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VENTURE CAPITAL IMPROVEMENTS ACTS OF 1980
DOCUMENTS

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BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCE

OF THE

COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE
HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

H.R. 7554

A BILL TO AMEND THE SECURITIES ACT OF 1933 AND THE
INVESTMENT COMPANY ACT OF 1940 TO PROVIDE INCENTIVES
FOR SMALL BUSINESS INVESTMENT, AND FOR OTHER
PURPOSES

AND

H.R. 7491

A BILL TO PROVIDE EXEMPTIONS FROM THE INVESTMENT
COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF
1940 FOR SPECIALIZED INVESTMENT COMPANIES ENGAGED
IN FURNISHING CAPITAL TO UNSEASONED ENTERPRISES
WHICH ARE UNABLE TO OBTAIN CAPITAL ON FAVORABLE
TERMS THROUGH CONVENTIONAL MEANS AND WHICH
FREQUENTLY NEED AND RECEIVE SIGNIFICANT MANA-
GERIAL ASSISTANCE AND FOR CERTAIN INVESTMENT
ADVISERS

JUNE 17, 1980

Serial No. 96-208

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VENTURE CAPITAL IMPROVEMENT ACTS OF 1980

TUESDAY, JUNE 17, 1980

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

The subcommittee met, pursuant to notice, at 9 a.m., in room 2218, Rayburn House Office Building, Hon. James H. Scheuer (chairman) presiding.

Mr. SCHEUER. Today the Subcommittee on Consumer Protection and Finance will be considering several pieces of legislation designed to facilitate the raising of capital for small businesses and to remove unnecessary impediments on the operation of venture capital companies.

The two principal bills we will be discussing are H.R. 7491 and H.R. 7554.

Although both bills would substantially alleviate securities laws burdens on venture capital companies, their approaches are diametrically opposed.

H.R. 7554 essentially would eliminate the application of the Investment Company Act of 1940 to all publicly owned venture capital companies including small business investment companies.

On the other hand, H.R. 7491 would apply the Investment Company Act of 1940 to all publicly owned companies but eliminate many, if not most, of the unnecessary burdensome restrictions.

I think it is fair to say H.R. 7491 is the SEC's proposal.

There is one common ground for agreement: The proposals are complex and intricate.

Accordingly, the witnesses today who are representatives of the SEC; the National Venture Capital Association; and the National Association of Small Business Companies, will all give their statements and then appear as a panel to criticize and comment upon the various provisions in each of the bills.

Among the kinds of things that the committee will be most interested in is which bill or combination of bills will most effectively accomplish the purposes of the legislation.

We will want to understand how broad the definition of a venture capital company or, as the SEC describes it, a "business development company" should be.

We will want to know to what extent these bills will protect the public investor from abuses.

It is important for us to know whether the enactment of either bill will open the door to a substantial erosion of the Investment

Company Act of 1940 by other companies seeking similar exemptions.

Perhaps most important, we will want to know whether the creation of the exemptions provided by either of these bills can generate the kind of speculative market fever of the late 1960's which resulted in such an enormous loss of investor confidence in our financial markets.

Our first interesting and stimulating witness will be SEC Commissioner Steve Friedman.

Before I call on him to testify I would like to ask my colleague, Congressman Broyhill, if he has a statement he would like to make.

Mr. BROYHILL. Thank you very much. I do thank the chairman for scheduling these hearings today. These are the third set of hearings with respect to this particular subject matter, that is, what we can do to give some incentive to creating capital for the small business community?

I note that there is an interest in this subject on the other side of the Capitol and the appropriate committee over there is looking into this subject matter as well.

I have alleged for some time that the 1940 act does constitute an unnecessary barrier to capital formation for small business, especially with respect to getting capital for small businesses through the venture capital companies and SBIC's.

I am pleased to note that the SEC is now supporting a bill that would amend the 1940 act in order to alleviate some of the problems that have been pointed out with respect to this act. I do believe that my bill does give a much fresher and clearer approach to meeting some of these longstanding problems, and would hope that this bill would get the support of this subcommittee.

I might point out there is increasing interest in the problems of small business and what we can do not only legislatively but also from the standpoint of the administration to alleviate small business problems. The White House Conference on Small Business that was held here in Washington recently pointed out vividly some of these problems. A number of recommendations were made and one of the key areas of concern was in this area of capital formation.

So, we do appreciate Commissioner Friedman coming today and we look forward to his comments.

Mr. SCHEUER. Without objection the text of H.R. 7491 and H.R. 7554 and agency reports thereon will be printed at this point in the record. Additional bills that will be considered in whole or part during the hearing are as follows: H.R. 2962, introduced by Mrs. Bouquard on March 14, 1979; H.R. 6580, introduced by Mr. Staggers on February 22, 1980; H.R. 6723, introduced by Mr. Broyhill on March 6, 1980; H.R. 7397, introduced on May 20, 1980 by Mr. Rinaldo; and H.R. 7516, introduced by Mr. Staggers on June 15, 1980.

[Testimony resumes on p. 48.]

[The text of H.R. 7491 and H.R. 7554 and agency report on H.R. 7491 follow:]

96TH CONGRESS
2D SESSION

H. R. 7491

To provide exemptions from the Investment Company Act of 1940 and Investment Advisers Act of 1940 for specialized investment companies engaged in furnishing capital to unseasoned enterprises which are unable to obtain capital on favorable terms through conventional means and which frequently need and receive significant managerial assistance and for certain investment advisers.

IN THE HOUSE OF REPRESENTATIVES

JUNE 4, 1980

Mr. SCHEUER (by request) introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

A BILL

To provide exemptions from the Investment Company Act of 1940 and Investment Advisers Act of 1940 for specialized investment companies engaged in furnishing capital to unseasoned enterprises which are unable to obtain capital on favorable terms through conventional means and which frequently need and receive significant managerial assistance and for certain investment advisers.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

1 That this Act may be cited as the "Business Development
2 Company Act of 1980".

3 TITLE I—AMENDMENTS TO THE INVESTMENT
4 COMPANY ACT OF 1940

5 DEFINITIONS OF BUSINESS DEVELOPMENT COMPANY AND
6 ELIGIBLE PORTFOLIO COMPANY

7 SEC. 101. Section 5 of the Investment Company Act of
8 1940 (15 U.S.C. 80a-5) is amended by adding at the end
9 thereof the following subsection:

10 "(d) 'Business development company' means any closed-
11 end investment company which is organized and operated
12 solely for the purposes of making investments in securities
13 purchased in transactions described in section 12(h)(1) of the
14 Investment Company Act of 1940, and making available
15 significant managerial assistance to the issuers of such
16 securities."

17 SEC. 102. Section 2(a) of the Investment Company Act
18 of 1940 (15 U.S.C. 80a-2(a)) is amended by adding at the
19 end thereof the following paragraph:

20 "(46) 'Eligible portfolio company' means any company
21 which—

22 "(A) is organized under the laws of, and has its
23 principal place of business in, any State or States;

24 "(B) has no class of securities that is registered
25 pursuant to section 12(b) of the Securities Exchange

1 Act of 1934 or with respect to which a member of a
2 national securities exchange, broker or dealer may
3 extend or maintain credit to or for a customer pursuant
4 to rules or regulations adopted by the Board of Gover-
5 nors of the Federal Reserve System under section 7 of
6 the Securities Exchange Act of 1934;

7 “(C) is neither an investment company as defined
8 in section 3 of the Investment Company Act of 1940
9 nor any person described in paragraphs (2) through
10 (13) of section 3(c) thereof; and

11 “(D) meets such other criteria, if any, as the
12 Commission may establish by rule as necessary or ap-
13 propriate in the public interest and consistent with the
14 protection of investors and the purposes fairly intended
15 by the policy and provisions of the Business Develop-
16 ment Company Act of 1980 and of the Investment
17 Company Act of 1940.”.

18 BENEFICIAL OWNERSHIP OF BUSINESS DEVELOPMENT

19 COMPANIES AND OTHER INVESTMENT COMPANIES

20 SEC. 103. Section 3(c)(1) of the Investment Company
21 Act of 1940 (15 U.S.C. 80a-3(c)(1)) is amended by deleting
22 the second sentence and adding at the end of the first sen-
23 tence thereof the following:

24 “(A) For purposes of this paragraph, beneficial
25 ownership by a company shall be deemed to be benefi-

1 cial ownership by one person; except that, if such com-
2 pany owns 10 per centum or more of the outstanding
3 voting securities of the issuer (or of its equity securities
4 when it has no voting securities), the beneficial owner-
5 ship shall be deemed to be that of the holders of such
6 company's outstanding securities (other than short-term
7 paper).

8 “(B) For purposes of subparagraph (A) of this
9 paragraph, beneficial ownership by a company owning
10 10 per centum or more of the outstanding voting secu-
11 rities (or of its equity securities when it has no voting
12 securities) of—

13 “(i) any issuer which is a small business in-
14 vestment company licensed to operate under the
15 Small Business Investment Act of 1958, or which
16 has received from the Small Business Administra-
17 tion notice to proceed to qualify for a license,
18 which notice or license has not been revoked,
19 shall be deemed to be beneficial ownership by one
20 person (a) if the value of all securities of small
21 business investment companies owned by such
22 company does not exceed 5 per centum of the
23 value of its total assets; or (b) if such securities of
24 the small business investment company are owned
25 by a State development corporation which has

1 been created by or pursuant to an act of the State
2 legislature to promote and assist the growth and
3 development of the economy within such State on
4 a statewide basis: *Provided*, That such State de-
5 velopment corporation is not, or as a result of its
6 investment in the small business investment com-
7 pany (considering such investment as an invest-
8 ment security) would not be, an investment com-
9 pany as defined in section 3 of the Investment
10 Company Act of 1940; and

11 “(ii) any issuer which is not an issuer de-
12 scribed in clause (i) of this subparagraph shall be
13 deemed to be beneficial ownership by one person
14 if the value of all securities owned by such com-
15 pany of all issuers (other than any issuer de-
16 scribed in clause (i) of this subparagraph) who are
17 excluded from the definition of investment
18 company by paragraph (1) of this section does not
19 exceed 5 per centum of the value of the
20 company’s total assets: *Provided*, That such
21 issuer nonetheless is deemed to be an investment
22 company for purposes of section 12(d)(1) of the
23 Investment Company Act of 1940.”.

1 FUNCTIONS AND ACTIVITIES OF BUSINESS DEVELOPMENT

2 COMPANIES

3 SEC. 104. Section 12 of the Investment Company Act
4 of 1940 (15 U.S.C. 80a-12) is amended by adding at the end
5 thereof the following subsection:

6 “(h) It shall be unlawful for any business development
7 company to hold any asset except—

8 “(1) securities purchased in transactions not in-
9 volving any public offering or in such other transac-
10 tions as the Commission, by rule, may prescribe if it
11 finds that the enforcement of this title with respect to
12 such transactions is not necessary in the public interest
13 and the protection of investors by reason of the small
14 amount involved or the limited character of the public
15 offering:

16 “(A) from any eligible portfolio company or a
17 controlling person thereof; and

18 “(B) from any company which is no longer
19 an eligible portfolio company because a class of its
20 securities is registered pursuant to section 12(b) of
21 the Securities Exchange Act of 1934 or because
22 it has issued a class of securities with respect to
23 which a member of a national securities exchange,
24 broker or dealer may extend or maintain credit to
25 or for a customer pursuant to rules or regulations

1 adopted by the Board of Governors of the Federal
2 Reserve System under section 7 of the Securities
3 Exchange Act of 1934 if—

4 “(i) immediately prior to the purchase of
5 such securities, at least 5 per centum of its
6 outstanding equity securities, or securities
7 convertible into at least 5 per centum of its
8 outstanding voting securities, are held by the
9 business development company, and

10 “(ii) immediately after the purchase of
11 such securities, not more than 20 per centum
12 of the cost of all securities described in para-
13 graphs (1) and (2) would be attributable to
14 securities described in this paragraph (1)(B)
15 and securities received in exchange therefor
16 or distributed with respect thereto;

17 “(2) securities received in exchange for or distrib-
18 uted with respect to securities described in paragraph
19 (1);

20 “(3) cash, and Government securities or high
21 quality debt securities maturing in one year or less
22 from the time of investment; and

23 “(4) office furniture, interests in real estate main-
24 tained to conduct its business operations, and other
25 noninvestment property necessary and appropriate to

1 its operations as a business development company, in-
2 cluding any notes or other evidences of indebtedness
3 acquired in connection with loans issued pursuant to
4 section 17(k) of the Investment Company Act of
5 1940.”.

6 EXEMPTIONS FOR CERTAIN LOANS AND OTHER TRANSAC-
7 TIONS INVOLVING BUSINESS DEVELOPMENT COMPANY
8 AFFILIATES

9 SEC. 105. Section 17 of the Investment Company Act
10 of 1940 (15 U.S.C. 80a-17) is amended by adding at the end
11 thereof the following subsection:

12 “(k)(1) Notwithstanding subsections (a) and (d) of this
13 section, any noncontrolling shareholder affiliate can sell to or
14 purchase from such business development company or any
15 company controlled by such business development company
16 securities or other property, or effect any transaction in
17 which such business development company or controlled
18 company is a joint or a joint and several participant with
19 such noncontrolling shareholder affiliates: *Provided, That—*

20 “(A) any such transaction is approved by a major-
21 ity of the directors of the business development
22 company who have no financial interest in the transac-
23 tion, including a majority of such directors who are not
24 interested persons thereof, on the basis that the terms
25 of the proposed transaction, including any consideration

1 to be paid or received, are reasonable and fair to the
2 business development company, and the proposed
3 transaction is consistent with the policy of the business
4 development company as recited in its registration
5 statement and reports filed under the Investment Com-
6 pany Act of 1940, and with the interests of its share-
7 holders; and

8 "(B) the board of directors records in its minutes
9 a description of such transaction, the findings of the
10 board and the basis therefor.

11 For purposes of this subsection (k)(1), noncontrolling share-
12 holder affiliate means any person (i) who is an affiliated
13 person of a business development company solely by virtue of
14 directly or indirectly owning, controlling or holding with
15 power to vote 5 per centum or more of the outstanding
16 voting securities of a business development company but does
17 not directly or indirectly control the business development
18 company, and any affiliated person of such a person, and (ii)
19 who is not an officer, director, employee, investment adviser,
20 member of an advisory board, promotor of, principal under-
21 writer for, directly or indirectly controlling person of, or di-
22 rectly or indirectly under common control with, the business
23 development company.

24 "(2) Notwithstanding paragraph (3) of subsection (a) of
25 this section, an officer or employee of a business development

1 company can borrow money from such business development
2 company for the purpose of purchasing securities issued by
3 the business development company pursuant to an executive
4 compensation plan: *Provided*, That such loan—

5 “(A) has a term of not more than ten years;

6 “(B) becomes due within a reasonable time, not to
7 exceed sixty days, after such person’s termination of
8 employment;

9 “(C) bears interest at no less than the prevailing
10 prime lending rate at the time that the loan is made;

11 “(D) at all times is fully collateralized (such col-
12 lateral may include any securities issued by the busi-
13 ness development company); and

14 “(E) is approved by a majority of the directors of
15 the business development company who have no finan-
16 cial interest in the transaction, including a majority of
17 the directors who are not interested persons thereof, on
18 the basis that the loan is in the best interests of the
19 business development company and its shareholders.”.

20 EXEMPTION FOR ISSUANCE OF CERTAIN SENIOR

21 SECURITIES BY BUSINESS DEVELOPMENT COMPANIES

22 SEC. 106. Section 18 of the Investment Company Act
23 of 1940 (15 U.S.C. 80a-18) is amended by adding at the end
24 thereof the following subsection:

1 “(l)(1) Notwithstanding subsection (c) of this section, a
2 business development company can issue more than one class
3 of senior security representing indebtedness if such business
4 development company does not have outstanding any pub-
5 licly held indebtedness, and all securities of each class are—

6 “(A) privately held by the Small Business Admin-
7 istration, or banks, insurance companies or other insti-
8 tutional investors, and

9 “(B) not intended to be publicly distributed.

10 “(2) Notwithstanding subsection (d) of this section—

11 “(A) a business development company can issue
12 senior securities representing indebtedness accompanied
13 by warrants, options or rights to subscribe or convert
14 to voting securities of such business development
15 company: *Provided, That—*

16 “(i) such warrants, options or rights expire
17 by their terms within ten years;

18 “(ii) such warrants, options or rights are not
19 separately transferable unless no class of such
20 warrants, options or rights and the senior securi-
21 ties accompanying them has been publicly
22 distributed;

23 “(iii) the exercise or conversion price is not
24 less than the current market value at the date of
25 issuance, or if no such market value exists, the

1 current net asset value of such voting securities;
2 and

3 “(iv) the proposal to issue such securities is
4 authorized by the shareholders of the business de-
5 velopment company, and such issuance is ap-
6 proved by a majority of its board of directors who
7 have no financial interest in such issuance, includ-
8 ing a majority of the directors who are not inter-
9 ested persons of the business development com-
10 pany, on the basis that such issuance is in the
11 best interests of such company and its sharehold-
12 ers; and

13 “(B) a business development company can issue
14 to its officers and employees warrants, options and
15 rights to purchase voting securities of such company
16 pursuant to an executive compensation plan: *Provided,*
17 That—

18 “(i) such securities satisfy the conditions in
19 (i), (iii), and (iv) of subparagraph (A) of paragraph
20 (2) of this subsection;

21 “(ii) such securities are not transferable
22 except for disposition by gift, will or intestacy;
23 and

24 “(iii) no investment adviser of such business
25 development company receives any compensation

1 described in paragraph (1) of section 205 of the
2 Investment Advisers Act of 1940, except insofar
3 as permitted by clauses (A) or (B) of that section,
4 if the amount of voting securities that would
5 result from the exercise of all outstanding war-
6 rants, options or rights issued pursuant to this
7 subparagraph (B) would exceed 3 per centum of
8 the outstanding voting securities of the business
9 development company.

10 “(3) Notwithstanding subsection (1)(2), the amount of
11 voting securities that would result from the exercise of all
12 outstanding warrants, options and rights at the time of issu-
13 ance shall not exceed 20 per centum of the outstanding
14 voting securities of the business development company.”.

15 EXEMPTION FOR CERTAIN ISSUANCE OF STOCK FOR LESS
16 THAN NET ASSET VALUE BY BUSINESS DEVELOP-
17 MENT COMPANIES

18 SEC. 107. Section 23(b) of the Investment Company
19 Act of 1940 (15 U.S.C. 80a-23(b)) is amended by inserting
20 after the phrase “provisions of section 18(d)” at the end of
21 paragraph (4) thereof: “or upon the exercise of any warrant,
22 option or right issued in accordance with the provisions of
23 section 18(1)(2)”.

1 TITLE II—AMENDMENTS TO THE INVESTMENT
2 ADVISERS ACT OF 1940

3 DEFINITION OF BUSINESS DEVELOPMENT COMPANY

4 SEC. 201. Section 202(a) of the Investment Advisers
5 Act of 1940 (15 U.S.C. 80b-2(a)) is amended by adding at
6 the end thereof the following new paragraph:

7 “(22) ‘Business development company’ means any com-
8 pany which is organized and operated solely for the purposes
9 of making investments in securities purchased in transactions
10 described in section 12(h)(1) of the Investment Company Act
11 of 1940, and making available significant managerial assist-
12 ance to the issuers of such securities.”.

13 SEC. 202. Section 203(b) of the Investment Advisers
14 Act of 1940 (15 U.S.C. 80b-3(b)) is amended by adding at
15 the end of paragraph (3) thereof the following: “For purposes
16 of determining the number of clients of an investment adviser
17 under this paragraph, no shareholder, partner, or beneficial
18 owner of a business development company, as defined in this
19 title, shall be deemed to be a client of such investment ad-
20 viser unless such person is a client of such investment adviser
21 separate and apart from his status as a shareholder, partner,
22 or beneficial owner.”.

23 SEC. 203. Section 205 of the Investment Advisers Act
24 of 1940 (15 U.S.C. 80b-5) is amended by:

1 (1) striking the word "or" preceding the letter
2 "(B)" in the sentence following paragraph (3) thereof,
3 and

4 (2) striking the period at the end of such section
5 205, substituting a comma in lieu thereof, and adding
6 the word "or" immediately thereafter, and the follow-
7 ing clause:

8 "(C) apply with respect to any investment ad-
9 visory contract between an investment adviser and a
10 business development company as defined in the In-
11 vestment Advisers Act of 1940: *Provided*, That the
12 compensation provided for in such contract shall not
13 exceed 20 per centum of the realized capital gains
14 upon the funds of the business development company
15 over a specified period or as of definite dates, com-
16 puted net of all realized capital losses and capital de-
17 preciation, and further provided that the condition of
18 section 18(l)(2)(B)(iii) of the Investment Company Act
19 of 1940 is satisfied."

96TH CONGRESS
2D SESSION

H. R. 7554

To amend the Securities Act of 1933 and the Investment Company Act of 1940 to provide incentives for small business investment, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JUNE 12, 1980

Mr. BROYHILL (for himself, Mr. PREYER, Mr. LUKE, Mr. SATTERFIELD, Mr. RINALDO, and Mr. DEVINE) introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

A BILL

To amend the Securities Act of 1933 and the Investment Company Act of 1940 to provide incentives for small business investment, and for other purposes.

- 1 *Be it enacted by the Senate and House of Representa-*
- 2 *tives of the United States of America in Congress assembled,*
- 3 That this Act may be cited as the "Small Business Invest-
- 4 ment Incentive Act of 1980".

1 TITLE I—AMENDMENTS TO THE SECURITIES

2 ACT OF 1933

3 DEFINITION OF ACCREDITED INVESTOR

4 SEC. 101. Section 2 of the Securities Act of 1933 (15
5 U.S.C. 77b) is amended by adding at the end thereof the
6 following new paragraph:

7 “(15) The term ‘accredited investor’ means—

8 “(A)(i) a bank as defined in section 3(a)(2),
9 whether acting in its individual or fiduciary capac-
10 ity, (ii) an insurance company as defined in para-
11 graph (13), (iii) an investment company registered
12 under the Investment Company Act of 1940, (iv)
13 a small business investment company licensed by
14 the Small Business Administration, (v) a venture
15 capital company as defined in section 2(a)(46) of
16 the Investment Company Act of 1940, or (vi) a
17 fund, trust, or other account with respect to
18 which a bank or insurance company exercises in-
19 vestment discretion (as defined in section 3(a)(35)
20 of the Securities Exchange Act of 1934), or a
21 person controlled by any such person; or

22 “(B) any person who purchases \$100,000 or
23 more of securities of the issuer sold for (i) cash,
24 (ii) an obligation to pay which provides for full re-
25 course against the purchaser of the securities and

1 for discharge of the obligation within sixty days of
2 the first issuance of the securities, or (iii) the can-
3 cellation of any indebtedness owed by the issuer
4 to the purchaser.

5 If the Commission finds it necessary or appropriate in
6 the public interest and consistent with the protection of
7 investors and the purposes fairly intended by the Small
8 Business Investment Incentive Act of 1980, it may, by
9 rule, (1) include within the term 'accredited investor'
10 any class or classes of persons, or (2) increase the
11 minimum purchase requirement contained in subpara-
12 graph (B) to the extent that it finds that inflationary
13 factors require such an increase."

14 TRANSACTIONS INVOLVING ACCREDITED INVESTORS

15 SEC. 102. Section 4(2) of the Securities Act of 1933 (15
16 U.S.C. 77d(2)) is amended by adding at the end thereof the
17 following: "For purposes of this paragraph, transactions by
18 an issuer not involving a public offering shall include transac-
19 tions in which all of the following factors are present:

20 "(A) The transaction is solely with one or
21 more accredited investors or persons that the
22 issuer, after making reasonable inquiry, reason-
23 ably believes to be accredited investors.

24 "(B) The security which is the subject of the
25 transaction bears a legend to the effect that such

1 security may not be sold or otherwise transferred
2 without compliance with the registration require-
3 ments of this Act or pursuant to an exemption
4 from such requirements.

5 “(C) There is no general advertising or gen-
6 eral solicitation in connection with the transaction
7 by the issuer or any person acting on the issuer’s
8 behalf.

9 Any resale by an accredited investor of a security ac-
10 quired in such a transaction shall not adversely affect
11 the exemption available under this paragraph to the
12 issuer in such transaction, provided that the issuer has
13 exercised reasonable care to assure that the purchasers
14 of the securities are not underwriters within the mean-
15 ing of section 2(11).”.

16 RESALE OF SECURITIES TO ACCREDITED INVESTORS

17 SEC. 103. Section 2(11) of the Securities Act of 1933
18 (15 U.S.C. 77b(11)) is amended—

19 (1) in the first sentence, by inserting “(A)” imme-
20 diately after “shall not include”; and

21 (2) by inserting immediately before the period at
22 the end of the first sentence the following: “, or (B) a
23 person (other than the issuer) who sells a security for
24 his own account or for the account of another person
25 (other than the issuer) if such sale is made to an ac-

1 credited investor or to a person that the seller, after
2 making reasonable inquiry, reasonably believes to be
3 an accredited investor. The Commission may adopt
4 such rules as it deems necessary to insure that the ex-
5 clusion from the term 'underwriter' contained in sub-
6 paragraph (B) shall not be utilized to permit the sale of
7 a security, after one or a series of transactions made in
8 reliance upon subparagraph (B), to persons other than
9 accredited investors."

10 LIABILITY IN PRIVATE OFFERINGS

11 SEC. 104. Section 12 of the Securities Act of 1933 (15
12 U.S.C. 77l) is amended by adding at the end thereof the fol-
13 lowing new sentence: "Notwithstanding the foregoing provi-
14 sions of this section, a person who sells securities, and who
15 has a reasonable basis for believing and does believe in good
16 faith that such sale does not involve any public offering pur-
17 suant to section 4(2), shall not be liable under paragraph (l) of
18 this section to a purchaser of such securities in such transac-
19 tion if all of the conditions set forth in section 4(2) or pre-
20 scribed in rules and regulations of the Commission concern-
21 ing such a transaction have been met with respect to such
22 purchaser, and such purchaser may not bring a civil action
23 for rescission of such transaction on the grounds that all such
24 conditions have not been met with respect to all purchasers
25 of securities in such transaction."

1 TITLE II—AMENDMENTS TO THE INVESTMENT
2 COMPANY ACT OF 1940 AND THE INVEST-
3 MENT ADVISERS ACT OF 1940

4 DEFINITION OF VENTURE CAPITAL COMPANY AND
5 ELIGIBLE VENTURE CAPITAL COMPANY

6 SEC. 201. Section 2(a) of the Investment Company Act
7 of 1940 (15 U.S.C. 80a-2(a)) is amended by adding at the
8 end thereof the following new paragraphs:

9 “(46) ‘Venture capital company’ means any com-
10 pany which meets both of the following conditions:

11 “(A) Such company is predominantly en-
12 gaged in one or more of the businesses of (i) fur-
13 nishing capital (other than through the purchase
14 of short-term paper) and making available man-
15 agerial assistance to new businesses, to businesses
16 in the development stage, to businesses in need of
17 reorganization, or to businesses which are unable
18 to obtain capital in the public markets on favora-
19 ble terms, (ii) purchasing securities (other than
20 short-term paper) of, and making available man-
21 agerial assistance to, issuers, the securities of
22 which had no ready market at the time of the ini-
23 tial investment by the venture capital company,
24 (iii) purchasing securities or the assets of, and
25 making available managerial assistance to, issu-

1 ers, including purchases made through leveraged
2 buy-outs, for the purpose of effecting a reorgani-
3 zation or other transaction which establishes one
4 or more independent business entities, (iv) assist-
5 ing small businesses as a small business invest-
6 ment company licensed under the Small Business
7 Investment Act, (v) any business which is inciden-
8 tal to the businesses described in clauses (i)
9 through (iv), or (vi) such other similar or related
10 activities as the Commission shall determine by
11 rule or order are consistent with the purposes of
12 this paragraph and section 3(c)(14).

13 “(B) At least 80 per centum of the assets of
14 such company (exclusive of office furniture and
15 equipment, interests in real estate, leasehold im-
16 provements and facilities maintained to conduct
17 its business operations, deferred organization and
18 operating expenses, and other noninvestment
19 property and assets necessary and appropriate to
20 its operations as a venture capital company),
21 valued at cost, consists of—

22 “(i) securities which were acquired di-
23 rectly from the issuer thereof in a transaction
24 or transactions not involving the registration
25 of the securities under the Securities Act of

1 1933 or were acquired otherwise than direct-
2 ly from the issuer thereof and, immediately
3 after such acquisition are treated by the ven-
4 ture capital company, for purposes of resale,
5 as if acquired directly from the issuer thereof
6 in a transaction exempt from registration by
7 virtue of section 4(2) of the Securities Act of
8 1933 and the rules thereunder, or pursuant
9 to the exercise of options, warrants, or rights
10 acquired in such transactions;

11 “(ii) securities which were received, in
12 exchange for securities acquired pursuant to
13 clause (i) of this subparagraph, in a reorgani-
14 zation of the issuer;

15 “(iii) securities which were distributed
16 on or with respect to any securities referred
17 to in clause (i) or (ii) of this subparagraph; or

18 “(iv) Government securities, short-term
19 paper and cash items.

20 “(47) ‘Private venture capital company’ means
21 any company—

22 “(A) which is primarily engaged in one or
23 more of the activities described in section
24 2(a)(46)(A) of this title,

1 “(B) at least 60 per centum of the assets of
2 which (exclusive of office furniture and equipment,
3 interests in real estate, leasehold improvements
4 and facilities maintained to conduct its business
5 operations, deferred organization and operating
6 expenses, and other noninvestment property and
7 assets necessary and appropriate to its operation
8 as a private venture capital company), valued at
9 cost, consists of assets described in sections
10 2(a)(46)(B) (i), (ii), (iii), or (iv) of this title, and

11 “(C) the securities of which are issued only
12 in transactions which are exempt from registration
13 under the Securities Act of 1933 by virtue of sec-
14 tion 4(2) thereof.

15 “(48) ‘Eligible venture capital company’ means—

16 “(A) any venture capital company that is and
17 has been actively engaged in business as a ven-
18 ture capital company for at least the three preced-
19 ing continuous years;

20 “(B) any other venture capital company if at
21 least 50 per centum of the proceeds to such com-
22 pany from the sale of each class of its securities
23 has been received from accredited investors or
24 persons that such company, after making reason-

1 able inquiry, reasonably believes to be accredited
2 investors; or

3 “(C) any private venture capital company.

4 “(49) ‘Making available managerial assistance’
5 means—

6 “(A) any arrangement whereby a venture
7 capital company offers to provide, and upon ac-
8 ceptance by an issuer of securities purchased by
9 the venture capital company does so provide,
10 guidance and counsel in the management and op-
11 eration of such issuer, or

12 “(B) control, actual or potential, of an issuer
13 by a venture capital company through contractual
14 arrangements, board membership, or otherwise for
15 the purpose of endeavoring to assure successful
16 operation of such issuer and protection of the in-
17 vestment of such venture capital company. For
18 purposes of this subparagraph, control includes
19 venture capital companies acting individually or
20 as part of a group which controls an issuer.

