registered SBICs. I view this as a problem which can best be accomplished by meetings and discussions of the parties, so that the views and needs of each can be recognized and a reasonable and practical solution achieved. I make no attempt to spell out more specifically the guidelines or limitations, but believe that the exemption from Commission prohibitions should be conditioned on SBA adoption of permissive regulations acceptable to the Commission and that such accommodation should be reached.

In summary, the relief suggested in this initial decision is designed to enable registered SBICs, which must lend to or invest in securities of small business concerns to whom credit has generally been denied by all conventional sources, to make relatively speedy

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26/ The divergent views on the expediency of a corporation's issuance of stock options are set forth in a host of pamphlets, legal periodicals and texts which it would serve no purpose to discuss. Cf. for example, Henry Ford II, "Stock Options Are in the Public Interest, Harvard Business Review, July-August 1961; and Erwin N. Griswold, "Are Stock Options Getting Out of Hand, Harvard Business Review, November-December 1960.

decisions regarding the problems of their portfolio companies where necessary, by avoiding the complexities of the rules and their administration under Section 17. A small company, as was stated with respect to portfolio companies, "can go down fast, and delay is costly." I believe we must rely upon the judgment of SBIC management and on its ability to act wisely and expeditiously, subject to the administration and the oversight mentioned above. The testimony indicates that the Investment Division of SBA, which has as its sole function the supervision of SBICs, is familiar with the individual SBICs and their problems and can give priority to their applications. There should be no added delay, nor any inhibitive fear that protracted delay might ensue.

I believe, also, that the ability to compete by attracting and retaining competent and knowledgeable management is essential, and that potential gains in the form of restricted stock options with their tax advantages, among others, are a necessary aspect of that ability. Whether reasonably permissive regulations can be worked out to the satisfaction of the Commission, the Applicant and the SBA is not at all certain. In my view, such efforts should be made.[27/]

Exemptions along the lines set forth herein should obviate another costly and protracted chapter in the hearings which have been held by Congressional committees over the years since 1958. Another chapter, it would seem, would produce much the same kind of evidence as was

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27/ Applicant states that on February 20, 1962, it submitted a "Proposed Rule 18d-1 to permit the issuance of 'restricted stock options' and suggests, as an alternative to exemption that the Commission reconsider that proposal."

given in these proceedings.

In other respects I conclude that Applicant has not sustained its burden of proof that exemptions are necessary or appropriate in the public interest. This includes one specific area with respect to which there was substantial testimony, but I am nevertheless not convinced that it is necessary or appropriate in the public interest that an exemption be granted from the restrictions on the issuance of convertible securities as in Section 18 of the '40 Act. Other sections of the '40 Act are either inapplicable or of no regulatory significance to SBICs, as pointed out in the application; or, on the record in these proceedings do not restrict their activities to an extent that justifies consideration of exemptions under Section 6(c) in the public interest.[28/] It is clear, of course, that the coverage of the provisions of all other statutes administered by the Commission, including the anti-fraud sections, the registration requirements, and the insider trading provisions remain in effect, and the '40 Act's reporting requirements for investment companies should afford to the Commission's staff further opportunity for oversight in administering the provisions of those other statutes with regard to registered SBICs.

Rule 16 of the Commission's Rules of Practice requires that an initial decision shall include, apart from the findings and conclusions with reasons therefor and other provisions, "an appropriate order." Because of what I regard a necessary lack of definitiveness at this stage of the proceedings in specifying the exemptions which I deem

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28/ For tax purposes the application, as stated above, does not request exemption from the registration provisions of Sections 8 and 24.

to be "appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of Section 6(c), my order in this initial decision is also lacking in definitiveness. Accordingly,

IT IS ORDERED that the application be and the same hereby is granted and registered SBICs shall be exempt from the provision of the '40 Act to the following extent:

> "From Section 17 and Rules thereunder, provided, however, that for a period of one year 29/ beginning with the effective date of the exemption under any order issued on the subject application, copies of all applications by registered SBICs for exemption pursuant to SBA Regulation 107.1004(b) or Regulation 107.1301 'Exemptions' shall be furnished for informational purposes to the Commission, and the SBA shall furnish to the Commission, contemporaneously with the issuance thereof, copies of all exemptions issued under said Regulations."
>
> "As to Sections 18(d), 19 and 23 and Rules thereunder, to the extent such Sections or Rules or any of them prohibit the issuance by a registered SBIC of stock options to officers or employees, on condition, however, that such exemption shall become effective only upon the adoption by SBA of regulations satisfactory to the Commission with respect to the issuance of restricted stock options."

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of practice.

Pursuant to Rule 17(b) of the Commission's Rules of Practice, a party may file a petition for Commission review of this initial decision within 15 days after service thereof on him. Pursuant to

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29/ See fn. 23, at page 25, supra, regarding Commission extension of this period.

Rule 17(f) this initial decision shall become the final decision of the Commission as to each party who has not, within 15 days after service of this initial decision upon him, filed a petition for review pursuant to Rule 17(b), unless the Commission pursuant to Rule 17(c) takes action to review this initial decision as to a party. If any party timely files a petition for review or if the Commission takes action to review as to a party, this initial decision shall not become final with respect to that party.[30/]

Sidney Ullman
Hearing Examiner

November 28, 1969

30/ All proposed findings and conclusions submitted by counsel for the parties have been considered, as have their respective arguments. To the extent that the proposed findings and conclusions are in accord with the views set forth herein they are accepted, and to the extent that they are inconsistent therewith they are rejected.

MAY 17 1971

(Investment Company Act Release No. 6523) ADMINISTRATIVE PROCEEDING
FILE NO. 3-1825

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.
May 14, 1971

In the Matter of	
THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES 537 Washington Building Washington, D. C.	FINDINGS AND OPINION OF THE COMMISSION
Investment Company Act of 1940 - Section 6(c)	

EXEMPTIONS

Transactions with Affiliates

Convertible Securities

Application by association of licensed small business investment companies, pursuant to Section 6(c) of Investment Company Act of 1940, for exemptions of small business investment companies so as not to require prior Commission approval of transactions with affiliates and so as to permit issuance by such investment companies of convertible securities, denied, the Commission finding that such blanket exemptions would be contrary to statutory scheme and interests of public investors in small business investment companies sought to be protected under Act.

Issuance of Stock Options

Application pursuant to Section 6(c) of Act for exemption so as to permit issuance of stock options by small business investment companies to their officers and employees, granted, subject to conditions for protection of investors.

APPEARANCES:

Sydney H. Mendelsohn and Paul R. Huard, for the Division of Corporate Regulation of the Commission.

Charles M. Noone, for The National Association of Small Business Investment Companies.

Eric W. Weinmann, Jerome Garfinkel and John J. Sharp, for the Small Business Administration.

Merle Thorpe, Jr. and Douglas A. Nadeau, of Hogan & Hartson, for Greater Washington Investors, Inc.

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The National Association of Small Business Investment Companies ("NASBIC"), an association of Small Business Investment Companies ("SBICs") licensed by the Small Business Administration ("SBA") pursuant to the Small Business Investment Act of 1958 ("SBI Act"), applied on behalf of its members, pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act"), for exemption of all SBICs subject to registration under the Act from most of the provisions of the Act. 1/ A number of NASBIC members joined in the application, and the SBA supported it. Following a hearing, the hearing examiner issued an initial decision conditionally granting exemption from the prohibitions of Sections 17(a) and 17(d) against certain dealings between a registered investment company and an affiliated person, and from Sections 18(d), 19 and 23 to the extent that they prohibit the issuance of stock options by a registered investment company to its officers and employees. 2/

The Division of Corporate Regulation ("Division") filed a petition for review, which we granted, with respect to the examiner's grant of the aforesaid exemptions. In addition, NASBIC requested review of the examiner's denial of exemption from the statutory provisions restricting the issuance of convertible securities. Briefs were filed by the Division opposing the grant of any exemptions, by NASBIC and SBA in support of exemptions, and by Greater Washington Investors, Inc. ("GWI"), a registered closed-end investment company, in support of an exemption for stock options, which it requested be made available to all "venture capital" investment companies. 3/ We heard oral argument. Our findings are based upon an independent review of the record.

I

The Statutory Provisions

Section 17(a) of the Act in general prohibits an affiliated person of a registered investment company from selling to or buying from such company any securities or other property, or borrowing from such company money or other property, subject, however, to the provision

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1/ The application recited that NASBIC has 230 active members, of which 29 were registered under the Act as closed-end management investment companies, and estimated that its members account for 80% of the assets currently committed to the SBIC program.

2/ The exemption from Sections 17(a) and 17(d) was subject to the condition that for a period of one year we be furnished copies of applications by SBICs registered with us for exemptions pursuant to SBA regulations and of the exemptive orders issued by SBA. The exemption for stock options was conditioned upon the adoption by SBA of regulations satisfactory to us with respect to the issuance of restricted stock options.

3/ "Venture capital" investment companies, for which special treatment is provided in Section 12(e) of the Act, generally engage in the business of furnishing capital to industry, financing promotional enterprises, and purchasing securities of issuers for which no ready market exists.

in Section 17(b) that upon application we shall exempt any such proposed transaction from such prohibition if evidence establishes that the terms of the proposed transaction are reasonable and fair and do not involve overreaching and the proposed transaction is consistent with the policy of each investment company involved and with the general purposes of the Act. Section 17(d) of the Act and Rule 17d-1 thereunder prohibit such an affiliated person from participating as a principal with such investment company in a joint enterprise or arrangement unless an application regarding such transaction is granted by us. 4/ Subject to the exceptions enumerated therein, Sections 18(d) and 23(a) of the Act prohibit, respectively, a registered management investment company from issuing warrants or rights to purchase its securities 5/ and a registered closed-end investment company from issuing any of its securities for services or for property other than cash or securities. 6/

Section 6(c) is a general exemptive provision under which we may exempt any person or any class of persons from any provision of the Act if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. It was designed to afford us discretionary authority to deal equitably with situations which could not be foreseen at the time the legislation was enacted. 7/ The propriety of granting the relief sought "largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish". 8/ We have noted that the power under Section 6(c) to free any person from any section of the Act is one which must be exercised with circumspection. 9/ The showing

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4/ Rule 17d-1(b) provides that in passing upon such an application, we will consider whether the participation of the investment company in such joint enterprise or arrangement is, among other things, "consistent with the provisions, policies and purposes of the Act."

5/ The convertibility feature of a convertible security has been held to be, in effect, a right to purchase prohibited by Section 18(d). Alleghany Corporation, 37 S.E.C. 424 (1956).

6/ Section 22(g) contains a similar prohibition with respect to a registered open-end investment company. Section 19 deals with the payment of dividends.

7/ The Great American Life Underwriters, Inc., 41 S.E.C. 1, 4 (1960).

8/ Transit Investment Corporation, 28 S.E.C. 10, 15-16 (1948).

9/ The Great American Life Underwriters, Inc., supra, p. 5; Variable Annuity Life Insurance Company of America, Investment Company Act Release No. 4686, p. 4 (August 25, 1966).

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required in order to meet the public interest and related standards set forth in Section 6(c) is that the compliance from which exemption is sought is not necessary to accomplish the Act's objectives and policies. 10/

The SBI Act's prime purpose is to establish a program to stimulate and supplement the flow of private equity capital and long term loan funds to small business concerns and for this purpose SBA is authorized to license and lend money to SBICs which in turn can provide the loans and equity type fundings to small business concerns.11/ The Investment Company Act is not applicable to an SBIC which does not have more than 100 securityholders and which is not making and does not presently propose to make a public offering of its securities,12/ but other SBICs are subject to the Act as closed-end management investment companies.13/

That SBICs may be subject to regulation both under our Act and the SBI Act is not an inadvertent result; Congress was aware of this situation at the time of the passage of the SBI Act in 1958, when it concluded that SBICs with a public investor interest should not be exempted from the basic provisions of the Investment Company Act. 14/ As the hearing examiner noted, as recently as 1967 Congress again recognized that SBICs were subject to regulation both by the SBA and by us and evidenced an intent not to totally exempt SBICs from our supervision and control when it amended the SBI Act to provide that SBA annual reports include information regarding actions undertaken by us to simplify compliance by SBICs with the Act and to eliminate overlapping regulation and jurisdiction. 15/

II

Prohibition Respecting Transactions by Affiliated Persons

In support of the exemption of SBICs from Sections 17(a) and 17(d), it has been stated that dual regulation of such companies by us and the SBA constitutes a serious burden upon and inhibits to a material extent the viability of the SBIC industry, that such exemptions would not result in a reduction of shareholder protection but would merely shift the administrative responsibility for it to the SBA, that SBA regulations appear to afford reasonably adequate protection against potential conflicts of interest, and that the term "public interest" as used in Section 6(c) includes consideration of the Congressional intent to facilitate the formation and growth of SBICs and of the hardship and difficulty incidental to compliance with the Act.

10/ The Trust Fund Sponsored By The Scholarship Club, Inc., Investment Company Act Release No. 5524, p. 5 (October 25, 1968).

11/ See Sections 102, 301 and 303 of the SBI Act (15 U.S.C. 661, 681 and 683).

12/ Section 3(c)(1) of the Act.

13/ As of September 30, 1968, there were 422 SBA licensed SBICs, of which 44 were also registered as investment companies under the Act and accounted for about 40% of the assets of all SBICs.

14/ The SBI Act amended the Investment Company Act only by adding Section 18(k), providing that certain asset coverage conditions in Section 18(a)(1) on the issuance of senior securities not be applicable to investment companies operating under the SBI Act.

15/ 15 U.S.C. 687(g)(2)(H) and (J).

Section 17, sometimes referred to as the "self-dealing" section, is intended, in general, to prevent abuses and unfair transactions by insiders of investment companies by requiring prior independent scrutiny by this Commission for the protection of investors of transactions with investment companies by officers, directors and similar persons associated with such companies. 16/ As such the Section is a keystone in the statutory scheme enacted for the protection of investors and implements the Congressional declaration in Section 1(b) that it is the policy and purpose of the Act to prevent the operation of investment companies in the interest of affiliated persons rather than in the interest of all securityholders. It is true, as pointed out by the hearing examiner, that the SBA has adopted certain regulations designed to protect SBICs and their shareholders against conflicts of interest. 17/ As the examiner noted, however, the SBA regulations have a coverage narrower than that of Section 17 and our rules thereunder. 18/ In declining to remove SBICs from the purview of the Investment Company Act, Congress indicated that it did not wish to reduce the protection given public SBIC securityholders. The primary concern under the Investment Company Act for the protection of public investors is at least as important in the case of SBICs which are engaged in the speculative activity of financing small enterprises 19/ as it is in other types of investment companies. Although the SBI Act now also concerns itself with the protection of SBIC shareholders, its primary thrust, of course, is to encourage the formation and growth of SBICs through financing assistance.

While compliance with the Investment Company Act does entail some increased costs and inconvenience to registered SBICs, or any other type of investment company, such consequence is a necessary incident to regulatory oversight and is not of itself a justification for a blanket exemption from this or any other section of the Act for an entire industry. We have by rule granted to SBICs two specific exemptions from Sections 17(a) and 17(d) in recognition of particular problems incident to SBIC activities. One such exemption covers situations where a registered SBIC invests in a small business concern, which by virtue of that very transaction becomes an affiliate of the SBIC. Under Section 17(a) any additional investment in the concern by the SBIC would require an application for our prior approval. Rule 17a-6 was adopted to eliminate this requirement by providing an

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16/ Transit Investment Corporation, 28 S.E.C. 10, 16 (1948).

17/ 13 CFR 107.1004 and 1005.

18/ For example, SBA Regulation 13 CFR 107.3 defines an "associate" to include a person who owns or controls 10% or more of any class of stock of an SBIC, while under Section 2(a)(3) of the Act the comparable test is 5% of the outstanding voting securities.

19/ The underlying investments of SBICs are generally made on a long term basis in unregistered and unmarketable securities of speculative companies. SBA Regulations, 13 CFR 107.301, require generally that SBICs finance small business concerns for a minimum period of five years.

exemption for any transaction between an SBIC and such portfolio company except where an officer, director or other person having a specified relationship to the SBIC is also a party to such transaction or has a financial interest in the portfolio company. The second exemption covers instances where a bank becomes an investor in an SBIC and an affiliate of the SBIC. As an affiliate, the bank was prohibited from participating in a joint enterprise or arrangement by making an investment in a small business concern in which the bank-affiliated SBIC made an investment without first filing an application for and receiving approval of such transaction under Rule 17d-1(a). Rule 17d-1(d)(3) was adopted to eliminate the requirement of such a prior application and substituted a requirement that an information report be submitted subsequent to the investment. 20/

The adoption of these rules, which in the areas covered enable SBICs to avoid the application procedure, has considerably minimized the impact of Sections 17(a) and 17(d) on the normal operations of SBICs. The SBA also has taken action to minimize the impact of dual regulation under these Sections and under the SBA regulations. 21/

The failure of Congress in 1961 to act on certain proposals for limited statutory exemptions of SBICs from Sections 17(a) and 17(d) might be attributed to statements made by a former Commission Chairman that the Commission was seeking to deal with the same areas with which those proposals dealt through the adoption of rules, and as we have shown above, amendments to our rules were in fact issued to provide exemptions in those areas. However, at no time did Commission officials represent that the exemption power under Section 6(c) would be used to exempt SBICs except in accordance with the standards and conditions of that Section. After consideration of all the circumstances, we conclude that the grant in this case to all registered SBICs of a blanket exemption from the self-dealing requirements of Sections 17(a) and 17(d) would not constitute an appropriate exercise of our discretion to grant exemptions under Section 6(c). 22/

III

Issuance of Stock Options

The examiner was of the view that registered SBICs should be allowed to issue stock options to officers and employees, subject to the adoption by SBA of regulations acceptable to this Commission with

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20/ See Form N-17D-1, prescribed by Rule 17d-2 as the form for reports required by Rule 17d-1(d)(3).

21/ SBA's Regulation 13 CFR 107.1004(e) provides that a registered SBIC which has been granted an exemption by this Commission under the Act or rules, for a transaction which would otherwise be subject to certain SBA prohibitions against conflicts of interest, shall be exempt from SBA's prohibitions, provided, however, that it report our action to the SBA and give public notice thereof.

22/ The cases of First National City Bank, Investment Company Act Release No. 4538 (March 9, 1969) and Ampal-American Palestine Trading Corporation, 25 S.E.C. 24 (1947), cited in support of the requested exemptions, do not aid applicants. Aside from the fact

(CONTINUED)

respect to the issuance of restricted stock options. 23/ In support of that exemption, it is asserted that stock options are a widely used form of executive compensation, and that the inability of registered SBICs to offer such options has placed them at a competitive disadvantage in the personnel market and was responsible in part for their inability in certain instances to attract and retain high level officials, and constituted a serious burden upon registered SBICs. While the SBI Act does not bar the issuance of stock options by SBICs, 24/ the Investment Company Act, as noted above, contains various provisions prohibiting registered investment companies from issuing stock options or from issuing any securities except for cash or securities. 25/

In our opinion a conditional limited exemption to permit the issuance by registered SBICs of "qualified" stock options under the Internal Revenue Code and subject to the adoption of SBA regulations satisfactory to us imposing appropriate limitations on SBIC employee stock option plans, would not offend the policies and purposes of the Act. 26/

It cannot be disputed that stock options are today extensively employed as an element in management compensation, and we see no basis in the record for disagreeing with the SBA's view that the ability to issue such options would assist in alleviating personnel problems. The adverse factors which have been stated as resulting from the issuance of options are not in our opinion persuasive in the case of SBICs. The potential dilution of equity and voting power inherent in options is applicable to operating as well as investment companies, and has not prevented the use of options in companies outside the purview of the Act. And the assertions that stock options tend to encourage speculative portfolio investments and to introduce complexity and uncertainty into the capital structure are not peculiarly applicable to SBICs. Unlike investment companies generally, SBICs normally make, and indeed are designed to make, investments on a long

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22 Continued/

that each of these cases involved an application for exemption by one applicant, the fact situations are so different as to be clearly distinguishable from the instant application.

23/ Restricted stock options which qualify under Section 422 of the Internal Revenue Code of 1954 as amended are entitled to certain special tax treatment.

24/ SBA Regulations, 13 CFR 107.805, permit licensed SBICs to issue stock options to management and employees for, among other things, "services previously rendered to the Licensee not to exceed fair value thereof."

25/ See, e.g., Sections 18(d), 23(a) and 22(g).

26/ We agree with the Division that GWI's request to extend any exemption to all venture capital investment companies is not properly an issue in this case, having been belatedly raised by GWI in the brief which it filed after we granted the limited review of the initial decision requested by the Division.

term basis in unmarketable securities of marginal companies and their own securities are not sold on the basis of net asset value.

Moreover, we note that the restrictions placed on "qualified" options under Section 422 of the Internal Revenue Code contain a number of safeguards. In general options are qualified under the Code only if they are issued to employees pursuant to a plan, approved by the stockholders, which sets forth the aggregate number of shares which may be issued under options and the employees eligible to receive them, and such options may not be transferable, and may not be exercisable after five years, their option price must be at least 100% of the fair market value of the shares at the time the option is granted, and the recipient may not own more than 10% of the voting power or value of all stock and may not resell his shares within three years of their acquisition. In any event, such further safeguards as may seem necessary for the protection of investors in SBICs would be provided through regulations to be adopted by SBA with respect to the issuance of options. We note that the brief of the SBA in this proceeding states there is no reason to doubt that our staff and the SBA staff can accommodate our requirements in this area. 27/

IV

Restrictions on Convertible Securities

The hearing examiner concluded that no showing had been made that it was necessary or appropriate in the public interest that an exemption be granted from the restrictions on the issuance of convertible securities. In its reply to the Division's brief on review, NASBIC requested review of the denial of an application for exemption to permit the issuance of convertible securities and, in support of such exemption, asserted that SBICs had encountered difficulties in seeking to make offerings of securities because of the restrictions on such issuances. The Division opposes NASBIC's request on the merits and also contends that the issue concerning convertible securities was not brought up for review and is therefore not properly before us.

While it would appear that review of the issue as to convertible securities was not sought in compliance with our Rules of Practice, in any event, we see no basis for disagreeing with the hearing examiner's conclusion that no showing has been made that it is necessary or appropriate in the public interest under the standards of Section 6(c) of the Act to grant this exemption.

27/ We recognize that in 1961 Commission representatives opposed a proposed statutory amendment which would have permitted registered SBICs to issue stock options, and that Congress failed to enact such proposal into law. It does not follow from such failure to provide general statutory authorization for stock options that Congress was opposed to the exercise of the Commission's exemptive powers under Section 6(c) to permit such options under appropriate conditions. In fact, in an earlier report of the Senate Select Committee on Small Business, on review of the operations of the SBI Act, that Committee recommended that the Commission permit the use of restricted stock options by SBICs. Senate Report No. 1293, 86th Cong. 2d Sess., page 17 (1960).

Accordingly, an order will issue providing for a conditional exemption to permit the issuance of stock options by SBICs, and denying the other requested exemptions.

By the Commission (Chairman CASEY and Commissioners OWENS, SMITH, NEEDHAM and HERLONG), with Commissioners OWENS and HERLONG dissenting from Part III of the opinion relating to stock options in a separate statement, and Commissioners SMITH and NEEDHAM dissenting from Part II of the opinion relating to transactions with affiliates in a separate statement.

Theodore L. Humes

Theodore L. Humes
Associate Secretary

Commissioners OWENS and HERLONG, concurring in part and dissenting in part:

We join in the views expressed in the Commission's opinion other than those in Part III granting SBICs exemption from the statutory prohibition relating to the issuance of stock options. We believe that such exemption is inconsistent with the purposes and policies of the Act, which as noted in the Commission's opinion contains various provisions prohibiting registered investment companies from issuing stock options or from issuing any securities except for cash or securities. 1/ The Commission has previously considered that the issuance of stock options by registered investment companies entails various consequences militating against the interests of investors which the Act seeks to protect, and also runs counter to the policy of the Act to prevent favored treatment to insiders as against securityholders as a whole. Among other factors, such options create a potential dilution of the equity and voting power, tend to encourage speculative portfolio investments, introduce complexity and uncertainty into the capital structure, and may impede future efforts to raise additional capital. For all of these reasons the Commission has consistently refused to permit issuance of stock options by registered investment companies. In doing so, it has concluded that the restrictions placed on stock options qualifying under Section 422 of the Code do not eliminate the dangers of harm to stockholders at which the Act is directed and are not sufficient to overcome the mandate manifest in the various provisions of the Act to keep the capital structure of an investment company free of such securities. 2/

With specific reference to SBICs, the Commission has stated these views to Congressional Committees in hearings on bills which would have permitted publicly held SBICs to issue restricted stock options, and such provisions were never adopted. 3/ In view of the failure of

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1/ See e.g., Sections 18(d), 23(a) and 22(g).

2/ See State Bond & Mortgage Company, Investment Company Act Release No. 4685 (August 25, 1966); Variable Annuity Life Insurance Company of America, Investment Company Act Release No. 4684 (August 25, 1966).

3/ See Hearings on S. 902, before a Subcommittee of the Senate Committee on Banking and Currency, 87th Cong., 1st Sess., pp. 115-117 (1961); Hearings on H.R. 6672, before Subcommittee No. 2 of the House Committee on Banking and Currency, 87th Cong., 1st Sess., pp. 82-84 (1961).

Congress to act on the proposals for legislative authorization, it would not seem appropriate for the Commission to grant such exemption by administrative action.

While we recognize that SBICs may differ in certain respects from certain other types of investment companies, particularly with respect to the pricing of securities and the nature of operations and investments, we do not consider that such differences affect the overall considerations set forth above. Again, as in the case of the requested exemption from Section 17, which the Commission has in this case denied, it is clear that while SBICs, as any other group of investment companies, would be relieved of various requirements if they were not subject to regulation under the Act, that fact in itself is not a sufficient basis for an exemption. We see no reason why it is more essential for registered SBICs to be able to issue stock options than for some other registered investment companies. Whatever benefits may be derived from the ability to issue options in terms of providing inducements to attract and retain management personnel, such benefits are outweighed by the potential abuses to which such options are subject and the Congressional policy against their use in the investment company field.

Commissioners SMITH and NEEDHAM, concurring in part and dissenting in part:

We join in the Commission's opinion except for Part II, which rejects an exemption of SBICs from the prohibitions of Sections 17(a) and 17(d) relating to transactions with affiliates. We are unable to conclude that the purposes and policies of the Act would be offended by conditionally granting such exemption. We would exempt an SBIC from those Sections with respect to any transaction for which an exemption is granted by the SBA under its conflict of interest regulations, subject to the conditions that the SBA regulations are amended so that "associate" is defined therein as broadly as its counterpart, affiliate, is defined under the Act, and that for a period of two years copies of applications by registered SBICs for exemptions pursuant to SBA regulations and of the exemptive orders issued by it be furnished to us.

In our opinion the term public interest, as used in Section 6(c) of the Act, includes consideration of any hardship and difficulty incidental to compliance with the Act and of the Congressional intent to facilitate the formation and growth of SBICs. The exemptions we would grant are consistent with and reflect the intention of Congress that dual regulation be eliminated by us within the standards and limitations of Section 6(c). 1/ We believe that with the adoption of a broader definition of the term "associate" SBA regulations would afford SBIC shareholders reasonably adequate protection against potential conflicts of interest. Although SBA is concerned with encouraging the formation and growth of SBICs primarily through financing assistance, we would assume that it would also effectively supervise and regulate SBICs in a manner consistent with the protection of investors that is provided by us under the Act entrusted to our administration. In any event, the two-year reporting requirement that we would attach would afford the Commission an opportunity to examine exemptions granted by SBA and reconsider the question of exemption from our Act if that should appear necessary.

1/ As noted in the Commission's opinion, Congress directed as recently as 1967 that SBA annual reports include information regarding actions undertaken by the Commission to simplify compliance by SBICs with the Act and to eliminate overlapping regulation and jurisdiction.

ADMINISTRATIVE PROCEEDING
FILE NO. 3-1825

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
May 14, 1971

In the Matter of	
THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES 537 Washington Building Washington, D. C.	ORDER GRANTING CONDITIONAL EXEMPTION, DENYING OTHER EXEMPTIONS, AND DECLARING INITIAL DECISION EFFECTIVE IN PART
Investment Company Act of 1940 - Section 6(c)	

The National Association of Small Business Investment Companies, an association of Small Business Investment Companies licensed by the Small Business Administration ("SBICs"), applied pursuant to Section 6(c) of the Investment Company Act of 1940, for exemption of SBICs from various provisions of the Act. Following a hearing, the hearing examiner filed an initial decision in which he conditionally granted exemptions from Sections 17(a) and 17(d) prohibiting an affiliated person from engaging in certain dealings with an investment company and from Sections 18(d), 19 and 23 to the extent said Sections prohibit the issuance of stock options to officers and employees, and denied all other requests. The Division of Corporate Regulation of the Commission filed a petition for review, which was granted by the Commission, with respect to the hearing examiner's grant of exemptions. The Association requested review of the examiner's denial of exemption from the statutory restrictions respecting the issuance of convertible securities and Greater Washington Investors, Inc. requested that the exemption respecting the issuance of stock options be extended to all registered venture capital investment companies. Briefs in opposition to the grant of any exemptions were filed by the Division, briefs in support of exemptions for SBICs were filed by the Association and the Small Business Administration, and oral argument was presented to the Commission.

The Commission having this day issued its Findings and Opinion, on the basis of said findings and opinion;

IT IS ORDERED that the requests for exemptions from Sections 17(a), 17(d), 18, 19 and 23 of the Investment Company Act of 1940 to the extent the aforesaid provisions prohibit certain dealings by an affiliated person and the issuance of convertible securities be, and they hereby are, denied.

IT IS FURTHER ORDERED that the request for an exemption from Sections 18, 19 and 23 of the Act to permit the issuance by registered Small Business Investment Companies of stock options to officers and employees be, and it hereby is, granted, subject to the condition that the exemption be limited to such options as qualify under Section 422 of the Internal Revenue Code as amended, and to the further condition that such exemption not be effective until notice is given of the adoption by the Small Business Administration of regulations satisfactory to this Commission with respect to the issuance of qualified options by Small Business Investment Companies.

FURTHER, the initial decision of the hearing examiner with respect to the requests for exemptions from other provisions of the Investment Company Act is hereby declared final and effective.

By the Commission. Theodore L. Humes

Theodore L. Humes
Associate Secretary

ADMINISTRATIVE PROCEEDING
FILE No. 3-1825

UNITED STATES OF AMERICA
Before The
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :	
THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ET AL. :	REPLY BRIEF OF THE SMALL BUSINESS ADMINISTRATION
(812-2297) :	
Investment Company Act of 1940 :	

This Reply Brief is directed to matters raised in the Proposed Findings of Fact, Conclusions of Law and Brief in Support thereof (Proposed Findings), of the Division of Corporate Regulation (Division), filed with the Commission on July 7, 1969. The main arguments of the Small Business Administration (SBA) are contained in its Proposed Findings of Fact and Conclusions of Law and Supporting Brief (Proposed Findings), previously filed on July 7, 1969.

I. PRELIMINARY STATEMENT

While the Division's Proposed Findings do not spell out with particular clarity the arguments against the granting of NASBIC's application for an exemption, it appears to SBA that the Division's contentions may be categorized as follows:

A. The evidence in the record does not support a finding that the standards for an exemption under Section 6(c) of the Act have been met;

B. Granting of the exemption would be contrary to the legislative history of Section 6(c) of the Act and would thwart the express policies of Congress;

C. The SBI Act and the Regulations promulgated thereunder do not afford the same quality of protection to the investor as do the Commission's Act and Rules;

D. If granted, the exemption should not apply retroactively;

E. Granting of the exemption may eliminate the favorable tax status for SBICs, which was not contemplated by NASBIC's application.

These contentions are not supported by the record and should be rejected by the Hearing Examiner. This Reply Brief will respond to the salient points of the Division's arguments.

II. EVIDENCE TO SUPPORT A FINDING THAT THE STANDARDS FOR AN EXEMPTION HAVE BEEN MET

The Division, on page 6 of its Proposed Findings, contends that the "record as a whole contains no evidence that regulation by the two agencies over SBICs is burdensome other than the unsupported testimony of some witnesses . . ." In support of this erroneous proposition, the Division cites various NASBIC

exhibits relating to the prepared written statements of certain witnesses. In addition, on page 23 of its Proposed Findings, the Division contends that the record does not support a finding that investors are adequately protected by the SBI Act and the Regulations promulgated thereunder. The Division's support for this position rests mainly on some false notion that several witnesses for NASBIC did not know what was meant by investor protection.

SBA submits that the record is replete with testimony of witnesses that dual regulation is burdensome and does impede the SBICs in accomplishing their statutory goal of aiding small business concerns. This testimony is set forth in detail on pages 4 through 10 of SBA's Proposed Findings. More specifically, testimony was given, revealing where dual regulation prevented SBICs from making quick decisions on questions requiring immediate answers [Tr. pp. 75-76, 247-250, 275-277]. Witnesses orally testified that dual regulation had caused SBICs to abandon opportunities for investment [Tr. pp. 30-34]. Further, testimony was given that compliance with dual regulation is time-consuming, expensive, and frustrating [Tr. pp. 15-16, 74, 102, 466-477]. Moreover, oral testimony was given to the effect that people engaged in the venture capital field have refused to enter the SBIC industry because of dual regulation [Tr. pp. 105, 108, 150-152].

As clearly shown above, and contrary to what the Division would have the Hearing Examiner believe, SBA's arguments regarding

dual regulation are not dependent on the prepared written statements of certain witnesses. On the contrary, these arguments are primarily supported by the uncontroverted oral testimony given by witnesses during cross-examination by Division Counsel. Furthermore, the testimony was given by witnesses who have expert knowledge of the SBIC program. And, as the Supreme Court has said, the uncontroverted testimony of experts concerning conditions within their fields of endeavor must be accepted. International Shoe Co. v. Federal Trade Commission, 280 U.S. 291 (1930).

As in the case of dual regulation, the Division's argument concerning evidence on investor protection must also fall, since it is without merit.

The Division states that several witnesses who gave testimony on the subject did not know what was meant by "investor protection." [See page 23 of the Division's Proposed Findings.] The cross-examination by Division Counsel on this subject was obviously intended to confuse the witnesses; since it is clear that they could not testify as to what the Act specifically meant by the term "investor protection." They could only testify as to what they, as experts in the SBIC field, thought was encompassed by such term. Their testimony on the subject is clear. Their answers fully support the proposition that the SBI Act and the Regulations promulgated thereunder adequately provide investor protection to the stockholders of SBICs. In this connection,

Mr. David Engelson, president of the First Connecticut Small Business Investment Company, testified as follows on pages 379 and 380 of the Transcript:

* * *

"Q. Now, based on your approximately eight years of experience with the SBIC program, do you have an opinion as to whether the Small Business Administration Regulations and Act protect the investors of a Small Business Investment Company?

* * *

"A. Well I feel that we're audited annually by a staff. We have generally two or three men that come down from the audit staff of S.B.A. and spend at least a week in our office because of a volume of loans and investments we have. And I think they do a very thorough job seeing to it that we comply with the S.B.A. Rules and Regulations. There are many parts of the S.B.A. Regulations which I think control the destinies of the company and so for that reason I would think protect stockholders.

"Q. Can you indicate what particular regulations you are aware of that would influence the question of whether an investor of an SBIC would be protected giving an example? Is there a conflict of interest regulation?

"A. Yes, sir.

"Q. Does that play a role in terms of investor protection?

"A. Yes, sir. There are cross-dealing prohibitions and size limitation prohibitions. There are many controlling factors that S.B.A. has in their regulation.

"EXAMINER ULLMAN: Have you had occasion to have them criticize your company for any violation of those regulations that you have just mentioned?

"THE WITNESS: We have had only very minor technical comments as a result of their audits. There was one situation where we had made a loan to a person who was connected with another SBIC, but they asked us to divest and we did so. There was no--I don't know how--back scratching is the word,

pardon the expression. But there was not a conflict there. There was no conflict, but in order to satisfy that we complied. But that was the only [sic] out of the 10 years that we have been in business.

"EXAMINER ULIMAN: When did this occur?

"THE WITNESS: About three years ago."

Mr. John Laslie, vice-president of Delta Capital Corporation, testified on page 421 of the Transcript:

* * *

"Q. One final question. Do you have an opinion with respect to S.B.A.'s ability to protect the interest of the investors in Delta Capital Corporation under the 1958 Act and its regulations governing SBIC's?

* * *

"THE WITNESS: Well, insofar as the S.B.A., they have definite regulations that I would say protect the shareholder. For instance, the limit on the loan, diversification of the loan, the request for diversification. This is a protection for the shareholder, an economic protection for the shareholder. I think there are rules against overreaching and self-dealing for the protection of the shareholder. It may incidentally protect S.B.A. as a creditor, but I think the reverse side of the coin is true that our shareholders are not creditors of the corporation but they and S.B.A. have a like kind of thought here. Therefore I do think they protect certainly in those areas."

The Division's discussion concerning SBA's failure to present evidence as to how the SBI Act or Regulations promulgated thereunder protect investors is specious. It is self-evident that the contents of the SBI Act and said Agency's Regulations are public documents of which official notice must be taken. Under

such circumstances, there is no need for SBA to call witnesses to testify as to their contents. Moreover, if such witnesses were called, their testimony on the subject could properly be challenged, since the documents speak for themselves.

The conclusion is inescapable that the record supports a finding that the standards for an exemption under Section 6(c) of the Act have been met. [See also pp. 40-41 of SBA's Proposed Findings.] It is respectfully submitted that the Division's Proposed Findings relating to insufficiency of evidence should be rejected.

III. WHETHER GRANTING THE EXEMPTION WOULD BE CONTRARY TO THE LEGISLATIVE HISTORY OF SECTION 6(c) OF THE ACT AND THWART THE POLICIES OF CONGRESS

The Division contends on page 21 of its Proposed Findings that "the success of the SBIC program is not a factor to be considered by the Commission in weighing an application for exemption under Section 6(c)." Such a theory is not only unsupportable by legal authority, it is indefensible as a matter of national policy. Adoption of such a view will inevitably cause a clash between the two Congressional policies which will reverberate adversely against the two Agencies. More importantly, however, this novel principle, if accepted, may result in further restrictions in the flow of funds to the small business sector of the economy, which is already suffering from a tight money market. Such a result could possibly

jeopardize the minority enterprise policy of the Government. Ultimately, the mandate of Congress to foster small businesses could be nullified.

The Division's premise even "flies in the face" of statements made by Mr. Edward Gadsby, the former Chairman of the Commission, who is relied upon by the Division as support for some of its other conclusions. In this regard, Mr. Gadsby, in a briefing on the Act before the American Management Association on December 1, 1958, stated:

> "Before I address myself specifically to small-business investment companies, it may be appropriate to consider generally the responsibilities of the Commission in the area of public financing. In the administration of the powers and responsibilities vested in it by these statutes [Securities Act of 1933 and Investment Company Act], the Commission is guided by two more or less overlapping standards, that of the public interest and that of the protection of investors. I say two standards, since the term 'public interest' includes more than concern for the protection of investors, as such. It requires the Commission to look beyond these immediate interests and to take into consideration the welfare of the economy as a whole. Thus, while it is looking to the protection of prospective investors in dealing with small-business investment companies, it must be careful not to erect such burdensome requirements as to hamper the raising of capital needed by these companies to perform their function of providing funds for small business." [Emphasis added.] 1/

1/ Briefing on the Investment Act, Committee Print, Senate Committee on Banking and Currency and Senate Select Committee on Small Business, 85th Cong., 2d Sess., p. 21 (1958)

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It is the contention of SBA that the respective statutes of the two Agencies must be harmonized so that the Congressional objectives can be achieved. In this connection, we must evaluate the relative differences between the SBI Act and the Regulations promulgated thereunder, and the Investment Company Act of 1940 and the Rules promulgated thereunder, and determine whether the differences are sufficiently great to preclude the granting of an exemption which SBA believes will foster the flow of private funds to the small business sector. This evaluation will be the subject of a later discussion herein.

The Division cites the American Participations case as standing for the proposition that the Commission will not grant an exemption from the Act, based upon a mere showing that it is financially difficult to comply with the Act. 2/ There is no quarrel with this holding, but it has no bearing upon the issues in this matter. The main issue in the present case is not the financial aspects of complying with the Act; rather, dual regulation and the inability to issue stock options, convertible debentures and warrants have impeded and hindered the SBICs from accomplishing their goal as established by Congress.

SBA submits that the granting of the requested relief would not leave a void with respect to investor protection. The

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2/ In the Matter of American Participations, Inc., 10 S.E.C. 430 (1940)

SBICs would still be subject to the provisions of the SBI Act and Regulations thereunder, and they provide substantial protection to the investor. 3/

Nor is there anything in the legislative history of Section 6(c) which indicates a congressional intent that its application be limited as to the sections of the Act from which an exemption may be granted. 4/

Furthermore, the Commission, by its many decisions and statements, has always adhered to the view that the provisions of Section 6(c) are properly applicable to SBICs. For example, on December 1, 1958, Chairman Gadsby appeared before the American Management Association and stated:

> "I would like to point out that, what with the exemptive powers granted . . . by Section 6(c) of the Investment Company Act . . . the SEC is given authority to apply with very great elasticity its regulation in the field opened up by the Small Business Investment Act." 5/

3/ For the details of such investor protection, see pp. 35-38 of SBA's Proposed Findings.

4/ In The Matter of Transit Investment Corp., 28 SEC 10, 14, 15 (1948). See SBA Proposed Findings, p. 27

5/ Briefing on the Investment Act, Committee Print, Senate Committee on Banking and Currency and Senate Select Committee on Small Business, 85th Cong., 2d Sess., p. 29 (1958)

This view was again stated to Congress by the then Commissioner Cary before the House Banking and Currency Committee in 1961:

> "In any event, if a particular occasion should arise in which it can be demonstrated that it is necessary and appropriate in the public interest and consistent with the protection of investors and the purposes of the Investment Company Act to grant an investment banker an exemption from the provisions of Section 30(f), the Commission has the power to grant such an exemption, either conditionally or unconditionally, under section 6(c) of the act." 6/

The Division further contends that the question of eliminating SBICs from the provisions of the Act has been before Congress on numerous occasions, and that in each instance, Congress has failed to enact an amendment eliminating SBICs from its basic provisions. The arguments presented by the Division are misleading for it fails to point out that in some cases Congress relied on statements of the Commissioners that the Commission was working toward solving the difficulties arising from being regulated by the Act. In this regard, a Senate Report stated:

> ". . . Also there was testimony to the effect that those SBICs which fall under the purview of the Investment Company Act of 1940 are hampered in their operations by some of the restrictive provisions of the 1940 act. The Chairman of the Securities and Exchange Commission reported that all but one of the recommendations for amendments to the Investment Company Act of 1940 are being handled by changes in SEC regulations.

6/ Hearings, Subcommittee No. 2, House Committee on Banking and Currency, 87th Cong., 1st Sess., p. 86 (1961).

> The other, an amendment to section 30(f) of the 1940 act dealing with insider trading, can be handled on an individual exemptive basis by the Securities and Exchange Commission. Under these circumstances, amendments to the Act appear unnecessary. However, the committee expects the Securities and Exchange Commission to issue these regulations promptly and to act promptly on requests from SBIC's for exemption under 30(f) of the 1940 act." (Emphasis added) 7/

In another situation, Congress relied on the testimony of SBA's Administrator that he wanted further time to explore the question of stock options. 8/

Another unsupportable proposition contained in the Division's Proposed Findings is that the granting of the requested exemption would thwart the express policies of Congress. This proposition is fallacious.