21 For purposes of this title, any requirement that a ven-
22 ture capital company make available managerial assist-
23 ance shall be deemed to be met in the case where a
24 venture capital company purchases securities in con-
25 junction with one or more other companies at least one

1 of whom is making or will make available managerial
2 assistance to the issuer of such securities.”.

3 EXEMPTION FROM INVESTMENT COMPANY ACT OF 1940

4 SEC. 202. Section 3(c) of the Investment Company Act
5 of 1940 (15 U.S.C. 80a-3(c)) is amended by adding at the
6 end thereof the following new paragraphs:

7 “(14)(A) Any eligible venture capital company
8 having each class of its equity securities registered
9 under section 12 of the Securities Exchange Act of
10 1934; or

11 “(B) Any eligible venture capital company which
12 has filed a registration statement pursuant to section
13 12 of the Securities Exchange Act for a class of its
14 equity securities (other than a company described in
15 subparagraph (A) of this paragraph), but only for the
16 one-hundred-and-eighty-day period beginning on the
17 date its outstanding securities (other than short-term
18 paper) become beneficially owned by more than one
19 hundred persons, as determined under paragraph (1) of
20 this subsection.”.

21 ATTRIBUTION OF BENEFICIAL OWNERS

22 SEC. 202A. Section 3(c)(1) of the Investment Company
23 Act of 1940 (15 U.S.C. 80a-3(c)(1)) is amended to read in its
24 entirety as follows:

1 “(1) Any issuer whose outstanding securities
2 (other than short-term paper) are beneficially owned by
3 not more than one hundred persons and which is not
4 making and does not presently propose to make a
5 public offering of its securities. For the purposes of this
6 paragraph beneficial ownership by a company shall be
7 deemed to be beneficial ownership by one person;
8 except that if such company owns 10 per centum or
9 more of the outstanding voting securities of the issuer,
10 the beneficial ownership shall be deemed to be that of
11 the holders of such company's outstanding securities
12 (other than short-term paper), provided that beneficial
13 ownership of outstanding securities of such issuer by
14 such company shall be deemed to be beneficial owner-
15 ship by one person if at the time of the purchase of the
16 voting securities by such company either (i) the value
17 of all securities of all issuers who are excluded from
18 the definition of investment company by this paragraph
19 owned by such company does not exceed 10 per
20 centum of the value of the company's total assets, or
21 (ii) such company is a general partner or promotor of,
22 or investment adviser to, such issuer, provided that the
23 issuer excluded from the definition of investment com-
24 pany by this proviso shall be deemed to be an invest-
25 ment company for purposes of section 12(d)(1). For

1 purposes of this paragraph, beneficial ownership of se-
2 curities by a beneficial owner and by all persons who
3 are ancestors, descendants, a spouse or former spouse
4 (or by custodian or trustee or other account for the ac-
5 count of such ancestors, descendants, spouse or former
6 spouse) of such beneficial owner shall be deemed to be
7 beneficial ownership by one person provided such an-
8 cestors, descendants, spouse or former spouse acquired
9 the securities by gift or donation inter vivos by the
10 beneficial owner or on divorce, or on death of the
11 beneficial owner by testamentary bequest or intestate
12 succession, or on distribution by a trust, custodianship
13 or other account established by the beneficial owner
14 inter vivos or by testamentary disposition.”.

15 RESTRICTIONS OF ELIGIBLE VENTURE CAPITAL
16 COMPANIES

17 SEC. 203. The Investment Company Act of 1940 (15
18 U.S.C. 80a) is amended by adding at the end of section 7
19 thereof the following new sections:

20 “DIRECTORS OF ELIGIBLE VENTURE CAPITAL COMPANIES

21 “SEC. 7A. (a)(1) An eligible venture capital company
22 which is not an investment company within the meaning of
23 this title solely by reason of section 3(c)(14) of this title and
24 which has not voluntarily registered as an investment com-
25 pany under section 8(g) of this title may not engage in any

1 business in interstate commerce unless a majority of the
2 members of such company's board of directors are not inter-
3 ested persons of such company.

4 “(2) If, by reason of the death, disqualification, or bona
5 fide resignation of a member of the board of directors, an
6 eligible venture capital company would be prohibited, under
7 paragraph (1) of this paragraph, from engaging in any busi-
8 ness in interstate commerce, such prohibition shall be sus-
9 pended for a period of ninety days or for such longer period
10 as the Commission may prescribe, upon its own motion or by
11 order upon application, as not inconsistent with the protec-
12 tion of investors.

13 “(b)(1) No director, officer, employee, investment ad-
14 viser, or member of an advisory board of an eligible venture
15 capital company which is not an investment company within
16 the meaning of this title solely by reason of section 3(c)(14) of
17 this title and which has not voluntarily registered as an in-
18 vestment company under section 8(g) of this title may pur-
19 chase, lease, or borrow any securities or other property
20 (other than ordinary goods and services offered for retail sale
21 to the general public) of any company whose securities are
22 beneficially owned by the venture capital company.

23 “(2) No controlling person, and no person controlling,
24 controlled by, or under common control with any director,
25 officer, employee, controlling person, investment adviser or

1 member of an advisory board, of an eligible venture capital
2 company which is not an investment company within the
3 meaning of this title solely by reason of section 3(c)(14) of
4 this title and which has not voluntarily registered as an in-
5 vestment company under section 8(g) of this title may pur-
6 chase, lease or borrow any securities or other property (other
7 than ordinary goods and services offered for retail to the gen-
8 eral public) of any company whose securities are beneficially
9 owned by the venture capital company, unless such purchase,
10 lease, or borrowing is approved under paragraph (4) of this
11 subsection.

12 “(3) No director, officer, employee, controlling person,
13 investment adviser or member of an advisory board of an
14 eligible venture capital company which is not an investment
15 company within the meaning of this title solely by reason of
16 section 3(c)(14) of this title and which has not voluntarily
17 registered as an investment company under section 8(g) of
18 this title, nor any person controlling, controlled by, or under
19 common control with any director, officer, employee, control-
20 ling person, investment adviser or member of an advisory
21 board of such company, may sell to, or purchase or borrow
22 from, such eligible venture capital company or any company
23 controlled by such eligible venture capital company any secu-
24 rities or other property, or participate as a joint or a joint and
25 several participant in any transaction in which such eligible

1 venture capital company is also a participant (other than on
2 behalf of the eligible venture capital company), unless such
3 transaction is approved under paragraph (4) of this subsec-
4 tion; except that this paragraph shall not operate so as to
5 authorize any transaction prohibited by paragraph (1) of this
6 subsection.

7 “(4) Any transaction described in paragraph (1), (2), or
8 (3) of this subsection shall be approved only if the required
9 majority (as described in paragraph (5) of this subsection) of
10 the directors of the eligible venture capital company approve
11 of such transaction on the basis that—

12 “(A) the terms thereof, the consideration to be
13 paid or received, are reasonable and fair to the share-
14 holders of the eligible venture capital company and do
15 not involve overreaching of the company or its share-
16 holders by another party;

17 “(B) the ownership or purchase is consistent with
18 the interests of the shareholders of the eligible venture
19 capital company and is consistent with the policy of
20 the company as recited in its articles of incorporation
21 and any other documents made available to the share-
22 holders generally; and

23 “(C) the board of directors records in its minutes
24 a description of such transaction, the findings of the
25 board and the basis therefor.

1 “(5) For purposes of this subsection, the ‘required
2 majority’ for approval of a transaction described in paragraph
3 (4) of this subsection means both a majority of the members
4 of such company’s board of directors who have no financial
5 interest in such transaction and a majority of the members of
6 such board who are not interested persons of such company.

7 “(c) The Commission may, by rule, require any eligible
8 venture capital company which is not an investment company
9 within the meaning of this title solely by virtue of section
10 3(c)(14) of this title and which has not voluntarily registered
11 as an investment company under section 8(g) of this title, to
12 comply with such provisions of sections 17(f) (except section
13 17(f) shall not apply to private venture capital companies),
14 (g), (h), and (i) of this title relating to the custody of securi-
15 ties, fidelity bonding and indemnification, and the rules there-
16 under, as it deems necessary or appropriate in the public
17 interest or for the protection of investors.

18 “(d) It shall be unlawful for any director, officer, em-
19 ployee, controlling person, investment adviser or member of
20 an advisory board of an eligible venture capital company
21 which is not an investment company within the meaning of
22 this title solely by reason of section 3(c)(14) of this title, and
23 which has not voluntarily registered as an investment compa-
24 ny under section 8(g) of this title, to engage in any fraudu-
25 lent, deceptive or manipulative act, practice, or course of

1 business in connection with the purchase or sale, directly or
2 indirectly, by such person of any security held by such eligi-
3 ble venture capital company.

4 "RECORDS, REPORTS TO SHAREHOLDERS, AND
5 INSPECTIONS

6 "SEC. 7B. (a) Any eligible venture capital company
7 which is not an investment company within the meaning of
8 this title solely by reason of section 3(c)(14) of this title and
9 which has not voluntarily registered as an investment com-
10 pany pursuant to section 8(g) of this title, shall give notice to
11 the Commission of the fact that it is or has become such a
12 company at such time and in such manner as the Commission
13 may by rule prescribe.

14 "(b) Every eligible venture capital company which is
15 not an investment company within the meaning of this title
16 solely by reason of section 3(c)(14) of this title and which has
17 not voluntarily registered as an investment company under
18 section 8(g) of this title, and every majority owned subsidiary
19 of such a company, shall make and keep for prescribed peri-
20 ods such accounts, books, and other records as the Commis-
21 sion, by rule, prescribes as necessary or appropriate in the
22 public interest, for the protection of investors, or otherwise in
23 furtherance of the purposes of this title.

24 "(c) All accounts, books, and other records required to
25 be maintained and preserved by any person pursuant to sub-

1 section (b), shall be subject at any time, or from time to time,
2 to such reasonable periodic, special, or other examinations by
3 the Commission, or any member or representative thereof, as
4 the Commission deems necessary or appropriate in the public
5 interest, for the protection of investors, or otherwise in fur-
6 therance of the purposes of this title. Any such person shall
7 furnish to the Commission, within such reasonable time as
8 the Commission may prescribe, copies of or extracts from
9 such records which may be prepared without undue effort,
10 expense, or delay, as the Commission may by order require.

11 “(d) The Commission may, by rule, require any eligible
12 venture capital company which is not an investment company,
13 within the meaning of this title solely by reason of section
14 3(c)(14) of this title and which has not voluntarily registered
15 as an investment company pursuant to section 8(g) of this
16 title, to file with the Commission and supply to its sharehold-
17 ers annually, a brief written statement, summarizing the risk
18 factors involved in an investment in the securities of such
19 company due to the nature of such company’s investment
20 portfolio, and to supply copies of such statement to any regis-
21 tered broker or dealer upon written request. The Commission
22 may further require, by rule, any person who, acting as prin-
23 cipal or agent, sells a security of such an eligible venture
24 capital company to deliver to the purchaser of such securities

1 the risk statement prepared by the company pursuant to this
2 section at or before the time of sale.

3 "PRIVATE ACTIONS

4 "SEC. 7C. (a) Any person who knowingly violates any
5 provision of section 7A or 7B of this title, or any rule or
6 regulation prescribed thereunder, shall be liable to any
7 person who is injured as a result of such violation. Any
8 person so injured may bring an action in law or in equity, in
9 any court of competent jurisdiction, against the person
10 committing such violation.

11 "(b) An action brought to enforce any liability created
12 under this section shall be barred unless such action is com-
13 menced within two years after the person bringing such
14 action knew or reasonably should have known the facts
15 giving rise to such action, but in no event more than four
16 years after the occurrence of the violation upon which such
17 action is based.

18 "LOSS OF EXEMPTION

19 "SEC. 7D. If the Commission finds, on the record after
20 notice and opportunity for hearing, that any eligible venture
21 capital company which is not an investment company within
22 the meaning of this title solely by reason of section 3(c)(14) of
23 this title and which has not voluntarily registered as an in-
24 vestment company pursuant to section 8(g) of this title—

1 “(a) has failed to be engaged in one or more of
2 the businesses described in section 2(a)(46)(A) (section
3 2(a)(47)(A) in the case of a private venture capital
4 company) of this title,

5 “(b) has failed to meet the assets test contained in
6 section 2(a)(46)(B) (section 2(a)(47)(B) in the case of a
7 private venture capital company) of this title, or

8 “(c) has failed to comply with the provisions of
9 section 7A or 7B of this title,

10 the Commission may, as it deems necessary or appropriate in
11 the public interest or for the protection of investors, enter an
12 order—

13 “(1) requiring that such company comply with the
14 provisions of sections 2(a)(46) (section 2(a)(47) in the
15 case of a private venture capital company), 7A, and
16 7B of this title,

17 “(2) requiring that such company register as an
18 investment company pursuant to section 8 of this title,
19 or

20 “(3) granting such further relief as the Commis-
21 sion deems appropriate.

22 “In making its findings and entering any order under
23 this section the Commission shall consider, amongst other
24 factors, the duration of any failure to comply with the provi-

1 sions of this title and whether such failure to comply was
2 intentional.

3 "INELIGIBILITY OF CERTAIN PERSONS

4 "SEC. 7E. The Commission may, by order, prohibit,
5 conditionally or unconditionally, either permanently or for
6 such period of time as it in its discretion shall deem appropri-
7 ate in the public interest, any person from serving or acting
8 as an employee, officer, director, member of an advisory
9 board, investment adviser, or depositor of or principal under-
10 writer for, an eligible venture capital company which is not
11 an investment company solely by reason of section 3(c)(14) of
12 this title and which has not voluntarily registered as an in-
13 vestment company under section 8(g) of this title, if it finds,
14 on the record after notice and opportunity for hearing, that
15 such person—

16 "(a) has willfully made or caused to be made in
17 any registration statement, application or report filed
18 with the Commission under this title any statement
19 which was at the time and in the light of the circum-
20 stances under which it was made false or misleading
21 with respect to any material fact, or has omitted to
22 state in any such registration statement, application, or
23 report any material fact which was required to be
24 stated therein;

1 “(b) has willfully violated any provision of the Se-
2 curities Act of 1933, or of the Securities Exchange
3 Act of 1934, or of the Investment Advisers Act of
4 1940, or of this title, or of any rule or regulation under
5 any of such statutes;

6 “(c) has willfully aided, abetted, counseled, com-
7 manded, induced, or procured the violation by any
8 other person of the Securities Act of 1933, or of the
9 Securities Exchange Act of 1934, or of the Investment
10 Advisers Act of 1940, or of this title, or of any rule or
11 regulation under any of such statutes;

12 “(d) has been convicted within ten years of any
13 felony or misdemeanor involving the purchase or sale
14 of any security or arising out of such person's conduct
15 as an underwriter, broker, dealer, or investment advis-
16 er, or as an affiliated person, salesman, or employee of
17 any investment company, venture capital company,
18 bank, or insurance company;

19 “(e) is, by reason of any misconduct, permanently
20 or temporarily enjoined by order, judgment, or decree
21 of any court of competent jurisdiction from acting as an
22 underwriter, broker, dealer, or investment adviser, or
23 as an affiliated person, salesman, or employee of an in-
24 vestment company, venture capital company, bank or
25 insurance company, or from engaging in or continuing

1 any conduct or practice in connection with any such
2 activity or in connection with the purchase or sale of
3 any security; or

4 “(f) is a company any affiliated person of which is
5 enumerated in paragraph (d) or (e).

6 For the purposes of this subsection, the term ‘investment ad-
7 viser’ shall include an investment adviser as defined in the
8 Investment Advisers Act of 1940.”.

9 TECHNICAL AMENDMENT

10 SEC. 204. Section 34 of the Investment Company Act
11 of 1940 (15 U.S.C. 80a-34) is amended—

12 (a) by inserting “7B(b),” immediately after the
13 word “section” in subsection (a); and

14 (b) by inserting “7B(b) or” immediately after the
15 word “section” in subsection (b).

16 ALTERNATIVE REGISTRATION

17 SEC. 205. Section 8 of the Investment Company Act of
18 1940 (15 U.S.C. 80a-8) is amended by adding at the end
19 thereof the following new subsection:

20 “(g) Notwithstanding any provision of this Act or any
21 other provision of law, a company which would be an invest-
22 ment company under this title but for the exclusion under
23 section 3(c)(14) of this title may voluntarily register and be
24 subject to regulation as an investment company if such com-

pany is not a personal holding company as defined under section 542 of the Internal Revenue Code of 1954.”.

3 AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF

4 1940

SEC. 206. (a) Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)) is amended by adding at the end thereof the following new paragraph:

8 “(22) A ‘private company’ means any company
9 (A) the business affairs of which, including its invest-
10 ment decisions, are conducted by a general partner or
11 general partners or management without the require-
12 ment of approval thereof by individual shareholders,
13 partners or beneficial owners, (B) which is formed for a
14 minimum term of existence of five years (or, if it is a
15 corporation, does not have a limited term of existence)
16 and during such minimum term (or, if a corporation,
17 during the term of its existence) the shareholders, part-
18 ners or beneficial owners do not own redeemable secu-
19 rities (as defined in section 2(a)(32) of the Investment
20 Company Act of 1940) of the company nor do they
21 have any other individual right of withdrawal, and (C)
22 the securities of which are issued only in transactions
23 which are exempt from registration under the Securi-
24 ties Act of 1933 by virtue of section 4(2) thereof.”.

1 (b) Section 203(b)(3) of the Investment Advisers Act of
2 1940 (15 U.S.C. 80b-3(b)(3)) is amended by adding at the
3 end thereof the following new sentence: "For purposes of
4 determining the number of clients of an investment adviser
5 under this paragraph, no shareholder, partner, or beneficial
6 owner of any company which is either an eligible venture
7 capital company (as defined in section 2(a)(48) of the Invest-
8 ment Company Act of 1940) or a private company shall be
9 deemed to be a client of such investment adviser unless such
10 person is a client of such investment adviser separate and
11 apart from his status as a shareholder, partner, or beneficial
12 owner."

13 TITLE III—EFFECTIVE DATE AND
14 MISCELLANEOUS PROVISIONS

15 EFFECTIVE DATE

16 SEC. 301. The amendments made by this Act shall take
17 effect on the date of enactment of this Act.

18 COMMISSION STUDY

19 SEC. 302. The Commission is authorized and directed to
20 conduct a study of the effect of the exemption from regulation
21 as an investment company and alternate regulation provided
22 by Title II of this Act. The Commission shall report to Con-
23 gress regarding the results of such study, including whether
24 such provisions (1) are in the public interest, (2) have resulted
25 in or are likely to result in the availability of venture capital

1 to industry, and (3) the manner in which the relief provided
2 by this Act from certain provisions of the Investment Com-
3 pany Act of 1940 may be made available to venture capital
4 companies which are organized in partnership form. The
5 Commission may also furnish such recommendations for new
6 or additional legislation as it deems advisable.



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

June 3, 1980

The Honorable Harley O. Staggers
 Chairman
 Committee on Interstate and Foreign
 Commerce
 United States House of Representatives
 Washington, D.C. 20515

Dear Mr. Chairman:

The House of Representatives has before it several bills which address an area with which the Commission is greatly concerned — the ability of small, innovative businesses to raise venture capital. The Commission has, however, strongly criticized the bills currently pending in the House on a number of grounds. First, as we have previously stated, the Commission itself has already taken, and proposes to take, a number of steps designed to remove unnecessary obstacles to the efforts of small businesses to raise venture capital. In this regard, we have established the Office of Small Business Policy within our Division of Corporation Finance to give a more substantial impetus to our initiatives on behalf of small business and have adopted rule changes under existing law that provide substantially the same access to capital for small businesses as is contemplated by certain provisions in those bills. Moreover, we are taking additional steps designed to meet concerns addressed in other portions of those bills in a manner consistent, in our view, with the preservation of appropriate protections for investors and the general public when they invest in small businesses and venture capital companies. Thus, the Commission has recognized the validity of the broad objectives expressed in those bills and has already embarked upon a course utilizing existing administrative authority to achieve them.

Moreover, despite our agreement with the basic goals of the proposed legislation, we are unable to support those bills as presently drafted because we believe the proposed amendments to the securities laws are overly broad in scope and unnecessarily remove investor protections and safeguards. With respect to proposed amendments to the Investment Company Act of 1940, we are particularly concerned about the breadth of exclusions which would be provided by those bills. Those exclusions could, in our view, permit the sale of securities to unsophisticated investors of companies having many attributes in common with investment companies regulated under that Act, but under conditions which would deprive those investors of fundamental protections.

Despite our serious misgivings with the pending bills, we believe that there are certain areas where amendments to the federal securities laws could appropriately balance the needs of small businesses by removing unnecessary impediments to the raising of capital, while at the same time retaining fundamental investor protections. In that regard, I am pleased to enclose a draft bill prepared by the Commission which would amend in significant respects the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Briefly, our amendments can be analyzed in two separate parts. First, there are amendments to both Acts which generally would exempt from regulation under those Acts investment companies which make nonpublic offerings to sophisticated investors and investment advisers who give advice to such companies or persons who invest in them. To the extent that such companies and investment advisers might presently fall under the Commission's jurisdiction, we believe that the proposed amendments would give appropriate recognition to the fact that such investors are in most respects able to fend for themselves and may not need the detailed investor protections provided by those Acts.

Second, the bill carefully defines "business development companies" to avoid semantical disagreements over precisely what is a small business or a venture capital company and, thus, provides for a new category of registered closed-end investment company. To facilitate the operations of such registered investment companies, the bill would exempt them from unnecessary regulatory requirements in three significant sections of the Act. Finally, an exemption is added to the Investment Advisers Act to permit the investment adviser to business development companies to receive a type of performance fee.

The Commission believes that it has struck a reasonable balance in drafting this bill. As the Commission has at various times stressed, however, there is always a difficult trade-off which must be made between removing unnecessary impediments to capital formation and preserving protections which are necessary to the very investor confidence which is so vital to our capital markets. In that regard, we would emphasize that these amendments, if adopted, should be viewed in the nature of an experiment.

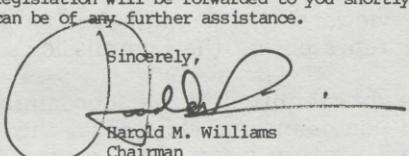
As the Commission has stated when promulgating rules under section 3(b) of the Securities Act of 1933, in many of these efforts to address the problems of small business the Commission is embarking on uncharted seas. Thus, in

adopting such rules, the Commission has placed substantial weight upon our administrative flexibility to monitor the results of these experiments and make appropriate adjustments where needed. Since the small business initiatives contained in the draft legislation would be amendments to the federal securities laws, however, we would be especially interested in tracking developments under these provisions. Accordingly, the Commission is considering whether to recommend that it be provided with the additional resources needed to monitor the effects of these proposed amendments and to report to the Congress within a specified time frame on its analysis of the operating experience of business development companies under these amendments.

The views expressed in that draft legislation are those of the Commission and do not necessarily represent the views of the President. We are simultaneously sending copies of this correspondence and the legislation to the Office of Management and Budget. We will inform you of any advice received from that Office concerning the relationship of these materials to the on-going program of the Administration respecting small business.

We appreciate the opportunity to prepare this draft legislation. We believe this represents a balanced effort to address the needs of small business in raising capital in a manner which will continue to provide appropriate and adequate investor protection. A detailed section-by-section analysis of the proposed legislation will be forwarded to you shortly. Please let me know if we can be of any further assistance.

Sincerely,



Harold M. Williams
Chairman

Enclosure Editors note: (The draft bill was subsequently introduced as H.R. 7491.)

cc: Mr. Bernard Martin
Office of Management and
Budget

Mr. SCHEUER. Mr. Friedman, please proceed.

STATEMENT OF STEPHEN J. FRIEDMAN, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY MARTIN E. LYBECKER, ASSOCIATE DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT; AND ALAN ROSENBLAT, ASSISTANT GENERAL COUNSEL

Mr. FRIEDMAN. Thank you, Mr. Chairman, and Mr. Broyhill.

Mr. SCHEUER. Your testimony will be printed in full at the appropriate point in the record so if you wish to just chat with us informally just as if we were together in the living room, by all means do so.

Mr. FRIEDMAN. I have prepared a short summary of my testimony which departs in some respects from the written statement, and which I would like to go through, if I may.

Mr. SCHEUER. Fine.

Mr. FRIEDMAN. I am pleased to appear before the subcommittee to present the views of the Commission on H.R. 7554 and H.R. 7491, the latter representing the Commission's own legislative proposals.

We have already submitted to the subcommittee a memorandum of our detailed comments on H.R. 6723, the predecessor of H.R. 7554, and we will, within a few days, submit a similar memorandum relating to H.R. 7554.

H.R. 7554 was introduced on June 12 in response to many of the concerns which we had expressed about its predecessor.

As to the Securities Act of 1933, we are gratified that the bill would not permit unconditional resales after 5 years by persons affiliated with the issuer. Nonetheless, we are still concerned that other amendments to the Securities Act may be too broad, and I am particularly concerned about the provisions permitting resales to accredited investors.

As to the Investment Company Act, we still have some questions about several aspects of the bill, including the scope and breadth of the definition of a venture capital company, the exemptions and the bill's limited restrictions on exempted venture capital companies.

Since the chairman has raised the question, I would like to spend a moment on what I believe to be the significance of the differences between the definitions in the two bills. The functional significance, although it is often expressed in terms of breadth, is really somewhat different.

Our concerns about the definition are twofold. First, as I will explain in a few minutes, we think it is important to the extent possible that the definition not create new defined terms which will in turn raise their own set of ambiguities in the future.

Second, our principal concern—and this will occur throughout the testimony, is that these steps represent a controlled experiment by the Congress in which we all know what we are doing at the outset and that we are in a position to assess the effects after a few years.

Accordingly, it is important to us that, in drawing this definition we be able to distinguish clearly between those companies which are either qualified venture capital companies or business develop-

ment companies—whichever term is employed—and other investment companies.

There are a number of respects that I will point out in a minute in which H.R. 7554 raises questions in our minds about our ability to distinguish between the functions being served by this new animal and the functions served by traditional investment companies.

In contrast, the definition in H.R. 7491, which embodies the Commission's proposal, contains a bright line which is easily ascertainable by both the Commission and by people operating these companies.

As one example of the problem we identified H.R. 7554 would permit exempted venture capital companies to make unlimited additional purchases of securities of companies whose securities had no ready market at the time of the initial purchase, so that if the company were a private company or otherwise qualified, an unlimited number of additional purchases would be permitted; even up to the point that the company were listed, for example, on the New York Stock Exchange.

A venture company's portfolio as it matures could be represented by securities which are not only listed and traded but were in effect purchased in the market.

Mr. SCHEUER. I don't understand the significance of that point.

Mr. FRIEDMAN. The purpose of this bill is to increase the flow of capital directly to small businesses. We think that—in trying to distinguish between companies which are not only small, privately held businesses but businesses which are in need of capital, and companies which have access to equity—it is important to draw a line so that you can tell at what point a company is no longer an appropriate object of this legislation because the companies in which the venture capital companies invest go to the normal public markets for this capital.

What H.R. 7554 says, as I understand it is that a venture capital company having made an initial investment in a portfolio company would continue to purchase securities in effect forever, without regard to the stage of development of the company in which the investment has been made.

Our bill does permit these recurring investments but in a more tailored way. It limits the amount of the business development company's portfolio that can be represented by those investments.

We are also concerned about section 202(A) of H.R. 7554 which amends section 3(c)(1) of the Investment Company Act; the amended version which deals with generic categories, present problems with the so-called attribution rules; and the circumstances under which an investment company is deemed to have more than 100 shareholders. In a variety of ways, section 202(A) permits the hundred shareholder limitation on private investment companies to be expanded very substantially and makes unavailable the provisions of the Investment Company Act that were intended to protect public investors.

H.R. 7554's final amendment to the Investment Company Act, section 203, imposes several restrictions on venture capital companies that qualify for exemptive treatment, but it does so in an incomplete manner which would substantially dilute present inves-

tor protections. For example, the bill does not adequately provide for restraints on self-dealing transactions by venture capital company management.

Finally, H.R. 7554 takes a novel approach to the status of general partners of venture capital companies and other companies organized as limited partnerships under the Investment Advisers Act, but we do not believe that it adequately addresses the problem of investor protection under that act.

Turning to our approach, I would like to summarize it briefly. First, we support legislative changes to the Investment Advisers Act and the Investment Company Act which would clarify the status of private venture capital pools and their advisers. Truly private activities in which the investors are largely institutional or wealthy are basically not the regulatory concern of the SEC under the Investment Company Act or, to some extent, under the Advisers Act if the conditions of that statute are satisfied.

With respect to public venture capital pools, we think the situation ought to be quite different, but we agree that there are some respects in which venture capital pools are different from other investment companies. Nevertheless, there are many other respects in which both our analysis and our enforcement program suggest the problems that originally led Congress to adopt the Investment Company Act are equally applicable, and that venture companies are quite different from industrial companies that are subject only to the Securities Act of 1933 and the Securities Exchange Act of 1934.

I might add a parenthetical note here. I think it is important that the committee understand what underlies some of our concerns. The Investment Company Act does two things. It not only involves the Commission directly in giving approvals in certain respects to activities by investment companies, but, much more importantly, it creates a Federal fiduciary standard and a Federal corporate standard for the operations of those companies. The effect of H.R. 7554 is to remove those standards and relegate these companies to the rules established by State law.

Our bill would basically recognize the special characteristics of venture capital companies by giving them relief from the provisions of the Investment Company Act in the areas where we think their special characteristics require relief. Like virtually all of the bills before this subcommittee we would transfer power of approval of most transactions with affiliated parties from the Commission to the independent directors of the venture capital fund. This is a step of great significance in a functional sense because it ends the requirement that venture capital companies go through a lengthy administrative process in order to carry out those transactions which recur quite frequently. Second, we would give venture capital companies substantial room under section 18 of the Investment Company Act to adopt stock options, for example, in order to compensate their management in a way that is typical for venture capital companies but quite atypical for the ordinary investment company. It would relieve venture capital companies of a restriction in the Investment Advisers Act against the payment of fees to investment advisers based upon a share of capital gains or other increase in the value of assets under management.

Companies desiring to take advantage of the special treatment would be required to confine their investments to direct placements of debt and equity securities from operating companies that are not listed on any securities exchange or on the list of approximately 1,250 additional companies the securities of which are specified by the Federal Reserve Board as eligible for margin loans. That leaves an enormous universe of companies which are eligible for investment by business development companies. It includes all privately held companies and, we estimate, two-thirds of all companies which fall within one or the other of the Commission's definition of public company; that is, approximately 8,000 of the 12,000 public companies would be eligible for investment. This approach would include so-called leveraged buy-outs—and we have created a “window” equal to 20 percent of the investment portfolio for follow-on investments in such companies even after their securities are listed on an exchange or eligible for margin loans.