Congress has been aware of the problem of dual regulation of the SBIC industry for a number of years and has clearly expressed the view that such should be eliminated to the greatest possible extent. Thus, in 1967, Congress enacted an amendment to Section 308(g)(2) of the SBI Act (15 U.S.C. 686(g)(2)) by providing in subparagraph H that

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7/ Report, No. 801, Senate Committee on Banking and Currency, 87th Cong., 1st Sess., p. 3 (August 28, 1961)

8/ Hearings, Subcommittee of Senate Committee on Banking and Currency, 87th Cong., 1st Sess., p. 17 (1961)

the Commission provide a report, enumerating action undertaken "to eliminate overlapping regulation and jurisdiction" [Emphasis added] as between the Commission and the SBA. Such provision clearly encompasses the intent of Congress to eliminate not only dual regulation but dual jurisdiction as well.

The congressional mandate that dual regulation be eliminated was further expressed at a later date in a House Report. On December 23, 1968, the House Select Committee on Small Business stated:

> "The SBIC exemption from regulation by SEC under provisions of the Investment Company Act of 1940 should be favorably considered, and the SBA should assume full responsibility for regulating the industry in this regard." 9/

Based upon the foregoing, SBA urges that the Hearing Examiner find that the granting of the requested exemption is in accord with the legislative history of Section 6(c) of the Act and would not thwart the express policies of Congress.

IV. WHETHER THE RELATIVE DIFFERENCES BETWEEN THE TWO AGENCIES' ACTS AND REGULATIONS BAR THE GRANTING OF THE EXEMPTION

A further issue raised by the Division is that the granting of the exemption would deprive investors in SBICs of certain basic protections not included within the SBI Act and the Regulations promulgated thereunder. In support of its position, the Division cited certain basic differences between the Acts of the two Agencies. Based on these

9/ H.R. Report No. 1979, 90th Cong., 2d Sess., p. 58 (1968)

differences, the Division has urged that the Hearing Examiner deny the request for an exemption [See pp. 25-30 of the Division's Proposed Findings].

SBA submits that a careful analysis of both Acts and the Rules and Regulations promulgated thereunder fully supports its view that the differences are differences without distinction; that the granting of a complete exemption from the Act would be in harmony with the dual objectives of Congress, viz., the funneling of private funds to small business concerns and at the same time provide the necessary protection to SBIC shareholders.

The Division argues that Sections 10 and 19 of the Act have no comparable counterparts under the SBI Act and Regulations thereunder. With respect to the SBICs, such Sections are not required for investor protection because of the basic differences in the nature of SBICs and the typical mutual fund. Section 10 of the Act concerns, inter alia, the prohibitions with respect to the affiliations of directors of the investment adviser and the mutual fund. Such a prohibition is not applicable to an SBIC because the SBIC normally is internally managed, as opposed to the typical mutual fund which utilizes investment advice and management from investment advisers.[10/] Section 19 of the Act concerns, inter alia, disclosures required when an investment company makes a cash distribution to its shareholders. The great majority of SBICs are indebted to SBA and are prohibited from making any cash

10/ For a detailed discussion concerning the differences in the nature of SBICs and mutual funds, see pp. 24-26 of SBA's Proposed Findings.

distribution to their shareholders except out of retained earnings.

The Division further contends that Section 13(a) of the Act and Section 107.1105(a) of SBA's Regulations are not compatible in that, under the Act, stockholders' approval is required for a change in investment policy while, under SBA Regulations, only post-approval from SBA is required. This, it is contended, deprives the stockholder of greater participation in the affairs of management. This again demonstrates a basic difference between SBICs and typical investment companies. SBICs are a regulated industry and are, by the SBI Act, limited to providing financing to a single segment of the economy, i.e., small business concerns. Further, SBICs are required to maintain a diversified investment policy [Section 107.101(c) of the Regulations]. Thus, not requiring stockholders' approval for a change in investment policy within this very narrow area of permissible change of investment policy does not substantially subtract from any investor protection.

The Division further contends that Section 16(a) of the Act and Section 301(c) of the SBI Act, and Section 107.1105 of SBA's Regulations are not compatible in that, under the Act, members of the board of an investment company must be elected by the stockholders, while under the SBI Act and Regulations, notification of any change in directors must be reported to SBA for post-approval. This, it is argued, gives rise to possible situations wherein directors could quickly turn control over to a new board, and such action could operate to the detriment of shareholders.

This argument is thoroughly unsupportable and shows a complete lack of knowledge as to the workings of the SBIC program. SBA requires that SBICs report all changes of directors, and SBA must give its approval to such changes and can institute appropriate action in the event that such is necessary to prevent any possibility of investor protection being harmed. Further, SBICs are incorporated under appropriate State laws and such laws govern the manner of election of directors. If such laws are not followed, the stockholders can institute appropriate action. The approval of directors by SBA is an additional safeguard for investor protection by taking into consideration the general business reputation and character of directors. It is submitted that SBA has available to it more information concerning a director upon which to make decisions than would be available to stockholders.

The Division observes that the Act provides any contract made in violation thereof is void and that the SBI Act and Regulations thereunder do not contain such a provision. Further, that the investor is given an opportunity to bring a shareholder derivative action to void such contract. It is submitted that the foregoing is not required for investor protection with respect to SBICs. Under the SBI Act and Regulations thereunder, SBA has the authority to institute appropriate action against an SBIC in the event there is a violation of such Act and Regulation.

The Division states that Congress intended the Commission to regulate conflicts of interest transactions, and that while SBA

Regulations encompass some of the prohibitions of Section 17(a) of the Act, they do not include material areas of that section.

This argument, in effect, goes to the form and not to the substance of SBA Regulations. Granted there are some language differences between Section 17(a) of the Act and Sections 107.1004 and 107.1005 of SBA Regulations; in actual substance, however, they are basically the same and provide substantial investor protection. The main differences that exist are due to the basic differences between an SBIC and the typical mutual fund. It would serve no useful purpose for SBA to adopt, in total, all of the provisions of Section 17(a) of the Act because all such provisions do not apply to SBICs.

SBA has promulgated extensive regulations concerning conflicts of interest and reviews these continuously. If updating is deemed necessary, it will implement amendments thereto.

The Division finds, without any evidence in support thereof, that stock options are inherently discriminatory and inequitable. It claims that options permit the holders to purchase stock at a price lower than that at which others may purchase, thereby diluting the interest of other shareholders [pp. 34-35 of the Division's Proposed Findings]. The Division relies on the testimony of Chairman Cary given in connection with S. 902 [p. 35 of the Division's Proposed Findings].

The Division fails to point out that in the same cited testimony of Chairman Cary, he stated:

> "Our basic objection to the proposed bill [allowing stock options] is this potentiality of abuse that may arise out of the enactment. We are not dealing with an operating company such as a utility whose business is carefully regulated . . . Further in connection with, say, a utility company, because of the regulation, there is not as much likelihood of abuse." [Emphasis added.] 11/

It is apparent that Chairman Cary's concern was directed to the lack of regulation over SBICs which could give rise to potential abuse. This testimony preceded several major amendments to the SBI Act which resulted in the SBIC industry being very rigidly regulated. Because of this regulation, the objections by Chairman Cary are no longer valid.

Equally important, the Division ignores the fact that there is a quid pro quo with respect to stock options. The competent services performed by the recipients of the stock options without question aid the investors because, without competent management, their investment probably would deteriorate to "rock bottom." In addition, if, as the Division contends, stock options are "inherently discriminatory and inequitable," one wonders why various types of industries in this nation utilize such incentives to retain competent personnel, and why, if it is such an evil,

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11/ Hearings, Subcommittee of Senate Committee on Banking and Currency, 87th Cong., 1st Sess., p. 119 (1961)

Congress has not taken action to abolish stock options outright.

The Division comments that it is questionable whether SBA could administer the investor protection provision with the same degree of impartiality as the Commission and cites in support the testimony of Chairman Gadsby before Congressional Committees [p. 24 of the Division's Proposed Findings].

This argument is purely conjecture and has no basis in fact. The cited testimony was given in 1960 and, at that time, the regulatory power of SBA was of a limited nature. Thus, Chairman Gadsby could properly express a concern regarding the need for the protection of investors. However, since 1960, major amendments to the SBI Act have been enacted by Congress (occurring in 1961, 1964, 1966, and 1967), and SBA has amended its Regulations in response to these changes. 12/ Such amendments now provide for the adequate protection of investors and overcome the concern of Chairman Gadsby.

The Division further argues that because the Act provides for the regulation of proxies and SBA has no such provisions, the granting of an outright exemption from such would create a void in investor protection.

12/ For the details of such, see pp. 36-38 of SBA's Proposed Findings.

This void is not of such compelling nature as to conclude the requested exemptions should not be granted nor that there is a loss of substantial investor protection. Congress, being well aware of the protection of investors, nevertheless, in its wisdom, did not conclude that, in all cases, proxy regulation was an absolute necessity for investor protection. This is evidenced by the various classes of companies Congress completely exempted from the Act pursuant to Section 3 thereof.

The SBIC industry, as stated previously, is a closely regulated industry. The many tools given by Congress to SBA has resulted in the ability of SBA to remedy any situation wherein there is an abuse of the use of proxies. For example, SBA must give its approval to any changes of the SBIC's charter, bylaws, increase in capitalization, financing plans, investment policy, officers and directors. 13/

The strict regulation of SBICs by SBA eliminates the need for proxy regulations. It is submitted that there is no loss of substantial investor protection if an exemption is granted from the proxy provisions of the Act.

It is obvious that both Acts and Regulations promulgated thereunder provide for strong supervision of the activities of SBICs and their officers and directors. Moreover, the SBI Act

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13/ Section 107.1105 of SBA Regulations

and the Regulations thereunder provide SBA with the necessary tools to prohibit or rescind transactions which are inherently unfair to stockholders of SBICs [Sections 309, 311, 312, 313, and 314 of the SBI Act; Sections 107.3, 107.101, 107.301, 107.601, 107.701, 107.801, 107.1001, 107.1004, 107.1005, 107.1102, and 107.1105 of the SBA Regulations].

While, admittedly, SBA does not have all the weapons that are available to the Commission, nevertheless, when weighing the two Congressional objectives--funds to small business concerns and investor protection--it is submitted that the balance should shift in favor of injecting funds to the small business sector of the economy. As previously shown, the loss of investor protection remedies under the Act is rather inconsequential when compared to the overriding need of injecting a new vitality into an industry which is suffering from a tight money market. As Commissioner Gadsby noted, the Commission, in consideration of investor protection, must be careful not to erect such burdensome requirements as to hamper the raising of capital needed by SBICs to enable them to carry out their statutory obligation of providing funds to small business concerns. 14/

In view of the foregoing, SBA requests that the Hearing Examiner find that investor protection afforded by the SBI Act

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14/ Briefing on the Investment Act, Committee Print, Senate Committee on Banking and Currency and Senate Select Committee on Small Business, 85th Cong., 2d Sess., p. 21 (1958)

and the Regulations promulgated thereunder is sufficiently comprehensive as to warrant the granting of the requested exemption.

V. RETROACTIVE APPLICATION OF THE EXEMPTION

The Division shows some concern regarding the possible granting of retroactive status to the requested exemption. The Division's discussion concerning this point is irrelevant to the proceeding. Neither SBA nor NASBIC has sought to give retroactive effect to the exemption during the hearings or in the Proposed Findings. They do not seek it now. SBA Counsel can only surmise that this issue was conjured up to be intentionally swatted down.

It is respectfully urged that the Division's discussion regarding retroactive application of the exemption be summarily rejected as being frivolous.

VI. POSSIBLE TAX IMPLICATIONS

The Division also discusses some possible adverse tax consequences should the exemption be granted. Any concern along these lines is unwarranted. By letter dated July 15, 1969, the Department of the Treasury advised SBA that if the Commission exempts SBICs from its regulation (other than the requirement that SBICs be registered under the Act), their status under Section 851(a)(11) of the Internal Revenue Code of 1954 (26 U.S.C. 851(a)(11)) would not be affected.

A copy of Treasury's letter is attached as Appendix A.

VII. CONCLUSION

The record, as shown above and in SBA's Proposed Findings, clearly demonstrates that an Order granting the requested exemption is necessary and appropriate in the public interest, consistent with the purposes fairly intended by the policy and provisions of the Act, and that the public interest and investor protection do not require the imposition of conditions on the requested exemptions.

Accordingly, it is requested that the unconditional exemption be granted.

Respectfully submitted,

Eric W. Weinmann
Jerome Garfinkel
John J. Sharp

By: John J. Sharp
Counsel for the
SMALL BUSINESS ADMINISTRATION

Dated: July 25, 1969

THE DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUL 15 1969

Dear Mr. Singer:

The purpose of this letter is to comment on the right of certain small business investment companies to qualify as regulated investment companies under section 851 of the Internal Revenue Code of 1954 in the event the small business investment companies are granted an exemption from regulation by the Securities and Exchange Commission. We have been advised that an application has been made for an exemption under the Investment Company Act of 1940 under which the Commission may grant exemption from any provision or provisions of that Act or of any rule or regulation thereunder.

Section 851 (a) (1) of the Internal Revenue Code provides that one of the qualifications for taxation as a regulated investment company is that the corporation be "at all times during the taxable year, . . . registered under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust . . . ."

Section 8 (a) of the Investment Company Act of 1940 provides that an investment company may register with the Securities and Exchange Commission by filing a "notification of registration" in such form as the Commission may prescribe. Section 8 (a) further provides that "[a]n investment company shall be deemed to be registered upon receipt by the Commission of such notification of registration." Section 8 (b) provides for the filing of a registration statement by "[e]very registered investment company" within a reasonable time "after registration."

It would seem, therefore, that an investment company becomes "registered" under the Investment Company Act as soon as the Securities and Exchange Commission has received the notification of registration, and that a company so registered at all times during the taxable year (either as a management company or as a unit investment trust) will meet the Internal Revenue Code qualification that it be "registered." Accordingly, if the Commission decides to exempt a small business investment company from regulation (other than the requirement that the company be registered) under the Act and if the company has

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registered, and continues to be registered, with the Commission within the meaning of section 8 of the Act, the exemption from regulation, as such, would not affect the company's status as a regulated investment company under section 851 (a) (1) of the Code.

Sincerely yours,

John S. Holan

John S. Holan
Deputy Assistant Secretary

Mr. Arthur H. Singer
Associate Administrator
for Investment
Small Business Administration
1441 L Street, N. W.
Washington, D. C. 20416

cc: National Association of Small Business
Investment Companies
c/o Charles M. Noone
1225 Connecticut Avenue, N. W.
Washington, D. C. 20036

CERTIFICATE OF SERVICE

I, John J. Sharp, hereby certify that I have caused the attached Reply Brief of the Small Business Administration, dated July 25, 1969, to be served this day by mailing two copies of this document to the following persons:

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John J. Sharp
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Dated: July 25, 1969

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* EXECUTIVE COMMITTEE

MEMORANDUM

TO: Dr. Al Osborne
Securities and Exchange Commission

FROM:
National Association of Small Business Investment Companies

RE: Regulation of Small Business Investment Companies under the Investment Company Act of 1940

DATE: November 30, 1977

Pursuant to the Securities legislation which has been introduced in Congress, the National Association of Small Business Investment Companies has surveyed its membership and found that:

1). A number of member companies have been prevented from pursuing capital-raising activities because of the Investment Company Act of 1940, and

2). The present dual regulation (between SBA and SEC) of those companies which currently are either forced by regulation or elect to fall under the jurisdiction of the '40 Act results in additional costs and operating inefficiencies -- i.e., economic waste.

Time and staff resource constraints prevented the pursuit and collection of data in a form which would lend itself to aggregation. However, responses voluntarily provided have been such that a sound case for relief can be built. Merits of the SBIC industry's arguments for exemption can be gleaned from NASBIC's "Application for Exemption from Provisions of the Investment Company Act of 1940" which was filed with the Commission on March 15, 1968. All that will be dealt with here are the economic effects on individual SBICs and the industry which are a direct result of regulation under the Investment Company Act of 1940.

Capital-Raising Constraints

One of the most difficult things to accurately estimate is the quantity of invested dollars which has not flowed into venture capital, and into the SBIC industry specifically, because of SEC regulation. The traditional wisdom within the industry is against the SEC because small business investment companies have historically found it very difficult to exist under the regulatory jurisdictions of both the Small Business Administration and the Securities and Exchange Commission. As a result, SBIC professionals in the field and trade association staff in Washington generally recommend strongly that existing or potential SBICs avoid the '40 Act at all costs. This obviously keeps capital out of the program since many interested inquiries come from groups or individuals who have no other method in which to raise the necessary capital for an SBIC other than to make a public offering and/or take in more than 100 investors thereby falling under the '40 Act.

NASBIC has no way in which to estimate how many persons and dollars would come into the industry if it were not for the Investment Company Act of 1940. Our survey showed, however, that at least a dozen existing SBICs would raise from $250,000 to $20 million each if it were not for the '40 Act.

Additionally, input from the Minority Enterprise (MESBIC) segment of the industry, which has all the capital problems and constraints of the regular SBIC industry plus those which are unique to minority enterprise, confirms that relief for the '40 Act would significantly help that severely undercapitalized group.

Living with the '40 Act

Presently, there are 32 small business investment companies operating under the regulatory jurisdiction of the Investment Company Act of 1940. This number has not increased recently and is not expected to unless relief is granted. Again, reporting and other general regulatory burdens under the '40 Act are delineated in the NASBIC "Application for Exemption from Provisions of the Investment Company Act of 1940". What will be dealt with here are some specific examples of problems encountered by SBICs which are regulated under the '40 Act.

We at NASBIC are concerned that our member companies are incurring expenses which would be unnecessary were it not for the SEC interpretation of the '40 Act. The concerns from a policy standpoint, of course, are those of overregulation and economic waste.

The economic waste comes from duplicative or otherwise unnecessary

expenditures which are burdened onto '40 Act SBICs. For example, one company was forced to adopt an accounting method for reporting to the SEC which is now used in addition to its historical accounting methods. To quote from their September 30, 1976 semi-annual report:

> "We are presently, in effect, maintaining two accounting methods. One method is used to report operating results to you, our shareholders, and the SEC. The other is used to report to the SBA..."

Outside legal fees are another significant expense for all '40 Act companies. We in the industry believe in good counsel and strict compliance. The National Association of Small Business Investment Companies has worked hard to help insure that the SBA regulations, while not overburdening SBICs, are as precise and demanding as they need to be to assure proper conduct on the part of each and every SBIC. We have also worked to upgrade the professionalism in the industry through such forums as our Annual Management Institute which focuses on regulatory compliance in its curriculum each year.

We do not feel, however, that one needs to have passed the bar just in order to comply with regulations. The Investment Division, working in close conjunction with the Office of General Counsel in that Agency, clearly and fairly administers its regulations so as to comply with all relevant law while at the same time keeping SBIC legal costs at a minimum level. This is possible since the Investment Division is quite adequately staffed to handle the small SBIC industry. Obviously, the SEC staff cannot possibly deal on such a personal basis with every company it regulates given the huge number of those companies.

Those costs, when looked at individually or collectively, do not seem earthshaking from a national economic perspective, but to small companies in a high-risk industry -- an industry which in its 19 year existance has never earned a return in excess of 9.5% -- they are indeed significant.

An example of a legal nightmare for SBICs comes under Section 17 of the '40 Act which regulates affiliated transfers even though the SBA has very strict and well-enforced regulations on affiliated activities. One company, due to the necessity for specialized counsel when dealing with the transactions under the SEC, spent $36,000 on the sale of one portfolio company just to comply with '40 Act regulations.

Another problem is dual regulation to the detriment of the shareholders. A good example of this took place when an SBIC made a second round investment in a very successful portfolio company. After revaluing the original investment, which had appreciated, and adding it to

the second investment, the company found that it had at that time a 26.4% (of total capital) commitment in the industry which was represented by that company. Since that was in excess of the SBIC's "25% in any one industry" investment policy, counsel advised the SBIC to divest itself of 1.4% of that investment. The SBIC did so.

In that case, the investors were deprived of part of their existing, and any future investment in a winning company. Anyone familiar with venture capital knows that the only way to be successful is to cash in on "winner" investments to the maximum extent possible. What was done in this case was not to the advantage of the shareholders of the SBIC. The sensible thing would have been to do what SBA does when an SBIC wishes to exceed the regulation which limits an investment to 20% of a licensee's private capital [13 CFR 107.301(d)]-that is deal with each occurance, or overline, on an individual basis. If an investment is potentially profitable and reasonably secure, a percentage overline should be allowed.

The above are but a few of many examples of problems SBICs encounter under an act we feel was never intended to regulate them. When the Investment Company Act of 1940 was written, 18 years before SBICs came into existence, exemptions were made for other financial institutions. Section 3(c)(3) exempts "any bank or insurance company; any savings and loan association, building and loan association, cooperative bank, homestead association or similar institution ..." Section 3(c)(5) exempts "Any persons substantially all of whose business is confined to making small loans, industrial banking, or similar businesses." Indeed, SBICs are the only Federally licensed and regulated entities also regulated under the Investment Company Act of 1940.

We, at NASBIC, hope that this information, in complement to our "Application for Exemption from the Provisions of the Investment Company Act of 1940", will be useful in your efforts to study the effects of SEC regulation on venture capital financing in the U.S. economy.

Mr. METCALFE. Mr. Carson, you summarized your statement, did you not?

Mr. CARSON. Yes.

Mr. METCALFE. Do you wish for the entire statement to be entered into the record?

Mr. CARSON. Yes, please.

Mr. METCALFE. I ask unanimous consent that the entire statement be entered into the record. Hearing no objection, it is so entered.

Mr. Carson, as you may know, last week the Senate passed H.R. 11567, which raises the ceiling under section 3(b) of the Securities Act to $2 million. I believe that it is quite probable that in the reasonably near future Congress may raise the ceiling to the levels which you have testified in favor of. Nevertheless, I would expect that the Commission will probably move more cautiously in raising the regulation A levels. One of their concerns may well be the absence of a certified financial statement requirement.

Would you comment on the desirability of regulation A containing such a requirement for financial statements?

Mr. CARSON. I think my own opinion would be that it will be very difficult to do a registration statement without a certified financial statement in it. Certainly we, if we were major stockholders of a company, would not let it make a public offering without a certified financial statement because we would be unwilling to take the liability. The uncertified statement might prove to be incorrect. So, my guess would be the larger offerings, regardless of whether there is a requirement that they have a certified statement, would in fact have certified statements in them.

I also can tell you with almost 100-percent certainty that no underwriter would want to underwrite an issue which did not have certified statements.

Mr. STULTS. Mr. Chairman, if I might just add, I think we were all a little disappointed at Chairman Williams' statement that the Commission will sit around and look at the $1½ million ceiling and stay at that level, no matter what Congress tells them the regulation on the offering level ought to be. It is the unanimous feeling, I think, of the underwriting community, the venture capital community——

Mr. BROYHILL. Could I intercede at this point? I have an amendment coming up on the floor in just a moment, I have been notified, and I would like to pursue this a little bit if I could, Mr. Chairman.

Mr. METCALFE. The Chairman recognizes the gentleman from North Carolina.

Mr. BROYHILL. As you know, the proposal has been made that rule 144 be changed, but I am still concerned about it. I know that it does change the rule from the 6-month requirement to 3 months, and does permit the sale of securities of 1 percent of the class over a 3-month period, or the greater of 1 percent, or the average weekly volume.

That still could take a considerable amount of time to dispose of a bloc of stock. And of course, the thing that concerns me about this is the effect that this is going to have on the entrepreneur that you and the others in your business are trying to help. It only

seems reasonable to me that if a person is going to be investing in securities of that type which are not liquid, he probably is going to ask for a discount, so the entrepreneur is not going to get really top dollar; he is not going to be able to get really sufficient capital to be able to exploit his ideas, or to be able to put together the necessary capital to carry out the plan that he has.

I wonder if you would comment on that aspect of the continued restrictions in rule 144.

Mr. CARSON. I think your comment is absolutely accurate, there is a significant cost involved to the company to be financed in having to sell restricted securities. The greater the restrictions that are placed on that security, the lower the price that the investor is willing to pay for it, the less capital the company has to work with, or the more expensive that capital becomes.

I think for a small company the implications are twofold. One, you can either sell securities and not raise as much money as you want; or, No. 2, you can defer the sale of securities, which means that the company cannot get capital growth as rapidly as it might like to. I think anything that helps to alleviate those restrictions on resale, really, has beneficial effects to both the issuer and the purchaser.

Mr. BROYHILL. Second, there is a provision in proposed rule 144 that after 5 years there be no more restrictions or limitations, but that would not apply to affiliates of the issuer. Affiliates of the issuer are those who are in some position of management, or on the board of directors, or own, I think it is 5 percent of the stock. Is that correct?

Mr. STULTS. We have gotten more than one opinion, Mr. Broyhill, it is either 5 percent or 10 percent because it is not spelled out in the statute.

Mr. BROYHILL. Well, it is a relatively small amount.

Mr. STULTS. That is right.

Mr. BROYHILL. What are some of the problems that this brings about? I mean, it would seem to me that the rule would continue to lock you in. So, in most cases I would assume you are not buying small amounts of stock, you are buying substantial amounts in order to finance a new enterprise.

Mr. CARSON. Very definitely. I think the essence of the venture capital business is buying a meaningful bloc of stock in a company which in our experience often runs 10 to as much as 50 percent of the ownership; and second, sitting on the board of directors of the company to provide management advice and strategic counseling to the company.

I think it imposes a significant burden on the venture capital investor to have this restriction. Obviously, a large company, a New York Stock Exchange listed company would have virtually no investor that owned more than 5 percent. So, almost by definition it has no affiliate sitting in management.

What this particular provision does is to focus on the small company which because of its small size does not have a widespread ownership and still does have one or more venture capital investors who might well be affiliates. I think those affiliates who are venture capital firms are being unfairly penalized by the provision.

Mr. BROYHILL. Well, then, under those circumstances, do you view the proposed changes in rule 144 as any changes at all?

Mr. CARSON. I think we have made some very significant strides. The speeding up of the selling period is something I view as highly constructive. I think to remove restrictions after 5 years, again, is very constructive. I think it would be even more constructive to go one step further and do away with the affiliate provision, or at least narrow that affiliate definition so that it does not affect an outside capital investor.

Mr. BROYHILL. If we cannot get the Commission to go along with a total exemption for affiliates, what other compromise would you offer. Do you have a specific one to make at this time?

Mr. CARSON. Well, I think probably the next best compromise would be to accelerate the amount of securities which could be sold after they have been held for 5 years. Our proposal would be that you move to 5 percent every 3 months instead of 1 percent the maximum amount of securities that could be sold.

Again, I think one of the things to understand here is that the law of the market is going to determine whether or not you can sell securities into the market. If there is a very thin market and there are no buyers, you cannot sell 1 percent. If, on the other hand, there is a very active market, you could easily dispose of 5 percent of the outstanding stock of the company in a 3-month period without having any impact at all on the market.

In fact, as I said in my testimony, you may often have a positive impact, and that you may create a broader and more efficient market for the company's securities.

I think one other thing to bear in mind is that the sale of restricted securities is really a one-time event. When these securities have been sold through a 144 transaction, they then become part of the public flow. So, I think that one could argue that there is a good deal of benefit in having as much of a company's securities as possible available for the public float, or any public float.

Mr. BROYHILL. Thank you, Mr. Chairman, and I apologize for interrupting Mr. Stults.

Mr. METCALFE. Thank you very much, Mr. Broyhill.

I believe Mr. Stults was testifying. Do you have a statement to make?

Mr. STULTS. Thank you, Mr. Chairman.

I was just pointing out that Chairman Williams seemed to say that no matter what Congress does on the regulation A ceiling, or on the law, the Commission would not issue implementing rules under regulation A until it had had a chance to carefully monitor the 1½ million ceiling which has just taken place.

Testimony before the House and the Senate Small Business Committees has been unanimous in saying, probably a $1½ million public offering is not viable in these days, so that it would be possible to have the Commission sit and look at a 1½ million ceiling and say, "See, nothing comes through" and decide that, in spite of Congress going to 2 million, 2½ million, 3 million, they will not implement this rule and it becomes meaningless. I would hope that this subcommittee would, as it goes along and increases regulation A ceilings by statute, that they ask the Commission to follow up with the implementing rules.

Mr. METCALFE. Thank you very much, Mr. Stults.

Mr. Carson, would you elaborate on the kinds of activities which an SBIC finds so necessary to operations, and which would be frustrated if the SBIC fell under the provisions of the Investment Company Act?

Mr. CARSON. My firm is not subject to the Investment Company Act of 1940. I would like to defer that question to Mr. Stults, if I could.

Mr. STULTS. Mr. Metcalfe, tomorrow Mr. Peter Van Oosterhout, who does represent a publicly owned SBIC, will come before your subcommittee and speak solely to the 1940 act question. So, with your permission, I think Mr. Carson and I would like to defer that until tomorrow's presentation if we might, sir.

Mr. METCALFE. Thank you very much.

Mr. Carson, I have one more question for you. It has been some 10 years now since your association filed its C–6 application with the Secretary for exemptions from certain of the provisions—with the SEC, I am sorry—of the Investment Company Act. Have you had any recent communications with the staff or with the Commission to determine whether or not they may now be willing to give favorable consideration to a new application?

Mr. CARSON. I would like to defer the answer to that to Mr. Stults again, if I could.

Mr. STULTS. In the testimony which Mr. Van Oosterhout will be presenting tomorrow, Mr. Metcalfe, he will indicate that we feel that we have exhausted the administrative remedies. Mr. Williams' testimony today indicated that the issue is drawn pretty clearly and it would take a statute, when he points out that over the last 20 years several SBIC's have been the subject of enforcement actions. He seems to draw the conclusion since there were a couple bad actors, or questionable actions by the SBIC's over the last 20 years, the Commission would not look with favor toward any significant lessening of 1940 act burdens on our companies. For that reason we have been delighted that members of this subcommittee and members of the Senate Small Business Committee have sponsored legislation which would statutorily transfer certain affiliated transactions and other types of enforcement actions from the Commission to the Small Business Administration.

Mr. METCALFE. Thank you very much, gentlemen.

There being no further questions, the subcommittee will stand adjourned, subject to the call of the Chair. Thank you.

[Whereupon, at 11:30 a.m., the subcommittee adjourned, to reconvene at 9:30 a.m., Thursday, September 28, 1978.]

SMALL BUSINESS INVESTMENT

THURSDAY, SEPTEMBER 28, 1978

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met, at 9:30 a.m., pursuant to notice, in room 2218, Rayburn House Office Building, Hon. Bob Eckhardt, chairman, presiding.

Mr. ECKHARDT. The committee will come to order.

Today we begin our second day of hearings on H.R. 10717, H.R. 13032, and H.R. 13765 which are designed to alleviate some of the burdens imposed by the securities laws and regulations on the raising of capital by small business concerns.

Good morning, you may proceed.

STATEMENT OF PETER VAN OOSTERHOUT, CHAIRMAN, PUBLICLY OWNED SECTION, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY WALTER B. STULTS, EXECUTIVE VICE PRESIDENT

Mr. VAN OOSTERHOUT. Thank you, Mr. Chairman. I am Peter Van Oosterhout, chairman, publicly owned companies section of the National Association of Small Business Investment Companies, and chairman of Clarion Capital Corp. of Cleveland, Ohio, which is an SBIC and is also subject to the provisions of the SEC in terms of the 1933 act, as it may apply.

I have been involved in this type thing with my company for 5 years and I have been involved with publicly held SBIC's for 18 years, so I have had quite a little experience with the various provisions of the Government regulatory agencies.

I believe you have received the statement which I will not bore you by reading, but I would be glad to elaborate.

Mr. ECKHARDT. Without objection, it will be placed in the record and you may summarize.

Mr. VAN OOSTERHOUT. My basic thrust, what I have been asked to comment on, are the provisions of the Investment Act of 1940 as they apply to not only SBIC's but any firm. It is my feeling, maybe wrongly, that I see very little protection to the investing public as the 1940 act is presently applied to a company such as mine. The costs and the negatives of complying or being subject to this act are such they far outweigh the cost-benefits that I can see going to the public stockholders.

My company has 550 stockholders. The public holdings consist of about 530 individuals or owners in various forms, and they repre-

sent about 10 percent of my holdings. However, in order to comply with the 1940 act because of their presence it will cost me well over $100,000 a year in a variety of hidden and some unhidden costs. Some of those costs I will have to admit would be present by virtue of other provisions of the securities laws, so it is not totally that amount that could be avoided by the 1940 act.

There are a lot of, in my thinking, sort of subtle nuances that come into the 1940 act problem. Basically, I think one reason you see it does not have much going for it, very few companies in their right mind would subject themselves to the vagaries of the 1940 act if they could avoid it. I am confident that our presence under the program is an act of congressional timing.

The provisions are awfully hard to apply to a venture capital concern. One of the major problems deals with our own capital formation in that the capital we raise is limited to one class of security and the 1940 act is also very limiting in the way we can deal with the shareholders regarding repurchase. The forms of capital organization pretty much limit the flexibility required for the ongoing operation of a company such as mine.

In addition, the other areas of basic concern are the vagaries surrounding the whole area of section 17 of the act which basically deals with conflict of interest. The SBA has a very complex set of conflict-of-interest provisions, and we have learned how to read those. When we think there is a problem, we know we can contact the SBA and get a relatively quick answer as to whether or not our fears are justified.

In dealing with the SEC, it is an entirely different matter because we are such a small part of the 1940 act's administration. The answer when we have tried to make these contacts, to find out whether a section 17 problem exists, is basically first of all, we don't know; the only way we know is if you will do what you are going to do and file an exemptive order or application for one.

Each time I have tried to follow up and find out how much that will take I am told it is 6 or 9 months. Obviously, for that reason we have not done it, which I believe is not of economic benefit to our shareholders or economic benefit to the companies with which we deal; but rather than go through a lengthy process, particularly not knowing when one is required, it causes us to back off.

There is another section of the act which concerns me and members of my industry, section 47, which is a very broad-reaching penalty section and which basically, because anything we do on any transaction we enter which may be in conflict, in violation of the act, should be a void transaction. Obviously if that were ever enforced that would be a heavy economic burden. So there is a penalty clause behind this which makes it very difficult to operate, particularly with the vagaries of the law.

I have always felt our industry was a stepchild. Our assets of about $250 million, representing about one-quarter of the SBIC program, is such a small piece in relation to the other mutual funds which are under the purview of the 1940 act there isn't a lot of attention paid to us. As a practical matter, the whole area was such a small piece of the problem within the bureaucracy, if you will, of the SEC that it is not lack of attention to our problems but it is really lack of time to understand what they may want.

There have been some improvements, some help, in terms of regulatory exemptive authority under section 17, one of which is very important to my company because effectively 90 percent of my stock is owned by 14 banks.

However, as far as the relief which has been suggested under 17(a), it is my opinion that the relief is so confusing it was no relief at all. I have before me, which I would be glad to provide to counsel, an opinion which my legal counsel at great expense provided to my company, and after reading through it I do not know whether I have a conflict situation or whether I am reading a guide to a Chinese puzzle. I am a lawyer by training and I do not understand it. Incidentally, if you would like this, I would be glad to provide it.

The whole area of vagary under the 1940 act to my mind is the real problem. My company being conservative and my board of directors being responsible, have basically taken the position whenever we see a problem under the 1940 act we walk away from the situation. That has cost my shareholders in some cases a considerable amount of money, but we feel that is the only way to do it.

I do not really know any way around that problem. As I say, the staff of the SEC we have never found to be overly cooperative in conferring with us as to whether or not we have a problem, and for that reason we just duck it.

The venture capital business and the SBIC business is probably as well regulated as any business I have been exposed to. I have been in the insurance and the banking businesses, all of which are subject to a considerable amount of regulation by one body or another. I have never had to operate under or have even seen an act which is as vague as the 1940 act, which has as much consequences as it does and which is so hard to understand. It is not a matter of avoiding regulations except it is avoiding one more tier of regulations which I frankly see no benefit to the investing public, which is really the body the SEC is supposed to be concerned about under the purview of the 1940 act.

As I mentioned, I have been involved in this business in one form or another for 18 years. The company with which I was involved before was one that made an early exit from the 1940 act back in 1966 during the days when the program was considerably restricted. It was a fairly simple thing to do. It should have been very easy because of the fact at that time the company had borrowed no Government money and the only connection with the Government was we did have 5,000 stockholders, which put us under the 1940 Act and also had an SBIA license.

We spent almost 3 years exiting from the 1940 act and the amount of money that I can document was $500,000 it cost to do so. We had to have three shareholders meetings to accomplish it, because in each case we went to the SEC, asked them how to proceed, and we then had a shareholders meeting; we proceeded. They then changed their mind and suggested that we do it another way, which caused another shareholders meeting. The expense to the shareholders was considerable and the benefits were negligible. This was the asset test exit where we were able to prove no more than 40 percent of our assets were in what they called investment securities. That is no small trick when there is no exact way of

valuing it, and we produced a couple of volumes that looked like the New York Telephone Directory along the way with considerable expense, both legal and accounting expense, to that. In the end result, it did not make much difference to the SEC because they let us exit through liquidation. But the point is it is a very difficult section.

At that time we discovered we were traveling in virgin fields with the valuation end. There is no known value at a given moment, and I defy anyone to tell me how to value as an exact science a portfolio which a venture capital company has.

The only argument I have ever been able to figure out is that in fact fits marketable, and most of our situation, not—and that is why we deal with them; at least at the outset—the only value would be zero they would put in our books. I do not believe that is adequate protection to the shareholders.

I rambled and I apologize, but I certainly would like to answer any questions you might ask.

[Mr. Oosterhout's prepared statement follows:]

STATEMENT OF PETER VAN OOSTERHOUT, CHAIRMAN, PUBLICLY OWNED SECTION, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

There is no question but that the Investment Company Act of 1940 ("40 Act") does act as a deterrent to our operations and does cost us a considerable amount each year in both hard and soft costs. As far as deterrent is concerned, I believe the following areas are appropriate to mention:

(*a*) The whole valuation and financial reporting process as required under the 1940 act is clearly not designed with an SBIC in mind. As far as the valuation aspect is concerned, the prevailing theories of valuing each investment at "fair value" as we understand it and as our independent accountants inform us they understand it, presents an impossible task for both management and more importantly, the independent members of our Board of Directors. There is absolutely no exact formula or method which is appropriate for valuing the vast majority of our investments. We have tried various methods primarily orientated towards carrying our investments individually at cost until something drastic occurs to vary our valuation one way or the other. Although we admit that this does not give a real individual valuation, it has however, over the years worked out on the balance when the entire portfolio is taken into consideration. The problem occurs whenever a deviation from cost occurs in applying an exact dollar value to what the changed circumstances may mean. The small business concerns of the type in our portfolio, and I believe in most SBIC portfolios, are subject to very wide swings in value and circumstances on almost a daily basis. In fact, over the years we have discovered that some of our most dire situations at one point in time, have at another point in time, been some of our brightest investments. Once we deviate from cost it becomes impossible to apply an exact value as of any point in time.

Where this is difficult for the management of an SBIC that works with the portfolio on a daily basis, it becomes even more impossible for a diligent independent director to understand both the overall value of a given investment and to apply an exact dollar amount to it. This further difficulty arises because of the fact that the independent director just doesn't have access to all the nuances and information that would cause these wide swings in the outlook for the small business. No amount of financial information or historical knowledge can fully buttress this position. Our business is really involved in futures and not history and the independent director has no way of valuing the creditability of the future of the company on a realistic basis. As I mentioned before, the management of an SBIC also has the advantage of being able to test this creditability on an ongoing basis because of more frequent contact with the underlying factors involved in a future assessment, but it is not realistic to expect an independent director to spend the time and have the perseverance to conduct an exhaustive search or review in this area. This is further complicated by the fact that a realistic outside appraisal of most of our assets on the required basis is not available at any price.

(*b*) As a variation on the theme of the valuation problem outlined in Paragraph a, it is very difficult to locate new independent outside directors as required under the

provisions of the 1940 act. This is occasioned not only by the time involved in doing the job diligently, particularly in the valuation area, but also the extreme fiduciary responsibility as occasioned by the 1940 act. Not only does the 1940 act require a "fish bowl" approach, but, in our legal counsel's interpretation, imposes an even higher degree of responsibility on the director than is true in most companies registered under other acts under the purview of the Securities and Exchange Commission.

(*c*) The whole area of financial reporting other than valuation as required under the present 1940 act accounting rules really isn't applicable to our company and effectively confuses our stockholders more than providing them with the information to which they otherwise would be entitled. Thus, the practical effect of the present accounting rules is to confuse the shareholders rather than to protect their interests.

(*d*) The whole area of conflict of interest as imposed by Section 17 of the 1940 act is unduly complicated. I have worked with the 1940 act in one form or another for 18 years and have had legal training, and I am still not sure just what Section 17 does or does not cover. This is particularly true when it comes to "affiliate of the affiliate" transactions. The practical effect of this confusion is that each time we deal with anyone with whom we have had prior experience, including stockholders, creditors consultants, lawyers, and others, we have to engage legal counsel to attempt to determine if a Section 17 problem exists. In our circumstances, it is further complicated by the fact that two major banks own a considerable amount of our company's common stock, and although there are some exceptions provided under 17(d), we can never be sure which of these transactions are exempt, and from time to time we have to file exemptive reports. We have taken a conservative view which has eliminated some transactions which would have made economic sense to the SBIC and have reported some transactions, I am sure, which really didn't require reporting. The SBA also has a rather formidable conflict of interest regulation which I believe, is some ways more restrictive than the SEC definition. However, it is much easier to understand and apply under most of the circumstances that we have encountered.

It is also much easier to get an interpretation in this area from the SBA than it is from the SEC, and this is true primarily relating to whether the regulatory requirement under the SEC that exemption orders may be required. Even short of this exemption order procedure, we have found it very difficult to get any one from the SEC to tell us that the application is even necessary, and in fact, have been advised from time to time that it may be necessary but that we should ignore this requirement. In light of the director problems mentioned above, we certainly can't rely on this type of advice, and in each case have not gone ahead with the proposed transaction rather than follow this procedure.

(*e*) A further area of concern caused by the 1940 act is the requirement that we issue only one class of security. This effectively blocks an SBIC from employing some more meaningful equity packages, and in fact keeps us out of the debt market except through the government guaranteed programs. Thus, where we otherwise might be able to put together additional financing and provide additional private capital for the SBIC industry, we have been effectively cut off from this route and thus forced to rely more heavily on the federally guaranteed program.

(*f*) Somewhat along the same line is the very vague definition of what does constitute additional classes of securities. It is my understanding that at least on one occasion the SEC has raised the position that the SBA guaranteed debt is effectively a "class of security" and thus questionable for an SBIC to issue.

(*g*) The interpretation of the 1940 act that we can only deal in our stock at net asset value also precludes most SBIC's from issuing additional common stock since most of us sell for less than book value.

(*h*) The above problem also effectively blocks any share-for-share exchanges at less than book value.

(*i*) There are numerous other provisions within the 1940 act which are very difficult to fathom, let alone understand. Underlying this whole problem is Section 47 of the 1940 act which contains some very disturbing language regarding the voiding of every contract made in violation of any provison of the act or any rule, regulation, or order thereunder. This obviously is a very far reaching penalty and one that no other business that I know of is subjected to while operating under such a vague statute. Obviously, if this penalty were applied the consequence to our company would be disastrous. It is my understanding that there has been no litigation under this Section but the fact of its presence is very unsettling to both the SBIC, and more importantly to its outside directors who really have no way of monitoring under these circumstances.

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(*j*) The labeling of the security of the SBIC as a 1940 act type investment immediately results in a tendency for our security to sell at discount. Although this isn't the direct result of the provisions of the act, it unfortunately has the effect of life arising from our registration under the act.