We believe that these criteria would greatly further the goal of removing unnecessary impediments to the flow of capital to small business enterprises.

At the same time, publicly held venture capital companies would be “registered investment companies” subject to certain other provisions of the Investment Company Act which we believe are as applicable to venture capital companies as to other investment companies. In our view, the continuing status of public venture capital companies as registered investment companies would have several advantages over the exemptive approach of the bills presently before this subcommittee:

As registered investment companies, they would be entitled to passthrough tax treatment under subchapter M of the Internal Revenue Code; without that status, public investors can avoid double taxation only if the fund is organized as a limited partnership, a form in which the rights of investors are considerably less certain than in the case of a corporation; and

The Commission's enforcement program in this area has shown that there is an important inspection and enforcement role for the Commission to play with respect to venture capital companies, a role that would continue under our suggested approach. The Commission supports changes in the Securities Act of 1933 and the Trust Indenture Act of 1939 that would both broaden the exemptions and afford less burdensome regulatory treatment to small and growing businesses.

Finally, Mr. Chairman, I have three further comments: First, since our bill was drafted and introduced we have become persuaded the definition of business development company, while wholly appropriate for publicly held venture capital pools, is too narrow to afford the kind of relief we intended for private venture capital pools under the Investment Advisers Act.

Accordingly, we will shortly submit an amendment to H.R. 7491 to make the necessary changes.

Second, with respect to SBIC's, any publicly held SBIC that has an investment portfolio qualified for the definition of business development company will have all the benefits of this bill. The Commission is opposed, however, to any general exemption from the Investment Company Act for SBIC's merely as a result of the

fact of their having been licensed by the SBA. Our program in the investment company area has shown us that there is a need for continued Commission presence in that area.

Third, I want to emphasize the importance in our view of treating publicly held venture capital companies as investment companies, registered under the Act, and granting them the kind of relief they require, rather than starting at the other end and exempting them from the Investment Company Act, and then taking significant sections of that act and rewriting them for this new animal.

There are three reasons that underlie our concern here. First, this careful approach is consistent with our philosophy of a controlled experiment in which we know what we are doing at the outset and also can measure its effects after a limited period of time. Second, it avoids creating a whole new regulatory regime with a new set of definitions and a new set of substantive provisions applicable to this new class of companies, which may in the end turn out to be relatively limited. None of us know how widely this new mechanism will be used. Third, as registered investment companies they would be entitled to passthrough tax treatment under subchapter M of the Internal Revenue Code. Without that status, passthrough tax treatment is only available to the limited partnership form, a form in which the rights of investors are considerably less certain than in the case of a corporation.

Mr. Chairman, we believe that the changes we have suggested would be important steps in the regulatory structure that Congress established in 1940 and elaborated on in 1970 and 1975. We recommend strongly against expanding this experiment until the Congress and the Commission have an opportunity to evaluate its results over time.

[Testimony resumed on p. 69.]

[Mr. Friedman's prepared statement follows:]

TESTIMONY OF STEPHEN J. FRIEDMAN, COMMISSIONER
SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SUBCOMMITTEE ON CONSUMER PROTECTION
OF THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

June 17, 1980

Mr. Chairman and members of this distinguished Subcommittee:

I welcome this opportunity to present the views of the Commission on H.R. 6723, the "Small Business Investment Incentive Act of 1980," and on a revision of that bill, H.R. 7554, introduced on June 12, 1980; on H.R. 6580, the "Small Business Issuers' Simplification Act of 1979;" and on the Commission's own legislative proposals which have been introduced as H.R. 7397, H.R. 7491, and H.R. 7516. The Commission has submitted to your Subcommittee a memorandum with our detailed comments on H.R. 6723.

Essentially, our views on H.R. 6723 can be summarized as follows: We believe its amendments to the Securities Act are overbroad in scope and unnecessarily remove safeguards on the resale of restricted securities after five years; we are concerned about both the great range of venture capital-related investment companies that fall within the bill's Investment Company Act exemption and the breadth of the exemption itself, especially in view of the fact that it contemplates wide public investment in exempted venture capital companies. We are also concerned that the bill's treatment of the status under the Investment Advisers Act of 1940 and under the Investment Company Act of general partners of publicly-held venture capital companies organized as limited partnerships would not afford adequate investor protections; first, because it would remove the protections of the Investment Advisers Act from this type of publicly-held investment company, and second, because of the uncertainties under the Investment Company Act of applying corporation law to such partnerships.

H.R. 7554, introduced on June 12, 1980, is apparently designed to deal with the concerns we have expressed about H.R. 6723. Because this new bill embodies complex provisions which differ in major respects from H.R. 6723, we have not completed a detailed written analysis of it. We will shortly be sending you one. However, I can make the following preliminary observations:

As to the Securities Act of 1933, we are gratified that H.R. 7554 would not permit unconditional resales of restricted securities after five years by persons affiliated with the issuer. Nonetheless, we are still concerned that the other amendments to the Securities Act are overbroad in scope.

As to the Investment Company Act, we still have problems with several aspects of H.R. 7554, including the scope and breadth of the definition of venture capital company, the exempting provision, and the bill's limited restrictions on exempted venture capital companies.

More specifically, with respect to the first clause of the definition of venture capital company in Section 201 of H.R. 7554, we are concerned that the bill uses overbroad, ambiguous terms to define the alternative types of enterprises in which a qualifying company may invest. For example, the definition includes businesses "in the development stage," or "in need of reorganization," and other, similarly indefinite terms. Such terms may be appropriately included in the preamble to the bill, but they are not sufficiently precise to be included as technical, operative terms. In contrast, the definition in H.R. 7491, which embodies the Commission's proposal, contains a precise, unambiguous definition of the types of securities in which exempted venture capital companies may invest

— a definition that encompasses an extremely large universe of small companies.

Also, the definition in H.R. 7554 would permit exempted venture capital companies to make unlimited additional purchases of securities that "had no ready market at the time of the initial investment by the venture capital company." This provision would permit purchases of securities of companies that had become well established, and that no longer needed venture capital financing. Although some "follow-on" investments by venture capital companies are a necessary and appropriate part of their business, this provision would allow such investments indiscriminately, thereby permitting the companies to operate in a manner functionally indistinguishable from ordinary mutual funds and other investment companies. Similarly, the bill permits so-called "leveraged buy-outs" in an overbroad way. Such transactions should be permitted, but in a more carefully tailored, limited way, such as the approach taken by the Commission's bill, H.R. 7491.

We are also concerned about Section 202A, H.R. 7554's amended version of the beneficial ownership attribution rule of Section 3(c)(1) of the Investment Company Act. Section 3(c)(1) presently exempts from the Act companies which have fewer than 100 beneficial owners, and which do not make public offerings of their securities. It also provides that, in certain circumstances, the shareholders of a corporate beneficial owner are themselves counted as beneficial owners for purposes of the 100-owner rule. The amended version of Section 3(c)(1) in H.R. 7554 is defective in that it opens up a large loophole which would permit substantial indirect public investment in investment companies — yet exempt those

companies from the provisions of the Investment Company Act that are designed to protect the public — by treating the companies as if they were privately held.

H.R. 7554's final amendment to the Investment Company Act, Section 203, imposes several restrictions on venture capital companies that qualify for exemptive treatment, but it does so in an incomplete manner which would substantially dilute present investor protections. For example, the bill does not adequately provide for restraints on self-dealing transactions by venture capital company management.

Finally, H.R. 7554 takes a novel approach to the status of general partners of venture capital companies and other companies organized as limited partnerships under the Investment Advisers Act, but we do not believe that it adequately addresses the problem of investor protection under that Act.

These are only a few examples of our concerns about H.R. 7554; our more detailed written analysis will explain our other concerns.

H.R. 6580 would amend only the Securities Act of 1933; it is modeled on our Rule 242, but we are concerned about our ability to set reasonable limits on the scope of this exemption. We believe it would be preferable to expand the exemption cautiously by administrative action.

Our basic approach in the venture capital area is this:

1. We are acutely aware of, and have been concerned about, the slowing of capital flows to small and growing firms in the 1970's. That trend has resulted in some impediments to innovation and has been a force for economic concentration. We believe that trend has been principally a product of underlying economic forces, particularly inflation, as well as the tax structure. Nevertheless the Commission, like all agencies, has an obligation to examine the regulatory burden on this sector and to eliminate regulation that is not necessary to fulfill the Commission's statutory responsibilities.

2. We support legislative changes to the Investment Advisers Act of 1940 and Section 3(c)(1) of the Investment Company Act of 1940 to eliminate uncertainties concerning the status of venture capital pools which do not have public investors, as well as the status of their managers.

3. The Commission agrees that public venture capital pools exhibit some substantial differences from investment companies that invest in more liquid securities. Nevertheless, there are other respects in which both analysis and the Commission's experience with its enforcement program under the Investment Company Act show that public venture capital pools have many of the same characteristics that persuaded Congress to create that Act; they are quite different from industrial companies that are subject only to the Securities Act of 1933 and the Securities Exchange Act of 1934.

Accordingly, the Commission has prepared a bill introduced as H.R. 7491 setting forth amendments to the Investment Company Act and the Investment Advisers Act that would recognize the special characteristics of venture capital companies by

- transferring the power of approval of most transactions with affiliated parties from the Commission to the venture capital company's independent directors; this is the approach taken by H.R. 6723;
- giving venture capital companies substantial room under Section 18 of the Investment Company Act to grant stock options and to have more complex capital structures than conventional investment companies; and
- relieving venture capital companies of a restriction in the Investment Advisers Act against the payment of fees to investment advisers based upon a share of capital gains or other profits.

Companies desiring to take advantage of the special treatment would be required to confine their investments to direct placements of debt and equity securities from operating companies that are not listed on any securities exchange or on the list of approximately 1250 additional companies the securities of which are specified by the Federal Reserve Board as eligible for margin loans.

Accordingly, the eligible portfolio companies include all privately-held companies plus about 8,000 of the approximately 12,000 companies that fall within one or more of the Commission's tests for public ownership. This approach would include so-called leveraged buy-outs. Moreover, we have created a "window" equal to 20 percent of the cost of the investment portfolio for follow-on investments in such companies even after their securities are listed on an exchange or eligible for margin loans. We believe that these criteria would greatly further the goal of removing unnecessary impediments to the flow of capital to small business enterprises.

4. At the same time, publicly-held venture capital companies would be "registered investment companies" subject to certain other provisions of the Investment Company Act which we believe are as applicable to venture capital companies as to other investment companies.

5. In our view, the continuing status of public venture capital companies as registered investment companies would have several advantages over the exemptive approach of the bills presently before this Subcommittee:

- as registered investment companies, they would be entitled to pass-through tax treatment under Subchapter M of the Internal Revenue Code; without that status, public investors can avoid double taxation only if the fund is organized as a limited partnership, a form in which the rights of investors are considerably less certain than in the case of a corporation; and
- the Commission's enforcement program in this area has shown that there is an important inspection and enforcement role for the Commission to play with respect to venture capital companies, a role that would continue under our suggested approach.

6. The Commission supports changes in the Securities Act of 1933 and the Trust Indenture Act of 1939 that would both broaden the exemptions and afford less burdensome regulatory treatment to small and growing businesses.

Mr. Chairman, these would be important changes in the regulatory structure which Congress established in 1940 and elaborated on in 1970 and 1975. In our judgment, they should be viewed as an experiment to see whether, in the special circumstances of venture capital companies, the responsibilities of independent directors and the disclosure system can substitute for Commission action. We recommend strongly against expanding this experiment until the Congress and the Commission have an opportunity to evaluate its results over time.

Before I discuss our legislative proposals in more detail, I would like briefly to summarize the positive steps we have taken as part of a comprehensive program to provide relief from those regulatory burdens that have hampered the capital-formation process of small and growing enterprises:

- We have established the Office of Small Business Policy within our Division of Corporation Finance. The purpose of this Office is to centralize the consideration of current small business problems arising under the federal securities laws. The Office is playing an active role at the Commission, and is working with several other government agencies and private organizations to explore all aspects of the capital-raising problems of small business, and to seek solutions to those problems.
- Pursuant to Congressional authorization, we amended Regulation A to increase from \$500,000 to \$1,500,000 the aggregate offering price of securities that may be sold under that small-offering exemption in a one-year period without full-scale registration under the Securities Act of 1933.
- We adopted a rule permitting the use of a modified offering circular prior to the commencement of certain offerings under Regulation A.
- We amended the disclosure requirements for certain private offerings made under Rule 146, so that the issuer may use the Regulation A standards rather than those required in a full registration statement.
- We amended Rule 144, which governs the resale of restricted securities, to permit a greater number of such sales under more circumstances than before.
- We adopted Form S-18, a simplified registration form that may be used by relatively small companies issuing less than \$5,000,000 worth of securities for cash. In its first year of use, this abbreviated form has permitted small companies to make aggregate offerings of over \$152,000,000 worth of securities without meeting the normal registration requirements.
- We adopted Rule 242, which provides an exemption from registration for offerings of up to \$2,000,000 worth of securities in a six-month period, to certain institutional investors and other "accredited persons," as well as any 35 other persons. There are no specific disclosure requirements, unless some of the offerees are nonaccredited persons.

Our Legislative Program

I. The Trust Indenture Act of 1939 and the Securities Act of 1933

Turning now to our legislative program: First, we support amendments to the Trust Indenture Act and the Securities Act to ease the registration burdens on small issuers. We have recently transmitted to your Subcommittee

our proposed amendments to Section 304 of the Trust Indenture Act of 1939, to increase the aggregate amount of securities that may be partially or totally exempt from the provisions of that Act. In effect, we suggest that the exemption in Section 304(a)(8) of the Trust Indenture Act should parallel the exemption in Section 3(b) of the Securities Act. We are gratified that those amendments have been introduced as H.R. 7516 by the Chairmen of both the full Commerce Committee and of this Subcommittee. Again, we submitted a detailed memorandum along with our proposal, and I will not go into further detail now.

With respect to the Securities Act of 1933, we support H.R. 7397, a bill recently introduced by Representative Rinaldo, that would raise the current \$2,000,000 ceiling on the Commission's authority under Section 3(b) of that Act to \$5,000,000. That section permits the Commission to create exemptions from the registration requirements of the Securities Act for issues which, because of their size, do not require the full application of the registration requirements. In our view, if the ceiling in Section 3(b) were increased to \$5,000,000, the Commission would have sufficient flexibility to create a variety of innovative exemptions targeted to small issuers. At the same time, the Commission would retain the ability to adjust the scope of these exemptions to respond to emerging abuses and to changing economic and market conditions.

II. The Investment Company Act of 1940 and the Investment Advisers Act of 1940

Second, as I have mentioned, we have drafted a bill, which has been introduced as H.R. 7491, to amend the Investment Company Act and the Investment Advisers Act of 1940, to provide considerable relief to both

public and private investment companies. Attached to the full written version of this testimony is a section-by-section analysis of the bill.

A. Privately-held Business Development Companies

Our proposed amendments to the Investment Company Act and the Investment Advisers Act generally would exempt from regulation under those Acts investment companies which make nonpublic offerings to sophisticated investors and investment advisers who give advice to such companies or persons who invest in them. With respect to companies held privately by no more than 100 beneficial owners, and which do not make public offerings of their securities, the bill expands the provision of the Investment Company Act that I have previously mentioned, Section 3(c)(1), that excludes such issuers from registration under that Act. It does so by providing that a corporation may own more than 10 percent of an investment company's voting securities without having its own shareholders treated as owners of that investment company's securities, so long as the corporation does not devote more than 5 percent of its assets to investments in such privately-held investment companies.

The bill also would codify our Rule 3c-2, which has long provided parallel exemptive relief to small business investment companies licensed by the Small Business Administration. With exemptive relief for both types of companies in the statute, large institutional investors could invest in both types up to the 5 percent ceiling for each type.

This provision would eliminate a problem that some privately-held investment companies, including venture capital companies, have had in attracting substantial amounts of capital from institutional investors

and other corporations without exceeding the 100-investor ceiling for exclusion from registration under the Investment Company Act. I should add that this exclusion would be available to any small investment company, not just SBIC's and business development companies.

Furthermore, with respect to the Investment Advisers Act, Section 9 of the bill provides that an investment adviser to a privately-held business development company (including a general partner of a limited partnership) will generally not have the beneficial owners of that company counted as his clients for purposes of Section 203(b)(3) of that Act. Thus, the adviser would not be required to register under the Advisers Act, as long as he does not hold himself out to the public as an investment adviser or have a total of fourteen or more other clients, thereby triggering the fifteen-client threshold for registration. This provision of the bill would allow non-public business development companies with sophisticated investors, and the companies' investment advisers, to remain outside of the Commission's regulatory jurisdiction—including the restrictions on performance-based compensation—except for the relevant antifraud provisions, presently applicable to investment advisers exempted from registration, including Section 206 of the Investment Advisers Act. Publicly-held business development companies would also be relieved of the restrictions in the Advisers Act against performance-based compensation.

B. Publicly-held Business Development Companies

The bill carefully defines "business development company" to avoid semantical disagreements over precisely what is a small business or a venture capital company and provides for a new category of registered

closed-end investment company. To facilitate the operations of such registered investment companies, the bill would exempt them from unnecessary regulatory requirements in three significant sections of the Investment Company Act and — as I have just mentioned — it would add an exemption to the Investment Advisers Act to permit investment advisers to publicly-held business development companies to receive a type of performance fee.

A central element of the exemptions from both the Investment Company Act and the Investment Advisers Act is the definition of business development company in Sections 1 and 8 of the bill. With respect to publicly-held business development companies, Section 1 of the bill would create a new classification of registered closed-end investment companies called "business development companies." To meet this definition, an issuer would have to be "organized and operated solely for the purposes of" investing in the securities of certain described companies and making available managerial assistance to those companies. Section 4 of the bill adds a substantive provision to the Investment Company Act, setting forth investment restrictions applicable to the registered business development companies. Essentially, this provision would require that all of a business development company's assets consist of securities purchased in non-public transactions from "eligible portfolio companies," as defined in Section 2 of the bill; securities issued in exchange for such securities; a limited amount of securities of previously eligible portfolio companies in which the business development company has retained at least a 5 percent interest; cash and short-term, high quality debt securities; and ordinary and necessary business assets.

Section 5 of the bill would amend Section 17 of the Investment Company Act, which generally requires investment companies to obtain Commission approval before effecting transactions in which conflicts of interest might be present because of the participation of certain affiliated persons. The amendment would eliminate the need for prior Commission approval when a business development company, or its controlled companies, desired to engage in transactions which involved persons who were deemed to be affiliates of the business development company solely by virtue of being non-controlling shareholders of the business development company, or affiliates of such shareholders. Rather than requiring Commission approval, the bill would permit a majority of the business development company's directors with no financial interest in the transaction, including a majority of the disinterested directors, to approve such transactions under specified standards of fairness. This provision, together with existing Commission rules, which already exempt many transactions involving "downstream affiliates," would exempt from Commission pre-approval requirements many additional transactions of business development companies. Such approval would be required only where an "upstream affiliate," such as a director, officer, or controlling person, was a participant in a proposed transaction.

Section 6 of the bill would relax the restrictions of Section 18 of the Investment Company Act to permit business development companies to issue multiple classes of debt securities to institutional investors in non-public offerings. This amendment would also permit such debt securities to be accompanied by warrants, options, or conversion rights,

subject to certain conditions. In addition, Section 6 would permit a business development company to issue warrants, stock options, and rights to key executives, subject to similar conditions. In no case, however, could the amount of voting securities that would result from the exercise of all such warrants, options and rights exceed 20 percent of the total outstanding voting securities of the business development company.

Finally, Section 10 of the bill would amend the Investment Advisers Act to permit the adviser to a registered business development company to charge a fee based on a percentage, up to 20 percent, of the realized capital gains upon the assets of the business development company over a specified time period, computed net of realized capital losses and capital depreciation. This type of performance fee is similar to those common in the venture capital industry.

* * *

Those are the major provisions of H.R. 7491, the Commission's proposed bill, in broad outline. One feature of the bill deserves somewhat more detailed treatment — the definition of "eligible portfolio company" — which is the key to determining which companies can enjoy the ultimate benefits of the bill's relaxation of restrictions under the Investment Company Act and the Investment Advisers Act. It is the great breadth of this definition that provides the proposed bill's most significant potential impact on the capital-raising problems of small and innovative businesses.

After defining "business development company" in Section 1, the bill specifies, in Section 4, what assets such business development companies may lawfully hold. Essentially, besides certain ordinary

items such as cash, Government securities, office furniture, and the like, qualifying companies are permitted to hold the securities of any "eligible portfolio company" as defined in Section 2 of the Bill. The pool of such eligible portfolio companies is very broad. Starting from a universe of all privately-held companies and most publicly-held companies, the bill excludes from eligibility only companies whose securities are listed on a national securities exchange; companies whose securities may be purchased on margin; and companies which are themselves investment companies or financial institutions. We estimate that there are about 12,000 publicly-held operating companies and that our proposed definition of "eligible portfolio company" would include about two-thirds, or 8,000, of those companies, plus all private companies.

I should note that our proposed definition, like H.R. 6723 and H.R. 7554, would permit business development companies to engage in leveraged buy-outs, which are accomplished by setting up a new corporation (the eligible portfolio company) to receive the assets of the business being purchased. Whether to permit such transactions in the context of venture capital legislation is a matter of policy for Congress to decide. We feel constrained to point out, however, that such transactions generally do not serve to facilitate the flow of capital to start-up and growing small business enterprises in order to expand plant and equipment, enter new markets or otherwise be put to productive use. While some of these transactions do serve to bring divisions of large companies back to separate ownership, in others, insiders may obtain capital from external sources to squeeze-out minority shareholders and retain

the business for themselves. Based on our experience with the latter type of transaction and the many letters of comment received from investors who have been involved in them, we believe that they may undermine investors' confidence.

In any event, the impact of the bill's wide-ranging definition of eligible portfolio company is broadened even further by the bill's provision that permits business development companies to hold the securities of eligible portfolio companies even after those portfolio companies no longer meet the definition. Nothing in the bill would require a business development company to sell a portfolio security, even after it is no longer eligible for additional financing. Such a decision would be left to the business judgment of the board of directors.

The other concern that venture capital companies have expressed in the past is their wish to be permitted to make "follow-on" investments in their portfolio companies, even after those portfolio companies had begun to prosper, and had perhaps reached the stage at which their securities could be listed on an exchange, or purchased on margin. Section 4 of the bill would amend Section 12 of the Investment Company Act to permit a business development company to purchase and hold securities of such prospering companies, provided that the business development company already held at least 5 percent of the portfolio company's securities, and that the new purchase would bring the total holdings of that company's securities to no more than 20 percent, at cost, of the business development company's portfolio.

We believe this approach is an appropriate way to deal with the issue of "follow-on" investments. If a business development company owned less than 5 percent of the securities of a portfolio company, it would not have a large stake in the success of the portfolio company, at least in the context of venture capital financing, and would not generally be expected to have a strong incentive to provide succeeding infusions of capital. In this connection, where the business development company did not have a substantial stake in a portfolio company listed on an exchange or eligible for margin purchase, it would be difficult to distinguish the business development company's investment in the exchange-listed portfolio company from any investment company's purchase of shares in a Fortune 500 enterprise.

Moreover, with respect to the 20 percent limit on such purchases, it is important to note that the 20 percent figure is calculated at the historical cost of the portfolio securities. Thus, viewed in the context of an actual portfolio, which will have both depreciated and appreciated securities, the 20 percent cost figure can represent a very substantial portion of the current value of the business development company's portfolio. Finally, we are concerned that any broader approach with respect to these two tests would cause difficult problems in distinguishing between true business development companies and other closed- or open-ended investment companies that typically invest in non-eligible portfolio companies.

* * *

In conclusion, I would like to re-affirm the Commission's strong desire to reduce unnecessary regulation affecting small business. In furtherance of that desire, we have proposed a legislative solution that is carefully tailored to provide needed relief from regulatory burdens, while at the same time preserving important investor protections and the flexibility the Commission needs to respond to changing circumstances. We stand ready to continue to work with the Subcommittee's staff to find a legislative solution to the problems of venture capital companies that is satisfactory to the Subcommittee, as well as to the Commission.

Mr. SCHEUER. Thank you very much.

Congressman Broyhill.

Mr. BROYHILL. Mr. Friedman, in your definition of a venture capital firm, you call it a "business development company". It seems to me you are rather restrictive here in the types of investments that you would permit. What is your view of what a venture capital firm should be investing in? Do you not feel that they should have the right to invest in a company that is in the development stage or in a reorganization stage if they are not otherwise a publicly held company?

Mr. FRIEDMAN. Mr. Broyhill, our definition would permit investment in any company so long as that company is not listed on an exchange or among the approximately 1,250 OTC margin stocks so it would include any privately held company. It would include about 8,000 publicly held companies and it would include follow-on investments in companies that are listed so the universe of companies is very large.

Let me make a more general comment, if I may. We wrestled a long time with the question of whether we should follow your lead and attempt to describe the substance of what a venture capital company is. That is an issue with which I personally have wrestled for a long time, including my time with the Treasury. Your bill does a better job of describing it than any definition I have seen.

Our final conclusion was that it is really not in the interests of the venture capital community to try to define them because the SEC, through its inspection program, would then have to be in a position of trying to assess for example whether or not a given investment is a turnaround or a leveraged buy-out or whether a company is in a development stage or in need of reorganization. These are extremely difficult judgments and I think inevitably would create friction between investigators and the companies regulated.

Our approach basically says the purpose of this legislation is to give special treatment to companies in the business of providing capital, not buying securities in the public market. If they provide capital to a privately held company, if it is not listed on an exchange, then those are the only requirements we are going to impose.

So in a significant sense our definition is much less restrictive. The one concern that we have not met in our definition is the so-called turnaround problem for companies which are listed on an exchange.

Mr. BROYHILL. That is what I was coming to next. How do we measure that? Is that not in the public interest?

Mr. FRIEDMAN. There is no question about the fact that people who describe themselves as venture capitalists invest money in turnarounds of public companies and, because of the languishing state of our equity markets there are listed companies whose stock is traded in the market but don't in a meaningful sense have access to the equity markets for new capital.

I agree that our definition would not permit that for this narrow class of cases. Why did we do that? Our principal problem here was that it is very hard to know—much like Mr. Justice Stewart's definition of obscenity: "I know it when I see it even though I can't

define it." Turnarounds are the same sort of thing. It is very hard to create an objective statutory definition for them.

We were very concerned that it would be very difficult to tell a venture capital company investing in publicly traded turnaround companies from the conventional investment company investing in publicly trade securities. Our resolution of that issue was to say as a first step we will exclude that class of investments and if this works, I think we can take a second look at this animal, or you can, more appropriately in a few years, and see whether it makes sense to expand that definition.

It would be possible if the subcommittee desired to go this route, to perhaps use some portion of what we have called our window, the 20 percent that we have used for recurring investments, to limit in some way the percentage of investments that would be eligible for turnaround investments but I think it is very hard to tell the difference between what is a turnaround—

Mr. BROYHILL. Do you have other restrictions in your bill on the investment of funds, that is, do you require a certain percentage of investments in various enterprises?

Mr. FRIEDMAN. No, if I understand you correctly. We require that, in effect, this business development company invest only in private placements of companies which are not listed and not on the Fed OTC margin list.

Mr. BROYHILL. Do you have a requirement that 100 percent of the funds be invested in venture-type companies or is that a requirement?

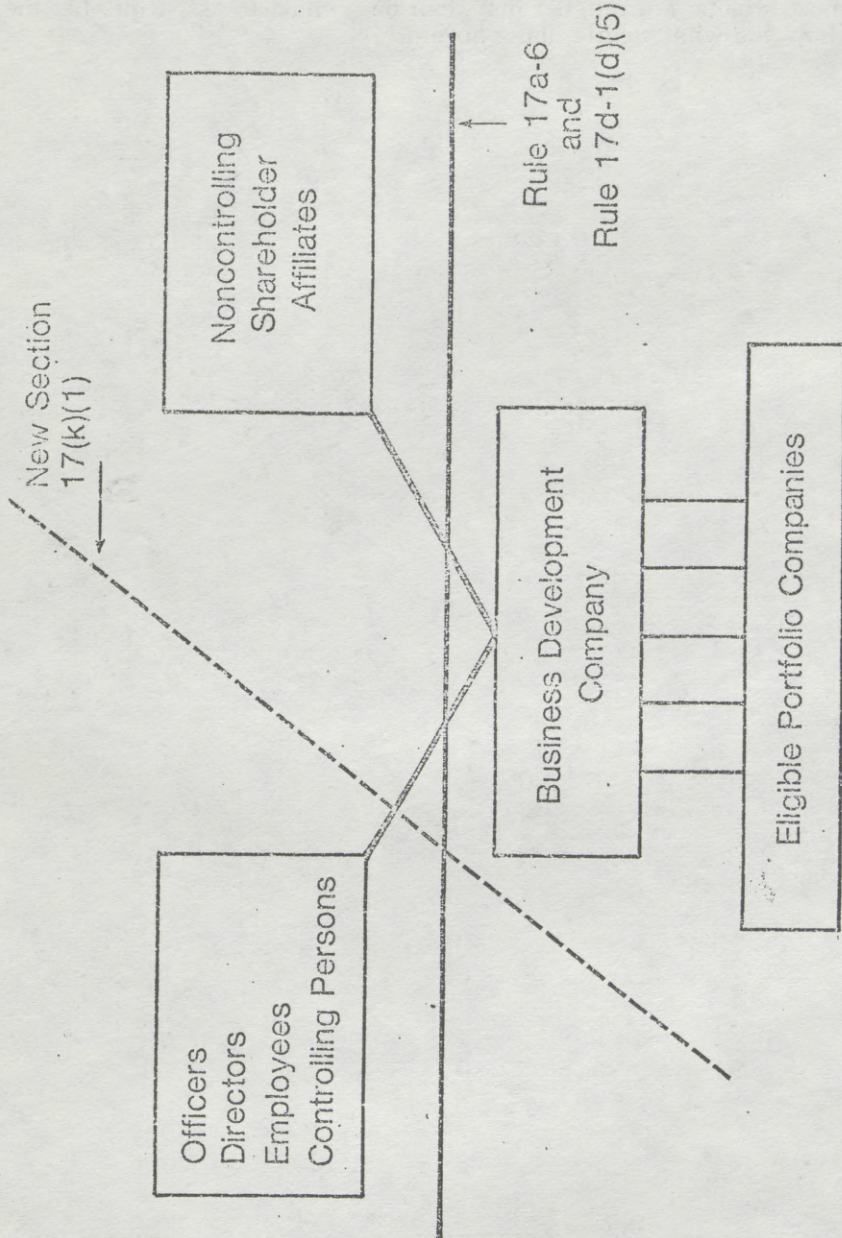
Mr. FRIEDMAN. No. Let me answer it this way: We have looked at the portfolio of these companies as in effect divided into two categories. One is money invested in the appropriate area and the other is money waiting to be invested. The money waiting to be invested could be invested, in effect, in money market securities for an unlimited period of time. With respect to the money invested in the appropriate area we have only defined what is appropriate by the fact that it is a restricted security under the 1933 act and the company is not listed.