(*k*) The applicability of the 1940 act requires us to deal with one more agency. This obviously compounds our expenses and the legal confusion surrounding an already complex industry. In the net I see no real stockholder protection arising out of this which comes any where near being practical on a cost benefit basis. In addition to the problems noted above, there are sizeable costs involved occasioned by our being subject to the 1940 act. Some of these are hard costs which are relatively easy to put a dollar value on, and others are soft costs such as management time, directors time and potential liabilities which are hard to assign an exact cost. Some of the principal costs are as follows:

1. The cost of preparing proxy material, which due to Section 17(d) questions, requires considerably more legal work than would be required of a non-1940 act SEC registered company. We estimate this to cost us at least $2,500 per year in additional legal review cost. This, of course, is in addition to the cost of preparing and mailing the proxy, which I assume would be required under the other SEC acts. The total cost of the proxy not including the legal expenses outlined above, normal legal expenses in reviewing the proxy, printing and mailing costs, amount to $6,000 per year.

2. After consideration of Section 17(d) questions, we have not filed thus far for any exemptions with the SEC in this area, but last year the cost of reviewing transactions to determine whether such a filing was required, cost us an additional $5,000 in legal fees.

3. The additonal cost of securing independent "non-inside" directors, as required under the 1940 act, and their related travel expenses cost us an additional $10,000 last year.

4. The valuation accounting method, particularly in light of the 1940 act requirements, is not only difficult but costly. The documentation required because of all of this costs us $4,000 per year to prepare and distribute. In addition, our independent accountants fee is approximately $7,500 higher than it otherwise would be due to the presence of the 1940 act requirements. This is primarily incurred in the valuation area even though they won't issue an unqualified opinion in this area.

5. The rigid custodial requirements under the 1940 act cost us an additional $6,000 per year. In addition, there are very few banks that are willing to service this type of formal custodial account and for that reason, we are unable to use a local bank. The travel required to service this is an additional $1,000 per year.

6. The annual and semi-annual reports as required under the 1940 act cost us approximately $8,000 to print and mail each year.

7. The bonding requirement under the 1940 act increases our cost in two ways. The bond itself costs us approximately $900 per year. If we were able to establish a reasonable deduction, we would be able to save $200 per year. However, the SEC prohibits the use of this deductible provision.

Mr. ECKHARDT. I understand your difficulty valuating securities. You are required to value your securities every day. If many of the stocks you deal with are rather thinly traded, this becomes a rather difficult matter, I assume.

Mr. VAN OOSTERHOUT. With one exception, the trading would be so thin under other circumstances I would seriously question whether you would define them as public trading. As far as our ability to trade in the market in relation to our size block and the market itself it is negligible.

Mr. ECKHARDT. If you were able to obtain exemptive orders expeditiously from the SEC, would that alleviate your problem?

Mr. VAN OOSTERHOUT. Not really. It would help. The problem is we do not know when we have a problem. As you see from this document I gave you, the difficulty is trying to figure out when you have a problem. Being a fairly thinly managed company and not wanting to spend all my shareholders' money with the lawyers, whenever we smell a problem we walk away from it.

Mr. ECKHARDT. Have you discussed this with the SEC?

Mr. VAN OOSTERHOUT. Not in recent years. I know representatives of the association have.

Mr. BROYHILL. How long does it take to get an exemption, those you attempted to get?

Mr. VAN OOSTERHOUT. I have a unique situation. In 18 years I have never filed for an exemptive order, because in those years I have not done the transaction rather than go through the delay. I am informed it has taken 9 months in the industry. We do have an affiliated transactions problem. We rented space in one of our banks which we thought might be an affiliated transaction. Our attorneys in our case thought we should get at least, if not an exemptive order, some acknowledgment from the SEC that was not the type of transaction prohibited. It took 4 months to get an answer which said basically: Don't bother us with this type of transaction.

Mr. ECKHARDT. Suppose you could get an answer quickly?

Mr. VAN OOSTERHOUT. Then the question has two levels. The first is, is this the type of transaction which requires the application for the exemptive order. As I say, that is where I get hung up. Assuming the decision was made, and I could get a quick answer that was subject to the provision, then we probably, if it took a considerable period of time, would not go ahead anyway. If that level were solved with a quick answer, we would go ahead, but there are two levels.

Mr. BROYHILL. The SEC says that the change in the rules that they have promulgated would solve the problem.

Mr. VAN OOSTERHOUT. Pure hogwash, in my humble opinion, and I deal with it every day. That is exactly the section I have in front of me. If that is a simple solution to a problem, my law school forgot to teach me how to read English, because that is a very complex section that raises more questions than it solves.

In the 17(d) exemption with the bank affiliation situation that is frankly easily understood, but the other is really complex and does not do what in my opinion it is supposed to do.

Mr. BROYHILL. The SBA in its statement said more study was needed "to address fully the implications of exempting SBIC's from the definition of 'investment company' for the purposes of the Investment Company Act of 1940." This is on page 6.

Mr. VAN OOSTERHOUT. In my opinion they have been studying that since 1960 when they first became involved in the program, and that seems to me like a long time to study. I do not really know. As I say, my problem is I work for my stockholders and when I see their money wasted to protect them from themselves, I have some real underlying economic problems. That situation has been under study for some time.

The benefit of the 1940 act to my shareholders in my humble opinion is zero. The cost to accomplish a benefit which is not real is considerable, in that case some part of a $100,000 a year. Some of that would be required under both the 1933 and 1934 acts. Certainly disclosure is not the problem. It is this vague area of consent with this big sword in the background of a section 17.

Mr. STULTS. If I may interject, I am disappointed at the SBA statement because in 1968 when NASBIC filed its application for exemption from the 1940 act SBA intervened in that case and

spoke very strongly in favor of the application of exempting SBIC's from the 1940 act.

Mr. VAN OOSTERHOUT. You have a copy of that provided with the application.

Mr. BROYHILL. Thank you, Mr. Chairman.

Mr. OPPER. Mr. Van Oosterhout, I take it from your statement that the difficulties you have in valuation of your portfolio are compounded by the fact that this valuation must be approved by the independent or disinterested directors?

Mr. VAN OOSTERHOUT. Right.

Mr. OPPER. I would assume that the disinterested directors would probably have very little background in this area to begin with. Is that true?

Mr. VAN OOSTERHOUT. We are fortunate in the fact that of my disinterested directors—and I have six of whom four are by definition disinterested—two of those gentlemen have had considerable venture capital experience. So I am fortunate in that area. But even with that expertise they have real problems. Each of these situations to value is totally subjective. There is absolutely no objective standard that you can apply to it numerically, which means they have been intimately involved with the affairs of the portfolio. I cannot pay them enough to do the job as they should be doing it. Every day these situations can change and they literally do.

Mr. BROYHILL. May I interject a question. Book value does not work?

Mr. VAN OOSTERHOUT. Book value does not work.

Mr. BROYHILL. Why is that?

Mr. VAN OOSTERHOUT. Primarily—you are talking book value of the portfolio we are valuing?

Mr. BROYHILL. Yes.

Mr. VAN OOSTERHOUT. It is hard to get less than zero, I guess. The other problem is that some of those firms are very successful in one business but have developed a negative book value in a business which is no longer involved. The book value really is a test which applies on liquidation, and we are not in the business of liquidating companies. We are in the business of, hopefully, growing.

Mr. OPPER. My understanding of the 1940 act is that it requires at least 40 percent of your directors to be disinterested. Does that provide a problem for your company?

Mr. VAN OOSTERHOUT. The only way a totally disinterested director could interest himself would be where they don't have the financial responsibility to care and they would not be smart enough to realize what they are getting themselves into. It is very difficult to convince good outside disinterested directors—which means they are not employees of the company and they are basically there as a pro bono type of representative—it is a very hard task to ask a responsible economically viable citizen to do. I am fortunate we have four such people, but frankly if one of them left I do not know where I could replace him. That is why I have six instead of a larger number.

Mr. STULTS. Some of our SBICs, publicly owned ones, have a capital of a $1 million to $2 million to pay good people. There is

prestige serving on the General Motors Board but in an SBIC prestige does not pay a very significant solid experienced director. An SBIC would have to pay them $10 or $20,000 to be on its board, and it is not generating that kind of income. That is not very good news for your shareholders, I don't believe, if you take all of your income and pay disinterested directors as defined by the 1940 act, and it certainly does not help your shareholders one nickel's worth.

Mr. VAN OOSTERHOUT. Too, the type person you referred to before, someone conversant enough with venture capital to be able to help on valuation, that type person is likely to be a very busy individual, and you are requiring an awful lot of his time, let alone his economic risk, if you will. It is a very dangerous place. Frankly, if I were in management of a company, I would not sit on a publicly owned venture capital company. There is no way you could convince me I would be rewarded for my time and effort involved.

Mr. OPPER. Thank you.

Mr. ECKHARDT. Thank you very much.

Mr. ECKHARDT. Next is Patricia M. Cloherty, Deputy Administrator, Small Business Administration.

STATEMENT OF HON. PATRICIA M. CLOHERTY, DEPUTY ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY JOHN WERNER, INVESTMENT DIVISION

Ms. CLOHERTY. With me is John Werner of the Investment Division and who has been closely associated with the Task Force on Equity and Venture Capital Investments.

If I may, I will in the interests of time, since you have our statement, submit it for the record and we will be pleased to answer questions.

[Ms. Cloherty's prepared statement follows:]

STATEMENT OF PATRICIA M. CLOHERTY, DEPUTY ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Mr. Chairman and members of this committee: I want to thank you for inviting us here today to present our views on H.R. 10717, 13032, and 13765—similar bills which would amend the Securities Act of 1933, and the Investment Company Act of 1940 to encourage investment in small business concerns.

I would like to say at the outset, that we appreciate and fully support the intent of these bills. However, it is clear to us that impediments to raising capital which have their roots in the Federal securities laws and regulations are only one set of problems. Other problems such as taxes and other Government regulations along with inflation and macroeconomic trends all operate to limit the opportunities of small businesses seeking capital. We must deal with all these problems in a systematic way if we are to facilitate the flow of investment money into small business concerns.

Nevertheless, we believe it is helpful to discuss initial steps toward facilitating the access of small businesses to the domestic flow of funds throught the capital markets, and major institutional financial intermediaries.

The basic problems as we see them are: (1) Restrictive conditions on the private placement of securities; (2) the quantitative limits on the resale of unregistered securities; and (3) the costs of initial and continuing disclosure requirements for the public offering of securities. These proposed bills do, in varying degrees, attempt to alleviate some of these basic problems.

However, we must recognize that although SBA and the Securities and Exchange Commission are both part of the same arm of Government, we have differences in our perspectives. SEC is the protector on the buy-side of the market, while SBA is the advocate of certain participants or potential participants on the sell-side of the primary markets.

Rule 146/Section 4(2) Private Placements

Section 1 of each of the three bills would amend Section 19 of the Securities Act of 1933 so that the SEC (in a transaction not involving a public offering) could not require that the offerees be furnished with other than material information. This provision is almost identical to a recommendation by the SBA Task Force on Venture and Equity Capital for Small Business which was contained in a report published in January 1977. Enactment of this provision would mean that a small business concern, in private offerings, would be spared the time and expense necessary to prepare other than material information and data. It should be noted, however, that SEC through its rule-making authority has the ability to do so and has, in the recent past, undertaken to reduce the burden on small business in this respect.

Rule 144/Sale of Restricted Securities

Rule 144 has been a most difficult problem for small, innovative firms which raise capital from institutional venture capital sources. Although Rule 144 was created to liberalize securities registration requirement in a way consistent with the SEC's role in protecting shareholders from being duped by investment offerings created for other than genuine risk/reward considerations, obstacles for small concerns attempting to obtain risk capital, unfortunately, still remain. Investors simply will not invest unless they can clearly perceive a means through which they can exit from their investment when they desire to do so, and Rule 144 limits the amount of unregistered securities which may be sold. The smaller issuer also must bear the cost of reporting requirements, as well as the burden of having small numbers of shares outstanding, if its share are to be sold in a manner contemplated under Rule 144.

Section 1 of all three bills states that the SEC may not impose onerous requirements in order for an affiliate of an issuer to obtain an exemption from registration. Further, the SEC would be unable to impose any limit on the amount of restricted securities which a person may sell if he or she has owned such securities at least five years.

I should note that the SEC recently has proposed rules increasing the amount of restricted securities which may be sold. We commend the SEC for its moves to modify these rules in a prudent manner beneficial to small businesses. These new rules may make the newly proposed Subsections (d), (e), and (f) to Section 19 of the Securities Act of 1933 unnecessary.

Seller liability

Section 2 of each of the three bills would provide that a seller in a nonpublic offering not be liable to the purchaser if all SEC rules and regulations have been met. We believe this could be important protection to the good faith seller in private offerings, but would not offer the buyer as much protection as he is afforded under current law.

Regulation "A" exemption list

As you know, Regulation "A" is the popular name for the regulations included in Sections 230.251 through 230.163 of 17 CFR which permit an issuer to offer securities not in excess of a fixed dollar amount ceiling in one year without full registration. These regulations require the use of a notification and offering circular supplying disclosure information about the issuer and the securities being offered. This set of regulations implements Section 3(b)—transactions in which the issue amount is small or limited and when registration is not in the public interest.

Unfortunately, the effectiveness of Regulation "A" as a general exemption for small offerings is questionable. The cost of a Regulation "A" offering is not significantly lower than that of an S–1 registration statement, despite any original intent to the contrary. Section 3 of all three bills would raise the exemption ceiling to $3 million which in our view is certainly preferable to the current ceiling of $1.5 million. I should note, however, that the ceiling was recently raised to $1.5 million by P.L. 95–283 on May 21, 1978, which, of course, we believe to be still too low. An enrolled bill, H.R. 11567, would raise the offering limit to $2 million.

SBIC's and the Investment Company Act of 1940

Section 4 of these proposed bills would exempt Small Business Investment Companies (SIBCs) from the Investment Company Act of 1940. It is our view that the SBA regulatory framework under which SBICs must operate, coupled with the requirements of the 1933 Act and/or the 1934 Act, may be sufficient to protect investors in publicly-held SBICs. However, we believe further study is needed to address fully

the implications of exempting SBICs from the definition of "investment company" for the purposes of the Investment Company Act of 1940.

In summary, Mr. Chairman, we at SBA support the intent of the changes in the Securities Act of 1933 and the Investment Company Act of 1940 proposed in the three bills under discussion here, but believe that many of the problems and obstacles addressed in these bills need to be studied further.

This concludes my prepared statement. I will be happy to respond to any questions you may have.

Mr. ECKHARDT. Without objection, your statement will be put in the record in full.

Ms. Cloherty, you point out that section 1 of the bills would require that only material information be given to investors in connection with a private offering. This, you suggest, would reduce certain burdens imposed on small issues. Is it your understanding that rule 146 presently requires the disclosure of other than material information?

Mr. WERNER. We base that statement on advice given to us in a report prepared by a task force at SBA in 1977 on venture and equity capital. This task force consisted of people that deal on almost a day-to-day basis with that element of the regulation or in the law. They advised us that, yes, some of the information required they considered immaterial or not significant to the protection of investors, and on the other hand very burdensome, especially to smaller issuers, whose costs of compliance, of course relative to the amount of money they might be acquiring, are relatively much higher.

Mr. ECKHARDT. Since the word "material" doesn't appear elsewhere in the Securities Act, do you have any thoughts on how it might be defined and where the definition should appear in the act?

Mr. WERNER. Certainly to take some of the subjectivity out of the area, because like anything else, what material is in any case is a matter of particular opinion at a particular point in time either by SEC staff or by the attorneys that might be preparing the answer.

Mr. ECKHARDT. You make an interesting point that the cost of a regulation A offering is not significantly less than a full registration statement, notwithstanding the intent of the regulation. It seems to me that you are suggesting that if we raised the section 3(b) ceiling to, say, $3 million and the Commission raised regulation A accordingly, regulation A at that level may not be significantly more attractive to a small issuer than a full registration.

Ms. CLOHERTY. It has been our view that the regulation A public offerings have problems that do not relate only to cost. Frankly, the brokers in the investment community handling those transactions have acquired a rather poor reputation, and the cost element in terms of the material a company would have to pull together for making an offering is comparable in many respects to that required for an S1. So we find the issue is not a great one.

The raising of the ceiling may be helpful to a number of companies, but in effect you would have to do a sales job on it to make it work.

Mr. WERNER. To address the issue of cost, first of all, there is no question there are economies of scale in the financial business. Many of the costs—and this is supported by SEC's own studies which includes all securities—their study on regulation A and its

cost shows that as with other registrations most of the costs are fixed, and consequently when you increase the limits, of course , it makes the relative cost to the people that are taking advantage of it, the larger issuers, lower.

Also, by raising the limits you include a broader spectrum of businesses that could avail themselves of regulation A. However, none of these comments or none of these proposed changes address the problem Mrs. Cloherty brought up, which I think is a credibility problem with regulation A. Most regulation A issues have been those placed on what is called a best-efforts basis. A few of them are underwritten. There are some specialists in the field that are underwriting, but by and large they are best-effort transactions.

The answer is that this does not address the issue of credibility of regulation A but it does, for those that are able to take advantage of it, cover a broader spectrum and a larger number small business, if you will.

Mr. ECKHARDT. From what we heard from witnesses yesterday, SBIC's do have a very significant burden under the 1940 act that probably ought to be alleviated. At the same time, from both your testimony and from what we have heard from Chairman Williams, there is some question about whether or not there should be an outright exemption.

You indicate a study might well be called for. I have given some thought to that. I have thought about discussing that with Chairman Williams. What would be your view of having the Small Business Administration and the SEC study this question and make some further recommendations?

Ms. CLOHERTY. I would say it is highly in order. My understanding, again, having come only recently to the agency, is it has been much discussed for years, so I think that some of other findings would be easily available and that the study could proceed forthwith.

Mr. ECKHARDT. Presently, in connection with the regulation of SBIC's, does the SBA attempt to coordinate its activities with the SEC and vice versa?

Mr. WERNER. More than anything else, it is not an active cooperation. It is a passive exchange of information, that is the way I would characterize it. Even though we are in contact with their staff.

Mr. ECKHARDT. Such a study could bring it into an active situation, but I do not think that such active participation should merely be directed at the ultimate conclusion of the study because there seem to be immediate problems that ought to be addressed such as continuous active interplay between the two agencies. Do you think that would be possible?

Ms. CLOHERTY. A part from the specific issue of dual regulation? You are speaking of a broader range of issues?

Mr. ECKHARDT. Yes.

Ms. CLOHERTY. We certainly would be prepared to see if we can enhance the level of cooperation that we have had. The SEC recently did have hearings, as you probably know, on small business.

Mr. ECKHARDT. Mr. Broyhill.

Mr. BROYHILL. As I have understood the past position of the SBA, they did support exemption of SBIC's for the 1940 act. As I under-

stand your testimony, you are saying that you have departed from that past position, and I would just wonder what has occurred to prompt the SBA to change its position from what it had been in the past.

Ms. CLOHERTY. I think just in the course of coming to some agreement with the Securities and Exchange Commission we do find ourselves in a position at the moment of recommending that there be some more rigorous analysis with an eye to making specific recommendations. I think it is through the collaboration that we have modified our position somewhat.

Mr. BROYHILL. You indicate that further study is needed. Who do you recommend do this study? Are you indicating that there is a formal study going on now between your agency and SEC?

Ms. CLOHERTY. No, there is not at all. Who would do it, how it would be scoped out and who would pay for it, at the moment I am just not prepared to answer.

Mr. BROYHILL. I am somewhat confused about your testimony at the bottom of page 4 and at the top of page 5 with respect to section 2 of the bill. We are specifically talking about the issue of whether or not rule 146 has been changed. I am not quite sure what you are saying here. I am confused as to what your position is. You say on the one hand you think this would be an important protection to good-faith sellers, but then you say it would not offer buyers as much protection as afforded under current law. In other words, what do you mean, and do you support the changes that the bill propose or not?

Mr. WERNER. My feeling is that what we are talking about here is the degree of specific coverage, how specific the coverage is in this particular element. I am not an attorney and not a securities specialist. I have to express it in layman's terms, but as I interpret this it in effect says that if any of the purchasers have somehow not gotten the information they should have, or regulations violated with respect to any purchaser, then all purchasers have grounds to move toward the issue and have it rescinded.

This is a form of very blanket coverage, and of course it has been, at least from what I have been told by the task force that we have had, it has been abused in some instances. An unhappy investor who did not realize what he truly expected from the investment from a return standpoint would search for a way to rescind it, using one of these as a sword rather than as a shield. Of course, I think because of the blanket nature of it, it possibly could be used that way.

However, the SEC, I think their position is, from purely an economic or staff level, it is much easier for them to administer such a law from a blanket standpoint than on a specific statement, and I can understand that.

Mr. ECKHARDT. If I may interject also, if you did not have it that way, there could be a rather loose operation under the act. The offender would say, "Oh, I have transgressed this time but I won't do it again," so what incentive is there for compliance?

Mr. WERNER. There is no law or regulation that can mandate good faith. It is just impossible. It cannot happen.

Mr. ECKHARDT. Excuse me.

Mr. BROYHILL. Is your position in support of the bill or in support of what the SEC has proposed?

Mr. WERNER. I think our position is what they call in the investment community a straddle. We see advantages to softening this area and yet we see how, as you say, it could be abused. It does pose some problems but it addresses the basic question that I do not think we have discussed yet, what is the balance in this particular element with respect to the public interest? Small business assistance vis-a-vis stockholder protection.

Mr. BROYHILL. Let me get to another point. I know that we have to go answer the vote. We have heard witnesses complain about duplicative conflicting regulations that are imposed upon both agencies. I wonder if the SBA has been taking any study of this or taking precautions to make sure that the rules are less burdensome or working with the SEC to try to come up with common reporting forms?

Ms. CLOHERTY. We do not have an effort currently under way to come up with such things as common reporting forms at the moment. From the standpoint of the agency in terms of its regulatory process, we have been most concerned that at least that aspect which is under our direct control be as straightforward and noncumbersome as possible for the SBIC's as to the 1940 act and the SEC, and the regulations are not under the jurisdiction of the Small Business Administration.

I think it is fair to say the previous witness, the part I heard of his testimony, was quite eloquent on the practical problems faced by companies in that industry. I think our interest is in working with the SEC to try to generate somewhat greater awareness of the requirements of the SBIC's in particular, but of small business generally, to which the securities law has not been specifically tailored in venture capital and private placements.

Mr. BROYHILL. Yesterday the SEC indicated that the SBA as a creditor of the SBBI's would be more interested in the question of protecting their own money rather than doing something to protect the interest of the investor. I wonder if you would comment on that aspect.

Ms. CLOHERTY. Yes; I understand that has been the position of having SBA put in a conflicting situation. However, I think that, again, we internally do intend to keep the regulatory aspect somewhat separate from the operating aspect, and I do not know that is an inevitable consequence of having the agency be the only regulator of the SBIC's

Mr. BROYHILL. That is all, Mr. Chairman.

Mr. ECKHARDY. Thank you very much. It has been helpful testimony.

The Subcommittee on Consumer Protection and Finance will be adjourned subject to the call of the Chair.

[The following statements were received for the record:]

STATEMENT OF DR. EDWIN V. W. ZSCHAU, CHAIRMAN
CAPITAL FORMATION TASK FORCE
OF THE AMERICAN ELLCTRONICS ASSOCIATION

Before the Subcommittee on Taxation and Debt Management
Senate Finance Committee
June 29, 1978

Mr. Chairman and Members of this distinguished Subcommittee.

I'm Edwin V. W. Zschau, Chairman of the Board of System Industries of Sunnyvale, California. System Industries, founded in 1968, is a manufacturer of minicomputer peripheral equipment. We employ about 250 people in the United States and sell about 25% of our total volume abroad.

Before founding System Industries, I was an Assistant Professor of Management Science in the Graduate School of Business at Stanford University and a Visiting Assistant Professor of Business Administration at Harvard University. Currently, I am a Lecturer in Business Policy at Stanford.

I am appearing before you this morning in my capacity as Chairman of the Capital Formation Task Force of the American Electronics Association (AEA), which was formerly known as WEMA.

AEA is an association of more than 950 high-technology companies in 38 states. Its members are manufacturers of electronic components and equipment or suppliers of products and services in the information processing industries. While our member companies employ more than one million Americans and include some of the nation's largest companies, two-thirds of our member companies are small, employing fewer than 200 people.

Mr. Chairman, the high-technology companies of the American Electronics Association strongly support the Investment Incentive Act of 1978 which was introduced as S3065 on May 11, 1978, by Senator Clifford P. Hansen of this Subcommittee and 59 Senate cosponsors. We believe

that restoring the tax treatment for capital gains to what it was prior to 1969 will stimulate more risk capital investment and result in extraordinary benefits to our economy. Still, we do not view this proposal as the ultimate solution to our country's capital formation problems. Rather, it is a major step in the right direction. We believe that eliminating all taxes on income from risk capital investments would significantly magnify the benefits resulting from the current proposal. We urge Congress to consider that extension of the Hansen bill since it would bring our tax treatment of capital gains into line with Japan and West Germany--our major competitors in world markets.

As members of this Committee are well aware, this hearing is focusing on an extremely timely issue. Just last week major articles in Business Week, Time, and the Wall Street Journal told us:

- The U.S. leadership in science and technology, which for decades has been our chief source of economic and military strength, has slipped so badly that the White House has had to order a massive 28-agency review of the problem;

- The growth in worker productivity in the United States has declined alarmingly to a meager 2.2%; and

- Our trade deficit in the first quarter, 1978, reached a record $6.95 billion, topping the old record set in fourth quarter, 1977.

Reading these articles separately, it's easy to lose sight of how closely these problems are interrelated. Without sufficient advances in technology, productivity suffers and U.S. companies become less competitive not only in foreign markets but also here at home.

In the opinion of many experts, these problems all stem from the same fundamental cause--insufficient risk capital investment. Today, we will provide you concrete evidence documenting that relationship.

THE AEA SURVEY

Our testimony today in support of the Investment Incentive Act of 1978 is based on the results of a major survey of the capital formation experience of U.S. electronic companies recently conducted by the American Electronics Association. It is the most extensive survey of its kind ever conducted and provides startling new information and valuable insight in four areas important to an understanding of S3065.

First, it documents and quantifies the benefits to the United States of a tax policy that stimulates more risk capital investment. The principal benefits would be:

- More jobs;
- Increased R&D expenditures to develop new technologies which, by extending the powers of the human body and intellect, can improve productivity and the quality of life;
- Increased exports to lessen our record foreign trade deficits;
- Increased tax revenues which result from the rapid growth for which small, high-technology companies have become famous.

Second, the survey provides additional documentation that there is a serious capital shortage today, particularly for starting and growing young companies. It shows that shortage has worsened sharply since 1969 when capital gains taxes were increased. As a result, small companies are not getting started or are badly undercapitalized. Another result of this shortage of homegrown capital has been a flow of foreign capital into U.S. companies which is resulting in foreign companies gaining control of U.S. companies and their most promising new technologies.

Third, we conclude from the survey that the most direct and perhaps the only solution to this risk capital shortage is to reduce significantly the tax rate on capital gains. The survey shows that the benefits of such tax reductions to the investors would be small in comparison to the benefits to the economy that their investments produce.

Finally, the survey provides additional evidence that reducing the capital gains tax rates should increase rather than decrease federal tax revenues. This evidence, rather than being based upon macroeconomic analyses, is based upon data of the surveyed companies which documents the remarkable capability of relatively modest investments to generate large federal tax revenues year after year.

The data in the survey comes from 325 companies which accounted for more than $45 billion in revenues in 1976. More than one third--$16.4 billion--of this came from exports and overseas operations. These companies employed nearly 750,000 people in the United States in 1976, spent $2.2 billion on R&D, and paid $1.8 billion in federal corporate income taxes and nearly $700 million in state and local taxes. Most of the companies in the survey are young companies--85% were founded in the past 22 years--and about 60% are still privately held. Their data is usually unavailable to the public.

METHODOLOGY OF THE AEA SURVEY

The survey form contained in Appendix I was sent to all 905 members of AEA at the time. Of those, 230 were actually operating units of parent companies. Eliminating such duplication, a total of 675 separate companies were surveyed. Responses were received from 269 of these, yielding a survey response ratio of 40%. Also, survey forms were sent to a number of nonmember electronics companies; 56 responses were received from those.

All of the responses were sent directly to the public accounting firm of Coopers & Lybrand in Palo Alto, California. Coopers & Lybrand held the raw data in strict confidence but reviewed each response to check for apparent errors. In such cases, the firm contacted the company to clarify or correct the data.

Once the authenticity of the data had been verified, Coopers & Lybrand prepared various data summaries and performed certain statistical analyses on which our testimony is based. The data summaries are contained in Appendix II.

WHAT THE AEA SURVEY SHOWS

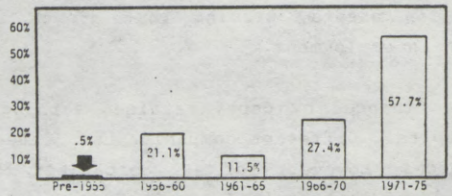
YOUNG COMPANIES CREATE JOBS FASTER

The AEA survey documents the importance of young companies in solving the nation's unemployment problem. It shows that young companies create jobs much faster than mature companies.

Exhibit 1

YOUNG COMPANIES CREATE JOBS MUCH FASTER THAN MATURE COMPANIES

Employment Growth Rates in 1976



Period of Founding	Pre-1955	1956-60	1961-65	1966-70	1971-75
Jobs Added	3,260	8,499	2,715	10,546	2,572
(Companies in Sample)	(47)	(26)	(38)	(135)	(77)

If we divide the companies in the sample into four categories--"mature" (more than 20 years old), "teenage" (between 10 and 20 years old), "developing" (5 to 10 years old), and "start up" (less than 5 years old)--the survey shows that the employment growth rate in 1976 for the teenage companies was about 20-40 times time growth rate in employment of mature companies. The developing companies had an employment growth rate in 1976 that was nearly 55 times the growth rate in employment of the mature companies, and the employment growth rate for the start ups in 1976 was 115 times that of the mature companies.

Even more startling is the fact that, although the mature companies averaged 27 times more employees than the younger companies founded since 1955, in 1976 those young companies created an average of 88 new jobs per company versus an average of only 69 new jobs per mature company.

NEW JOBS REQUIRE RISK CAPITAL

The AEA survey data shows that new jobs require risk capital investment.

On the average, the young companies in the survey founded since 1955 required $32,720 of assets for each job created. Moreover, detailed statistical analyses indicate a high correlation between increased in jobs and increases in assets, proving that growth in assets is necessary for growth in employment.

Asset growth can be financed by debt, retained earnings, or injections of new risk capital. Different companies use different mixes of these financial sources. However, for all companies, the amount of debt that can be used and the retained earning generated are limited. Therefore, all rapidly growing companies require new infusions of risk capital to support employment increases. For the 276 young companies in the survey, an average of $14,000 of risk capital was required to create each of the 131,000 new jobs generated since 1955.

RISK CAPITAL INVESTMENTS GENERATE STREAMS OF OTHER BENEFITS

The creation of jobs is not the only benefit that the country reaps from risk capital investments. The AEA survey shows that risk capital investment in a high-technology company generates annual streams of export sales, R&D expenditures, and tax revenues to Federal, state and local governments. The AEA survey documents for the first time the magnitudes of these benefits. They are surprisingly large and they begin quickly.

Let's take, for example, the 77 companies founded most recently in the 1971-75 time period and look at the benefits that those companies were already providing in 1976 even though they were, on the average, just four years old. In 1976, for each $100 of equity capital that had been invested in these companies, they generated export sales of $70, spent $33 on R&D, paid $15 in federal corporate income taxes, paid $5 in state and local taxes, and generated $15 of personal federal income tax revenue through the jobs created by that investment. Notice that the Federal Government received an incredible $30 of tax revenue in 1976 for every $100 invested in these companies founded during 1971-75.

Exhibit 2

BENEFITS IN 1976 PER $100 INVESTED IN THE COMPANIES FOUNDED DURING 1971-75

- $70 in exports
- $33 on R&D
- $15 in federal corporate taxes
- $15 in personal income tax revenues
- $5 in state and local taxes

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The table below compares the benefits generated in 1976 for every $100 of risk capital invested in companies founded during each of the time periods in the survey. Although the amounts vary somewhat, the conclusion is clear: risk capital investment is like the goose that lays golden eggs. An investment made once generates streams of benefits year after year. These benefits are large and they start soon after the investment.

BENEFITS IN 1976 PER $100 INVESTED

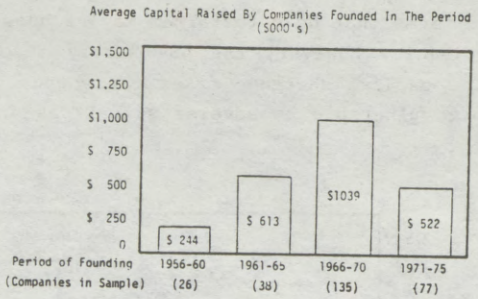
Years Founded	Companies in Sample	Foreign Sales	R&D Expense	Federal Corporate Tax	State & Local Tax	Personal Income Tax	Total Fed. Tax Revenue
1956-60	26	$91	$19	$ 7	$3	$12	$19
1961-65	38	89	18	9	5	13	22
1966-70	135	57	20	12	4	11	23
1971-75	77	70	33	15	5	15	30
1956-75	276	$76	$20	$10	$4	$12	$22

SINCE 1970, RISK CAPITAL HAS BECOME SCARCE

Increases in tax rates on capital gains, which have made risk capital investments less attractive in recent years, have unwittingly been killing the goose that lays these golden eggs. The AEA survey documents that capital has become severely scarce even for high-growth electronics companies. The chart below, stated in current dollars not adjusted for inflation, shows that in the first years of their existence, the companies founded during 1971-75 were able to raise only one half as much equity capital on the average as those firms founded during 1966-70. By 1970, the 135 firms founded in the 1966-70 period had raised an average of $1,039,000 in risk capital, while by 1975 the 77 companies founded during 1971-75 had raised only $522,000 per firm. That was even less than the capital the companies founded during 1961-65 raised in 1961-65.

Exhibit 3

RISK CAPITAL HAS BECOME SCARCE
(Current Dollars)

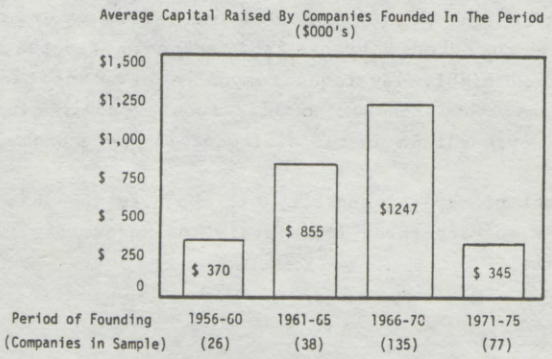


When inflation is taken into account, though, the true magnitude of the capital scarcity problem is revealed.

The chart below, stated in constant 1972 dollars, shows the firms founded in 1971-75 were able to raise on the average less than 30% as much capital as firms founded during 1966-70 raised during the 1966-70 period. In fact, in terms of purchasing power, the new companies formed since 1971 raised less capital per firm in their early years than firms founded at any time in the past 20 years!

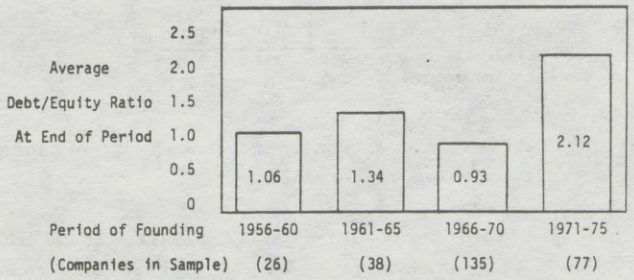
Exhibit 4

RISK CAPITAL HAS BECOME SCARCE
(Constant 1972 Dollars)



CAPITAL SCARCITY MAKES YOUNG COMPANIES VULNERABLE

Some effects of capital scarcity are obvious: Firms that would get started don't, and firms that do get started may be unable to grow as rapidly as is desirable. However, the AEA survey also documents a hidden problem: The capital shortage makes the young companies that do get started more vulnerable to adverse situations in the economy and their markets.



The chart above compares debt-to-equity ratios of firms founded since 1955. For the 15 years up through 1970, the debt-to-equity ratio of the firms founded during those years was about 1:1, putting them in a relatively good position to withstand adverse circumstances. However, in 1976 the capital-starved firms founded in the period 1971-75 had an average debt-to-equity ratio of more than 2:1, making them far more susceptible to adverse events and economic fluctuations. In fact, because such highly leveraged companies often go bankrupt in economic downturns, they tend to amplify such economic fluctuations and, therefore, represent an unstable element in the economy.

This hidden effect of capital scarcity will magnify the next economic downturn unless steps are taken immediately to improve the availability of risk capital.

RISK CAPITAL INVESTORS SEEK CAPITAL GAINS

In determining how to solve the capital scarcity problem, it is important to understand the motivation of the investors that contribute risk capital to young growth companies. The AEA survey suggests that investors who invested the equity capital that permitted the young companies to get started and grow made their investments to obtain appreciation on their invested capital rather than to obtain dividends. Specifically, the survey showed that dividends paid in 1976 as a percentage of the equity capital invested were less than 0.8% on the average of all companies founded since 1955. Moreover, for the new companies formed during 1971-75, the dividends paid as a percent of equity invested were less than 0.1%. No investor would be attracted by such a low dividend yield.

There are two reasons why risk capital investors must seek capital gains in making their investments. First, since high-growth companies can't generate enough retained earnings to finance their growth, they need constant injections of new equity capital. Therefore, they can ill afford to pay out a portion of their scarce equity in dividends. Second, the risks of investing in a young high-technology company are extremely high. These risks are particularly severe in the electronics industries where the possibility of R&D failures and rapid technological obsolescence are added to the many challenges that other small companies face. In order to justify investing in such high risk ventures, the investor requires a high potential rate of return. Such high returns don't come from dividends. They are only possible from capital gains.

As members of this Subcommittee are well aware, the Tax Reform Act in 1969 and subsequent tax legislation have increased the maximum tax rate on capital gains from 25% to more than 49%. This has significantly and adversely altered the risk/reward ratio in making risk capital investments. The rewards have been reduced, but the risks of such investments have remained the same or have perhaps even increased in today's uncertain economy plagued with inflation. As a

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result, people have become unwilling to risk losing their money in new ventures. The AEA survey shows that. The goose that lays the golden eggs is dying.

INVESTOR GAINS ARE SMALL COMPARED TO BENEFITS GENERATED BY THEIR INVESTMENTS

AEA survey data provides important new insights into the question of who benefits most from tax legislation that stimulates risk capital investment. The table below summarizes calculations used in estimating the average annual gain to investors per $100 invested in the survey companies.[1]

ESTIMATING THE AVERAGE ANNUAL INVESTOR GAIN PER $100 INVESTED

Years Founded	Estimated Total Mkt. Value ($Million)	Total Invested ($Million)	Total Gain ($Million)	Total Gain (Per $100)	Average Holding Period (Years)	Average Annual Gain (Per $100)
1956-60	1266.7	700.6	566.1	81	3.5	23
1961-65	1004.2	360.1	644.1	179	6.5	28
1966-70	1204.7	708.5	496.2	70	3.7	19
1971-75	86.5	66.8	19.7	29	2.2	13

[1] These estimates were made by multiplying the profits earned by the companies in 1976 by a price/earnings multiple of 10--an appropriate multiple in today's market for companies like these. The total investor gain is the difference between this market value and the amount of investment made in the companies since their inception. Dividing the total gain per $100 invested by the average holding period of the investments yields the average annual gain to the investor per $100 invested.

These estimates of potential investor gains are certainly much higher than what the investors could actually realize from their investments. Specifically:

- Many of these investments are in private companies, so the investors are either unable to realize their gain through sale of the stock or the sale must be made at a discount price in a private placement;

- These gains are prior to any capital gains taxes being levied;

- All calculations are in current dollars, so that much of these apparent gains are nothing more than the result of inflation;

- Since our survey only reached companies still in existence, these estimated gains ignore investments which were unsuccessful and in which the capital risked by these same investors was lost.

The table below summarizes these pre-tax average annual gains per $100 invested compared to the benefits to the economy that the investments produced in 1976.

COMPARING INVESTOR GAINS TO BENEFITS THEIR INVESTMENTS PRODUCE
(Per $100 Invested)

	Investor	Benefits in 1976 to U.S. Economy			
Years Founded	Average Annual Pretax Gain	Total Taxes Paid*	Estimated Salary/Wages Paid	R&D Expenses	Export Sales
1956-60	$ 23	$ 22	$ 72	$ 19	$ 91
1961-65	28	27	78	18	89
1966-70	19	27	66	20	57
1971-75	13	35	80	33	70
1056-75	$ 22	$ 26	$ 72	$ 20	$ 76

*Federal, state, local, and personal income taxes (see table on pg.7)

It's clear that the benefits our country reaps from the risks these investors take far exceed the gain they can hope to receive. It's startling to see that, even if capital gains were not taxed at all, the annual tax revenues flowing to government as a result of these investments are about the same or even greater than the maximum potential gains of the investors. The investors took the risk but the federal, state and local governments can get an even larger return than he can!

We should also keep in mind that many of these benefits from risk capital investment, such as jobs, technology development, export sales and even tax revenues, are realized even if the companies fail. In those cases, the investors lose, but our country is still better off because the possibility of a reward motivated them to try.

CONCLUSIONS OF THE AEA SURVEY

SINCE 1970, RISK CAPITAL HAS BECOME SCARCE

The survey documents the risk capital scarcity problem. It shows that in recent years this needed capital has become extremely difficult to raise. The capital shortage has not only stifled formation and growth of young companies but has made those companies that were able to get started vulnerable to economic fluctuations.

THE INVESTMENT INCENTIVE ACT OF 1978 WOULD STIMULATE MORE INVESTMENT

Based on the results of this survey we conclude that a substantial and lasting reduction in the capital gains tax rate is the most direct and perhaps the only way to stimulate needed investment. Investors put their money into young companies for potential capital appreciation. The Investment Incentive Act of 1978, by increasing

that potential after tax returns would stimulate more investment. Of course, reducing the capital gains tax rate still further would be even more effective.

MORE RISK CAPITAL WOULD ENABLE NEW COMPANIES TO GET STARTED AND GROW

The survey shows that young companies need constant injections of risk capital in order to get started and grow. In their formative years, they are investing heavily in development of new products and the establishment of their organizations before they begin generating profits. Later, when they are profitable, their potential growth is greater than they can finance through retained earnings and borrowings. The availability of adequate risk capital would result in many new companies being formed and growing to their full potential.

MORE RISK CAPITAL WOULD FINANCE NEW JOBS

The data in the AEA survey indicates that the young, high-growth companies are the most effective in creating new jobs. Improved availability of risk capital would enable more of these companies to get started and expand. The new jobs that would be created would be high-quality positions with a future both for the workers and their communities rather than make-work, "public service" type jobs.

MORE RISK CAPITAL WOULD RESULT IN ADVANCES IN TECHNOLOGY

The survey documents the relationships between invested risk capital and R&D expenditures in the high-technology industries. We need increased R&D expenditures if we are to maintain our technological leadership and to improve the productivity of our workers.

If the availability of risk capital does not improve, the young, high-technology companies will continue to seek and obtain investment

from foreign sources. As in the case of my own company, System Industries, such investments from foreign sources often result in the sale of technology as well as ownership in the U.S. company, enabling foreign competitors to reach a technical parity with their U.S. counterparts. Such transactions, which have been occurring more frequently in the electronics industry recently, will reduce the favorable trade balances that the U.S. high-technology industries have enjoyed in the past, and breed increased competition from foreign companies in the U.S. market. What has occurred with television sets and now calculators will certainly occur with semiconductors and computers unless incentives for investment are improved and improved quickly.

Our failure to maintain dominance in science and technology also weakens our defense posture. This nation's strategic position in the world today is based increasingly on our ability to maintain technological rather than numerical superiority over our adversaries. Since the fields of important technology have become so broad and R&D appropriations have shrunk, our defense capabilities have become increasingly dependent on commercially-developed innovations rather than relying primarily on government funded R&D. The private sector in the United States must continue to provide the needed technology, but it needs more risk capital to do it.