It would be possible in theory, for example, for one of these companies to invest in the privately placed equity securities of IBM. On the other hand, our definition does not encompass such purchases because it is generally not a realistic alternative for a lot of reasons. Established industrial companies are not going to be interested in affording the types of returns or agreeing to the kind of covenants that venture capital companies require. I think what we have achieved here is a definition which is clear, which imposes the less substantive restriction but as a practical matter will end up in a place where these investments are made in the right kind of company because the others are not going to be interested.

Moreover, the Commission, under our bill, has the power—to the extent we have opened this window a little wider than it ought to be—to narrow it.

Mr. BROYHILL. Let's talk for just a moment about some of the restrictions on the activities of directors. Is my understanding, correct that in your bill there would be an absolute restriction on any director having any financial interest in any transaction even though it is an indirect one?

Mr. FRIEDMAN. We are getting into the area that is probably the most arcane. Let me, if I may, call on a chart to assist me. Let me show you what we are doing here.



Basically, what the act does is to prohibit any transaction between anybody on this chart and then says if you want to do any of these things you have to come to the Commission. That has been the source of all the problems in this area because you can't operate a business where there are recurrent investments between various firms, which there are in this business, and have to keep running to a Government agency.

The Commission has adopted two rules, 17a-6 and 17d-1(d)(5), which basically said that transactions below this line, between the business development company and the companies which they invest in, including transactions involving shareholders of the business development company that own less than 5 percent—of its voting securities or equity—all those things are all right and board approval is not required.

The section of the statute which we propose goes further and says that shareholders of the business development company can also participate in these transactions because it is not uncommon in the second and third round of financing to have an investment by the venture capital company in which one of the shareholders is also participating because they are otherwise in the venture capital business. Under our proposal that would be permitted even though they have more than 5 percent of the business development company stock if they have less than 25 percent and otherwise are not controlling stockholders, providing the board of directors approved.

What we have tried to do is to leave Commission approval only for those transactions which involve very direct conflicts of interest, those in which the officers, directors or employees of this company [indicating] have a financial interest or a true controlling shareholder of this company has a financial interest.

Mr. BROYHILL. What about the case where the officer or director owns a company that it is trying to sell back to the business development company? What restrictions have you put in there?

Mr. FRIEDMAN. If these people own the company, have a direct interest in one of the eligible portfolio companies, then they have a financial interest in this transaction, and Commission approval would still be required.

Mr. BROYHILL. It would be required in that instance?

Mr. FRIEDMAN. Yes, sir.

Mr. BROYHILL. What about having the directors make that decision?

Mr. FRIEDMAN. Mr. Broyhill, in some respects how you resolve that question I would have to say depends on where you start. We start with an existing statutory framework. The Congress made a judgment in 1940 that there were special problems with investment companies. They made them different from ordinary industrial companies and under those circumstances the Government ought to be involved in approving conflict of interest transactions.

The problem was that prohibition was written so broadly that it required companies to come back to the Commission for all sorts of things which all of us agree in retrospect are unnecessary. But the core notion here which is when the management of the investment company has a direct conflict of interest, that is an appropriate occasion for the Commission to become directly involved.

It is true one can think up examples in the unregulated area with industrial companies that are just as bad, and I am not suggesting all of those ought to be directly regulated. But what I am saying is that Congress has in effect split up the world and we think there are special problems with this kind of creature. Venture capital companies, in our view, are enough like this kind of creature so that they ought to be regulated in the same way.

Mr. SCHEUER. Will the gentleman please yield?

Mr. BROYHILL. Yes.

Mr. SCHEUER. Mr. Commissioner, you are talking about something that Congress did 40 years ago, this bifurcation. Let's engage in a little zero-based analysis.

Forget the entire legislative format that exists now. Forget that we have an Investment Advisers Act and a 1940 act, and just say we are looking at this problem.

Where is the abuse? What is the abuse that we are trying to evaluate and who are the people that we are trying to protect and how much do they need protection?

We are operating in a very different environment than we operated in in 1940.

You know post-World War II Washington was the beneficiary of all those happy little hotdogs coming down from Harvard Law School.

[Discussion off the record.]

Mr. SCHEUER. I really don't think we should legislate blindly based on a bifurcation Congress dreamed up 40 years ago. We ought to be looking at today's problems and today's challenges.

What are the abuses we are concerned about? In the record have there been this kind of abuses? Who are the people we are trying to protect and how much protection do they need? Are they widows and orphans who are totally unsophisticated, putting their life savings into the security market; or are they pretty sophisticated investors who are looking for a topside profit and who are willing to take considerable risk commensurate with the profit they are looking for?

Mr. FRIEDMAN. I would be happy to respond to that if I could make one preliminary comment, which is that the Commission undertook the so-called mutual fund study in the midsixties which culminated in an extensive congressional consideration in the sixties and a series of amendments to the Investment Company Act so that this issue has not been lying dormant for 40 years. It was considered again by the Congress only 10 years ago. Having said that, I think the question certainly is fair and one I have to respond to.

What we are concerned with here is the fairness to different parties transactions in which the fund, which has public investors is involved and in which someone else is involved and has a potential conflict of interest.

Mr. SCHEUER. Who are the public investors in these funds?

Mr. FRIEDMAN. I answer this without empirical data at the moment, but I am certain, by and large, the investors in public mutual funds and investment companies are small investors. They are not all widows and orphans—and I would hate to concede that it is only they who require protection—but they are not institu-

tions, by and large, and they are not what I would call the core of the venture capital industry.

In this regard we haven't excepted public SBIC's from the Investment Company Act and I think they can speak better about their investors than I can. Certainly mutual funds in general are characterized by a large number of very small investors.

Second, I think in our economy today there is a very large appetite through a broad spectrum of the investing public for speculative gains. We see that in public investment in the options market, in the futures market. We see it in the hot issue market in Denver.

When people's financial assets are being eroded by inflation, which they are, they want to make it up quickly so that I would think that—and I don't mean this in a pejorative way at all—there is a significant market for people who would be interested in the kind of gains that may be available through good, sound venture capital investment, so I think there would be a lot of small investors.

Mr. SCHEUER. If they want to make quick gains on the upside, shouldn't they be willing to take the risks of the market on the downside? I am not saying that they should take the risks of fraud, I am not saying they should take the risks of the implications of conflict of interest. But assuming there is no fraud and assuming that the conflict of interests are there on the table and people can evaluate them, what is wrong with saying that people who want to make a substantial investment on the upside should take the risk that is commensurate with their upside potential for profit?

Mr. FRIEDMAN. Because I think in the first place we are not talking about quick gains—because venture capital is characterized by the long term—but people who are interested in substantial gains ought to be and are in fact subject to those restrictions. That has nothing to do with conflicts of interest on the pricing of a particular investment on the second or third round.

One of the things that characterizes these investments in privately held companies is there is generally no market for these securities. So we are talking about placing a very heavy burden on the people who are charged with making the decision as to whether a particular transaction involving those securities is fair. Traditionally these pools have been done privately with sophisticated investors who are in a position to look after themselves as to whether or not the management is dealing fairly with them. When you have a public pool with a large number of small investors, then those people are not really in a position to do that.

It is true we have a disclosure system, but one of the things that is unique about venture capital is that there is a much greater need for concern about conflict of interest transaction than there is with an ordinary investment company because you don't know what is going to happen with a venture capital investment for 4 or 8 years. These are risk investments so you don't really know what is happening in terms of whether it is a good or bad investment, whether the price is good or bad, until it proves out. You don't have the discipline of a contemporaneous market price that lets the shareholder know.

These are some of the main reasons why in a case of direct conflict that Commission involvement is appropriate. I will say, coming back to the question Mr. Broyhill raised, there has been a lot of concern on the part of lawyers and others that the term "financial interest" in these rules we have adopted will be applied in an overly broad way to pick up highly indirect financial interests. It is not our intent that be so and we are examining the question of whether or not we can clarify the reach of the financial interest concept somewhat.

Mr. SCHEUER. Sam, do you have any questions?

Mr. DEVINE. I have no questions, Mr. Chairman.

Mr. SCHEUER. Can we now invite Mr. Kipling Hagopian, general partner of Brentwood Associates, representing the National Venture Capital Association, to join us, and Arthur D. Little, president, National Association of Small Business Investment Companies.

Commissioner, would you bear with us if we ask these two gentlemen to present their statements and then we will have questions for all of you.

First, Mr. Hagopian. Would you make your statement and let me tell you at this point it will be printed in the record so I suggest that you simply hit the high spots and refer, if you will, to anything you have heard this morning either from Commissioner Friedman or from any of us and then I am sure we will have questions for you and the rest of the panel. [See p. 89.]

STATEMENT OF B. KIPLING HAGOPIAN, GENERAL PARTNER, BRENTWOOD ASSOCIATES AND BRENTWOOD ASSOCIATES II, AND ALSO MEMBER AND COCHAIRMAN OF THE SEC COMMITTEE, BOARD OF DIRECTORS, NATIONAL VENTURE CAPITAL ASSOCIATION, ACCOMPANIED BY MICHAEL J. HALLORAN, COUNSEL (NVCA)

Mr. HAGOPIAN. Mr. Chairman and members of the committee:

I am a general partner of Brentwood Associates and Brentwood Associates II, venture capital partnerships located in Los Angeles.

I am also a member of the board of directors of the National Venture Capital Association—NVCA—and cochairman of its SEC committee.

NVCA is composed of about 80 venture capital firms with total assets of more than \$1.5 billion. I appreciate this opportunity to comment on H.R. 7554, a bill which the NVCA strongly supports.

I have submitted testimony which we will revise. I was given the wrong bill numbers.

The clear and simple objective of H.R. 7554 is to reduce restrictions on the flow of capital to small and innovative businesses.

In this regard the bill is responsive to SEC Chairman Harold Williams' oft stated goal of modifying securities regulation to make it easier for small business to raise capital.

At the same time, H.R. 7554 is designed to insure that adequate investor protections are retained so as not to subvert the spirit of the amended statutes. To this end, the most recent version of the bill, which you have before you, has been substantially revised to accommodate many of the concerns expressed by the SEC and the staff of this committee.

H.R. 7554 treats three areas of the securities laws in an attempt to remove the obstacles which presently restrict the flow of capital to small business.

First, the bill would amend the Securities Act of 1933 in order to make it easier and less expensive for businesses to raise capital from highly sophisticated investors.

Second, the bill would amend the Investment Company Act of 1940, to exempt venture capital companies from registration under that act; this would make it practicable for qualified venture capital companies to raise capital from the public.

Third, H.R. 7554 would clarify the Investment Advisers Act of 1940 to confirm its inapplicability to venture capital companies, thereby increasing the flow of capital to venture pools.

The need for legislation in the securities area is acute. The value and importance of stimulating the flow of capital into small and innovative growth businesses is well recognized. The overwhelming body of evidence suggests that relative to dollars invested, small companies increase productivity and employment at a much higher rate than large companies.

Increasing the flow of capital to these businesses, therefore, can make a major contribution to treating our country's dual economic maladies, inflation, and unemployment. Unfortunately, current securities laws, as interpreted, applied and enforced by the Securities and Exchange Commission are working to restrict the flow of capital to these businesses.

H.R. 7554 will remove some of these restrictions.

As stated in Chairman Harold Williams' recent letter to the Senate Banking Committee, "the Commission has recognized the validity of the broad objectives expressed in (the) bills."

However, while the Commission contends that it plans to provide effective relief in the areas covered by the bill, we greatly fear, after years of discussion and debate with the staff on the issues covered by the bill, that achieving something workable is not likely.

We have concluded, therefore, that progress can best be made through the legislative process.

Amendment to Securities Act of 1933:

The first section of H.R. 7554 is an amendment to the Securities Act of 1933 which would make it easier for businesses to raise capital privately from sophisticated investors. This amendment is basically an extension of the SEC's recently promulgated rule 242—which is limited to financings of \$2 million every 6 months.

Simply stated, the provision would reduce the long and costly disclosure requirements which are currently imposed on issuers, as long as the securities sold are purchased solely by sophisticated and financially substantial investors such as banks, insurance companies, registered investment companies, and others whose investment is more than \$100,000.

The premise underlying this provision is that this type of a purchaser, termed an "accredited investor" by the bill—and by rule 242—is perfectly able to fend for himself, and that he neither needs nor wants the Government's protection in insuring that sufficient disclosure is made to him.

Extending this logic, resales from one accredited investor to another accredited investor would also be exempted from registration.

Amendment to Investment Company Act of 1940:

The second key provision embodied in the bill is an amendment to the Investment Company Act of 1940—1940 act. This amendment is based on the premise that the 1940 act is inappropriate in its application to venture capital companies, with the result that the public, which represents one of the largest sources of capital for venture pools, has been largely precluded from investing.

Particularly onerous is section 17 of the act which requires an SEC exemptive order for transactions between a registered investment company and its investee "affiliates."

Additionally, the act contains various provisions which together work to prohibit equity incentives for management.

H.R. 7554, by exempting qualified venture capital companies from the act, would make it more attractive to these companies to sell shares to the public, thereby increasing the flow of capital to new and developing businesses.

Mr. SCHEUER. Mr. Hagopian, we have a 19-page statement from you. Why don't you just talk to us. You know your subject matter very well. Chat with us.

Mr. HAGOPIAN. I would like to read an excerpt from the statement having to do with the Investment Advisers Act. We do support the entire bill; we have, however, a very strong interest in the amendment to the Investment Advisers Act and I would like to read this excerpt.

The third area of the bill concerns the Investment Advisers Act of 1940—Advisers Act—and is nothing more than a clarification of the law as we and leading securities lawyers believe it presently exists.

NVCA believes that this section of H.R. 7554 is potentially the most crucial to the future vitality of the venture capital industry.

The Advisers Act is anathema to venture capital funds. Of primary concern is section 205(1) of the act which prohibits compensation to an "adviser" on a profit-sharing basis.

Since profit-sharing arrangements are standard in the industry, and in our view contribute immeasurably to enhancing investor returns, the effect of their prohibition would be to dissuade the most qualified venture fund managers from participating in venture capital.

For the 40 years of the Advisers Act's existence, venture capital fund managers have never been compelled to register under its provisions. This is so because the plain language of the act clearly distinguishes the activities of an investment adviser from those of a typical venture capital fund manager. Nonetheless, over the last 10 years various members of the staff of the SEC, in unofficial private and public statements have suggested that venture capital fund managers may in fact be investment advisers.

Moreover, these staff members have suggested that, in the case of a venture fund organized as a limited partnership, the advisee or client of the manager is not the limited partnership itself but each of the individual limited partners.

Since registration under the act is required if an adviser has more than 14 clients, under this theory a general partner of a

limited partnership would be compelled to register if his fund had more than 14 partners.

The Advisers Act problem was exacerbated in 1978 by a court decision in the case of *Abrahamson v. Fleschner*. In this case the judge made an inadvertent statement in a footnote to his opinion to the effect that the general partners in that partnership, which was an investment fund commonly known as a "hedge fund," were investment advisers, not to the partnership but to each of the limited partners.

On rehearing, the court modified its opinion to remove this statement. Even so, and even though the facts in that case were dramatically different than those in a typical venture capital partnership, additional uncertainty was created.

Notwithstanding the SEC's unofficial remarks and the since deleted language of the *Abrahamson* case, all of the major law firms with whom we have consulted have taken the position that the managers of venture capital funds are exempt from such registration.

Many law firms, however, are understandably reluctant or unwilling to give unqualified opinions to this effect while the current cloud of uncertainty exists.

As a result, for years venture fund managers have limited the number of limited partners they would accept to 14. Accordingly, the amount of venture capital available for small business has been diminished significantly.

Mr. SCHEUER. Why would that follow? Why would the limitation of the venture capital fund to the 14 limited partners be a reduction in venture capital?

Why would that lead to a restriction in the availability of venture capital?

Mr. HAGOPIAN. By limiting your number of limited partners to 14 instead of 25 you are substantially curtailing the amount of capital you take into a pool.

Mr. SCHEUER. Why is that?

Mr. HAGOPIAN. A case in point is when we raised capital for Brentwood back in 1972 we were told by our counsel we should be very careful not to go over 14.

Mr. SCHEUER. I understand that.

Mr. HAGOPIAN. We could have taken in six more partners who might have produced \$6 million more of capital but we had to cut it off at a defined number.

Mr. SCHEUER. If you had J. P. Morgan as one of those 14, or John D. Rockefeller, you could produce all the venture capital that you wanted.

Mr. HAGOPIAN. Except each one of these investors want to limit their exposure to a certain amount. Morgan Guaranty is one of our limited partners and in our second partnership they invested \$1.5 million. I would have liked for them to invest \$5 million.

Mr. SCHEUER. Do you have a list of who your venture partners are?

Mr. HAGOPIAN. Not a list but I can recount almost all of them.

Mr. SCHEUER. Why don't you?

Mr. HAGOPIAN. American Express Co., Morgan Guaranty Trust Co., First National City Bank, on behalf of commingled pension funds; New England Life Insurance Co., the 3M Corp.

Mr. SCHEUER. Are these the people you are trying to protect? Obviously, they are all little guys.

Mr. FRIEDMAN. No, Mr. Chairman, that is the difference between the private funds and the public funds I was talking about. We agree with Mr. Hagopian that the private line is not drawn by the 14 investors. It is really the Investment Company Act line of a company which doesn't have more than 100 shareholders and is not making a public offering. We agree with respect to these private pools of capital in which there are institutional or wealthy investors that the Investment Company Act should have nothing to do with it and as I noted at the end, we also agreed that the exemption from the Advisers Act that has the effect of permitting incentive compensation of the kind Mr. Hagopian says is traditional is too narrow to take care of pools like Brentwood, and we are revising it in a way which we hope will pick up a very large portion or all of the universe of private funds.

I am not sure we favor doing it precisely the way he has suggested. But I think we can do it in a way that affords clear relief under the Advisers Act to those entities without raising other questions.

Mr. HAGOPIAN. I am delighted with Mr. Friedman's comments and that the SEC has apparently recognized this is a serious problem with the industry.

It has been a problem for 10 years and in the last year and a half we have intensively tried to convince the SEC that something should be done to clarify the issue so that an increased flow of capital could go to small businesses.

We don't agree with the approach that the SEC intends to take to clarify the issue, although under certain conditions I think it might be acceptable.

As it stands now, H.R. 7491 is totally unacceptable to NVCA in that it ties an exemption from the Advisers Act to an extremely restrictive definition of venture capital.

The SEC's approach has always been to try to confine and impose very narrow boundaries on what private venture capital investors can do; we think this is inappropriate, particularly given the highly sophisticated nature of our investors.

Our investors don't need the SEC's protection and don't want it. They want to negotiate their own deal with the professional venture capital managers, and they feel that they are more than capable of doing so and entering into a transaction they consider to be favorable to their interests.

Mr. FRIEDMAN. May I say something?

Mr. SCHEUER. Yes.

Mr. FRIEDMAN. Unlike the Securities Act, which deals with public offerings, the Investment Advisers Act has no private placement concept, so that if someone says, I am going to be an investment adviser for institutions and holds himself out as an adviser for the most sophisticated institutions, the act says he has to register.

Mr. SCHEUER. Should that be changed?

Mr. FRIEDMAN. I think my off-the-cuff answer is no, but I haven't considered that issue afresh, which is really what you are saying.

Mr. SCHEUER. I think Congress is saying we ought to look at all the problems in the past and see what kind of Government interventions are relevant today that are necessary to protect people who need protection and where there is unnecessary bureaucratic presence that doesn't seem to have purpose and need, sunset it.

Mr. FRIEDMAN. Congress did have an opportunity to focus on that issue in 1970, and again in 1975 and decided not to make that change. That is what creates the problem here. If you start with the proposition that Congress intended that fairly limited provisions of the Investment Advisers Act apply even to institutions, then the problem Mr. Hagopian is raising is the difference between having individual clients where the Advisers Act applies and having a pool where the act doesn't apply.

The problem is that it is possible there are advisers who have only 13 or 14 clients because they don't want to be registered. Then more clients come along and they start focusing on whether or not it is appropriate to form a limited partnership with 16 investors. There are different regulatory judgments involved. I think we can deal with this problem for venture capital companies without getting into those broader issues under the Investment Advisers Act.

Mr. HAGOPIAN. First of all, I want to make it clear that not all of the investors in the private venture capital pools are like Morgan Guaranty Trust Co. Some are just extremely wealthy, highly sophisticated individuals. In our case the substantial number of our limited partners are institutions. I would, however, not want to proscribe, John D. Rockefeller or his heirs from participating if they wanted to invest in venture capital.

The other thing I would like to say is the Advisers Act, in our view, was designed by Congress to protect the public—widows and orphans did get included in their concern—from so-called tipsters who might take their money and gamble with it and pursue their own self-interest rather than their client's interest.

We are not dealing with that kind of situation here in venture capital funds. We believe and our counsel concurs that we are clearly not advising anybody. The plain meaning of advise suggests if I advise you, you have the right to accept or reject that advice. A pool is something that is organized as an entity through the sale of a security—a very important distinction—to a group of highly sophisticated people.

There is no advisory relationship that exists between ourselves and those people, nor is there an advisory relationship between ourselves and that fund.

The approach we have taken in H.R. 7544 is to beg the issue of whether we are an adviser or not. We feel strongly we are not. It just ought to be patently clear that we are not advising the individual limited partners or shareholders if we are organized as a partnership or corporation.

The clear issue is when does an advisory relationship exist and when does it not exist? Again, I say we do not have an advisory relationship with those partners.

Mr. FRIEDMAN. I am not trying to get the last word in here but Congress focused on this issue in 1940 when the question arose as

to whether a discretionary account managed by someone else in which the advisee is not consulted and doesn't have anything to say about individual investments, constitutes an advisory relationship, and the answer was clear that it does constitute an advisory relationship.

But, again, I might say something else, too, and that is aside from the people who are tipsters and write advisory letters, there is a very large group of professional investment counselors and advisers, and all of their clients are sophisticated, and all of them are wealthy because those people only take clients with substantial sums to invest.

That was clear in 1940 and 1970 and it has always been very clear. The reach of the statute is much broader than that.

Again, I want to emphasize I don't view us in an adversary position on the private funds because I think we can afford relief for at least venture capital pools that they require and will not have a lot of bear traps in it.

Mr. HAGOPIAN. I don't want to sound like I am trying to get the last word either but there is one thing you left out. I am not familiar with any case where a client of an adviser gives discretionary power to that adviser without the right to terminate it on some reasonable period of business notice.

I think the key issue is, I can give discretion to an adviser but if I have the right to terminate it then I have retained my right to accept or reject that advice. We don't have that situation in a venture capital fund.

For the most part, these funds are organized for periods of 7 to 15 years and the limited partner, while he may be able to sell his interest, is not able to withdraw his capital. That is in our opinion a major distinction between what we do and the kind of advisory relationship contemplated by the act in 1940 and by Congress in 1970.

I just think there is such a clear distinction here that I am frustrated in my inability to articulate it. We are selling securities—

Mr. SCHEUER. You are investing. You are not advising.

Mr. HAGOPIAN. We are selling securities to sophisticated investors who purchase securities in our company; we then turn around and invest that capital in small businesses. That is such a clear distinction to me from advising, I am sorry if I seem—

Mr. FRIEDMAN. It is not a distinction we really disagree with under certain circumstances. I haven't examined Brentwood; if Brentwood came to the Commission and said, we would like you to tell us whether or not you think in our case, on our facts, it is an advisory relationship, there is probably a high likelihood the Commission would respond negatively.

Mr. SCHEUER. Would they then be exempt from the act?

Mr. FRIEDMAN. Yes, but you do something different when you take those standards and make a different legislative judgment and put them in a statute because there are three or four standards which appear to make sense but there are other situations—and one can think of a number of them—in which having a broad exemption can be misused, moreover, if the Congress adopts the statute that says you are not an adviser if people are locked in for

5 years, the inevitable result of that is to encourage people to adopt pools in which people are locked in for 5 years. That is fine in the venture capital business because you are locked in for that time anyway due to the type of investments they make.

The result is that you will have other people with different investment strategies creating pools and I am not sure that is necessarily in the interest of investors. It is for that reason—because of the uncertain reach of simply adopting these standards in a legislative context—that we have tried to take a somewhat different approach to this point.

Mr. HAGOPIAN. The bill that we support does not require a 4- or 5-year lock. It only requires that the individual shareholder or limited partner not be allowed to withdraw his capital, not be allowed to go to the manager and say, give me my money back. He can still sell his security to someone else just as any stockholder in an industrial corporation.

There is no suggestion of a 5-year lock-in although the securities are sold in a private transaction anyway.

All we are talking about is the inability of the investor to go to his venture fund manager and say, give me my money back. The reason we put this provision in the bill is we think we understand the SEC's principal concern, which is for hedge funds. The typical hedge fund partnership is managed on a basis that the limited partners can go in and out of the fund on 30 days notice.

Looking at that situation I can see how one could construe that as an advisory relationship. But not in the case of a venture capital fund where you are locked in for 7 or 10 years.

Mr. OPPER. If I may interject a question, as I understand from your initial statement, Mr. Hagopian, it is your belief although you haven't yet had an opportunity to review it the Commission's proposed but yet unpublished amendment to their bill would largely resolve your problems. Perhaps we could have a discussion of what the Commission is thinking about and to what extent that might alleviate your concerns under the Advisers Act.

Mr. FRIEDMAN. What we are discussing is a definition patterned on an earlier draft of an approach to this problem that I think was generated by the National Venture Capital Association, which would say: For pools that are not required to be registered under the Investment Advisers Act their assets have to consist of a substantial percentage—70 percent or so which represent private placements and less than OTC margin companies, an additional 30 percent can be in anything, and that the 70- and 30-percent limitations are done without regard to money market investments. So you look at the investment portfolio and say we want to make sure you are basically a venture capital company.

Mr. Hagopian and I had a long discussion yesterday and I am trying very hard to do something that will work before we give birth to it. We are trying to design this in a way so it is not possible to float out of compliance with it because of changes in value of various portfolios, so that the judgment is made at the time of investment and you have a clear line; to the extent that existing pools may have some special problems we are at least willing to consider a grandfather provision. Our real purpose is to say existing venture capital companies ought to have relief from

the registration provisions of the Advisers Act but we would like to take this first step by confining it to private venture capital companies so we don't have to worry about what we are generating in the other corners.

Mr. HAGOPIAN. Does that suggest with respect to the hundreds of existing closed in investment companies, both private and public, that are not venture capital companies, that you will now ask the presidents and vice presidents of those companies to register?

Mr. FRIEDMAN. No. Our intention is not to change the law as it exists with respect to anybody else. I think we should make that clear. This is not a backhanded way of doing anything. If the Congress wants to consider that broader question we would be happy to consider it with you, but we have come at this problem from a slightly different tack, which is what I call riding the venture capital horse. To get off that horse and look at the broader question of what is "internal" or "external" management at this point is, I think, going to delay things.

Mr. SCHEUER. If it is going to produce a much more intelligent remedy and if it will help fine tune the Government's regulatory and protective effort, let us say, and will remove a great deal of bureaucracy where it isn't particularly needed and can't be justified, maybe it is worth the look.

Mr. HAGOPIAN. If you put it that way I can only agree.

Mr. FRIEDMAN. This is a tough problem. I think we ought to be able to do better than we have done in addressing the broad problem but it is hard to deal with in a legislative sense because there are opportunities for abuse at the edges.

Mr. SCHEUER. Abuse against whom?

Mr. FRIEDMAN. There are all the people who have private money management operations.

Mr. SCHEUER. Money management.

Mr. FRIEDMAN. Money management services.

Mr. SCHEUER. Abuse against them?

Mr. FRIEDMAN. The people who seek money management services, the people who purchase the services of money managers.

Mr. SCHEUER. What kind of people do this?

Mr. FRIEDMAN. Some of them are pension funds and a lot of them are simply individuals, some are widows.

Mr. SCHEUER. Are these people to the extent they are wealthy individuals or is this a way somebody would invest \$5,000 or \$10,000?

Mr. FRIEDMAN. There are some investment advisers, I think perhaps not now, but a while ago that had advisory relationships as low as \$10,000, although a lot of those tended to put those—it is a good question because some of the managers who were prepared to manage smaller sums of money said, the way we ought to deal with this is to do one of two things: put them in an investment partnership so they could manage it as a pool; and the second which created the so-called mini account controversy in which they said, "I will maintain all of these separate accounts but manage them all the same. I am going to treat them in terms of my investment decisions as if they were pooled."

That raises questions of whether that is an investment company.

The first alternative raises questions about whether or not we really want those kinds of investors to be managed outside of the Investment Advisers Act which provides a Federal antifraud standard and other provisions, simply because their advisory relationships are put in partnership form.

That is a problem.

Mr. SCHEUER. I would say the people who are investing \$10,000 probably need a higher level of investment than an investment fund.

Mr. FRIEDMAN. Higher level of protection.

Mr. SCHEUER. Higher level of protection; yes.

Mr. FRIEDMAN. In fairness, I have to say that a lot of the advisers are representing much wealthier people but it is important to remember the standards under the Advisers Act are different from those under the Investment Company Act. The Investment Company Act brings the Commission in with both feet, as it were.

The Advisers Act imposes an antifraud standard. There is a registration requirement. The Commission is given the right to inspect them. We have adopted rules requiring certain kinds of disclosures but it is a relatively limited kind of regulation and it is not inappropriate for individuals.

Mr. SCHEUER. Wealthy individuals.

Mr. FRIEDMAN. Even wealthy individuals.

If we talk about this in terms of only Morgan Guaranty, I think it tends to distort the consideration of this.

Mr. HAGOPIAN. Commenting on this concern about organizing widows and orphans and even wealthy individuals into limited partnership form—this is a concern that has been expressed to us. I guess I am at a loss, really, to respond to it, because I think it is really important that we remember what we are talking about here is a simple clarification of what we and leading securities lawyers in the country already believe the act says. In effect what we are saying is we believe the act has declared that wall over there to be a sort of beige color and the SEC is saying, no, it is red.

We would like the Congress again to affirm that that wall is not red, that it is beige.

Mr. FRIEDMAN. That is not accurate. What these law firms have done is tell you with respect to the fund they have focused on, they look at the facts and say, under those circumstances and under the conditions listed in your bill that is not an advisory relationship.

I am saying that is fine but there may be other circumstances under which even with those conditions there is an advisory relationship or there are other unintended consequences of your proposed congressional action.

Mr. HAGOPIAN. Certainly there are conditions under which you could organize a limited partnership and it would be an advisory relationship. We are saying let's identify those facts that have to exist in order to make it clear there is no advisory relationship, and those facts are basically incorporated in H.R. 7554. If those facts are present in this partnership or corporation, then it is clear, the court would hold that the limited partners or shareholders are not advisees.

Again, that is the interpretation of the act by all of the leading securities lawyers we have consulted.

Yet, we have not been able to convince the SEC to stop making unofficial statements to the effect that, maybe those partners are really advisees. The effect of this position on the industry is that everyone is shaking in his boots that at some point the SEC is going to bring an enforcement action against a limited partnership and in effect take away the profit-sharing arrangement.

Mr. OPPER. I would like to define where we are. The Commission apparently, if I interpret H.R. 7491 correctly, agrees that there should be a broader exemption than merely applying the rule of 15 clients to a general partner of a venture capital company. Is that not right?

Mr. FRIEDMAN. Yes.

Mr. OPPER. The question then is how to create parameters in the definition so as not to let in other than bona fide venture capital companies.

Mr. FRIEDMAN. That is what I would identify as the problem.

Mr. OPPER. I suspect that Mr. Hagopian probably understands it can create a problem if the definition is too broad and not carefully drawn.

Further, as I understand it, the kind of thing that the Commission and venture capital people are talking about is the definition of a venture capital company which would require at least 70 percent of its assets be invested in venture capital type situations—over-the-counter, if you will—and the other 30 percent in any other kind of investment.

If I understand what Mr. Friedman is saying, that may take a little fine-tuning to insure that doesn't bring in other than bona fide venture capitalists.

If I understand what Mr. Hagopian is saying, "that definition would suit us fine assuming your fine-tuning doesn't exclude bona fide venture capitalists."

Is this a fair summary of where you are?

Mr. HAGOPIAN. Except for one thing. I would say certainly it is very important to see in print what the definition says because the more fine-tuning that occurs, the more potential problems we may have, if not today, in the future. Definitions have a way of becoming obsolete.

The other thing I would add is, intellectually I think it is the wrong approach. I have declared that in my testimony and I have restated it here today. I am not suggesting that we would be intractable on this issue. I would just like to see what it says. My fear is when the SEC sits down to write the definition their hands will shake.

Mr. SCHEUER. I would like to continue a focus on who is it that needs what level of protection and if you can't prove that case then maybe there should be intervention by the SEC under any of these acts. Maybe we just ought to wipe the deck clean.

If you can't prove groups now covered need a given level of protection, why is there a Federal intervention? I think we are in an age where Federal intervention has to be justified. I think over a period of time needs change. Perhaps the need for effective mechanisms for aggregating capital for small businesses has grown. We know over half the jobs in the United States are provided by

small businesses and almost half of the production in the United States is carried on by small businesses.

I think the Federal Trade Commission would tell you that in order to produce a really vibrant marketplace we want to encourage the viability of small businesses to compete with the big guys in raising capital as well as in other things.

My general philosophy is, show me.

We are not going to settle all these things this morning. Who needs protection and what level of protection do they need?

Mr. LEMOV. I am special counsel to NASBIC. The point you are making is one of the major issues that divides the two bills before the subcommittee. H.R. 7554 is a bill which essentially wipes the slate clean of the 1940 act and substitutes a modern provision based on independent directors approving transactions and responsibility of the corporation nor its own activities.

It wipes out the concept of going to the Government in advance of transactions and getting prior Government approval of these transactions. It substitutes self-responsibility.

That is why the approach of that bill, as Mr. Broyhill described many of the subcommittees are on is so different from the SEC's approach which cuts a narrow path through the thicket and asks these companies to squeeze into a narrow definition. That is why I think your comments are so appropriate on the nature of the current regulatory dilemma you are faced with.

Mr. FRIEDMAN. In the first place, except in the narrow classification in which an officer or director or shareholder owning more than 25 percent has a direct financial interest, our bill does precisely the things Mr. Lemov mentions in terms of transferring authority to the board of directors.

That issue really, I think, is not in dispute here.

Second, I think there are other concerns which you may view as parochial because we are a regulatory agency, but we view as terribly important to protecting the investors' public funds, and confidence in the securities market.

One of the remarkable things in my view about the investment company area, which is one in which there are thousands of pages of studies and hearings about abuses and problems—generated 40 years ago—but there have been very few problems in the last 40 years. One of the reasons is because we have had a very effective regulatory system. I am not saying that is fixed in concrete and has to stay forever. But I think this is an area in which we have to proceed very carefully.

Mr. SCHEUER. This committee always proceeds carefully, Mr. Friedman.

Mr. FRIEDMAN. Of course.

Mr. LEMOV. Following up on Mr. Friedman's point, I am glad to hear he agrees with the general philosophy he stated. The Investment Company Act of 1940—and I have reviewed it very carefully—is 53 sections long. There are restrictions in there I venture to say very few of the Members of Congress would consider at all necessary in this era for this kind of venture capital company.

I wonder if the committee realizes that section 12, which the SEC never looks at in their bill says an investment company cannot

purchase securities or margin, can't have a joint trading account, can't make short sales, act as an underwriter.

Section 10 has an anachronism that says a majority of the board of directors of an investment company cannot be bankers or persons affiliated with an investment banker. Why should these companies be treated differently from industrial companies?

I have given you two sections which the SEC bill doesn't look at and they say they are clearing up this thicket.

Sections 15, 16, 23, 47, which is a tremendous problem—none of these are addressed by the SEC's bill which is why the other approach which says we are going to stop this except for the heart of the self-dealing provisions and invest those and vest those in the independent directors is so much a better approach at this time.

Mr. OPPER. I would note Mr. Hagopian has to leave at 11 o'clock and I don't think he has finished with his presentation.

Mr. HAGOPIAN. No. I would like to make one or two additional comments.

I think it is germane to consider what the chairman has said today, which is who are we trying to protect? I think this debate between the SEC and the industry has become fairly typical. It is a standard debate over how much protection the public requires and what is truly in the public interest. I would like to say that NVCA is not out to harm the public interest. We, as a matter of fact, believe in the need for confidence in securities markets. Also, I certainly don't feel there are any sinister people down at the SEC who are out to get industry.

In fact, I think all the people I have met at the SEC are very bright and well-intentioned but, they are regulators. Our feeling is that economic freedom is also in the public interest. Investments in small business have proven to be in the public interest, certainly in the economic interest and I think we need to weigh the benefits to the public of this kind of investment in contrast to the potential conjectural benefits that may be ascribed to additional securities regulations.

It always seems to come down to that kind of argument. In our view this Nation is approaching an economic crisis in which we have to take some modicum of risk. I am not in any way saying we ought to throw out the baby with the bath water. I believe strongly, however, that we have to lighten up on the industry and let it do what it knows how to do—let it pursue its enlightened self-interest within a little bit broader boundary.

Certainly we don't want to remove any of the antifraud laws or abrogate the Securities Act of 1933 or the 1940 act—although I have heard some arguments in favor, we are not suggesting that. But we are suggesting that the public's interest is served in many ways and protecting them from themselves is only one. We would like to have a reasonable amount of risk assumed by the Government in this regulatory area.

[Testimony resumes on p. 152.]

[Mr. Hagopian's prepared statement and attachments follow:]

STATEMENT OF

B. KIPLING HAGOPIAN

General Partner, Brentwood Associates and
Brentwood Associates II; and

MEMBER AND CO-CHAIRMAN OF THE SEC COMMITTEE
BOARD OF DIRECTORS
NATIONAL VENTURE CAPITAL ASSOCIATION

* * * * *

PRESENTED TO THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
OF THE COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE

UNITED STATES
HOUSE OF REPRESENTATIVES

* * * * *

JUNE 17, 1980

I. INTRODUCTION

Mr. Chairman and Members of the Committee:

I am a General Partner of Brentwood Associates and Brentwood Associates II, venture capital partnerships located in Los Angeles. I am also a member of the Board of Directors of the National Venture Capital Association ("NVCA"), and Co-chairman of its SEC Committee. NVCA is composed of about 80 venture capital firms with total assets of more than \$1.5 billion. I appreciate this opportunity to comment on HR 7491, a bill which the NVCA strongly supports.

II. SUMMARY OF HR 7491

The clear and simple objective of HR 7491 is to reduce restrictions on the flow of capital to small and innovative businesses. In this regard the bill is responsive to SEC Chairman Harold Williams' oft stated goal of modifying securities regulation to make it easier for small business to raise capital. At the same time, HR 7491 is designed to ensure that adequate investor protections are retained so as not to subvert the spirit of the amended statutes. To this end, the most recent version of the bill, which you have before you, has been substantially revised to accommodate many of the concerns expressed by the SEC and the staff of this committee.

HR 7491 treats three areas of the securities laws in an attempt to remove the obstacles which presently restrict the flow of capital to small business. First, the bill would amend the Securities Act of 1933 in order to make it easier and less expensive for businesses to raise capital from highly sophisticated investors. Second, the bill would amend the Investment Company Act of 1940, to exempt venture capital companies from registration under that Act; this would make it practicable for qualified venture capital companies to raise capital from the public. Third, HR 7491 would clarify the Investment Advisers Act of 1940 to confirm its inapplicability to venture capital companies, thereby increasing the flow of capital to venture pools.

III. THE NEED FOR LEGISLATION

The need for legislation in the securities area is acute. The value and importance of stimulating the flow of capital into small and innovative growth businesses is well recognized. The overwhelming body of evidence suggests that relative to dollars invested, small companies increase productivity and employment at a much higher rate than large companies. Increasing the flow of capital to these businesses, therefore, can make a major contribution to treating our country's dual economic maladies, inflation and unemployment. Unfortunately, current securities laws, as interpreted, applied and enforced by the Securities and Exchange Commission are working to restrict the flow of capital to these businesses. HR 7491 will remove

some of these restrictions.

As stated in Chairman Harold Williams' recent letter to the Senate Banking Committee, "the commission has recognized the validity of the broad objectives expressed in (the) bills." However, while the Commission contends that it plans to provide effective relief in the areas covered by the bill, we greatly fear, after years of discussion and debate with the staff on the issues covered by the bill, that achieving something workable is not likely. We have concluded, therefore, that progress can best be made through the legislative process.

IV. DISCUSSION OF THE BILL

Amendment to Securities Act of 1933

The first section of the HR 7491 is an amendment to the Securities Act of 1933 which would make it easier for businesses to raise capital privately from sophisticated investors. This amendment is basically an extension of the SEC's recently promulgated rule 242 (which is limited to financings of \$2,000,000 every six months). Simply stated, the provision would reduce the long and costly disclosure requirements which are currently imposed on issuers, as long as the securities sold are purchased solely by sophisticated and financially substantial investors such as banks, insurance companies, registered investment companies and others whose investment is more than \$100,000. The premise underlying this provision is that this type of a purchaser, termed an "accredited investor"

by the bill (and by Rule 242) is perfectly able to fend for himself, and that he neither needs nor wants the government's protection in ensuring that sufficient disclosure is made to him. Extending this logic, resales from one accredited investor to another accredited investor would also be exempted from registration.

Amendment to Investment Company Act of 1940

The second key provision embodied in the bill is an amendment to the Investment Company Act of 1940 ("'40 Act"). This amendment is based on the premise that the '40 Act is inappropriate in its application to venture capital companies, with the result that the public, which represents one of the largest sources of capital for venture pools, has been largely precluded from investing. Particularly onerous is Section 17 of the Act which requires an SEC exemptive order for transactions between a registered investment company and its investee "affiliates". Additionally, the Act contains various provisions which together work to prohibit equity incentives for management. HR 7491, by exempting qualified venture capital companies from the Act, would make it more attractive to these companies to sell shares to the public, thereby increasing the flow of capital to new and developing businesses.

It should be noted that public ownership of venture capital companies is not presently prohibited. In fact, there are several, albeit a dwindling number of publicly held venture capital companies. Currently, however, the public's only

available investment participation is in companies whose potential is materially handicapped by the severe operational constraints of Section 17 of the Act and the inability of these companies to offer equity incentives to management. In other words, in the name of protecting the public interest, the '40 Act works to diminish the value of the public's investment. Moreover, as the law currently stands, anyone calling himself a venture capitalist, regardless of his qualifications, can sell stock to the public. In contrast, under HR 7491 an established venture capital company seeking exemption from the '40 Act would have to have an operating history of at least three years. In order for a new fund to avail itself of the exemption, it would have to have received favorable consideration of its qualifications through the sale of 50% of its public offering to sophisticated "accredited investors". NVCA suggests that investment in a company that is so qualified is clearly more attractive to the public than investment in a company whose operations are severely constrained, and whose management does not have sufficient financial incentives to succeed.

Amendment to Investment Advisers Act of 1940

The third area of the bill concerns the Investment Advisers Act of 1940 ("Advisers Act") and is nothing more than a clarification of the law as we and leading securities lawyers believe it presently exists. NVCA believes that this section of HR 7491 is potentially the most crucial to the future vitality of the

venture capital industry.

The Advisers Act is anathema to venture capital funds. Of primary concern is section 205(1) of the Act which prohibits compensation to an "adviser" on a profit sharing basis. Since profit sharing arrangements are standard in the industry (and in our view contribute immeasurably to enhancing investor returns), the effect of their prohibition would be to dissuade the most qualified venture fund managers from participating in venture capital.

For the 40 years of the Advisers Act's existence, venture capital fund managers have never been compelled to register under its provisions. This is so because the plain language of the Act clearly distinguishes the activities of an investment adviser from those of a typical venture capital fund manager. Nonetheless, over the last ten years various members of the staff of the SEC, in unofficial private and public statements have suggested that venture capital fund managers may in fact be investment advisers. Moreover, these staff members have suggested that, in the case of a venture fund organized as a limited partnership, the advisee or client of the manager is not the limited partnership itself but each of the individual limited partners. Since registration under the Act is required if an adviser has more than 14 clients, under this theory a general partner of a limited partnership would be compelled to register if his fund had more than 14 partners.

The Advisers Act problem was exacerbated in 1978 by a court decision in the case of Abrahamson vs. Fleschner. In this case the Judge made an inadvertant statement in a footnote to his opinion to the effect that the general partners in that partnership (which was an investment fund commonly known as a "hedge fund"), were investment advisers, not to the partnership but to each of the limited partners. On rehearing, the court modified its opinion to remove this statement. Even so, and even though the facts in that case were dramatically different than those in a typical venture capital partnership, additional uncertainty was created.

Notwithstanding the SEC's unofficial remarks and the since deleted language of the Abrahamson case, all of the major law firms with whom we have consulted have taken the position that the managers of venture capital funds are exempt from such registration. Many law firms, however, are understandably reluctant or unwilling to give unqualified opinions to this effect while the current cloud of uncertainty exists. As a result, for years venture fund managers have limited the number of limited partners they would accept to 14. Accordingly, the amount of venture capital available for small business has been diminished significantly.

NVCA has formally proposed to the SEC that it resolve the uncertainty surrounding this issue by issuing a rule making it clear that the limited partners of a venture capital partnership

are not clients of the manager. I am including a copy of this proposal for the record, which I respectfully urge all of you to read as background on this matter. Recognizing that there are conditions under which the general partners of a partnership may in fact have an advisory relationship with the limited partners -- as in the case, for example when limited partners are free to enter and exit the partnership at will -- we proposed that the rule set forth the characteristics of a partnership, which must exist for it to be clear that an advisory relationship did not exist between the general partners and individual limited partners. Specifically, we proposed to the SEC and continue to propose in HR 7491, that a venture fund manager not be deemed to be an advisor to his limited partners (or shareholders) if the following conditions are met:

- (1) the business affairs of the partnership, including its investment decisions, are conducted by general partners or management without the requirement of approval thereof by individual partners, shareholders or beneficial owners;
- (2) the partnership is formed for a minimum term of existence of five years (or, if it is a corporation, does not have a limited term of existence) and during such minimum term (or, if a corporation, during the term of its existence) the partners, shareholders or beneficial owners do not have any individual right to withdraw their capital; and,
- (3) the securities of the partnership are issued only to sophisticated investors in private transactions.

To date, the SEC has been unwilling to adopt this approach, fearing apparently, that some actual advisers might attempt to escape registration by complying with the rule's provisions. Instead the Commission in June, 1979, proposed its own Rule 205-3. This rule would exempt managers of so-called "Business Development Companies" (as defined) from the profit sharing prohibitions of the Advisers Act as long as the manager registered as an investment adviser and subjected himself to the extensive other regulatory burdens imposed by the Act. In other words, as a price of being assured that it can continue to conduct its operations in the same manner it has since the Act's enactment, the industry is being asked to hereafter subject itself to government regulation. Ironically, this has been proposed at a time when the President, the Congress and the public all seem to have recognized the deleterious effect excessive government regulation has on the nation's economy. In addition to being conceptually repugnant, the definition of Business Development Company contained in the rule is so restrictive that in a straw poll of venture firms it was determined that about 74% in number and 63% in dollar amount of a typical venture firm's investments would not qualify. As you might expect, the letters of comment on this proposed rule have been universally negative. Nevertheless, the rule has not been withdrawn nor modified at this date. For your information, I am attaching to my testimony a copy of proposed Rule 205-3 and NVCA's letter of comments.

In NVCA's opinion, the Adviser Act issue revolves around two

fundamental questions: First, is whether there is a legal basis in the Act for imposing registration (i.e. government regulation) on venture fund managers. We submit that the Act leaves no doubt whatever that no such legal basis would exist for imposing registration on virtually any of NVCA's members (except those which may be advisers separate and apart from their activities as a venture capital company.) In confirmation, we have received an unqualified legal opinion to this effect from the San Francisco firm of Pillsbury, Madison and Sutro, one of the nation's foremost experts in the securities laws. The entire text of this opinion is attached to this testimony; I would, however, like to read a brief excerpt from it now:

"In our opinion, neither the plain meaning of advice nor the legislative and administrative history of the Advisers Act support the conclusion that the phrase "advising others" includes making investments utilizing the funds of another under circumstances in which the person providing the funds has no right to accept or reject the investment decision or to withdraw the funds at the disposition of the person making the investments.

Even if a court were to hold that the general partners of a venture capital limited partnership were advising others...it is clear that the inability of individual limited partners to accept or reject investment decisions would result in the partnership constituting a single

client for purposes of determining the number of clients under...the Advisers Act."

Also impacting the Advisers Act controversy is a practical consideration. Have there been improprieties or abuses of the public interest by the managers in question that should encourage the SEC to strain its interpretation of the Act in an effort to "serve the public interest"? Additionally, do the investors (or might the investors) in the companies administered by the managers in question, need the protection that might be afforded by registration? We submit that there have been no material improprieties or abuses and that, given the extreme sophistication of the investors in such companies, and the protection already afforded them by the anti-fraud laws and the Securities Acts of 1933 and 1934, no purpose would be served by subjecting these managers to regulation.

What about the possibility of an adviser organizing his clients into a partnership or corporate form as a "means of avoiding the Act"? We believe it is clear that when (and if) an adviser does this he completely changes the character of his relationship with his clients, and as a result, ceases to be their "adviser". Instead, clients would go from being advisees who can accept or reject the advice of their adviser, to being the owners of equity securities in a closed-end investment company; as limited partners or stockholders they would then have no ability individually to accept or reject advice. Clearly this is a very substantive difference, and is the basis for hundreds of

managers of both public and private closed-end investment companies operating free from even the suggestion that they need register.

Because the nature of the relationship is so totally different, it is inconceivable that either advisers or their clients would want to form closed-end investment companies as a means of avoiding the Act; and even if that were their motive, it wouldn't change their legal right to do so. Moreover, I reiterate: a multitude of other securities and anti-fraud laws are extant to protect the shareholders or limited partners of such companies.

In completing my remarks on the Advisers Act, I hope you will consider carefully the likely consequences of each of the courses of action the Congress has available to it. Simply stated, the alternatives are:

- (1) enact this bill, making it clear that if a company (either partnership or corporation) has the characteristics indicated, the individual limited partners (or shareholders) are not advisees; or
- (2) do nothing.

We are convinced that if the "do nothing" course is followed the result, at best will be a continued restriction of the flow of funds to small business. Worse, the SEC could adopt a rule such as rule 205-3 which might further restrict this flow.

If the bill is enacted, however, the only certain result will be an increase in the flow of funds to small business. Any other possible consequences are purely conjectural. It is our belief that there will be no other consequences. The typical adviser will not be able to use the amendment as a means of "avoiding registration" because in most cases, such a notion will either be unacceptable to the adviser's clients or disallowed under other securities laws (the regulations governing private placements, for example). By passing HR 7491, the Congress would simply be affirming that the sale of a security (unless by its terms it provides for individual rights of withdrawal at short intervals) is distinctly different from and does not constitute the establishment of an advisory relationship as defined by either the letter or the spirit of the act.

V. COMMENTS ON THE SEC'S PROPOSED "BUSINESS DEVELOPMENT ACT"

I have reviewed the Sec's proposed alternative to HR 7491, entitled the "Business Development Act of 1980". Unfortunately, I have only recently received this proposed bill, which is highly complex and technical in content; accordingly, I have not had time to study it carefully. My comments will be limited, therefore, to only the few areas of the proposed bill which I have been able to digest. By omission, I do not mean to imply that the other sections of the bill would be supported by NVCA.

In addressing the SEC's bill I would first like to take this opportunity to thank the SEC, and in particular Chairman Williams, whom I respect most highly, for the thoughtful consideration given to the financing problems of small business. I would particularly commend Chairman Williams, the Commission and the staff of the Corporate Finance Department for the several recent changes in corporate finance regulations they have effected. These changes have had a positive impact on capital formation for small business.

Substantial additional change is required, however, specifically in the areas covered by HR 7491. Unfortunately, I believe the SEC's proposed alternative falls short of the mark. The most crucial and most disturbing aspect of the SEC bill is the definition of "business development company".

This definition is critical because it basically determines by government edict rather than free market forces, the scope and nature of a venture capital company's activities. NVCA recognizes the practical importance of imposing some boundaries on the activities of venture capital companies as a condition of providing effective relief from the '40 Act. It is not our intention to define the venture capital so broadly that the important principals of the Act are violated. We believe, however, that the definition contained in the Business Development Act of 1980 is so restrictive that, in order to comply with its provisions, the great majority of NVCA's members would have to curtail a substantial portion of their investment activities.

Some of the types of investments presently made by venture capital companies which would be prohibited are the following:

- (1) Investments in which "significant managerial assistance" is not rendered (perhaps because a co-investor is providing such assistance or because the company is so well managed that it requires no assistance).
- (2) Investments made through the purchase of securities from a selling shareholder who is not a controlling person of the investee company.

- (3) Investments in the liquid stock of small emerging growth companies whose stock is traded on an exchange (even a small regional one) or is listed on the Federal Reserve margin list.
- (4) Investments in existing portfolio companies whose stock has subsequently become traded on an exchange or gone on the Federal Reserve margin list, unless at least 5% of the portfolio company was owned at the time of the additional investment.
- (5) Investments in non-U.S. based companies.

I roughly estimate that, depending on the interpretation of the phrase "making available significant managerial assistance", somewhere between one-third and two-thirds of the investments of today's venture capital funds would be prohibited under this definition. While we can understand the value of limiting the percentage of certain types of investments (e.g., marketable securities) we see no value in reducing investment flexibility to this extent. We urge the Congress, therefore, to reject the SEC's definition in favor of the one contained in HR 7491.

With respect to the Advisers Act, NVCA sees no need for a definition of venture capital (or business development company). In fact, establishing a definition for the purposes of

facilitating exemption from this Act would obscure the essential issue -- that is, the question of whether a venture capital manager is in fact advising his partners (or shareholders). Additionally, imposing any definition on venture capital companies as a condition of excluding them from registration under the Act, would result in an unnecessary and inappropriate limitation of their activities. To do so would be a regressive step insofar as capital formation is concerned.

My final comments on the SEC bill pertain to Section 3(c)(1) of the '40 Act. I was extremely disturbed to see that, along with some favorable changes in 3(c)(1), the SEC bill has taken a significant step backwards in its impact on venture capital partnerships. Presently, 3(c)(1) provides that, for the purpose of determining the number of beneficial owners of an investment company's securities, the stockholders of any investor who holds 10% or more of the voting securities of that investment company will be treated as beneficial owners of securities in the investment company. Often, including these additional shareholders will give rise to a requirement to register under the '40 Act. Because limited partnership interests do not have voting power, positions in excess of 10% have for years been issued to corporate investors without the unbearable consequence of having the shareholders of those corporations attributed to the limited partnership. The change to "equity securities" contained in the SEC's bill would be

contrary to Congress' intent when it promulgated this Act and would have the practical effect of restricting corporate investment in venture capital companies to individual positions of less than 10% of the money raised. NVCA knows of no logical basis for this regressive step and opposes it strenuously.

VI. CLOSING REMARKS

In closing, I would like to address the issue of public interest and the division of opinion between the SEC and the venture capital industry over how best to serve it. Given its charter, it is understandable that the SEC would be inclined primarily to support those changes in securities laws which tend to increase investor protection. Securities regulation, as a result, has become increasingly more complex, burdensome and restrictive. NVCA believes that economic freedom is also in the public interest and that the merits of any regulation imposed on industry must be considered in this light and weighed in relation to its real cost to the economy. This cost is not only measured in terms of tax dollars spent on the expansion of the regulatory bureaucracy, but can also be measured in terms of higher unemployment, lower tax revenues and higher inflation. Our nation is suffering from a serious economic malaise caused in large measure by a lack of innovation and investment. In our view, this situation demands action even if some modicum of risk must be assumed in the process. After

considering the safeguards retained in the statutes affected, the multitude of other securities laws, regulations and anti-fraud statutes, we believe that the changes embodied in HR 7491 would not represent a material risk to investors' welfare.

We are convinced, therefore, that the public interest can best be served by enacting HR 7491 and rejecting the Business Development Company Act of 1980.

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September 12, 1979

National Venture Capital Association
2030 M Street, N. W., Suite 403
Washington, D. C. 20036

Gentlemen:

You have asked us to advise you whether, in our opinion, the general partner or partners of a venture capital limited partnership are "investment advisers" within the intendment of section 202(a)(11) of the Investment Advisers Act of 1940 and, if so, whether the partnership is a single client or each individual limited partner is a client for purposes of determining the availability of the exemption contained in section 203(b)(3) of that Act. For purposes of our analysis, we have assumed that a "venture capital limited partnership" would have the following characteristics:

1. Its affairs, including investment decisions, would be conducted by the general partners without the necessity of approval by the individual limited partners;
2. The partnership would be formed for a minimum term of five years, during which individual limited partners would not have a right of withdrawal or right to transfer their limited partnership interest free of restrictions on transferability contained in the partnership agreement;
3. The limited partnership interests would be offered only in connection with the formation of the partnership and, although subsequent contributions by or assessments of limited partners may be permitted, the limited partnership interests would not be offered on an ongoing basis except to the extent that employee or other special limited partners may be admitted during the term of the partnership; and

4. The limited partnership interests would not be offered to the public, but would be sold primarily to institutional investors in reliance on the exemption from registration under the Securities Act of 1933 contained in section 4(2) thereof.

Although venture capital limited partnerships customarily concentrate their investment activities on the purchase of restricted securities of corporations which are not publicly traded, as indicated by the following discussion, we do not believe that the nature of the securities invested in by the fund is a relevant factor in determining whether the general partner of the fund is an investment adviser to the partnership or to the individual limited partners.

Although no reported decision prior to Abrahamson v. Fleschner, 568 F. 2d 862 (2d Cir. 1977), cert. denied 436 U. S. 913 (1978), suggested that the general partners of a partnership operating as an investment fund are advising others for purposes of section 202(a)(11) of the Advisers Act, investment partnerships, including venture capital limited partnerships, have been in operation during the entire 39 year period subsequent to the adoption of the Advisers Act. At no time during this period had the Commission either by interpretation or enforcement proceeding attempted to maintain that the general partner of a limited partnership is an investment adviser. In the most recent public expression by the Commission on this issue, Investment Advisers Act Release No. 680, the Commission made it clear that it was not taking a position on whether a limited partnership formed for the purpose of making business development investments should be construed as one client or whether the limited partners should be counted individually for purposes of the exception to registration provided by section 203(b)(3) of the Advisers Act. However, neither that Release nor any other public pronouncement by the Commission has affirmatively taken the position that the general partner of a venture capital limited partnership is rendering investment advice within the meaning of section 202(a)(11). The brief of the Commission as amicus in Abrahamson v. Fleschner was directed to the issue of whether the general partners of hedge funds are investment advisers. That brief may be viewed as a contention that under the special circumstances there present, including the annual right of the limited partners to withdraw from the partnership, the general partners were investment advisers who were using the partnership form in an attempt to insulate an investment advisory business from its statutory obligations.

Traditionally, the general partners of partnerships formed to invest in oil and gas, real estate and similar development ventures, the investments of which frequently constitute securities for purposes of the Advisers Act, have neither sought nor been required to register as investment advisers in connection with the registration of their offerings under the Securities Act of 1933. To date, the general partners of only two partnerships have sought registration under the Advisers Act. Thus, both the administrative interpretation of the Advisers Act and the nearly universal interpretation placed on that Act by the legal community supports the proposition that the general partner is not "advising others" for purposes of registration under the Act.

The conclusion reached by the Court of Appeals for the Second Circuit in Abrahamson v. Fleschner may be considered to be limited to hedge funds and other partnerships in which individual limited partners receive investment advice which they may accept or reject by electing to become a limited partner or to liquidate their limited partner's interest at frequent intervals. In contrast, the limited partner in a venture capital limited partnership is not the beneficiary of discreet or separate investment advice or recommendations and has no right, by withdrawal or otherwise, to accept or reject particular investment decisions made by the general partner.

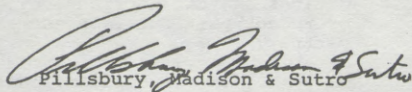
In our opinion, neither the plain meaning of "advice" nor the legislative and administrative history of the Advisers Act support the conclusion that the phrase "advising others" includes making investments utilizing the funds of another under circumstances in which the person providing the funds has no right to accept or reject the investment decision or to withdraw the funds at the disposition of the person making the investments.

Even if a court were to hold that the general partner of a venture capital limited partnership were advising others for purposes of section 202(a)(11), it is clear that the inability of individual limited partners to accept or reject investment decisions would result in the partnership constituting a single client for purposes of determining the number of clients under section 203(b)(3) of the Advisers Act. The withdrawal by the Court of Appeals for the Second Circuit of that portion of a footnote in Abrahamson v. Fleschner which suggested that the limited partners are individual clients for purposes of the Advisers Act, when considered in connection with the brief submitted to, but not officially filed with the Court of Appeals by the National Venture Capital Association as *amicus curiae*, may be read as recognition

by the Court of Appeals that the original suggestion that the limited partners were each clients was ill considered and lacking in authoritative support. Because the individual limited partners of a venture capital limited partnership have no right to approve or disapprove particular investments, we believe no basis exists for concluding that the individual limited partners are separate clients for purposes of the Advisers Act.