LOWER CAPITAL GAINS TAXES DON'T MEAN REVENUE LOSS

Mr. Chairman, we realize that this Subcommittee must be concerned with generating adequate federal tax revenues. We also realize that tax rate reductions are usually expected to result in revenue loss. However, because of the unique ability of long-term investment to generate jobs and economic growth, reducing capital gains taxes may not decrease the federal tax revenues at all. In fact, data from the AEA survey indicates that a significant reduction in the capital gains tax rate could actually <u>increase</u> rather than decrease federal tax revenues.

This assertion is based on two factors that have been ignored by the "static" analyses that you have been provided by the Treasury Department. First, substantially lower tax rates on capital gains will increase the potential after-tax returns from risk capital investments, and stimulate investment of more funds. Allowing the investor to retain more of the gains will also put more capital at his disposal. Second, as the AEA survey has documented, a surprisingly large annual flow of federal tax revenues results from capital investment. The additional investment stimulated by the rate reduction would generate ordinary income tax revenues that would offset and surpass the revenue lost from the lower tax rate. Moreover, that additional investment would also result in more jobs, increased exports and new technology.

AN EXAMPLE

An example, based on the survey data and some reasonable assumptions, may clarify how this would occur.

Let's suppose that the average return on successful risk capital investments is about 15% per year compounded. At that rate, a $100 investment today would be worth $200 in 5 years. If we assume a capital gains tax rate of 40%, then the tax revenue on the $100 capital gain earned after 5 years would be $40.

If, however, enlightened new tax legislation were enacted eliminating all federal taxes on capital gains, the Treasury would lose the $40 of capital gains tax revenue.

But eliminating the capital gains tax would increase the after-tax return on the $100 capital investment by 67% (old return=$60; new reutrn=$100; gain=$40; 40 ÷ 60 = 67%). Given this increase in returns from investments; it's reasonable to suppose that investors would increase their investments to some extent. Let's assume for this example that the level of investments increased by 50%.

The AEA survey has shown that for companies founded since 1955, the average annual federal taxes generated by $100 of investment is $22. Therefore, we would expect that the total federal tax revenues over 5 years resulting from each additional $50 investment would be $55 ($50 ÷ $100 x $22 x 5 years). This more than offsets the $40 revenue loss.

THE INVESTOR'S GAINS FROM INVESTMENTS ARE SMALL COMPARED TO THE BENEFITS:

The AEA survey enables us to measure the gains received by investors for risking their capital in comparison to the benefits to the economy from those investments. In the case of tax revenues, the survey shows that the investor's potential annual gains are less than the annual tax revenues to federal, state, and local governments generated by those investments. In addition, those investments generate the jobs, technological developments, and export sales needed to combat our economic problems.

Exhibit 5

INVESTOR GAINS COMPARED TO BENEFITS THEIR INVESTMENTS PRODUCE
(Per $100 Invested In Companies Founded Since 1955)

Investor:

Average Annual Gain = $ 22

But this gain:

- Is pre-tax
- Is often not liquid--can't be realized
- Is largely due to inflation
- Ignores unsuccessful investments that also produce benefits

Economy:

Benefits in 1976

- Total taxes paid = $ 26
- Salary and wages paid = $ 72
- R&D expenditures = $ 20
- Export sales = $ 76

* * *

Mr. Chairman, we believe that the essential point to be learned from the AEA survey data is that invested capital is unique in its ability to create benefits to this nation. A one-time investment can generate a stream of annual benefits.

For that reason, gains from investments should be viewed differently than ordinary income. The gains are incentives for individuals to risk their capital and make those investments. Taxes on those gains aren't just revenues to the government. They're also disincentives that discourage individuals from making such investments. Substantially reducing or eliminating those disincentives would be the most direct and perhaps the only way to stimulate the risk capital investment that this country needs so desperately.

Mr. Chairman, we hope that the AEA survey data will help this Subcommittee and the Senate Finance Committee in formulating and analyzing tax policy alternatives. In addition to the data summaries contained in this testimony, the Association would be pleased to perform further analyses of the raw data or to solicit other information from our membership that you might request.

I thank you for your attention and would welcome your questions.

APPENDIX I

WEMA

CAPITAL FORMATION SURVEY OF HIGH-TECHNOLOGY COMPANIES

Instructions

While the form is self-explanatory, the following comments are included to help avoid any misunderstanding.

1. Each column should contain information for a single year, except for "Equity Capital Raised" which, as explained in footnote 3, should show aggregate raised during the five-year periods 1956-1960, 1961-1965, 1966-1970, and 1971-1975.

2. The first five line items all refer to income statement items. Thus, "Federal Corporate Income Taxes" (including the total of current and deferred), "State and Local Taxes," and "Company Funded R&D" should reflect the expense for the year. If R&D amounts were capitalized prior to 1975, please show the R&D expenditures actually made during the year (equivalent to the restated amounts required under SFAS #2).

3. Line items for "Total Assets," "Shareholders' Equity," "Retained Earnings," and "Total U.S. Employees" refer to balances or amounts at the end of the year.

4. "Employee Federal Income Taxes Withheld" should be the amount withheld during the year.

5. "Equity Capital Raised" should include the exercise of stock options and warrants as well as company-sponsored stock purchase plans. Companies that are subsidiaries should consider equity provided by the parent as "From Private Sources".

Divisional organizations should send this questionnaire and enclosed material to their parent company with the recommendation that the corporate office respond.

WEMA

CAPITAL FORMATION SURVEY OF HIGH-TECHNOLOGY COMPANIES

(Fiscal or Calendar Year End Figures in Thousands of Dollars)

	1960	1965	1970	1975	1976
Total Revenues					
Total Foreign Revenues					
Company Funded R&D					
Federal Corporate Income Taxes (accrual basis)					
State and Local Taxes (1)					
Total Assets					
Total Shareholders' Equity (2)					
Retained Earnings					
Dividends Paid					
Equity Capital Raised During Period (2) (3)					
–From Private Sources					
–From the Public					
Total U.S. Employees					
Employee Federal Income Taxes Withheld					

_____ Year company was founded.

_____ Year company first sold equity securities to outside (nonmanagement) investors.

_____ Year company stock was first publicly traded.

Name of Company _____

Name of Preparer _____

Telephone # _____

(1) including both income and property taxes; accrual basis.
(2) including all senior securities convertible into equity securities.
(3) for years other than 1976 show aggregate raised during the previous five-year period.

SEND DIRECTLY TO: Nicholas G. Moore
Coopers & Lybrand
Two Palo Alto Square
Palo Alto, CA 94304
(415) 493-1552

This data is submitted with the understanding that it will be held in confidence under the CPA Code of Ethics. It will be used only in aggregate industry compilations.

APPENDIX II

AEA SURVEY DATA

The data from the 325 survey respondents are summarized on the following pages. The data are summarized in total and by period of company foundings.

All dollar amounts are in thousands of dollars. However, all ratios involving dollars are in dollars. All other numbers are as they appear in the summaries.

The following abbreviations were used for identifying data line items.

Abbreviation	Heading
TOT REVENUE	Total Revenues
TOT FOREIGN REVENUE	Total Foreign Revenue
FUNDED R&D	Research and Development Expense
FED INC TAX	Total Federal Income Tax Expense
S AND L TAKEN	Total State and Local Tax Expense
TOT ASSETS	Total Assets
S/H EQUITY	Total Shareholder Equity (Total Net Assets)
RET EARNING	Retained Earnings
DIV PAID	Dividends Paid
EQUITY RAISED	Equity Raised
- PRIVATE	- From Private Sources
- PUBLIC	- From Public Sources
TOT US EMPLOYEE	Total U.S. Employees
EMP FIT W/H	Total Federal Income Taxes Withheld From Employees
CUM TOT EQUITY	Cumulative Total Equity Raised
- PRIVATE ($)	- From Private Sources ($000's)
- (%)	- From Private Sources As A Percentage Of Total Cumulative Equity
- PUBLIC ($)	- From Public Source ($000's)
- (%)	- From Public Source As A Percentage Of Total Cumulative Equity

Abbreviation	Heading
REV/CUM EQUITY	Revenues Reported Per Dollar of Cumulative Equity Raised
R&D/CUM EQUITY	Research and Development Expense Per Dollar of Cumulative Equity Raised
FED TAX/CUM EQU	Federal Income Tax Expense Per Dollar of Cumulative Equity Raised
S&L TAX/CUM EQU	State and Local Tax Expense Per Dollar of Cumulative Equity Raised
T ASSET/CUM EQU	Total Assets Per Dollar of Cumulative Equity Raised
EMPLOYEES	Total U.S. Employees
PERIOD INCR	Increase in Total U.S. Employees
T ASSET/JOB	Total Assets Per U.S. Employee (in Dollars)
REVENUE/JOB	Total Revenue Per U.S. Employee (in Dollars)
CUM EQUITY/JOB	Cumulative Equity Raised Per U.S. Employee

For companies founded prior to 1955, the equity raised prior to 1955 was not submitted in the survey data. The employee taxes withheld were only submitted for the years 1960 and later. Therefore, data regarding these items does not appear on the following summary sheets.

ALL RESPONSES
ALL SALES

NUMBER OF RESPONSES: 325

	1960	1965	1970	1975	1976
TOT REVENUE	6,411,434	11,457,221	22,487,095	40,347,910	45,262,982
TOT FOREIGN REV	873,975	2,213,450	5,941,056	14,871,016	16,392,510
FUNDED R&D	218,282	431,437	1,010,159	2,027,570	2,223,119
FED INC TAX	325,763	611,512	909,411	1,304,076	1,792,109
S AND L TAXES	64,197	215,185	328,761	645,602	699,980
TOT ASSETS	4,564,148	9,257,122	22,704,467	37,495,305	41,630,910
S/H EQUITY	2,692,853	5,503,596	12,759,246	21,427,309	24,366,325
RET EARNINGS	1,215,502	3,126,705	6,801,380	12,910,481	15,197,088
DIV PAID	169,985	326,896	778,167	1,251,362	1,510,622
EQUITY RAISED	501,884	520,807	2,744,987	2,757,907	563,092
-PRIVATE	103,842	127,345	224,657	391,135	75,145
-PUBLIC	398,042	395,664	2,520,203	2,365,981	487,990
TOT US EMPLOYEE	330,612	511,780	700,985	719,174	746,851
EMP FIT W/H	-------	-------	291,665	690,409	782,708
CUM TOT EQUITY	501,884	1,022,691	3,767,678	6,525,585	7,088,677
-PRIVATE ($)	103,842	231,187	455,844	846,979	922,124
- (%)	20.69	22.61	12.10	12.98	13.01
-PUBLIC ($)	398,042	793,706	3,313,909	5,679,890	6,167,890
- (%)	79.31	77.61	87.96	87.04	87.01
EMPLOYEES	330,612	511,780	700,985	719,174	746,851
PERIOD INCR	-------	181,168	189,205	18,189	27,677
T ASSET/JOB	13,805	18,088	32,389	52,136	55,741
REVENUE/JOB	19,392	22,387	32,079	56,103	60,605

FOUNDED PRIOR TO 1955
ALL SALES

NUMBER OF RESPONSES: 47

	1960	1965	1970	1975	1976
TOT REVENUE	6,378,927	11,268,278	21,379,349	36,108,725	39,820,822
TOT FOREIGN REV	873,821	2,208,009	5,753,787	13,745,599	14,982,796
FUNDED R&D	217,475	420,781	915,315	1,735,316	1,857,403
FED INC TAX	324,816	603,593	877,994	1,189,281	1,612,451
S AND L TAXES	64,025	213,355	316,555	598,515	618,165
TOT ASSETS	4,544,458	9,057,009	21,456,617	34,138,680	37,339,004
S/H EQUITY	2,683,280	5,423,603	12,222,313	19,788,214	22,046,341
RET EARNINGS	1,214,030	3,107,298	6,787,420	12,603,072	14,530,466
DIV PAID	169,818	326,651	776,896	1,247,166	1,503,295
EQUITY RAISED	495,517	461,607	2,191,931	1,831,176	271,914
-PRIVATE	99,919	94,242	66,314	73,387	15,642
-PUBLIC	395,598	367,365	2,125,617	1,757,789	256,272
TOT US EMPLOYEE	329,179	503,411	657,943	612,394	615,654
EMP FIT W/H	--------	---------	248,499	515,851	557,409
CUM TOT EQUITY	495,517	957,124	3,149,055	4,980,231	5,252,145
-PRIVATE ($)	99,919	194,161	260,475	333,862	349,504
- (%)	20.16	20.29	8.27	6.70	6.65
-PUBLIC ($)	395,598	762,963	2,888,580	4,646,369	4,902,641
- (%)	79.84	79.71	91.73	93.30	93.35
EMPLOYEES	329,179	503,411	657,943	612,394	615,654
PERIOD INCR	-------	174,232	154,532	-45,549	3,260
T ASSET/JOB	13,805	17,991	32,611	55,746	60,649
REVENUE/JOB	19,377	22,383	32,494	58,963	64,680

FOUNDED 1956 TO 1960
ALL SALES

NUMBER OF RESPONSES: 26

	1960	1965	1970	1975	1976
TOT REVENUE	32,607	120,217	535,263	1,588,638	1,978,533
TOT FOREIGN REV	154	3,960	103,120	525,741	636,727
FUNDED R&D	807	5,106	29,386	115,179	135,550
FED INC TAX	947	5,136	15,224	35,830	50,994
S AND L TAXES	172	1,569	6,540	17,306	21,961
TOT ASSETS	19,690	153,142	519,721	1,329,257	1,715,945
S/H EQUITY	9,573	59,893	242,586	733,947	1,030,316
RET EARNINGS	1,472	20,536	39,942	297,630	424,304
DIV PAID	167	185	192	1,013	2,068
EQUITY RAISED	6,367	35,874	203,822	304,179	150,310
-PRIVATE	3,923	25,592	52,081	83,488	7,794
-PUBLIC	2,444	10,282	151,741	220,691	142,516
TOT US EMPLOYEE	1,433	5,251	18,483	40,270	48,769
EMP FIT W/H	------	------	15,413	69,303	86,590
CUM TOT EQUITY	6,367	42,241	246,063	550,242	700,552
-PRIVATE ($)	3,923	29,515	81,596	165,084	172,878
- (%)	61.61	69.87	33.16	30.00	24.68
-PUBLIC ($)	2,444	12,726	164,467	385,158	527,674
- (%)	38.39	30.13	66.84	70.00	75.32
REV/CUM EQUITY	5.12	2.85	2.18	2.89	2.82
R&D/CUM EQUITY	.13	.12	.12	.21	.19
FED TAX/CUM EQU	.15	.12	.06	.07	.07
S&L TAX/CUM EQU	.03	.04	.03	.03	.03
T ASSET/CUM EQU	3.09	3.63	2.11	2.42	2.45
EMPLOYEES	1,433	5,251	18,483	40,270	48,769
PERIOD INCR	-----	3,818	13,232	21,787	8,499
T ASSET/JOB	13,740	29,164	28,118	33,008	35,185
REVENUE/JOB	22,754	22,894	28,959	39,449	40,569
CUM EQUITY/JOB	4,443	8,044	13,312	13,663	14,364

FOUNDED 1961 TO 1965
ALL SALES

NUMBER OF RESPONSES: 38

	1960	1965	1970	1975	1976
TOT REVENUE	0	68,726	395,909	1,012,574	1,196,164
TOT FOREIGN REV	0	1,481	67,984	280,201	320,303
FUNDED R&D	0	5,550	38,907	50,253	64,152
FED INC TAX	0	2,783	9,980	22,685	32,535
S AND L TAXES	0	261	3,685	9,340	18,625
TOT ASSETS	0	46,971	551,272	749,917	876,243
S/H EQUITY	0	20,100	202,475	294,821	407,833
RET EARNINGS	0	-1,129	25,368	-7,535	92,882
DIV PAID	0	60	1,079	1,931	2,480
EQUITY RAISED	0	23,326	208,948	116,999	10,793
-PRIVATE	0	7,511	18,614	21,925	6,036
-PUBLIC	0	18,017	190,334	95,074	4,762
TOT US EMPLOYEE	0	3,118	16,627	23,520	26,235
EMP FIT W/H	0	-------	20,282	37,127	47,965
CUM TOT EQUITY	0	23,326	232,274	349,273	360,071
-PRIVATE ($)	0	7,511	26,125	48,050	54,086
- (%)	.00	32.20	11.25	13.76	15.02
-PUBLIC ($)	0	18,017	208,351	303,425	308,187
- (%)	.00	77.24	89.70	86.87	85.59
REV/CUM EQUITY	.00	2.95	1.70	2.90	3.32
R&D/CUM EQUITY	.00	.24	.17	.14	.18
FED TAX/CUM EQU	.00	.12	.04	.06	.09
S&L TAX/CUM EQU	.00	.01	.02	.03	.05
T ASSET/CUM EQU	.00	2.01	2.37	2.15	2.43
EMPLOYEES	0	3,118	16,627	23,520	26,235
PERIOD INCR	0	3,118	13,509	6,893	2,715
T ASSET/JOB	0	15,064	33,155	31,884	33,399
REVENUE/JOB	0	22,041	23,811	43,051	45,594
CUM EQUITY/JOB	0	7,481	13,969	14,850	13,724

FOUNDED 1966 TO 1970
ALL SALES

NUMBER OF RESPONSES: 135

	1960	1965	1970	1975	1976
TOT REVENUE	0	0	176,574	1,482,993	2,019,745
TOT FOREIGN REV	0	0	16,165	292,316	406,101
FUNDED R&D	0	0	26,551	111,931	143,769
FED INC TAX	0	0	6,213	52,461	86,083
S AND L TAXES	0	0	1,981	18,900	28,123
TOT ASSETS	0	0	176,857	1,198,264	1,550,439
S/H EQUITY	0	0	91,872	584,935	823,837
RET EARNINGS	0	0	-51,350	29,741	150,234
DIV PAID	0	0	--------	1,252	2,716
EQUITY RAISED	0	0	140,286	465,287	102,953
-PRIVATE	0	0	87,648	180,871	18,558
-PUBLIC	0	0	52,511	283,625	84,438
TOT US EMPLOYEE	0	0	7,932	38,531	49,077
EMP FIT W/H	0	0	7,471	61,723	80,873
CUM TOT EQUITY	0	0	140,286	605,573	708,526
-PRIVATE ($)	0	0	87,648	268,519	287,077
- (%)	.00	.00	62.48	44.34	40.52
-PUBLIC ($)	0	0	52,511	336,136	420,574
- (%)	.00	.00	37.43	55.51	59.36
REV/CUM EQUITY	.00	.00	1.26	2.45	2.85
R&D/CUM EQUITY	.00	.00	.19	.18	.20
FED TAX/CUM EQU	.00	.00	.04	.09	.12
S&L TAX/CUM EQU	.00	.00	.01	.03	.04
T ASSET/CUM EQU	.00	.00	1.26	1.98	2.19
EMPLOYEES	0	0	7,932	38,531	49,077
PERIOD INCR	0	0	7,932	30,599	10,546
T ASSET/JOB	0	0	22,296	31,098	31,591
REVENUE/JOB	0	0	22,260	38,488	41,154
CUM EQUITY/JOB	0	0	17,686	15,716	14,437

FOUNDED 1971 TO 1975
ALL SALES

NUMBER OF RESPONSES: 77

	1960	1965	1970	1975	1976
TOT REVENUE	Ø	Ø	Ø	154,980	246,737
TOT FOREIGN REV	Ø	Ø	Ø	27,159	44,583
FUNDED R&D	Ø	Ø	Ø	14,891	21,833
FED INC TAX	Ø	Ø	Ø	3,819	10,246
S AND L TAXES	Ø	Ø	Ø	1,541	3,062
TOT ASSETS	Ø	Ø	Ø	79,187	147,570
S/H EQUITY	Ø	Ø	Ø	25,392	57,539
RET EARNINGS	Ø	Ø	Ø	-12,447	-3,799
DIV PAID	Ø	Ø	Ø	-------	63
EQUITY RAISED	Ø	Ø	Ø	40,266	26,517
-PRIVATE	Ø	Ø	Ø	31,464	26,515
-PUBLIC	Ø	Ø	Ø	8,802	2
TOT US EMPLOYEE	Ø	Ø	Ø	4,459	7,031
EMP FIT W/H	Ø	Ø	Ø	6,404	9,735
CUM TOT EQUITY	Ø	Ø	Ø	40,266	66,783
-PRIVATE ($)	Ø	Ø	Ø	31,464	57,979
- (%)	.ØØ	.ØØ	.ØØ	78.14	86.82
-PUBLIC ($)	Ø	Ø	Ø	8,802	8,804
- (%)	.ØØ	.ØØ	.ØØ	21.86	13.18
REV/CUM EQUITY	.ØØ	.ØØ	.ØØ	3.85	3.69
R&D/CUM EQUITY	.ØØ	.ØØ	.ØØ	.37	.33
FED TAX/CUM EQU	.ØØ	.ØØ	.ØØ	.Ø9	.15
S&L TAX/CUM EQU	.ØØ	.ØØ	.ØØ	.Ø4	.Ø5
T ASSET/CUM EQU	.ØØ	.ØØ	.ØØ	1.97	2.21
EMPLOYEES	Ø	Ø	Ø	4,459	7,031
PERIOD INCR	Ø	Ø	Ø	4,459	2,572
T ASSET/JOB	Ø	Ø	Ø	17,758	20,988
REVENUE/JOB	Ø	Ø	Ø	34,756	35,092
CUM EQUITY/JOB	Ø	Ø	Ø	9,030	9,498