For the foregoing reasons, in our opinion, a court should hold that the general partner of a venture capital limited partnership is not an investment adviser to the partnership or its limited partners within the meaning of the Investment Advisers Act and, if a court were to reach a contrary conclusion, the partnership rather than the individual limited partners would constitute the client for purposes of determining the availability of the exemption from registration provided by section 206(b)(3) of the Investment Advisers Act.

Very truly yours,


Pillsbury, Madison & Sutro

SEC PROPOSAL TO PERMIT PERFORMANCE-BASED COMPENSATION OF
INVESTMENT ADVISERS TO BUSINESS DEVELOPMENT COMPANIES

JUL 16 1979

SECURITIES AND EXCHANGE COMMISSION
[17 CFR Part 275]
[Release No. 1A-680, File No. S7-788]

PERFORMANCE-BASED COMPENSATION OF REGISTERED
INVESTMENT ADVISERS TO BUSINESS DEVELOPMENT
COMPANIES

AGENCY: Securities and Exchange Commission.
ACTION: Proposed rule.

SUMMARY: The Commission is issuing for public comment a proposed rule under the Investment Advisers Act of 1940 ("Advisers Act") which would permit certain registered investment advisers to business development companies to be compensated on the basis of a share of net capital gains upon, or net capital appreciation of, the funds, or any portion of the funds, of the business development company. Such means of compensation is currently prohibited by the Advisers Act.

DATE: Comments must be received on or prior to August 31, 1979.

ADDRESSES: Interested persons should submit their views and comments in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All submissions will be made available for public inspection at the Commission's Public Reference Section, Room 6101, 1100 L Street, N.W., Washington, D.C. and should refer to File No. S7-788.

FOR FURTHER INFORMATION CONTACT: W. Scott Cooper, Esq., Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549, (202) 755-3507.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission has under consideration the adoption of new Rule 205-3 [17 CFR 275.205-3] under the Investment Advisers Act of 1940 ("Advisers Act") [15 U.S.C. 80b-1 et seq.].

I. BACKGROUND

Business development companies 1/ are enterprises engaged in the business of investing in relatively small and unseasoned companies in the developmental stage. These investee companies are typically privately held and may be managed by persons who do not have extensive entrepreneurial abilities. In addition, such companies are generally considered to represent risky investment opportunities and, therefore, have limited access to public and institutional financial markets. Since there is usually no ready market for the securities of investee companies, investments in these companies are generally illiquid in nature. Accordingly, business development companies frequently must be willing to take long-term positions in such companies and play an active role in nurturing their growth in order to realize a return on their investment commensurate with the risks involved.

The rule the Commission is proposing is designed to exempt certain registered investment advisers to business development companies from the provisions of Section 205 (1) of the Advisers Act [15 U.S.C. 80b-5 (1)]. That section prohibits an investment adviser, unless exempt from registration, from receiving compensation

1/ Depending on the precise nature of their activities, business development companies might also be referred to as "venture capital companies". However, because the term "venture capital company" is used in a variety of contexts, the Commission is defining and using the term "business development company" for purposes of the proposed rule.

which is based on a share of capital gains upon, or capital appreciation of, the funds, or any portion of the funds, of clients. 2/

Congress enacted Section 205 (1) to protect advisory clients from profit-sharing fee arrangements which could encourage an investment adviser to take undue risks with such clients' funds in order to realize or increase an advisory fee. 3/ The Commission believes that the practices and abuses that Section 205 (1) was designed to prevent are unlikely to develop in the limited circumstances, described below, under which performance fees could be paid to investment advisers to business development companies pursuant to the proposed rule. In addition, the Commission believes that the proposed rule will have the effect of facilitating the flow of needed capital into new and developing companies which are frequently unable to obtain financing from sources other than business development companies. In this regard, it appears to the Commission that investment advisers to business development companies have traditionally received performance-based fees which are not permitted to be paid to registered investment advisers under Section 205 (1). Because of the types of activities in which business development companies engage, many investment advisers might be reluctant to serve such companies unless their compensation can be based upon a share of the capital gains or capital appreciation of the company. To the extent that such reluctance might impede investments in small and developing enterprises, the Commission believes it appropriate to take action designed to remedy this difficulty.

Section 206A of the Advisers Act authorizes the Commission, by rule, regulation or order, to exempt conditionally or unconditionally any person or transaction from any of the provisions of the Advisers Act, if and to the extent such action is necessary or appropriate in the public interest and consistent with the protection of investors. 4/ In enacting Section 206A, Congress specifically contemplated Commission action in appropriate cases "to exempt persons . . . from the ban on performance-based advisory compensation in . . . Section 205 (1) of the Advisers Act." 5/

Pursuant to Section 206A, the Commission has recently granted two applications for orders of exemption from the provisions of Section 205 (1) to permit registered investment advisers to companies engaged in business development-type activities to be compensated on the basis of a share of capital gains, in one case, 6/ and capital appreciation, in the other. 7/ Certain common conditions existed in both applications, such as the limited number and sophisticated nature of the investors in each business development company and the substantial investments made in the business development companies by the re-

2/ The Commission is not herein suggesting a position as to whether a limited partnership formed for the purpose of making business development investments should be construed as one client or whether the limited partners of a business development partnership should be counted individually for purposes of the exception to registration provided by Section 203 (b) (3) of the Advisers Act [15 U.S.C. 80b-3 (b) (3)].

3/ See H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940).

4/ 15 U.S.C. 80b-6a.

5/ S. Rep. No. 91-184, 91st Cong., 1st Sess. 46 (1969).

6/ In re Weiss, Peck & Greer, Investment Advisers Act Release No. 625 (April 25, 1978).

7/ In re Foster Management Company, Investment Advisers Act Release No. 651 (November 28, 1978).

spective investment advisers to each business development company, which, together with other facts and circumstances, made the exemptions appropriate.

The Commission believes that investment in small and developing companies would be facilitated by a rule of general applicability which provides certain relief from the performance-based fee limitations of the Advisers Act with respect to business development companies. The rule proposal contained herein reflects certain of the conditions and concepts set forth in the aforementioned applications. The rule proposal also contains certain other conditions and limitations which the Commission believes may be necessary and appropriate to include in a rule of general application.

II. GENERAL PROVISIONS OF THE PROPOSED RULE

A. Exemption

Paragraph (a) of the proposed rule would provide relief from Section 205(1) of the Advisers Act so as to permit a registered investment adviser to enter into, extend, renew or perform an advisory contract which provides for compensation on the basis of a share of net capital gains upon, or net capital appreciation of, the funds or any portion of the funds of a business development company provided that all of the conditions set forth in the proposed rule are satisfied. 8/ The proposed rule would apply to any advisory agreement pursuant to which an investment adviser to a business development company is compensated, whether it be a separate advisory contract, or some other form of agreement or arrangement such as a partnership agreement or a corporate charter.

B. Business development company

A "business development company" is defined by paragraph (b) of the rule proposal as a company which is formed and operated primarily for the purpose of directly acquiring, in transactions eligible for the exemption from registration provided by Section 4(2) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. 77d(2)], securities of eligible portfolio companies, as defined in paragraph (c) of the proposed rule, and which, in general, has all of its assets invested in securities purchased directly from and issued by such companies.

Paragraph (b)(3) of the proposed rule would require a business development company to own beneficially at least five percent of the voting securities of each eligible portfolio company in which it invests. However, if the failure of the business development company to own at least five percent of the voting securities of any eligible portfolio company in which it has an investment is due solely to the issuance of additional voting securities by the eligible portfolio company, subsequent to the initial investment therein by the business development company, this condition would be deemed to be satisfied. This condition could also be met by the ownership of securities of the eligible portfolio company which are not voting securities, but which are immediately convertible at the option of the holder into voting securities of the eligible portfolio company without restriction or additional payment by the holder. The beneficial ownership condition is proposed in view of the Commission's understanding that business development companies typically own a sufficiently large portion of their portfolio companies so as to enable the business development company, generally acting through its investment adviser, to participate actively in the management of the portfolio company, and it is this active participation which, in part, might justify the payment of a performance-based fee to the investment adviser.

8/ It should be noted that the proposed rule would provide no relief from any other applicable provision of law, including Section 206 of the Advisers Act [15 U.S.C. 80b-6].

Paragraph (b)(4) of the proposed rule also contains provisions which would tend to limit the availability of the exemption to business development companies whose investors are relatively sophisticated persons, able to appreciate and evaluate the nature and effects of a performance-based advisory fee, as well as to bear the economic risks of the investment. Specifically, under paragraph (b)(4)(i) all of the securities of the business development company (other than those issued to its officers, directors or employees pursuant to a profit-sharing, stock option or stock purchase plan) would have to be issued in transactions not involving any public offering of securities.

In addition, under paragraph (b)(4)(ii) of the rule proposal, such securities would have to be issued in transactions wherein the business development company, and any person acting on its behalf, shall have reasonable grounds to believe, and shall believe, immediately prior to making any sale of securities of the business development company, after making reasonable inquiry, either (i) that the purchaser has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment in the business development company, or (ii) that the purchaser and the purchaser's representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment in the business development company and that the purchaser is able to bear the economic risk of the investment. This provision of the rule proposal is similar to paragraph (d)(2) of Rule 146 under the Securities Act [17 CFR 230.146(d)(2)] which concerns offeree qualifications. Accordingly, interpretations relating to that provision of Rule 146 would be relevant to paragraph (b)(4)(ii) of the proposed rule.

Under paragraph (b)(4)(iii) of the proposed rule, prior to the sale of any securities of the business development company, purchasers must have access to, or be furnished with, all material information reasonably necessary under the circumstances to enable such persons to make an informed decision as to an investment in the business development company. Satisfaction of this condition would, of course, depend on all the facts and circumstances regarding any transaction. The information required by paragraph (b)(4)(iii) would generally include, but not necessarily be limited to, information relating to the business development company, the nature of the offering, the terms of the performance-based compensation to be paid to the investment adviser, the fact that the purchaser must bear the economic risks involved in purchasing securities of the business development company and the limitations concerning the disposition of securities of the business development company. Paragraph (b)(4)(iii) is intended to require information which would, in many cases, be largely similar to the information required under paragraph (e) of Rule 146 [17 CFR 230.146(e)]. Accordingly, if the conditions specified in paragraph (e) of Rule 146 relating to the type of information which must be furnished to offerees or to which offerees must have access are satisfied, then the conditions of paragraph (b)(4)(iii) would be deemed to be met. 9/

Paragraph (b)(4)(iv) of the proposed rule would require each purchaser of securities in the business development company to purchase securities in the business development company in a unit or units of at least \$150,000 each. Furthermore, the units could not be fractionalized or otherwise divided into smaller units, except as permitted by paragraph (f), and could not be

9/ Compliance with the requirements of paragraph (b)(4)(iii) would not, however, relieve the business development company of any other applicable disclosure requirements under the federal securities laws.

sold, transferred or otherwise disposed of, in a transaction or transactions involving a public offering of securities. Thus, if any purchaser of a unit later resold it to a third person, the price of the unit on resale would presumably be at least \$150,000 unless the unit had declined in value.

Paragraph (f) of the proposed rule would permit the business development company to fractionalize or otherwise divide the units issued by such company to any person, including its investment adviser and persons associated with the investment adviser, provided that such fractionalization or division is approved by the vote of a majority of the outstanding securities of the business development company entitled to vote thereon, and that, immediately following such fractionalization or division, each outstanding unit of the business development company has a net asset value of at least \$150,000.

If payments for the units were made on a deferred or installment basis, all such payments would be required to be due within 12 months from the date of purchase of the securities and would have to be evidenced and secured by a full recourse note or notes of the purchaser.

Paragraph (h)(3) provides that a business development company cannot be an investment company which is required to be registered under the Investment Company Act of 1940 ("Investment Company Act") [15 U.S.C. 80a-1 et seq.]. This requirement would have the practical effect of limiting the number of investors in the business development company to not more than 100 persons, taking into account the attribution provisions of Section 3(c)(1) of the Investment Company Act, 10/ unless some other statutory or administrative relief from the registration requirements of the Investment Company Act was available. 11/

Paragraph (e) of the proposed rule would permit business development companies to hold assets in the form of cash, money-market instruments with a maturity not exceeding one year, or securities received by the business development company in exchange for securities of eligible portfolio companies, provided it intends and reasonably anticipates to invest or reinvest those assets in securities of eligible portfolio companies. This limited exception is intended to provide business development companies with a reasonable period of time in which to invest or reinvest their funds without having their performance-based fee arrangements become disqualified under the proposed rule.

C. Eligible portfolio companies

Eligible portfolio companies are defined, in part, in paragraph (c) of the rule proposal as companies which did not have an average annual net income after Federal income taxes in excess of \$400,000 for the two fiscal years immediately preceding the initial investment of the business development company therein, and which were not making and had not made any public offering of their securities. Furthermore, at the time of any investment (whether or not initial) by a business development com-

pany, 10/ Section 3(c)(1) of the Investment Company Act [15 U.S.C. 80a-3(c)(1)] excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of securities.

11/ As noted below, however, the Commission is considering issuing a proposed rule under the Investment Company Act to provide exemptive relief for business development companies. If, by reason of such a rule, a business development company were not required to register under the Investment Company Act, the rule now being proposed to permit performance-based fees under the Advisers Act could be applicable even if the business development company had more than 100 shareholders.

pany, an eligible portfolio company could not be a company subject to the reporting requirements of Section 13 of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78m] 12/ nor could it be an investment company as defined in Section 3 of the Investment Company Act [15 U.S.C. 80a-3]. With respect to the latter condition, the eligible portfolio company's exclusion from the definition of investment company in Section 3 of the Investment Company Act must be based upon some factor other than Section 3(c)(1) thereof. 13/ Thus, the rule would prohibit a business development company from investing in any company, such as a hedge fund or other business development company, which is excluded from the meaning of investment company solely by reason of having not more than 100 shareholders and meeting the other conditions of Section 3(c)(1).

The condition relating to the eligible portfolio company's net income at the time of the business development company's initial investment, set forth in paragraph (c)(1)(i) of the proposed rule, is one of the financial characteristics used by the Small Business Administration ("SBA") to define a small business concern for the purpose of receiving financial or other assistance from a small business investment or development company (see 13 CFR 121.3-11 (1978)). The Commission is considering, and requests public comment upon, the feasibility and desirability of using certain other standards used in that SBA rule to define further an eligible portfolio company. For example, using the SBA standards, the Commission might provide also that an eligible portfolio company cannot have assets exceeding \$9 million and cannot have a net worth exceeding \$4 million.

The Commission does not believe that it is appropriate to apply the net income limitation with respect to subsequent investments in an eligible portfolio company by the business development company. Although the proposed rule is designed to provide relief only with respect to business development companies which invest in relatively small and unseasoned enterprises, it would appear desirable for business development companies to be able to further their initial investments in eligible portfolio companies by making additional investments in such companies, even though the portfolio company might have developed to a stage where it no longer meets the net income test. However, such additional investments could be made only if the eligible portfolio company continued to meet the condition that it had not made a public offering of its securities, and that the business development company had maintained a continuous investment in the eligible portfolio company. The latter condition is set forth in paragraph (c)(2)(i) of the proposed rule, which provides that, at the time of each additional investment the business development company cannot have sold, transferred, or otherwise disposed of, any securities of the eligible portfolio company which it had previously acquired, except for securities of the eligible portfolio company converted into or exchanged for other securities of such company.

The proposed rule would not restrict the business development company to investments in any specific type of security. Thus, it would permit investments in either equity or debt securities of eligible portfolio companies. In addition, the business development company would be permitted to invest in companies engaged in any manner of business, so long as such companies meet the requirements set forth in paragraph (c) of the proposed rule. Subsequent investments in an eligible portfolio company

12/ Under Section 13 of the Exchange Act, issuers of securities registered on national securities exchanges, or issuers who have assets in excess of \$1 million and a class of equity securities held of record by 500 or more persons, must, unless otherwise excluded, file such reports and information as the Commission shall specify by rule.

13/ See note 9 *supra*.

would not be limited to the same class of securities which comprised the initial investment in the eligible portfolio company by the business development company.

Although the proposed rule would not permit a business development company to make additional investments in an eligible portfolio company if the portfolio company's securities became publicly traded, the proposed rule would not specifically prohibit a business development company from continuing to hold an investment in an eligible portfolio company if, after the business development company had made its investment, the securities of the portfolio company became publicly traded and the company no longer qualified as an eligible portfolio company. However, a business development company which had a substantial portion of its assets invested in large, publicly traded companies would no longer be operating "primarily" for purpose of directly acquiring securities of eligible portfolio companies, and therefore the company would cease to qualify as a business development company under paragraph (b)(1) of the proposed rule. The Commission is of the tentative view that the "primary" standard will prevent performance-based fees from being paid in cases where a business development company's investments have matured and the investment adviser is no longer performing the types of services which would justify such a fee, while at the same time avoiding an unduly restrictive condition which might have the effect of forcing a business development company to dispose of an investment at an inopportune time. However, public comment is requested as to whether the "primarily" standard set forth in paragraph (b)(1) is sufficiently specific to ensure that, in general, performance-based fees will not be paid where the business development company holds securities of mature companies. As an alternative to, or in addition to, that standard, the rule could require that any investment by a business development company be disposed of within a specific period of time, such as 10 years.

Another matter concerning which the Commission specifically requests comment is whether the requirement that all of a business development company's assets be invested in eligible portfolio companies (except for interim investments as permitted by paragraph (e)) is unduly restrictive. It might be appropriate to provide that some percentage of the business development company's assets, such as 10 percent, could be invested without restriction, particularly if the Commission ultimately determine to impose a general requirement that investments in eligible portfolio companies be disposed of within a stated period of time.

D. Additional conditions

Paragraph (d) of the rule proposal sets forth certain additional conditions which would have to be satisfied in order for performance-based compensation to be paid to an investment adviser by a business development company.

The investment adviser, and associated persons of the investment adviser, would generally be required by paragraph (d)(1) to beneficially own, at all times, by reason of having purchased, for cash or other tangible property, securities (other than senior securities as defined in Section 18(g) of the Investment Company Act [15 U.S.C. 80a-18(g)] 14) in the business development company in an amount not less than the greater of one percent of the amount invested or agreed to be invested in the business development to purchase securities in the business development company, or \$150,000. Such required investment is intended to help ensure that the in-

14/ Section 18(g) defines a "senior security" as any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends.

vestment adviser has a sufficient amount of money invested in the business development company so as to reduce the likelihood of the adviser taking undue risks with the funds of the business development company, since his own funds will be subject to the same risks. The investment adviser's purchase, like that of other investors, would have to be in units of at least \$150,000 each which could not be fractionalized or otherwise divided, except as permitted by paragraph (f), and which could not be sold, transferred, or otherwise disposed of, in a transaction or transactions involving a public offering.

Paragraphs (d)(2) and (3) of the proposed rule relate to the computation of an investment adviser's compensation. Under paragraph (d)(2), the adviser's performance-based fee must be computed on the basis of capital gains or capital appreciation, net of all realized capital losses and unrealized capital losses (capital depreciation). Thus, for example, even if the fee was based only upon capital gains and not unrealized capital gains (capital appreciation), unrealized capital losses would have to be taken into account. Paragraph (d)(3) would require that the compensation be based upon a written valuation of the assets of the business development company, prepared or reviewed by a qualified independent appraiser who is not a person associated with the investment adviser or a person otherwise providing services to the investment adviser pursuant to any agreement or understanding. The appraiser would have to certify to the business development company that the valuation is fair and reasonable. This requirement is proposed in recognition of the fact that the potential for abuse in this area is higher where, as would usually be the case, the business development company's holdings have no ready market.

III. POSSIBLE PROPOSED RULE UNDER THE INVESTMENT COMPANY ACT OF 1940

The Commission currently is considering the possibility of issuing a proposed rule to provide exemptive relief for business development companies under the Investment Company Act. The Commission anticipates that any such proposed rule will be consistent with, and largely similar to, such rule as the Commission might ultimately adopt as a result of the present rule proposal under the Advisers Act.

AUTHORITY:

The rule proposed herein would be adopted pursuant to the authority contained in Sections 206A [15 U.S.C. 80b-6a] and 211(a) [15 U.S.C. 80b-11(a)] of the Advisers Act.

COMMISSION ACTION:

It is proposed to amend Part 275 of Chapter II of Title 17 of the Code of Federal Regulations under the Investment Advisers Act of 1940 by adding new §275.205-3 as follows:

§275.205-3 Exemption from the compensation prohibitions of Section 205(a) for registered investment advisers to business development companies.

(a) *General.* The provisions of Section 205(i) of the Act shall not prohibit any registered investment adviser from entering into, extending, renewing or performing an investment advisory contract which provides for compensation to the investment adviser on the basis of a share of net capital gains upon, or net capital appreciation of, the funds, or any portion of the funds, of a business development company if all of the conditions set forth in this section are satisfied.

(b) *Business development company.* For purposes of this section, "business development company" shall mean any company which

(1) is formed and operated primarily for the purpose of directly acquiring, in transactions eligible for the

exemption from registration provided by Section 4(2) of the Securities Act of 1933, securities issued by eligible portfolio companies;

(2) except as provided in paragraph (e) of this section, has all of its assets invested in securities acquired directly from and issued by eligible portfolio companies;

(3) beneficially owns at least five percent of all the voting securities (including securities immediately convertible without restriction into voting securities at the option of, and without the payment of any additional consideration by, the holder thereof) of each eligible portfolio company in which it has an investment: Provided however, That the foregoing condition shall be deemed to be satisfied if the business development company's failure to own at least five percent of such securities results solely from the issuance of additional voting securities by the eligible portfolio company subsequent to the initial investment therein by the business development company;

(4) has issued all of its outstanding securities (other than those issued to its officers, directors or employees pursuant to a profit-sharing, stock option or stock purchase plan)

(i) in transactions not involving any public offering of securities;

(ii) in transactions wherein the business development company, and any person acting on its behalf, shall have reasonable grounds to believe and shall believe, immediately prior to making any sale of securities of the business development company, after making reasonable inquiry, either (A) that the purchaser has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment in the business development company, or (B) that the purchaser and the purchaser's representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment in the business development company and that the purchaser is able to bear the economic risk of the investment;

(iii) to persons each of whom, prior to the sale of any securities of the business development company to such persons, have access to, or are furnished with, all material information reasonably necessary under the circumstances to enable such persons to make an informed decision as to an investment in the business development company; and

(iv) to persons, other than the investment adviser and persons associated with the investment adviser, each of whom purchases, or agrees in writing to purchase, securities of the business development company in a unit or units of at least \$150,000 which may not be fractionalized or otherwise divided, except as provided in paragraph (f) of this section, and which may not be sold, transferred or otherwise disposed of, by the purchaser in a transaction or transactions involving a public offering of securities, and such persons pay for such securities in cash, or other tangible property, in a single payment of, or in installment payments in the aggregate amount of, \$150,000 or more (all deferred and installment payments to be due within 12 months from the date of purchase of the securities and evidenced and secured by a full recourse note or notes of the purchaser); and

(5) is not required to be registered as an investment company under the Investment Company Act of 1940.

(c) Eligible portfolio company. For the purposes of this section, an "eligible portfolio company" shall mean any company which

(i) at the time of the initial investment therein by a business development company

(i) did not have an average annual net income, after Federal income taxes, for the immediately preceding two fiscal years in excess of \$400,000 (average annual net income to be computed without the benefit of any loss carryover);

(ii) is not making and has not made a public offering of its securities;

(iii) is not subject to the reporting requirements of Section 13 of the Securities Exchange Act of 1934; and

(iv) is not an investment company as defined in Section 3 of the Investment Company Act of 1940, provided that the sole basis therefor is not the exclusion set forth in Section 3(c)(1) of such Act.

(2) at the time of each additional investment therein by the business development company

(i) satisfies all of the conditions described in paragraphs (c)(1)(ii), (iii) and (iv) above, and

(ii) has not previously issued to the business development company any securities which have been sold, transferred, or otherwise disposed of, by such company, except for securities converted into, or exchanged for, other securities of the eligible portfolio company.

(d) Additional conditions. The exemptive relief provided in paragraph (a) of this section shall not be available unless all of the following conditions are satisfied:

(1) the investment adviser, and persons associated with the investment adviser, shall at all times beneficially own, by reason of having purchased for cash or other tangible property (which shall have been received by the business development company), securities (other than senior securities as defined in Section 18(g) of the Investment Company Act of 1940) of such business development company (i) in a unit or units of at least \$150,000 which may not be fractionalized or otherwise divided, except as provided in paragraph (f) of this section, and which may not be sold, transferred, or otherwise disposed of, by the investment adviser, or persons associated with the investment adviser, in a transaction or transactions involving a public offering of securities and (ii) in an amount not less than the greater of: (A) one percent of the aggregate amount of the cash and other tangible property invested (or agreed to be invested) in the business development company by all other persons who have purchased (or have agreed in writing to purchase) securities of such business development company; or (B) \$150,000;

(2) any computation of net capital gains or net capital appreciation for purposes of determining compensation of a type described in paragraph (a) of this section shall be made net of all realized capital losses and unrealized capital losses (capital depreciation) of the business development company during the period for which the computation is made; and

(3) any compensation paid pursuant to paragraph (a) of this section shall be based on a written valuation of the business development company's assets which is prepared or reviewed by a qualified independent appraiser (i) who is not (A) a person associated with the investment adviser or (B) a person otherwise providing services to the investment adviser, pursuant to any agreement or understanding, and (ii) who certifies in writing to the business development company that the valuation is fair and reasonable.

(e) Permissible interim investments. Notwithstanding any other provision of this section, a business development company may hold assets in the form of (1) cash or money-market instruments maturing in one year or less from the time of investment or (2) securities received by the business development company in exchange for securities of eligible portfolio companies, provided that such business development company intends, and

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reasonably anticipates, to invest or reinvest such assets in securities of eligible portfolio companies.

(f) Fractionalization of units. Notwithstanding any other provision of this section, units issued by a business development company may be fractionalized or otherwise divided by such company provided (1) that such fractionalization or division is approved by the vote of a majority of the outstanding securities of such company entitled to

vote thereon and (2) that, immediately following such fractionalization or division, each outstanding unit of the business development company has a net asset value of at least \$150,000.

By the Commission.

June 19, 1979.

George A. Fitzsimmons
Secretary.

-- End of Section F --

NATIONAL VENTURE CAPITAL ASSOCIATION
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August 20, 1979

Mr. George A. Fitzsimmons
Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Re: Proposed Rule 275.205-3
(File No. S7-788)

Dear Mr. Fitzsimmons:

This letter of comment (in triplicate) is being submitted to the Commission by the National Venture Capital Association in response to the invitation contained in Release No. IA-680 (File No. S7-788) proposing a new Rule 205-3 (the "proposed Rule") under the Investment Advisers Act of 1940 ("Advisers Act") relating to performance-based compensation of registered investment advisers to "business development companies." We appreciate the opportunity to submit our comments relating to the proposed Rule prior to its adoption.

The National Venture Capital Association is an association of approximately 76 venture capital companies which have total combined assets in excess of 1.5 billion dollars, and its membership includes most of the leading venture capital companies in the United States. A venture capital company is basically an investment vehicle which specializes in investing in corporations attempting to exploit a new product or technology, whether as a start-up operation or as an expansion of an existing business. For tax reasons, most of such venture capital companies are organized as limited partnerships. Since the nature of its investments involve a relatively high risk-return ratio,

and because a public offering of its securities would eliminate the exemption from the Investment Company Act of 1940 (the "1940 Act") under Section 3(c)(1) of that Act, the securities of a venture capital company are generally sold only to highly sophisticated investors in private offerings exempted from the Securities Act of 1933 (the "1933 Act").

This Association proposed to the Commission by Memorandum dated March 13, 1979, a solution to the basic problem to which the proposed Rule is addressed (see discussion under I. below). In order to avoid repeating all of the matters set forth in that proposal, we are attaching hereto as Annex I a copy of the March 13, 1979 Memorandum. That proposal would accomplish the stated desire of the Commission to facilitate the "flow of needed capital into new and developing companies." While we have set forth below our comments on the detailed provisions of the proposed Rule, we have not suggested any detailed amendments. We believe that we have already suggested the proper course of action in the attached Memorandum of March 13, 1979.

I. General Comments

The Commission in the above-referenced Release has coined a new phrase - "business development company" - to describe the entities which are encompassed by the proposed Rule. It may be appropriate to use a new name in the proposed Rule, since it would restrict the activities of venture capital companies to which it might apply to the point where they might very well either go out of existence or become a different type of enterprise. An informal survey of six representative venture capital companies indicates that, if the restrictions and prohibitions contained in the proposed Rule had been applicable to them in the past, they would have prevented 62% to 80% of the actual.

investments of such companies in terms of numbers and 45% to 81% in terms of dollar amount. In the aggregate for all six companies, 74% of all investments in terms of numbers, representing 63% of the dollar amount, would not have qualified as permissible investments under the proposed Rule.

In these comments, we have avoided the use of the new phrase "business development company," since we would like to direct our comments to venture capital companies as they presently exist.

The purpose of the proposed Rule is stated to be that "the Commission believes that the proposed rule will have the effect of facilitating the flow of needed capital into new and developing companies which are frequently unable to obtain financing from sources other than business development companies." In our view this perception is erroneous. We believe that the proposed Rule will impede or prevent the formation of new venture capital companies and will, in fact, hinder, rather than facilitate, the flow of needed capital into new and developing companies.

It is highly important to recall the legal issue which gave rise to consideration of the proposed Rule, but which the proposed Rule ignores. The exemption from registration under the Advisers Act for an investment adviser with fewer than 15 advisory clients has been considered by the leading firms in the Securities Bar to be applicable to a general partner of a venture capital company formed as a limited partnership, even though it has more than 14 limited partners, since the general partner (to the extent that he may be considered to be giving investment advice) has only one client, the partnership entity. He does not render advice to each of the limited partners.

Therefore, none of such general partners of venture capital companies have (prior to last year) registered as investment advisers. Such registration, among

other things, would make applicable the prohibition contained in Section 205(1) of the Advisers Act against sharing in the capital gains of the fund. Nevertheless, because of past vacillation on this issue by the Staff of the Commission, most of such companies have restricted the number of limited partner investors to 14. Others did not, in reliance upon the advice of eminent counsel that the requirement of registration in this situation was not determined by the number of limited partners.