FOUNDED 1976
ALL SALES

NUMBER OF RESPONSES: 2

	1960	1965	1970	1975	1976
TOT REVENUE	Ø	Ø	Ø	Ø	981
TOT FOREIGN REV	Ø	Ø	Ø	Ø	Ø
FUNDED R&D	Ø	Ø	Ø	Ø	412
FED INC TAX	Ø	Ø	Ø	Ø	0
S AND L TAXES	Ø	Ø	Ø	Ø	44
TOT ASSETS	Ø	Ø	Ø	Ø	1,709
S/H EQUITY	Ø	Ø	Ø	Ø	459
RET EARNINGS	Ø	Ø	Ø	Ø	1
DIV PAID	Ø	Ø	Ø	Ø	Ø
EQUITY RAISED	Ø	Ø	Ø	Ø	6ØØ
-PRIVATE	Ø	Ø	Ø	Ø	6ØØ
-PUBLIC	Ø	Ø	Ø	Ø	Ø
TOT US EMPLOYEE	Ø	Ø	Ø	Ø	85
EMP FIT W/H	Ø	Ø	Ø	Ø	136
CUM TOT EQUITY	Ø	Ø	Ø	Ø	6ØØ
-PRIVATE ($)	Ø	Ø	Ø	Ø	6ØØ
- (%)	.ØØ	.ØØ	.ØØ	.ØØ	1ØØ.ØØ
-PUBLIC ($)	Ø	Ø	Ø	Ø	Ø
- (%)	.ØØ	.ØØ	.ØØ	.ØØ	.ØØ
REV/CUM EQUITY	.ØØ	.ØØ	.ØØ	.ØØ	1.64
R&D/CUM EQUITY	.ØØ	.ØØ	.ØØ	.ØØ	.69
FED TAX/CUM EQU	.ØØ	.ØØ	.ØØ	.ØØ	.ØØ
S&L TAX/CUM EQU	.ØØ	.ØØ	.ØØ	.ØØ	.Ø7
T ASSET/CUM EQU	.ØØ	.ØØ	.ØØ	.ØØ	2.85
EMPLOYEES	Ø	Ø	Ø	Ø	85
PERIOD INCR	Ø	Ø	Ø	Ø	85
T ASSET/JOB	Ø	Ø	Ø	Ø	2Ø,1Ø5
REVENUE/JOB	Ø	Ø	Ø	Ø	11,541
CUM EQUITY/JOB	Ø	Ø	Ø	Ø	7,Ø58

STATEMENT

JACK M. ALLEN, PRESIDENT

FOR

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

AND ON BEHALF OF

CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION
KANSAS INDEPENDENT OIL AND GAS ASSOCIATION
KENTUCKY OIL AND GAS ASSOCIATION
LIAISON COMMITTEE OF COOPERATING OIL AND GAS ASSOCIATIONS
LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS AND ROYALTY OWNERS
MICHIGAN OIL AND GAS ASSOCIATION
NORTH TEXAS OIL AND GAS ASSOCIATION
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
PENNSYLVANIA OIL, GAS AND MINERALS ASSOCIATION
INDEPENDENT OIL PRODUCERS TRI-STATE, INC.
NATIONAL STRIPPER WELL ASSOCATION
ILLINOIS OIL AND GAS ASSOCIATION
TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION
WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION
OHIO OIL AND GAS ASSOCIATION
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES
PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION
THE LAND AND ROYALTY OWNERS OF LOUISIANA
PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION

BEFORE THE

HOUSE SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

ON

H.R. 10717, H.R. 13032 and H.R. 13765

SEPTEMBER 28, 1978

Statement of Jack M. Allen, President
Independent Petroleum Association of America
Before the House Subcommittee on Consumer Protection and Finance
September 28, 1978

Mr. Chairman, I appreciate the opportunity to submit this statement for your hearings on H.R. 10717, H.R. 13032 and H.R. 13765, which would amend the Securities Act of 1933 and the Investment Company Act of 1940 to encourage investment in small business concerns. I am Jack M. Allen of Perryton, Texas, an independent oil and gas operator currently serving as President of the Independent Petroleum Association of America (IPAA).

The IPAA is a national organization of some 5,000 independent explorer-producers of crude oil and natural gas, who operate in every producing region of the United States. Most of these producers operate as non-public entities either as sole proprioterships, partnerships, or closely held subchapter "S" corporations. Since the IPAA was founded in 1929, there have been almost 1,800,000 oil, gas, and service wells drilled in the United States and independents have probably accounted for about 85% or over 1,500,000. According to a recent survey by the American Association of Petroleum Geologists, independents account for 75% of significant new oil and gas fields and over 50% of all oil and gas reserves found domestically.

We strongly commend the effort of this Committee to review the important legislation which Congressman Broyhill has introduced to loosen some of the regulatory restraints which have contributed to the scarcity of venture capital for small businesses. Many independent producers have found that the time and expense of complying with the pertinent provisions of the Securities Act of 1933 have directly affected the availability of capital for drilling oil and gas wells.

Mr. Chairman, the IPAA is pleased to support the initiatives taken by Mr. Broyhill and urges that the Committee act favorably on his proposals. We would like at the same time to comment on some related considerations, directly pertinent

to the intent of this legislation. We would respectfully request that the Committee consider the addition of further provisions in its final product, so that the small independent will have the fullest opportunity to seek new domestic oil and gas supplies.

A great deal of the present concern of the independent producer centers upon Rule 146 of the Securities and Exchange Commission. Mr. Broyhill's proposals touch upon this rule by limiting the effects of rescission sought under the rule. I would like to suggest further beneficial steps that might be taken with respect to Rule 146. Although it is not the intent of the pending legislation to single out a particular industry, let me describe a few difficulties which Rule 146 has created for independent producers. Perhaps the remedy for some of these problems may be applicable to other industries as well.

For the smaller independent, the kind of producer who makes up the bulk of IPAA's membership, Rule 146 is very complicated. It is time consuming to comply with, and usually very costly; since a consulting lawyer or accountant -- or both -- is almost necessary to review the information which has been presented in a disclosure statement. Here, I mention that the average cost of drilling per onshore well is in the $158,000 range. Usually each well is a separate venture for Securities Regulation purposes. There are a variety of estimates for an "average fee" for legal consultation in drilling such a well, and it appears that this cost is in the $15,000 to $20,000 range. This is a significant portion of the cost of many wells. Clearly, over the long haul, these legal costs add up to many wells which are not drilled.

Typically, the independent producer deals repeatedly with a relatively small group of investors whom he knows personally. The investor is relying more on his knowledge of and trust in the personal business judgment and past performance record of the producer than on any specific financial data which may be furnished. We therefore believe that the characteristics of the purchaser should be a key factor, in satisfying the safe harbor requirements of Rule 146. Objective tests,

such as whether the purchaser has previously participated in oil and gas exploration ventures could be important in this regard. For instance, participation in three or more years, particularly if the purchaser participated with the same operator, could be a realistic test that would remove some of the complications of Rule 146.

Another possible objective standard might be the size of the individual investment in a particular well. For instance, is the investment in a particular well, partnership, or project in excess of $25,000 per investor. This standard could be used in satisfying both subsections (d) and (e) under Rule 146.

I come now, Mr. Chairman, to a particular sore spot with independent producers. This is the recently required Form 146 which must be filed by those who claim that safe harbor of Rule 146. Ostensibly, the form is to alert the Securities and Exchange Commission to the extent of usage of Rule 146. SEC releases have stated the concern that the Section 4(2) exemption may be, or might become, a haven for the illegal activities which have taken place under cover of Schedule D in recent years. The legitimate operator is severely hampered because assembly of the data necessary to complete Form 146 requires almost the same time, effort and experience as a formal registration. The illegal promotor will always find some way to shortcut the requirement.

Although the initial Form 146 proposed by the SEC has been simplifed in response to public comments, this action does not lead to any optimism over the future growth of the information requirements in the form. The private transaction exemption of Section 4(2) stands in clear contrast to the considerable registration requirements in other parts of the Act. It does not seem appropriate that any filing be required in conjunction with a private placement. We certainly do not look forward to the inevitable addition of reporting requirements in the form which will bring it closer and closer to a formal registration.

The IPAA believes that the federal securities laws are a significant factor in determining whether funds can be secured for oil and gas exploration. This

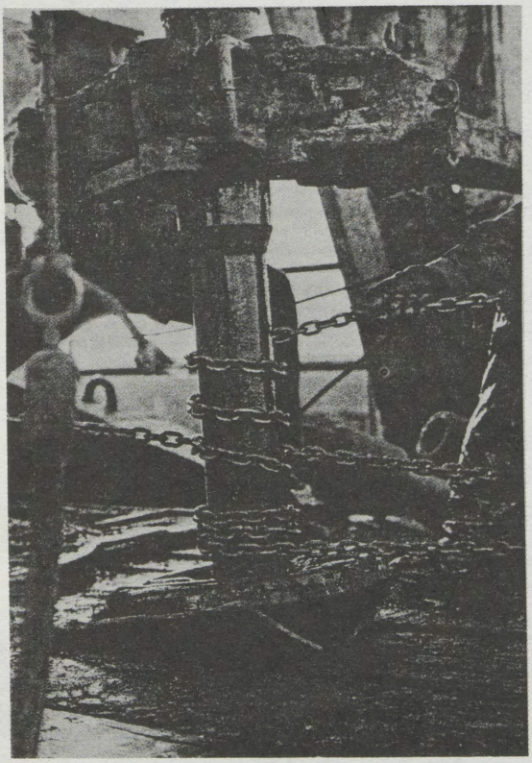
belief has brought us to participate in these hearings and to urge that the present trend of regulatory treatment of private transactions be reversed. We recognize that a certain amount of federal regulation is necessary to keep the undesirable elements in the business world from securing funds fraudulently from investors. However, it now seems that the drift of interpretations of the relatively short statement of Section 4(2) in the Securities Act of 1933, together with the time and costs involved in either registering or attempting to secure the exemption, are becoming so burdensome that they restrict unnecessarily the legitimate operator in his attempt to secure funds for oil and gas exploration.

Mr. Chairman, we have endeavored to keep our members informed of SEC actions regarding private placement treatment, and I have attached to this statement a copy of an article which recently appeared in our association's magazine, Petroleum Independent. We hope that the forthcoming activities of the Committee will reduce the need for such activity. The members and staff of IPAA would be pleased to contribute in any way we can toward seeking legislative provisions which will restore what we believe to be the original intent of Section 4(2) of the 1933 Securities Act. If the Committee chooses to move in this direction, it will have made a considerable contribution to the maximum use of capital resources available to small businesses of every kind.

I thank the Committee for the opportunity to provide these comments.

Private Placements
Under the Federal Securities Law

by J. Richard Emens



DAVID MOODY PHOTO

Recently there has been much discussion and writing concerning a change in the law relating to private placements of securities exempt from registration with the US Securities and Exchange Commission (SEC). In fact, this change is not now as significant as has been indicated elsewhere because it does not affect the usual private placement method of financing used by IPAA members. The change, which requires a filing with the SEC, affects only those who attempt to comply with Rule 146, which is a separate, alternate method of securing the private placement exemption from registration with the SEC.

This discussion will review briefly the background of oil and gas interests' treatment as securities under the federal securities laws, the historically utilized private placement exemption—Section 4(2), and the alternate method of securing the same exemption from registration—Rule 146.

Background. The federal Securities Act of 1933 was adopted by the US Congress for the stated purpose of protecting investors. It is primarily a disclosure statute. Section 5 of the Securities Act of 1933 (Act of '33) requires that all securities offered by use of the mails or other channels of interstate commerce be registered with the SEC. Congress did provide certain exemptions in the Act from such registration provisions where there was no practical need for registration or

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Mr. Emens is a partner in the firm of Emens, Hurd, Kegler & Ritter of Columbus, Ohio, and is the chairman of IPAA's Accounting Principles & Financial Reporting Committee.

where the public benefits of registration were too remote. One of the exemptions from registration is provided by Section 4(2) for "transactions by an issuer not involving any public offering."

It should be understood that the sale of fractional interests in an oil and gas lease, the sale of limited partnership interests in a limited partnership for the drilling of wells for oil and gas, and shares of stock in a Subchapter S or other oil and gas corporation are all securities within the definition of the Securities Act of '33 and thus subject to registration with the SEC unless exempt. The author had a friendly argument continuing over a ten-year period with the late Harold McClure, former IPAA president, who loved to argue that "oil and gas interests are real estate and therefore not securities." But he always made the argument with a twinkle in his eyes, as he knew fractional oil and gas interests were securities, though he wished they were not.

Section 4(2) Private Placements. Section 4(2) is usually referred to as the private placement exemption, and is the exemption Association members typically rely on. Every decision to sell interests in an oil and gas lease or a limited partnership to drill for oil and gas requires consideration of the effect of the Act of '33 on the transaction. An issuer-operator seeking to avoid the delay and expense involved in a registered public offering has considerable difficulty, however, determining whether the proposed financing meets the several tests of Section 4(2) of the Act of '33.

Poor judgment as to whether 4(2) is available could expose the issuer-operator both to suits for recision brought by any purchaser in the offering and to an SEC enforcement action. While in the past there have been relatively few complaints to the SEC or law suits asking for money back brought by those investors who participated in drilling ventures of Association members, it appears that our society in general and investors in particular have become more litigious lately. Thus, it is vital that the issuer-operator fully understands the requirements necessary to secure the exemption provided by Section 4(2).

Judicial and administrative interpretation of the relatively simple language of Section 4(2) as included in the Act of '33 has established several conditons which are rather difficult to comply with—and all of these conditions must be satisfied for the issuer-operator to secure the exemption: (1) The offeror has the burden of establishing that the exemption is available; (2) The offerees must be given substantially the same information that would have been provided had the securities been registered; (3) The offerees must be able to fend for themselves "in terms of financial sophistication and ability to bear the risk of the investment"; (4) the securities must be purchased for the investor's own account without intention of reselling them; (5) There must not be more than the permissible number of offerees; (6) The offering should not be too large; and (7) The offering must be made in manner so as to be truly a private and not a public offering.

The SEC and the courts have said that there are four factors deemed important to the exemption: (1) "The number of offerees and their relationship to each other and the issuer," (2) "The number of units offered," (3) "The size of the offering," and (4) "The manner of the offering." But whether there are four or seven considerations, the major problem for the issuer-operator under Section 4(2) is that he cannot be certain he has secured the exemption. The often cited case of *Continental Tobacco* seems to have interpreted the facts to narrow the exemption further than necessary, and there are no clear answers as to what an issuer-offeror must do in order to comply with Section 4(2), particularly in the area of the number of permissible offerees where considerable confusion exists. While the often accepted approach to the number of offerees (note that this is not purchasers, but anyone who is "offered" the opportunity to participate) is that so long as there are not more than 25 offerees there are not "too many," cases have held that an offer to one person can make the Section 4(2) exemption unavailable. Thus, there is no certainty as to how many offerees will be determined by a court not to be too many.

Rule 146. Largely because of the uncertainty involved with Section 4(2), on April 23, 1977, the SEC adopted Rule 146 to provide objective standards for one method of determining when offers or sales of securities by an issuer would be exempt from registration within the meaning of Section 4(2) of the Act of '33. Before reciting briefly the provisions of Rule 146, the *SEC stated that Rule 146 did not replace Section 4(2)*, and that it was not an exclusive method of securing a private placement exemption. In its preliminary notes to Rule 146 the SEC stated:

"*Transactions by an issuer which do* ►

not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions. Issuers wanting to rely on that exemption [Section 4(2)] may do so by complying with administrative and judicial interpretations in effect at the time of the transactions. Attempted compliance with this rule [Rule 146] does not act as an election; the issuer can also claim the availability of Section 4(2) outside the rule."

Prior to May 3, 1978, there were six specific technical requirements to be met to comply with Rule 146, and each and every condition of the rule must be established by the issuer in order to have the exemption available. A summary of these conditions, which basically cover the same factors a court looks at under Section 4(2) is as follows: (1) The nature and qualification of the offerees—the offeree must have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the offeree must be a person who is able to bear the economic risk and is provided with advice from another person so that together they have such knowledge and experience that they are capable of evaluating the merits and risks; (2) The manner of the offering—there can be no general solicitation or advertising; (3) The necessity of furnishing information or providing access thereto—each offeree shall have access during the course of the transaction and prior to the sale to the same kind of information he would have had if the offering were registered, or each offeree or offeree representative shall have been furnished during the course of the transaction and prior to the sale with the same kind of information he would have had if the offering were registered; (4) The offering shall not be made as part of a larger offering—an offering will not be integrated with another offering so long as it takes place prior to the six-months period preceding or after the six-months immediately following any offers pursuant to this Rule; (5) There shall not be too many purchasers—there are no more than 35 purchasers of the securities of the issuer in any offering pursuant to Rule 146, with certain limited exclusions; and (6) There is a limitation on subsequent disposition of the acquired securities—the issuer must exercise reasonable care to assure that purchasers are acquiring the securities for their own accounts and not on behalf of others or with the intent to dispose of the securities to others.

Effective May 3, 1978, a seventh condition must also be complied with by the issuer in order to obtain the exemption provided by Rule 146, that condition is that three copies of a report on Form 146 must be filed with the SEC Regional Office for the region in which the issuer's principal business operations are conducted "at the time of the first sale" of securities in any offering made in reliance on Rule 146. While no Form 146 needs to be filed for an offering of less than $50,000, this will be of little help to members of the IPAA. Form 146 is a one-page form requiring: the name, address, telephone number, and date and state of incorporation or organization of the issuer; an indication of the type of business (oil and gas, real estate, other); the full name of the chief executive officer, the general partners, promoters and controlling persons of all organizers, promoters, sponsors of and of all offeree representatives involved in the offering; the title and the class and aggregate dollar amount of the sales and if any securities are to be sold for other than cash the nature of the of the other consideration; whether the issuer has made previous filings with the SEC under Rule 146 or otherwise under the Act of '33 or under the Act of '34; and the issuer's signature with a footnote at the bottom indicating "intentional misstatements or omissions of fact constitute federal, criminal violations."

It is generally recognized that Rule 146 does provide some objective standards for securing the exemption under Section 4(2). The major problem with Rule 146 is it is so complicated that its interpretation is as difficult as compliance. It's likely that many persons who attempt to comply with Rule 146 will not successfully meet all of the seven conditions and therefore will not secure the benefit of the exemption provided under Rule 146. The SEC currently is considering whether revisions should be made in Rule 146, and one of these considerations is whether it should be simplified. I believe that there are several methods by which its interpretation and use could be simplified. One of these methods would be to provide that items (1) and (3) listed above are complied with if the investor is a person who is participating to the extent of $25,000 or more and the investor has participated in similar investments in three prior years.

Caveats. In considering whether to attempt to use Rule 146 to secure the exemption uder Section 4(2) of the Act of '33, there are several additional ►

points to remember as follows: (1) As indicated above, Rule 146 is not the exclusive method of securing the section 4(2) exemption—the private placement under Section 4(2) as it has historically been utilized is still available, and Rule 146 is an alternative. A recent SEC Release, No. 5913 issued March 6, 1978 states:

"... *the Commission wishes to reassert the 'non-exclusive' nature of Rule 146. . . . It is not the intention of the Commission that it be the only way to establish the exemption. Issuers may rely on current administrative and judicial interpretations of the [Section 4(2)] exemption without regard to Rule 146.*"

It is possible for an issuer to attempt to comply with both the historical Section 4(2) and Rule 146 in the same offering, and satisfaction of all the conditions of either will secure the private placement exemption: (2) State securities law is not affected in any way by Rule 146. In the large majority of the states where state securities law requires a filing or other steps to be taken in connection with the offering of oil and gas wells, such filings or other steps must be taken in addition to filing with the SEC or obtaining an exemption from the federal securities law; (3) The term "offering" is not defined in the rule. The determination as to whether offers, offers to sell, etc. are part of an offering—that is, whether they will be deemed to be integrated with another offering, still depends on the particular facts and circumstances. While it would seem clear that offerings which do not relate to the same oil and gas lease or leases should never be considered part of the same offering, there may still be some slight question in this area which needs to be cleared up by the SEC in an interpretative release; (4) Neither Section 4(2) nor Rule 146 provide any exemption from criminal penalties of the Section 17 anti-fraud provisions of the Act of '33 which relates to an untrue statement of a material fact or omission of a material fact in connection with the offer or sale of a security. Section 4(2) and Rule 146 relate only to the registration requirement of Section 5 of the Act of 1933; (5) Rule 146 is available only to the issuer of the securities and is not available to affiliates or other persons for sales of the issuer's securities; (6) An additional complication in the consideration of Section 4(2) and Rule 146 has recently been brought about by the SEC response to the no-action request by Amtex Oil and Gas. In that letter from the SEC, available April 3, 1978, an oil and gas exploration company, which planned to contract to turnkey the drilling of one of its oil and gas leases for an unaffiliated partnership seeking the private placement exemption, would be deemed a co-issuer in the view of the staff of the SEC Division of Corporation Finance.

Historically, if an independent operator had an oil and gas lease on which it agreed to turnkey a well for an unrelated entity, and where the unrelated entity was fully responsible for raising the money, dealing with the investors, etc., the independent oil and gas operator believed it had no obligation or liability to those investors, and that its only liability was to the entity for whom it was turnkeying the well to see that the well was drilled pursuant to the turnkey contract. The SEC has now taken the position in Amtex that the independent oil and gas exploration company will be deemed a co-issuer and thus have issuer liability under the Act of '33. The Amtex letter may also have some integration implications. If these views, which we believe clearly erroneous, continue and are upheld by the courts, then an oil and gas exploration company entering into such a turnkey contract must become involved in seeing that all of the conditions of Section 4(2) or in the alternative Rule 146 are complied with if there is not proper securities registration.

Conclusion. While it is true that the SEC has adopted, effective May 3, 1978, an additional condition which must be complied with in order to secure the exemption under Section 4(2) of the Act of '33 provided by Rule 146, that does not mean that every oil and gas operator-issuer offering private placements must file with the SEC. The private placement exemption provided by Section 4(2) of the Act of '33 is still available and the SEC has stated on several occasions that Rule 146 is an alternative method of complying with Section 4(2) and is not an exclusive method of complying with Section 4(2). Unfortunately, however, the administrative and judicial interpretations of the private placement exemption provided by Section 4(2) have so narrowed the exemption that it is very difficult to comply with; and, while Rule 146 does provide objective standards, the interpretation and compliance with all seven of these complicated conditions are most difficult to accomplish. It is hoped that Section 4(2) and Rule 146 will both be simplified by further SEC administrative action. ▲▲▲

[Whereupon, at 10:30 a.m., the subcommittee adjourned.]

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