This tendency to restrict the number of limited partners to 14 or less in the formation of new venture capital companies has been accentuated in the past two years because of an ill-considered dictum, subsequently withdrawn, in the case of Abrahamson v. Fleschner.^{1/} The court initially stated that (in the case of the particular hedge fund partnership before the court in that case) each limited partner would be a separate advisory client. In addition, as indicated in the above-referenced Release, two advisers of venture capital companies have obtained exemptive orders from the Commission exempting the advisers of those funds from the restrictions of Section 205(1).

The result of this situation has been to impede the flow of needed capital into new and developing companies, since many persons contemplating forming a new venture capital company have either refrained from doing so entirely or limited the number of investors to 14 or less (which obviously restricts the amount of capital which can be raised). Also, the general partners of existing venture capital companies, even if they have less than 15 limited partners, have been deterred from forming a new company with other investors. Counting each of the limited partners in two funds as advisees might require registration under the Advisers Act if the aggregate number exceeded 14, even

^{1/} 568 F.2d 862 (2d Cir. 1977), cert. denied, 436 U.S. 913 (1978).

though each fund was limited to 14 or fewer limited partners. This latter factor is the most important, since it means that the managers of a venture capital fund, no matter how successful, may be precluded from expanding their business.

This question regarding the legal interpretation of the Advisers Act is the fundamental issue, but it has been ignored by the Staff in Release No. IA-680, except in a footnote where it is stated that "the Commission is not herein suggesting a position" on that issue. This will of course have the effect of engendering further concern among persons who might otherwise form venture capital companies and certainly deter some of them from doing so. Instead of addressing this question, the proposed Rule attempts to impose restrictions upon venture capital companies somewhat resembling those applicable to Small Business Investment Companies, but with additional restrictions not applicable to SBICs and without the advantage of the government financing available for SBICs.

The fundamental defect of the proposed Rule is that it would to a large extent substitute the requirements of the proposed Rule as to what venture capitalists are permitted to invest in for the business judgment of the venture capitalists, and embark the Commission upon a course of capital allocation, for which it has no statutory authority.

II. Possible Effect of the Commission's Action on State Regulation

A collateral consideration of importance to venture capital companies is the possible effect which a public expression of the Commission's doubt as to whether general partners of venture capital companies must register under the Advisers Act may have on the application of the

investment advisory statutes of the various states. There are 34 states which also require registration of investment advisers. Of these, 24 have the same prohibition which is contained in Section 205 of the Advisers Act against the investment adviser receiving a share of the capital gains or capital appreciation of the funds or any portion of the funds of his clients.

Most of these states grant an exemption for advisers who only advise certain specified types of institutional investors and a maximum number (usually 5) of other clients in the state. There are, however, eight states^{2/} which have no exemption for any maximum number of non-institutional clients and four states^{3/} which have no exemption based either on type or number of clients. Therefore, if any one investor in a venture capital company is located in any of the last four states, or if any one investor not meeting the definition of institutional investor is located in any of the first eight states, a separate application for exemption might have to be made to the state administrator, if it is considered that the general partner is advising each of the limited partners. That application might or might not be granted and might or might not be subject to additional restrictions other than those imposed by the Commission. If more than five (or other number specified in a particular state) of the investors (not meeting the definition of institutional investor) were located in any other state of the 34 requiring registration, then a separate application for exemption or a separate registration might have to be filed in that state.

If the Commission were to take the lead in resolving the fundamental issue by a rule or release to the

^{2/} Delaware, Indiana, Louisiana, Minnesota, Montana, North Dakota, Oregon and Wisconsin.

^{3/} Illinois, Nevada, Tennessee and Virginia.

effect that the general partners of a venture capital company are not considered to be investment advisers to each of the limited partners, this would probably also resolve the issue on the state level. By avoiding this issue and publicly expressing doubt concerning it, the Commission will predictably cause similar problems at the state level.

It may legitimately be asked what abuse or impropriety the Commission has identified in connection with the past operation of venture capital companies that it hopes to remedy by subjecting such companies to additional regulation. None is identified in the above-referenced Release.

III. Discussion of the Detailed Provisions of the Proposed Rule 205-3

Preliminary Statement.

As a preliminary comment to the detailed provisions of the proposed Rule, it is noted that such provisions impose a large number of complex prohibitions and restrictions on the investment policies of venture capital companies, and the proposed Rule mandates 100% compliance, with absolutely no room for error. As bad as these restrictions may be as a substantive matter, they become worse when the application of the proposed Rule is considered. The purpose of the proposed Rule is to exempt certain compensation arrangements of the managers of venture capital companies who register and comply with its terms. However, several of the restrictions, as discussed below, relate to things not within their control, even in a theoretical sense, since they are things done by the portfolio companies. Why should the compensation of these managers be forfeited because someone mistakenly does something prohibited by these sweeping restrictions? If someone attacks the managers'

right to compensation, will they have to prove a half-a-dozen to a dozen negatives (that none of these things has ever happened), in accordance with the general rule that a person must prove his entitlement to an exemption?

Subsection (b)(1).

This paragraph requires, as one of the elements of the definition of "business development company", that the company be "formed and operated primarily for the purpose of directly acquiring, in transactions eligible for the exemption from registration provided by Section 4(2) of the Securities Act of 1933, securities issued by eligible portfolio companies." There is no doubt that all venture capital companies are formed primarily for the purpose of making investments which are issued by the portfolio companies pursuant to private offerings exempt from the 1933 Act, and of course they are operated for the same purpose so long as investments are being made. Therefore, on the face of the text of this portion of the proposed Rule, venture capital companies would not have any problem complying with it (except for the concept of "eligible portfolio companies", which is discussed below).

However, the Release accompanying the proposed Rule makes the suggestion that if most or all the stocks of the portfolio companies became publicly traded, by continuing to hold them a venture capital company would no longer be "operated" "primarily" for the purpose specified in this paragraph. No explanation is given as to why it is considered inappropriate for venture capital companies to own securities of a class which are publicly traded or what public interest is intended to be served by this interpretation.

The result of this interpretation, of course, would be that a venture capital company would then no longer be a defined "business development company" and the "performance" of its contract to pay compensation to the

investment adviser on the basis of capital gains would retroactively become illegal. The investment adviser would then receive nothing because he had been so successful that all of the companies selected for investment were able to make public offerings. We suggest that this interpretation was given inadequate thought.

The Release also suggests that perhaps even the "primarily" standard, as so interpreted, is not sufficiently restrictive and invites comment on other restrictions which might also be imposed on the business judgment of venture capital companies.

The Release states that the proposed Rule "would not specifically prohibit" the business development company from continuing to hold an investment in a single portfolio company if its stock became publicly traded after the venture capital company made its investment. The suggestion is made, however, that perhaps the proposed Rule ought to be changed to force venture capital companies to dispose of such an investment within a period of time, such as 10 years. The Release again does not indicate why there is anything wrong with holding an investment for more than 10 years or what public interest would be furthered by such a requirement.

The discussion in the Release of subsection (b)(1) of the proposed Rule typifies the approach of the entire Release that venture capital companies should be prohibited from doing all kinds of things which they have done in the past. How this would serve the public interest or protect investors is not discussed.

Subsection (b)(2) and Subsection (c).

Subsection (b)(2) requires that all investments must be acquired directly from the issuer of the securities. This would absolutely prohibit any secondary purchases of securities. Such purchases by venture capital companies are

very common, either in connection with a financing of the issuer or independently thereof. Moreover, this provision might arguably be interpreted to prohibit any leveraged buy-outs (i.e., financing a newly-organized corporation to enable it to purchase the outstanding stock of an existing company), which are also a very common form of venture capital investment.

Subsection (b)(2) also requires that all assets of the venture capital company be invested in "eligible portfolio companies" (except for temporary investments held in cash or money-market instruments as permitted by subsection (e)). On its face, this requirement would prohibit a venture capital company from owning any office furniture or equipment. This is merely one example of the total lack of any leeway permitted by many provisions of the proposed Rule.

In combination, these two provisions (subsections (b)(2) and (c)) mandate that, in order to be considered a "business development company" entitled to the benefits of the proposed Rule, a venture capital company must have all of its assets invested in so-called "eligible portfolio companies" as defined in subsection (c). This concept of an eligible portfolio company contains several elements, for none of which is there offered any justification and all of which exhibit a lack of understanding of the manner in which venture capital companies are operated. These elements are as follows:

1. The portfolio company must not have had an average annual net income after taxes for the immediately preceding two fiscal years in excess of \$400,000 (to be computed without the benefit of any loss carry-over). The Release suggests that the Commission is considering adding to this restriction other standards applicable to investments by SBICs, such as requirements that the portfolio company not have assets exceeding \$9,000,000 or a net worth

exceeding \$4,000,000.^{4/} If the organizers of venture capital funds had been able to achieve their investment objectives by forming an SBIC, that is what they would have done in the first place and venture capital funds would not exist.

In any event, we believe that the size of a company which a venture capital company invests in has nothing to do with the purposes of the Advisers Act.

2. It is required that the eligible portfolio company must be a company which is not making "and has not made a public offering of its securities." This requirement would disqualify a substantial percentage of the investments historically made by venture capital companies through the requirement that the company never have made a public offering of its securities. Whether or not the company has ever made a public offering has nothing to do with its present needs for capital or the opportunities which may be presented to it to develop a new product or technology.

Furthermore, even though a potential investment involved a company which no one would think of as a "public company", unless there are not more than one or two shareholders it would probably not be possible for the venture capital company to obtain an opinion of counsel that the company has never made a "public offering," given the highly nebulous state of the law on that subject. For example, if a family corporation had over the years acquired 15 to 25 shareholders, it is highly unlikely that any competent securities lawyer would be willing to give an opinion that it had never made a public offering.

^{4/} It is worthy of note that these requirements may soon become obsolete even as to SBICs, since the SBA is considering modifying them, and that they ignore the alternative test of number of employees applicable to a permissible investment by an SBIC.

This requirement again attaches a doomsday machine to the managers' arrangement for compensation, since a determination that on one occasion the venture capital company had invested in a company, which 10 years before had made an offering to three or four people that was a "public offering",^{5/} would retroactively deprive the managers of any right to compensation.

3. In order to be an eligible portfolio company, the company must not be subject to the reporting requirements of Section 13 of the Securities Exchange Act of 1934 (we assume this is intended to mean only Section 13(a) of the 1934 Act, since everyone is subject to the reporting requirements of Section 13(d) and Section 13(g) of the 1934 Act). This requirement would mean that a portfolio company must not at any time have had 500 or more shareholders (unless it now has less than 300 shareholders and has deregistered).

The requirement that none of the portfolio companies be a reporting company would eliminate a significant portion of the investments which have been made by venture capital companies. Even SBICs, which seem to have been the model employed by the Staff in formulating the proposed Rule, are not restricted in the purchase of securities of reporting companies, nor are they required to sell their holdings within some arbitrary period of time. We believe that this condition would be unacceptable to many persons contemplating the formation of a venture capital company.

4. In order to be an eligible portfolio company, the company must not be an investment company as defined in the 1940 Act whether or not required to be registered and whether or not excluded from the definition of "investment company" by Section 3(c)(1) of that Act. This condition would preclude a venture capital company from owning an

^{5/} Cf. Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978).

SBIC, which many of them do, and from investing as a participant in another venture capital company. No reason for these prohibitions is stated.

5. In addition, subsection (c)(2) requires that an eligible portfolio company meet all of the foregoing requirements (except the average annual net income requirement) at the time of any additional investment therein by the venture capital company and that the venture capital company not have transferred any of the securities previously acquired from that company. The foregoing comments regarding the initial requirements are equally applicable to the same requirements at the time of an additional investment. These requirements are, however, even more inappropriate in the latter context since they will have the effect of penalizing success. In other words, if the portfolio company has been successful and has made a public offering which made it a reporting company, the venture capital company is precluded from making any additional investment in it. How this will "facilitate the flow of needed capital" is not apparent.

It is entirely possible that additional capital may be needed to realize upon or preserve the values created by the initial investment, and its best or only source may be the venture capital companies which made the initial investment. A governmental prohibition against doing that may only result in an unwillingness of an intelligent investor to enter the venture capital business.

As to the requirement that the venture capital company not have transferred any of the securities previously acquired before it makes an additional investment, the purpose of this provision is stated to be to assure that "the business development company had maintained a continuous investment in the eligible portfolio company." Why or how the maintenance of such a continuous investment furthers the purposes of either the Advisers Act or of the proposed Rule or facilitates the flow of capital, however, is not explained. We do not understand why a venture capital company should be

prohibited from making another investment in a portfolio company because it had made a previous investment and sold it, much less why it should be prohibited from doing so because, for whatever reason, it had transferred a small portion of the securities previously acquired.

This prohibition would even apply if preferred stock of the portfolio company held by the venture capital company had been redeemed or the debt securities held by it had been paid, since it refers to a sale, transfer, or "other disposition." If there is something wrong about a venture capital company selling or voluntarily transferring some of the securities it first acquired, which is not apparent or explained, we do not understand why an involuntary redemption or payment should forever preclude further investment.

There can be little doubt that the imposition of the requirements discussed in the preceding paragraphs 1 through 5 upon venture capital companies would discourage the formation of such companies. Any such restrictions on the investment opportunities available to venture capital companies would cause many investors to lose interest in investing any more funds in such a pooled enterprise, since they can invest their own funds directly (although probably at greater cost and perhaps without as great success) without any governmental dictation as to what they should invest in.

Subsection (b)(3).

This paragraph requires that the venture capital company own at least 5% of the voting securities of every company in which it invests. Securities immediately convertible into voting securities are included (presumably on the basis of assuming full conversion of all outstanding convertibles), but securities underlying warrants are not included. This would preclude the investment in any company by a venture capital company through the use of straight debt plus warrants. We would assume that this was not intended.

This requirement discriminates, without reason, against smaller venture capital companies which participate with other investors (principally other venture capital companies) in financings, and some of which almost never get more than 5% of the voting stock of the issuer as their share. Even as to the larger companies, many financings are arranged where the share of each venture capital company participating in the financing is less than 5%.

This requirement would also prohibit a venture capital company from making a loan to a potential investee to save it from bankruptcy while the deal regarding the permanent investment is being negotiated (a so-called "bridge loan"). This sort of arrangement is in fact quite common in connection with venture capital investments and is obviously in the interest of the business seeking capital and in the interest of the investor.

Subsection (b)(4).

This provision in subparagraphs (i), (ii), (iii) and (iv) incorporates a miniature Rule 146 with respect to transactions in connection with the issuance of the securities of the venture capital company, without the limitation of Rule 146 on the number of purchasers (presumably because the minimum investment of \$150,000 required by subparagraph (iv) would cause the purchaser not to be counted under Rule 146). Almost all venture capital companies have issued their securities in private offering transactions, since making a public offering would deny to the venture capital company the exemption from registration under the 1940 Act contained in Section 3(c)(1) of that Act.

However, the incorporation of this requirement in the proposed Rule means that the one-year statute of limitations specified by Congress for someone to challenge the validity of a claimed private offering exemption has been extended to the entire life of the enterprise. Under this provision any investor in a venture capital company

could claim 10 or 15 years after the securities were sold that the initial sale of securities did not meet all of the requirements of Rule 146 or Section 4(2) of the 1933 Act and, if the court agreed with him, could deny the managers any compensation for their efforts over the past 10 or 15 years.

Clause (iv) of this subsection requires that the sales of securities of a venture capital company be made in units of at least \$150,000, that the securities may not be sold by the purchaser "in a transaction or transactions involving a public offering of securities" and that the securities be paid for by the purchaser in a single payment or in installments all of which are due within 12 months from the date of purchase. The requirement that the units be sold in minimum amounts of \$150,000 probably does not present any practical problem, although it serves no useful purpose if the investor qualifies under Rule 146, nor does the prohibition of a public offering by the purchaser, since the venture capital company would not want to give any single investor the power to destroy the Section 3(c)(1) exemption from registration under the 1940 Act (although why the Commission should be interested in prohibiting a subsequent registered offering, and the consequent registration of the company under the 1940 Act is not apparent).

The requirement that all installment payments be made within 12 months of the initial purchase would preclude a venture capital company from structuring its receipt of the consideration for its securities over a longer period of time to correspond with its anticipated investment schedule, for no apparent reason. It is very common for venture capital funds to be organized with staged financing over two or three years, in order to avoid sterilizing the money of the investors over that period of time. It does not "protect investors" to mandate that it be so sterilized.

Subsection (d)(1).

This provision requires that the investment adviser and persons associated with the investment adviser

make cash purchases of securities of the venture capital company equal to the greater of \$150,000 or 1% of the total investment in the venture capital company by all other investors. The proffered reason for this requirement is that it "is intended to help ensure that the investment adviser has a sufficient amount of money invested in the business development company so as to reduce the likelihood of the adviser taking undue risks with the funds of the business development company." The general partners of a venture capital company already have a powerful incentive to try to make the enterprise succeed, since their compensation is based largely upon the achievement of that success. The investment strategy is known to and approved by the investors in the venture capital company, who are highly sophisticated. If they desire that the general partners also make a cash investment in the enterprise, they can and will insist upon that at the time of the formation of the venture capital company. To mandate that the investment adviser make such a minimum investment is wholly unnecessary to achieve the stated purpose. There is no such government-imposed requirement on the managers of industrial companies or even the managers of other types of investment companies. Furthermore, there are many instances where highly competent managers who have worked for banks, insurance companies or 1940 Act investment companies may not have been able to accumulate a sufficient estate to make that kind of investment at the time they go into venture capital management.

Subsection (d)(2).

This subsection requires that, in calculating the compensation of the investment adviser of a venture capital company, all unrealized capital losses be taken into account whether or not unrealized capital gains are included. Since it would obviously be unfair to include in the computation unrealized capital losses without including unrealized capital gains, what this provision as a practical matter does is to mandate that such compensation arrangements include all gains and losses, realized or unrealized. This

in turn would require a valuation of all securities in the portfolio not yet sold, which in many cases would be highly speculative. Paragraph (3) of the same subsection provides that such valuation must be prepared or reviewed by a "qualified independent appraiser." While it would doubtless be possible to obtain such an appraisal, since appraisers will purport to appraise anything, it is highly questionable in our view to mandate that the adviser's compensation be based upon such an exercise.

The provisions discussed under the last three headings would substitute the judgment of the Commission as to desirable protections for the judgment of the highly sophisticated investors who participate in venture capital funds. The concept that some of the largest financial institutions in the country and the members of some of the richest families in the country need the protection of the Commission is really not defensible.

IV. Summary

Proposed Rule 205-3 would not achieve in any degree its stated purpose of "facilitating the flow of needed capital into new and developing companies" but would have exactly the opposite effect. We think it is safe to predict that no managers of any venture capital companies would voluntarily register under the Advisers Act and subject themselves to these restrictions. Therefore, the Rule would be a completely dead letter and the only effect of its issuance would be that venture capital companies would be prejudiced by the public expression of doubt by the Commission as to whether their managers are required to register as investment advisers if the fund has more than 14 limited partners. As a result, future venture capital funds may be limited to less than 15 limited partners and therefore may not be as large as they otherwise could be in

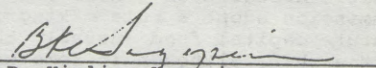
terms of assets and the formation of subsequent funds by the managers of an existing venture capital company may be prevented.

We again urge the Commission to face the fundamental issue that has given rise to the proposed Rule and adopt a rule providing that the managers of a venture capital fund are advising only one client so far as any single fund is concerned. As suggested in our Memorandum dated March 13, 1979, the definition of an entity to be covered by the rule should contain only the elements that it be organized for a minimum period of time, such as 5 years, that there be no individual right of withdrawal during that term, that it not engage or intend to engage in any continuous or periodic offering of its own securities, and that it not have more than 100 investors.

Respectfully submitted,

NATIONAL VENTURE CAPITAL ASSOCIATION

By


B. Kipling Hagopian

cc: Commissioners,
Securities and Exchange Commission

M E M O R A N D U M

TO: The Securities and Exchange Commission

FROM: The National Venture Capital Association

DATE: March 13, 1979

RE: Proposed Rule to Exempt the Managers of
Venture Capital Funds From the Investment
Advisers Act of 1940.

This memorandum is submitted to the Securities and Exchange Commission ("Commission") by the National Venture Capital Association ("NVCA") in support of a proposal that the Commission adopt a rule making it clear that the managers of a venture capital fund (usually the general partners of a limited partnership, although in some cases the board of directors and officers of a corporation) are exempt from any requirement to register as investment advisers to the fund or to its owners under the Investment Advisers Act of 1940 ("Advisers Act"). The NVCA is an association comprised of 76 venture capital organizations whose combined assets exceed 1.5 billion dollars. The NVCA membership includes virtually all of the leading venture capital organizations in the United States.

1. Statement of the Problem.

The problem to which this memorandum is addressed was created essentially by the decision of the Court of Appeals for the Second Circuit in the case of Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir.1977), cert. denied, 436 U.S. 913 (1978), and the sweeping nature of certain statements contained in the initial opinion in that case. One such statement indicated that the general partners of a partnership operating an investment fund, of a type commonly known as a "hedge fund", were investment advisers and that the general partners were advisers, not to the partnership, but to all of the limited partners in the fund. The significance of this latter statement is that the general partners could not claim the exemption in Section 203 (b) (3) of the Advisers Act for an adviser who has fewer

than 15 advisory clients. While the court, on rehearing, modified its opinion to remove the express statement that the general partners would be viewed as advising each of the limited partners, the court did not specifically repudiate its previous suggestion that this might be true.

Abrahamson was the first case to suggest that the general partners of a limited partnership might be required to register under the Advisers Act since they were viewed as giving investment advice to the limited partners. No such general partners have ever registered under the Advisers Act (for that reason alone) and the Commission in the 39 years of the Act's existence has never taken action to compel any of them to register. Presently, the position of the Staff of the Commission is that it will give no advice as to whether or not the managers of a venture capital fund must register under the Advisers Act.

The Abrahamson case, together with the Staff's position, has created an intolerable dilemma for venture capital funds and their managers which, if not satisfactorily resolved, will restrict the flow of capital to such funds. Over and above the costly regulatory burdens imposed by the Act, at least one of its provisions (Section 205(l) which prohibits compensation to the managers based on a sharing of capital gains or capital appreciation) is wholly incompatible with the basic method of operation of venture capital funds. Profit sharing arrangements are universal in the industry, and prohibition of such arrangements, while serving no useful purpose, would deter the most qualified venture capital managers from starting new funds.

The best legal advice which we can obtain is to the effect that the holding of the Abrahamson case, even if correct on the facts relating to the particular fund involved in that case, does not apply to the completely dissimilar operations of a venture capital fund. All of the major law firms with whom we have consulted have taken the position that the managers of venture capital funds are exempt from such registration. These law firms, however, are understandably reluctant or unwilling to give unqualified opinions to this effect while the Abrahamson case (even as modified) stands as the only authority on the issue.

The Staff has heretofore addressed this problem by inviting venture capital funds to register under the Act and apply for an exemption from Section 205(l). We understand

that the Staff is now considering a proposed Rule which would obviate the need for a specific exemption from this provision in each individual case. For the reasons pointed out below, however, it is our view that this proposed partial exemption is wholly inadequate to solve the basic problem and would not be in the public interest.

2. Nature of a Venture Capital Fund.

In order to understand the reasons why the statements of the court in the Abrahamson case do not apply to a venture capital fund, even if correct on the facts of that case, it is necessary to refer to the basic characteristics of such a fund, which differ in all respects from those of the fund involved in that case.

A venture capital fund is an enterprise administered by its manager without direct consultation with its individual partners or stockholders. This type of organization contrasts sharply with the separate advisory relationship which exists between an adviser and each of his clients. As the name suggests, venture capital funds invest primarily in companies attempting to exploit a new product or technology, whether as a start-up operation or as an expansion of an existing business. The management of a venture capital fund not only make judgments as to the prospects of each particular investment at the time it is made, but are also intimately involved in the affairs of the portfolio company (usually assuming a board seat) in an attempt to assist it in realizing its potential. These latter activities of the managers of a venture capital fund differ little from the activities of an officer of a holding company in monitoring the affairs of a subsidiary, although the latter has more authority to enforce his recommendations.

A venture capital fund is typically organized for a duration of 7 to 15 years. There is no individual right of withdrawal on the part of any of the investors during that term. While it may be possible for the investors to dissolve the fund during that period by a majority or super-majority vote (although in some cases they have no such right), this differs in no respect from the right of the shareholders of a corporation to dissolve it by a specified vote, if they do not wish to continue the enterprise.

A venture capital fund makes an offering upon its organization which is typically the only sale of its securities that is made by the fund at any time during its existence.

While it may be legally possible to have such a subsequent offering by the fund, the problem of valuation of its "unmatured" investments is so great that, as a practical matter, this is almost never done.

No venture capital fund makes a public offering of its securities, since this would eliminate the exemption from the Investment Company Act of 1940 under Section 3(c)(1) of that Act. Other than the private placement offering circular distributed at the time of the fund's formation, which does nothing more than describe the experience and qualifications of the managers and their proposed investment plan, no communications are sent to the limited partners or other persons for the purpose of providing a basis for a decision by them to withdraw, maintain or increase their investment.

The investors in a venture capital fund are always composed primarily of institutional investors, such as pension funds and family trusts or corporations with very large amounts of money to invest, although occasionally a very wealthy individual may be an investor. These persons are invariably advised by their own lawyers, accountants and investment experts at that stage.

If the nature of a typical venture capital fund as outlined above is compared with that of the fund involved in the Abrahamson case, it will be seen that it is exactly opposite in all of these respects. In that "hedge fund" the investors had a right of withdrawal at the end of each year and the fund was continuously soliciting new investors; it was periodically sending to its investors a description of its portfolio and its investment strategy, which should have been sufficiently accurate, as the court held, to permit the investors to make an informed judgment as to whether they should exercise their right of withdrawal; the investors consisted simply of those persons, whoever they might be, with sufficient money and a sufficient desire to speculate in the stock market; and the activities of the managers consisted solely of determining when to buy and when to sell securities widely traded in the public market (or restricted securities of a class which was widely traded in the public market).

3. Reasons Why the Managers of a Venture Capital Fund Should Be Exempted from the Advisers Act.

There are four reasons why the managers of a venture

capital fund should be exempted from any requirement of registration under the Advisers Act:

- (i) They do not give investment advice;
- (ii) There has been no indication that such regulation of venture capital fund managers is necessary to achieve any purpose of the Advisers Act;
- (iii) If there are any benefits in subjecting venture capital fund managers to Advisers Act regulation (which are not apparent), they cannot justify the cost and other burdens of that regulation; and
- (iv) Exemption from registration will remove an impediment to the flow of capital to venture capital funds which in turn will increase the availability of capital for new and developing businesses.

a. Venture Capital Fund Managers
Do Not Give Investment Advice.

There is nothing in the Advisers Act or its legislative history which indicates that this statute was intended to encompass the activities of a venture capital fund manager. In fact, to require such registration would be to repudiate almost 40 years of Commission interpretation and of understanding by the legal community.

The manager of a venture capital fund makes investment decisions and otherwise manages the operations of the fund without consultation with the individual partners or stockholders of the fund. While venture capital fund managers do report to investors periodically about the fund's investments and operations, these communications deal for the most part with securities that cannot be purchased by fund investors.

It is clear from the legislative history of the Advisers Act and the enforcement policy of the Commission that the scope of this Act was not intended to apply to the internal management of an enterprise. For example, portfolio managers and investment officers of financial institutions, who are responsible for the management of billions of dollars of securities portfolios, are not viewed as investment advisers within the meaning of the Advisers Act and do not register as such. The internal management of registered, closed-end

management investment companies do not register as investment advisers. This is particularly significant since Section 203(b)(3) of the Advisers Act provides that any investment adviser who advises a single investment company registered under the Investment Company Act of 1940 must register as an investment adviser. In other words, the fewer than 15 clients exemption from registration has no application if there is a single advisory client that is a registered investment company. Thus, the Commission and the Staff must view the activities of the internal management of a closed-end management investment company as not involving any investment advisory services.

After a venture capital fund is organized and the capital has been raised, no individual investor makes any further investment decision with respect to the fund. The fund is an enterprise separate and apart from the individual investors, usually with a term of existence from 7 to 15 years. Communications from the manager to the investors, therefore, do not in any sense involve "investment advice".

For the reasons given above, it is clear that no advisory relationship exists between a venture capital fund manager and the investors in that fund. Also, it is clear that, if the manager is considered to be giving "investment advice", the recipient of that advice is the fund rather than the investors. Accordingly, the venture capital fund manager should be exempt from registration by reason of Section 203(b), even if he is regarded as an investment adviser, since he has only one client.

- b. Subjecting Venture Capital Fund Managers to the Advisers Act is Unnecessary for the Protection of Investors.

Managers of venture capital funds have in general conducted their operations in an ethical, legitimate manner. They have not been shown to be engaged, or even alleged to be engaged, in any of the abusive and unethical practices which led to the adoption of the Advisers Act. Nor has there been any showing whatsoever that regulation of venture capital fund managers is necessary or appropriate in the public interest or for the protection of investors.

The fact is, considering the nature of a venture capital fund as outlined above, imposition of the

provisions of the Advisers Act on the managers of such funds would add nothing to the protections otherwise afforded by the provisions of Rule 146 and Rule 10b-5 at the time of the formation of the fund, the common law fiduciary duties of partners or corporate officials, and the provisions of Rule 10b-5 as applied to the continuing activities of the managers, most of which would involve the purchase or sale of a security. While it is true that the court held in the Abrahamson case that the plaintiff, a limited partner, had no cause of action under Rule 10b-5 because his complaint was that he was misled into failing to withdraw his money, rather than in connection with the purchase or sale of a security, this problem could not arise in connection with a venture capital fund since, as pointed out above, no such right of withdrawal exists.

It is also possible that the Supreme Court will hold in the case currently before it that the Abrahamson case was wrong in holding that a private right of action exists under Section 206 of the Advisers Act; if that should happen, any conceivable benefit to investors from the application of the Advisers Act to the managers of these venture capital funds would disappear.

Although venture capital by its nature is a relatively high risk-reward investment medium, the nature of this risk-reward relationship is well known to the investors in venture capital funds who are institutions and sophisticated, wealthy individuals. As indicated earlier, these investors are capable of negotiating adequate safeguards and are well able to afford any adverse consequences of venture capital investment.

The nature of the profit sharing arrangements of venture capital fund managers is such that their share of profits is based upon the long term profitability of the venture capital fund. Accordingly, such managers have no incentive to time portfolio transactions in a manner that would run counter to the best interests of the investors. The long term nature of venture capital fund investments and the illiquidity of these investments do not permit the use of speculative market strategies, regardless of profit sharing arrangements.

c. The Costs and Burdens of Advisers Act Regulation Clearly Outweigh any Conceivable Benefits.

Registration under the Advisers Act will subject venture capital fund managers and the Commission to a costly

regulatory burden. This cost will be borne directly by taxpayers to support increased governmental regulation. Venture capital fund managers and investors in these funds will also bear the cost of complying with the additional regulation, as well as being subject to the burdens of this regulation. Exhibits A and B attached hereto will demonstrate that the paperwork and the regulatory burdens involved in requiring registration are very substantial, even assuming Section 205(1) (prohibiting profit sharing) were made inapplicable by rule. Moreover, it seems clear that any public benefit would not be at all commensurate with such regulatory burden.

Of particular concern is the probability that State securities officials would view action by the SEC to provide only a limited exemption from the Act as an assertion by the Commission that venture capital fund managers are investment advisers. It is likely that the States would take a similar position, thereby subjecting venture capital funds to further regulation. If an applicable State Blue Sky Law had a similar prohibition against profit sharing, not subject to waiver, venture capital funds would perhaps find themselves in a worse position. At the very least, such funds would be compelled to seek similar exemptions from State officials, possibly in all of the States where their investors are located.

In contrast to the very tangible and significant costs and burdens associated with Advisers Act registration, there is very little benefit to be gained by subjecting venture capital fund managers to the Act. As indicated above, the investors in venture capital funds are capable of looking after their own interests, and venture capital funds do not lend themselves to the types of abuse the Act was designed to prevent. Moreover, there has been no showing that venture capital fund managers have acted unethically or otherwise abused the trust they have been given. For these reasons, there seems little to be gained in a regulatory sense by insisting that venture capital fund managers register under the Act.

d. Exemption from Registration for Venture
Capital Fund Managers will Contribute
to the Capital Formation Process.

Venture capital funds are one of the most important sources of permanent capital for new and developing businesses. The uncertainties created by the Abrahamson case have complicated the organization of these funds and in some

cases have resulted in the deferral of their organization. One reaction to the Abrahamson problem has been to cause venture capital fund managers to limit the number of investors in each fund to 14 in order that the Section 203(b)(3) exemption from registration under the Advisers Act will be available. A limitation on the number of investors in venture capital funds will have the effect of severely limiting the total capital these funds may have available for investment.

Exempting venture capital fund managers from registration will avoid the imposition of this regulatory cost on the venture capital process. It will also avoid any 14 investor limit on venture capital funds and thus remove an unneeded barrier to the financing of new businesses.

4. The Proposed Solution.

In order to prevent this problem becoming one more regulatory roadblock in the process of capital formation in the United States, it is proposed that the Commission issue a Rule which exempts the managers of venture capital funds completely from any requirement of registration under the Advisers Act. We believe that such a Rule is the only logical and equitable solution to the problem. Some other form of pronouncement, or the resumption of the issuance of "no action" letters by the Staff, would not afford the persons affected the protection of Section 211(d) of the Advisers Act against any possible civil liability if the courts should hold to the contrary.

It is proposed that the Rule state that the managers of a fund described in the Rule are not investment advisers within the meaning of the Advisers Act. If the Rule merely declared that the managers of a venture capital fund are advising only one client so far as any single fund is concerned, it might exacerbate the problem under the State Blue Sky Laws, all of which do not have this exemption.

The proposed Rule should apply to all forms of organization of venture capital funds, whether partnerships, corporations or otherwise. The particular organizations to be comprehended within the Rule should be defined in terms of the essential relevant characteristics as outlined above:

(1) The Rule should provide that a fund covered by the Rule must be organized for a minimum period, such as

five years, and that there be no individual right of withdrawal by any investor during the initial term of the fund. (There may be, in some cases, a provision for an extension of the term by a specified vote and a concomitant right of withdrawal on the part of dissenters, and such a provision should not be precluded.)

(2) The Rule should require that the fund not engage or intend to engage in any continuous or periodic offering of its own securities to new investors, after the initial organizational phase, and that it not have more than 100 investors. There should not be an absolute prohibition of a subsequent offering; but, as indicated above, for practical reasons the managers would almost always organize a new fund (with perhaps some of the same investors) whenever they seek to bring additional capital under management.

These two requirements alone will weed out any organizations of the type which concerned the court in the Abrahamson case. If there are legitimate fears that presently unknown types of investment vehicles might attempt to qualify for the exemption, however, a third requirement relating to portfolio composition could be added. For example, the portfolio of the fund might be required to consist, to the extent of 60 per cent (at cost), of securities purchased from the issuer which at the time of such purchase were not of a class listed on any National Securities Exchange or traded on NASDAQ.* Such a requirement would restrict the benefit of the Rule to venture capital funds; if it is added, however, the Release accompanying the Rule should make clear that it is non-exclusive, so that other persons are not prejudiced by it.

We have not undertaken in this presentation to suggest specific language of the proposed Rule, but we would be glad to assist the Staff in the formulation of the specific terms along the lines suggested, if the principle is accepted.

* The portfolio company may of course later "go public"; and this may be contemplated as a necessary part of the plan for the ultimate realization by the venture capital fund of its profit.

We appreciate the opportunity to present these views to the Commission and the Staff. We are certain that you share our conviction that the encouragement of capital formation is of vital concern to the Nation.

Respectfully submitted,

NATIONAL VENTURE CAPITAL ASSOCIATION

EXHIBIT A

Paperwork Burdens

If the venture capital fund managers are required to register under the Advisers Act, they will thereafter be subject to the paperwork burdens imposed by that act (and probably by applicable state law) upon registered investment advisers. At present, these burdens include the filing of an initial registration form; the amendment of that form at any time when any of the information set forth in it becomes inaccurate; and the keeping and maintenance of records so voluminous that the mere description of the type of information and records to be kept occupies more than four single spaced pages of Rule 204-2 of the Commission's Rules under the Advisers Act.

In addition, Section 204 of the Advisers Act authorizes the Commission to impose reporting requirements on registered investment advisers and that Section authorizes the Commission to amend or expand the record keeping requirements. Therefore, the existing paperwork burden is likely to be materially increased in the future.

Proposed Rule 204-1(c) will, if adopted in its present form, require a filing each year by registered investment advisers, the purpose of which is to advise the Commission as to whether or not there have been any material changes in the information set forth in the initial registration form. Further, proposed Rule 204-4 will, if adopted in its present form, require registered investment advisers to furnish to each client a written disclosure statement containing extensive information regarding the adviser's source of information, evaluation of information, business and education background and the business and educational background of their associates.

EXHIBIT B

Regulatory Burdens

Under Section 203(e) of the Advisers Act, the Commission may suspend or revoke an investment adviser's registration, thereby preventing him from maintaining existing relationships, if it finds that either the adviser or a "person associated with the adviser" has made misstatements to the Commission or been convicted of certain crimes or been enjoined from certain conduct or has willfully violated, or aided and abetted in the violation of, the provisions of the Federal securities laws. The term "person associated with an investment adviser" is broadly defined in the Advisers Act to include persons which are directly or indirectly controlled by the adviser. A venture capital fund manager, therefore, could conceivably be suspended to have his license revoked by the Commission simply because one of the venture capital fund's portfolio companies (in which it has an investment and in the management and supervision of which the manager may play an active part) has done something which is proscribed by Section 203(e).

In addition, although for the most part the Commission has sanctioned registered investment advisers only when their conduct appeared to involve serious infractions, the Commission has in the past revoked registrations for minor infractions such as failure to amend filings to show a change of address. See, e.g., In the Matter of Hawley, 32 S.E.C. 375 (1951).

If a suspension or revocation of a venture capital fund manager's investment advisory license were to occur, it would disrupt the essential relationship on which the fund and its investors heavily rely. Much of the efforts of a venture capital fund manager involve maintaining ongoing relationships with the management of portfolio companies as well as giving guidance and counsel to them. Unlike an adviser with respect to a marketable securities portfolio, who may readily be replaced with another such adviser, replacing one venture capital manager with another may have serious adverse consequences. A rupturing of these relationships and activities produced by Commission sanctions could not be easily remedied and could jeopardize the interests of the investors

in the venture capital fund. The mere possibility that this might occur could deter investors from investing in venture capital funds.

A second area of concern involves State regulation of investment advisers. Many State securities laws and regulations regulate the conduct of investment advisers, since Section 222 of the Advisers Act specifically reserves to the States the right to regulate investment advisers in a manner not inconsistent with the Advisers Act. If venture fund managers are regarded as investment advisers for purposes of the Advisers Act, there is legitimate concern that they will similarly be regarded for purposes of State securities laws. If subject to State regulation, venture capital fund managers may well become subject to requirements such as testing and bonding of their personnel and maintaining minimum net capital. Furthermore, State administrators also have broad powers to suspend or revoke an investment adviser's registration and thereby to disrupt the essential, long-term relationship discussed above.

Furthermore, the Advisers Act may possibly be changed to increase the regulation and paperwork burdens imposed upon those who are subject to it. There have been a number of proposals to increase the scope of regulation under the Act, including a recent but unsuccessful attempt by the Commission to have the Advisers Act amended to require minimum standards for licensing. In addition, the proposed Federal Securities Code, which has been approved by the American Law Institute, would subject investment advisers to further burdens if ultimately adopted. There is also the potential for increased regulatory burdens on registered investment advisers arising out of State legislative and administrative initiatives.

Mr. OPPER. Mr. Hagopian, your membership in the NVCA are all private companies; is that not right?

Mr. HAGOPIAN. Yes, sir.

Mr. OPPER. None of them is registered under the Investment Act of 1940?

Mr. HAGOPIAN. I am not sure about that. There may be one or two that are registered.

Mr. OPPER. Your principal focus of concern is on the applicability of the Advisers Act and the manner in which that handicaps your operations as a private company. Is that right?

Mr. HAGOPIAN. We have that area of concern. That is paramount in our minds because it potentially can destroy the entire venture capital industry if it is misapplied. I am not suggesting SEC intends to do that. But we are also concerned about restricting the flow of capital to small business from the public, which represents one of the largest sources of capital—and who is largely constrained from seeing their capital go into small business because of the 1940 act.

In one case we are trying to prevent harm from being done to the private venture capital industry. With respect to the 1940 act provisions we are suggesting that we should loosen up and allow a greater flow of capital to go into the venture capital industry. Arguably, this is not really in the best personal interests of the private venture capital pool managers if you can see what I mean, except insofar as it benefits the economy as a whole.

Mr. OPPER. Clearly the Advisers Act places certain constraints on your operations but how would you characterize the availability of venture capital today?

Mr. HAGOPIAN. Fortunately because of the reduction in the capital gains tax and because venture funds have performed so well over the past 10 years, there has been a substantial inflow of private funds into private venture capital companies. To my knowledge, the flow of public funds into venture capital companies has been nil. But there have been in the last 2 years an extensive amount of capital come from pension funds and insurance companies and the like. Again, we think this is proving to be a very positive thing for the economy and we would like to see that continued.

Mr. McMAHON. You indicated you have experienced a tremendous increase of private venture capital into your funds from, let's say, pension funds, et cetera. How much has inflation contributed toward that phenomenon?

Mr. HAGOPIAN. I guess to the extent that inflation may reflect itself in increased profits—that is, businesses are able to maintain profitability, then stocks are attractive in that regard.

I don't know that inflation per se has attracted institutions to venture capital.

I think what has attracted them to it is a potentially higher after-tax return—and the reduction in the capital gains tax has increased that return—and because venture capital funds have outperformed all the market averages.

When I say venture capital funds, I am talking about in the aggregate. Certainly there are individual funds that have not done

as well. Generally speaking, the members of the association have done very well by their investors and that is the main reason why anybody invests.

Mr. McMAHON. So it is mostly those people who are wealthy to begin with, or institutions that can sustain that loss?

Mr. HAGOPIAN. Certainly. To my knowledge, nobody has ever lost money in a fund we have managed. We have managed three funds now. I don't know of any members of NVCA—I am sure there are some, by the way—who have lost capital for their investors. When we talk about this extraordinary risk in venture capital, that has to be taken into account.

Mr. OPPER. Would you agree that a portion of the downside risk in venture capital or lack thereof is attributable not only to the kind of investors that you have but also because of the kind of management which is under enormous pressure from the sophisticated investors to do a good job and participates to some extent in the management of the portfolio companies?

Mr. HAGOPIAN. I think there is absolutely no question of that. The industry over the years has become increasingly more professional, more institutionalized and those of us who have been in it a long time, by our mistakes have learned how to manage this capital effectively.

We are highly motivated by the profit-sharing arrangement we have and as a result we have produced good returns for these investors. I think they would like to see us continue to do that.

Mr. OPPER. To the extent these investors became less sophisticated and management became less involved in the participation and operation of the portfolio companies, would you concede the risks might be greater for the investors in venture capital companies?

Mr. HAGOPIAN. To the extent that the managers are less qualified and to the extent that the managers do not practice the business in the way that it is generally practiced, which is to become involved and try to help the small business to be successful, I think there is a risk that those companies might not be as successful.

That is one of the reasons why in H.R. 7554 there is a provision that requires if a company is going to seek funds from the public it pass some kind of qualification test for the manager. We proposed one of two qualification tests:

If it is an existing venture capital company, the company should be in business for at least 3 years and show a track record to the investor. This gives some indication of what kind of management the venture capital manager is.

The alternative test, if it is a new company going public would be that the managers first have to sell 50 percent of the offering to so-called accredited investors.

The principle here is that if they can pass muster before the likes of Morgan Guaranty as we have had to, then the public can coattail on this sophisticated analysis. These provisions are not in the SEC's bill and it is a mystery to me why they are not in the bill. I would say I am concerned they are not. I feel they should be because we are very concerned that the public, when it does invest in a venture capital fund, do so with as well qualified a manager as possible.

Mr. OPPER. If you establish the venture capital company track record as H.R. 7554 would require, with sophisticated investors and the kind of management participation we have discussed in the portfolio companies and then sold shares to the public, might that then create a greater downside risk? You may end up with largely unsophisticated investors or with management that does not participate in the portfolio company? Could that not happen?

Mr. HAGOPIAN. You mean after the initial public offering in which the sophisticated investors purchase their stock, that they would then sell their stock?

Mr. OPPER. That is right.

Mr. HAGOPIAN. Certainly they have that right but I don't know why they would do that unless they became disenchanted with the investment that they had in which case the record that caused them to be disenchanted would be there for everyone to see.

Mr. OPPER. Normally would your venture capital investors stay in for 7 or 10 years?

Mr. HAGOPIAN. Yes.

Mr. OPPER. At that point venture capital companies become what we call mature. The investments which were originally speculative unseasoned companies presumably would become more successful and appreciate substantially in value. At this point, because of the tax incentives and the desirability to invest in other ventures many of your sophisticated investors would like to sell their interests.

Mr. HAGOPIAN. Yes.

Mr. OPPER. Doesn't it seem logical that H.R. 7554 would be a perfect vehicle for them to then liquidate their interest to the general public? But what do you have, you have a mature venture capital company which is no longer the same kind of company that we have been talking about previously?

Mr. HAGOPIAN. I don't understand why that follows.

Mr. OPPER. This assumes they are reinvesting but—

Mr. SCHEUER. Reinvesting profits, too. Equity appreciation.

Mr. OPPER. If the sophisticated investors leave at that point, then the portfolio would be largely owned by unsophisticated investors?

Mr. HAGOPIAN. Yes, but those who would have a substantial track record to look at and a basis upon which to make a judgment about the value of that company.

Mr. OPPER. But you wouldn't agree a large part of that track record was created because of the kinds of initial investors you had? If you have Citibank and 3M they are going to apply enormous pressure on management to do a good job?

Mr. HAGOPIAN. No, sir. We get no pressure. Certainly the pressure we feel is internal. We know those investors will never invest with us again if we are not successful but it is not the kind of investor we have that causes us to be successful.

It is, first of all, our own integrity, our absolute sense of obligation as a fiduciary and it is our experience and our capability that allows us to perform effectively.

Mr. SCHEUER. It seems to me Mr. Opper has a certain point that after a certain period of years some of the biggest might move out and conceive the loss of their moderating influence could have an

impact on the decision but I also feel you have to weigh costs and benefits.

If you are interlarding a burdensome regulation on this industry that is raising capital for small businesses, what is it worth? I personally feel we are not trying to create a marketplace in which loss on the downside is conceivable for even the small investor.

There are plenty of ways that small investors can invest money safely, at the one end of the spectrum they can put money into Government bonds or put money in various kinds of bank deposits and get 11 or 12 percent these days or invest in a closed end or open end fund.

Mr. HAGOPIAN. Or own their own home.

Mr. SCHEUER. Or invest CDS. Here they are looking for a high return even unsophisticated investors know and if they don't know they ought to know when you go into a potentially high profit situation there are risks on the downside. I don't think it should be the business of the Government to protect even small investors who chose to reach for a high return to prevent them from any risk on the downside.

There are winners and losers in the securities market. Every time somebody makes a gain, presumably somebody else hasn't done so well. There are winners and losers and investors know that and if they don't know it they ought to know it.

I don't feel that the SEC ought to consider itself the nanny for every small investor who wants to make a substantial profit or a killing and who is not satisfied with the return that he can get from a whole variety of investment fund opportunities that offer them comparatively safe returns.

There are closed end investment funds that specialize in current return, there are others that specialize in special situations and capital appreciation and they are all comparatively safe.

If a small investor chooses to put his own money into this field for a very substantial profit potential, it seems to me they ought to be expected to understand that there are risks on the downside too.

Mr. FRIEDMAN. I agree with that statement completely. There is nothing in our bill that is designed to protect the investors against economic loss or economic risks or financial risks.

Mr. OPPER. The point I was really trying to make is not that the investor should be deprived of his right to invest in a speculative investment but I was trying to suggest there might not be anything in your bill which necessarily requires the portfolio of your company at the end of a number of years be continuously turned over so that it is continuing to invest in highly speculative investments.

When I talked about a mature portfolio I am talking about the kind that many of your companies have now with listed securities and with securities with many market makers. The distinction I am trying to draw is if you sell this company to the public at this point when it is a mature portfolio, how can you distinguish it from the garden variety closed end investment companies that now are all registered under the act? How can we prevent these people saying to us, "wait a second, if Mr. Hagopian's fund, which looks like any closed end investment company with all of these mature and listed securities, can be sold to the public without registration, why can't we get the same benefits?" I think this is a problem.

Mr. HAGOPIAN. Except that under our proposal I think it is clearly distinguishable because the definition requires that any time a gain is taken, unless you are going to keep it in cash it has to be reinvested in those same qualifying investments. Here I think we do have a requirement. Whenever they take a gain they have to reinvest it in those same kinds of businesses. It is conceivable somebody would be so fortunate as to have one or two large successful investments right off the mark and just hold those for 20 years, in which case how is the public damaged? I think arguably the definition——

Mr. LEMOV. They might be out of compliance with the definition.

Mr. HAGOPIAN. I would like to introduce Mike Halloran. I have asked him if he would sit in if there were any additional questions. I would appreciate if I could have him substitute.

Mr. SCHEUER. Fine. At this time we hear from Arthur D. Little.

STATEMENT OF ARTHUR D. LITTLE, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY MICHAEL R. LEMOV, COUNSEL

Mr. LITTLE. I would like to respond to a few of the questions that were put forth. First of all, if you are contemplating that there would be one of these venture capital funds, the private investors who would then, as you put it, burden themselves with their token public offering, I would suggest to you you will never get an underwriter for that public offering.

The nature of the business is such that when we invest in a company that goes public, I cannot remember any case in which we were allowed to sell our shares in that company, because the underwriters said to us, if you sell, you will undermine the public confidence in this public offering and, therefore, if you want to sell we don't want to underwrite it. So I think that is one point.

The second point is that under our bill there is a written required statement issued yearly to the shareholders of the degree of risk, so I think if you look at this bill very carefully you will find there are all kinds of investor protection provisions that have been put in here specifically in response to the SEC's concerns along those lines.

I am delighted to have a chance to be here again. I think you know I testified before this subcommittee on November 7, of last year, and I said a lot of things then which you will be glad to know I will not repeat.

I am encouraged, not terribly, but encouraged by the fact that the SEC, by offering legislation, has shown that they have come to the conclusion that a problem does exist and that the solution must be one that is legislative.

However, I think it is important to discuss the difference in approaches between the SEC bill and H.R. 7554 and to explain why we think H.R. 7554 is a much superior approach.

Basically, the SEC's bill would continue a paternalistic regulatory scheme which, frankly, we believe is outdated and we also feel really was intended for the mutual fund industry and is really not applicable to the venture capital industry.

What they are proposing is that they will let us squeak out of a few of the sections. As Mr. Lemov has suggested, there are a lot of sections in the 1940 act that are troublesome.

H.R. 7554, on the other hand, has been tailored to meet the peculiar needs of the venture capital industry, providing shareholder protections which, unlike those of the Investment Company Act, do not frustrate the legitimate operation of a business.

Unlike the scheme of the Investment Company Act and the bill prepared by the SEC, H.R. 7554 does not establish an intricate set of restrictions on the business activities and business judgment of the managers and directors of a venture capital company.

Rather, it relies on the twin pillars of shareholder disclosure and independent director control, allowing the company to operate in a manner which makes sense in the business world rather than forcing it into a regulatory straightjacket and later out of business.

I would like now to turn your attention to some of the problems the venture capital industry sees with the SEC's approach to our Investment Company Act problems. The first thing I want to say, however, is that although we strongly believe that the SEC bill would not solve the 1940 act problems of the venture capital industry, it does represent significant movement from the Commission's earlier position and it shows the SEC's awareness that there is a need for change.

To the extent that it represents an initial effort to draft acceptable legislation rather than the Commission's "bottom line" we believe that it can play a constructive roll in developing a legislative solution to the venture capital industry's problems.

Just as H.R. 7554 has benefited from the comments of the SEC on earlier legislation drafted by industry and the congressional staff, we trust that the Commission will recognize that there were bound to be gaps in their first effort and will respond positively to the constructive criticism offered by the industry.

We really feel the SEC bill will not solve the problems that we have. However, it is a significant movement from the Commission's earlier position.

I have mentioned before in various testimony that if H.R. 7554 were passed or any of its predecessors, my company margin set capital would not be able to qualify for a period of 2 to 4 years. So we are not writing something here that will enable us to say: "Whoopie, we will get out from underneath all these restrictions."

One of the most significant criticisms we have of the SEC bill is its definition of a venture capital company. Without going into all the details, the SEC's bill basically requires that a venture capital company invest only in those companies which neither have their securities listed on a securities exchange nor have their securities listed on the Federal Reserve Board's margin list.

While these will, in general, be the types of companies in which venture capital companies invest, there are two basic problems with the SEC definition. First, the fact that a company has securities listed on a securities exchange or on the Fed's margin list does not mean it is an inappropriate recipient of financing from a venture capital company.

There are many very small companies which happen to have their securities listed on an exchange or on the margin list. Fur-

thermore, the fact that a company has its securities listed on an exchange does not mean it has ready access to the capital markets. Although there is a public market for a company's securities, the market is often too thin to allow a company to raise capital publicly when needed.

Moreover, venture capital companies do not only invest in very small companies with limited markets for their securities. They often invest in the innovations of more established businesses. Many venture capital companies specialize in investing in certain industries and may have businessmen, scientists, and engineers on their staff with a great deal of expertise in those areas. These venture capital companies will look for companies with ideas for new products or processes but which need management assistance and more capital than they can generate internally or at favorable rates in the public markets. One or several venture capital companies will provide such a company with needed capital and the expertise to help it market its innovation. Such efforts can involve investments of as much as \$30 million in companies with assets of as much as twice that amount. Such investments would be barred by the SEC bill.

Mr. SCHEUER. Why would they be barred?

Mr. LITTLE. There are several problems that you run into. Let's take the turnaround Congressman Broyhill asked about. Photomat is an excellent example of where a company went public, ran into a great deal of trouble, and was invested in a turnaround mode by venture capital companies. They succeeded in turning it around and having a very successful investment, thereby helping out the original public shareholders who bought Photomat in the first place and also the shareholders of those various investment companies or venture capital companies. Having already been publicly owned and on one of the lists, that investment could not have been made.

A second factor which the SEC has failed to take into consideration in drafting its definition is the need of a venture capital company for a source of income to cover operating expenses. The developing companies in which a venture capital company invests are generally unable to pay dividends for several years, and probably should not pay dividends because they should plow all their money back into the business to make it continue to grow. In order to insure their ultimate survival and success, they must plow every dollar they make back into the business. Recognizing that they are unlikely to realize much income from their initial investments for several years, a venture capital company often must make other investments that will provide operating funds. Under the SEC's bill these investments would be limited to U.S. Government securities and high quality debt securities with a maturity of less than 1 year.

To make such investments would not make business sense. While such instruments are the safest and most liquid of investments, these very factors also mean that they produce the lowest rate of return. Faced with the task of meeting the SEC's investment criteria, a venture capital company would be faced with two alternatives, neither of which would be beneficial to shareholders.

I think this is a key point. Some of the things SEC forces us to do actually hurt the shareholders who are the people they are supposed to be trying to protect.

First, it could invest a larger portion of its assets in income-producing short-term debt than it would be required to if it were free to invest in other types of securities for purposes of generating operating funds. This would leave less money available to fulfill its primary mission of furnishing venture capital to industry.

Second, it could require that the firms in which it invests issue debt securities as well as equity securities. While this is a common practice when investing in some industries, in many instances the investee company will be unable to start paying back investors for several years. Forcing it to pay interest to investors from the start may jeopardize its ultimate survival and the investment of the venture capital company. It is inappropriate with many types of startup businesses. There really ought to be equity-type financing.

A further difficulty with the Commission's definition is that it effectively precludes a company from obtaining passthrough tax treatment under subchapter M of the Internal Revenue Code. Commissioner Friedman recently noted before the Senate Subcommittee on Securities that the SEC's approach, by causing venture capital companies to register as investment companies, would allow them to make use of the passthrough provisions of subchapter M.

While we applaud and support the Commission's interest in giving venture capital companies favorable tax treatment, it must be pointed out that, due to the nature of their business, many venture capital companies are unable to meet the diversification requirements imposed by subchapter M. However, the Commission's definition of a venture capital company would make it even more difficult for a venture capital company to qualify under subchapter M.

You are going to put a whole new series of regulations on top of the SEC, on top of the ones of the IRS.

By requiring that the venture capital company make all its investments in short-term Government securities or securities acquired from a small company in a private placement, it is highly unlikely that a venture capital company could meet the requirement of subchapter M. This is really the key issue with which we have great problems in our company.

Another problem with the SEC's bill involves the limited relief from the intricate maze of restrictions on affiliated transactions created under section 17 of the Investment Company Act.

Section 17 forbids virtually all transactions between a venture capital company or its affiliates or controlling persons and any of the companies controlled by a venture capital company or affiliated with a venture capital company, and affiliates of any affiliates.

If that is confusing to you it is confusing to us, too, and we deal with it all the time.

By virtue of the broad definitions of the terms "controlling person" and "affiliate," section 17 effectively precludes anyone who has anything to do with a venture capital company from dealing with anyone else with any relationship to the venture capital company.

Granted you can get relief under section 17 by going to the SEC and getting an exemptive order. The shortest period of time we have been able to work through that process is 80 or 90 days. This is a regular occurrence for us.

The SEC has, to some extent, ameliorated the harsh impact this section can have on the operations of an investment company. However, due to the breadth of section 17 and the limited nature of relief provided by Commission rules, compounded by the large number of uncertainties with those rules, section 17 still remains a complicated maze which often baffles the most sophisticated practitioners, let alone those who have not spent a lifetime studying its provisions.

The Commission's bill provides limited and inadequate relief from the regulatory nightmare created by section 17. It allows affiliates who are such solely by virtue of their owning 5 percent or more of the securities of a venture capital company to deal with investee companies controlled by the venture capital company, subject to the approval of the board of directors.

One of the things I did when I received the SEC bill was send it to the lawyer who deals with these sort of things. I would like, if I might, to enter the letter that he sent me in response to my request into the record.

Mr. SCHEUER. There will be no objection. It is so ordered.

[The letter referred to was subsequently received for the record:]

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June 9, 1980

Mr. Arthur D. Little,
Chairman of the Board
Narragansett Capital Corporation
40 Westminster Street
Providence, RI 02903

Dear Arthur:

Re: Business Development Company Act of 1980

I have had a limited amount of time today to review and reflect on the SEC's entry into the area of exemptive legislation for venture capital companies as embodied in the proposed Business Development Company Act of 1980 (the "BDCA"). Nevertheless, I have had an opportunity to develop some general thoughts on the proposed legislation.

Rather than making life easier for companies performing the vital function of providing venture capital to American industry, the Commission is proposing what appears to me to be a new layer of regulation and control within the structure of the Investment Company Act of 1940 (the "'40 Act"), while holding out some minor "carrots" of relief from the burdens of the '40 Act. Quite frankly, the statement at the beginning of the proposed legislation that it is designed "to provide exemptions

from the Investment Company Act of 1940 and Investment Advisers Act of 1940 for specialized investment companies" seems intellectually dishonest. It is true that exemptions are provided (one of which is significant but of no help to Narragansett), but they do not resolve the substantial regulatory problems imposed by the '40 Act and the SEC acting under the '40 Act which impair the ability of registered venture capital companies from carrying out their purposes in a timely and orderly fashion.

Let me quickly review some portions of the proposed legislation which are not of overwhelming significance to Narragansett:

1. Section 1 of the BDCA amends Section 5 of the '40 Act to create a new classification of closed-end investment company: the business development company. The definition seems overly restrictive as to the purposes which must be served by a business development company for it to be classified as such. However, I really cannot get too excited about this, because, as described below, the advantages accorded business development companies by the BDCA are not very earth-shattering, so we should not worry too much about whether Narragansett qualifies (I think it would anyway).

2. Section 3 of the BDCA amends Section 3(c)(1) of the '40 Act to exempt from the Act SBIC's and other issuers on certain conditions even though a company with more than 100 stockholders owns more than 10% of the investment company (right now the stockholders of such a 10%-or-more owner count toward the 100-shareholder threshold for '40 Act coverage). This is a significant step forward for some SBICs which are subsidiaries of larger institutions, but of no concern or help to Narragansett.

3. Sections 6 and 7 of the BDCA combine to amend

Sections 18 and 23 of the '40 Act to permit more flexibility to business development companies in the issuance of senior securities and warrants and options to purchase voting securities pursuant to executive compensation plans. I understand Narragansett has encountered some problems in this regard in the past, but I am not personally familiar with the circumstances. Also to the extent that the BDCA seems on the surface to grant relief to issue securities under executive compensation plans, I am not convinced the legislation provides any relief from the necessity of getting the plan itself approved under Section 17 of the '40 Act when its provisions might apply (as they probably would).

4. Section 8 of the BDCA provides some interesting relief for business development companies in their investment adviser relations, permitting performance-based fees to a limited degree. This could prove helpful to Narragansett in its management services arrangements in the future, and the proposal is worthy of favorable comment before the House Committee.

Now let us turn to the sections of the BDCA which I believe are of particular significance to Narragansett:

A. Sections 2 and 4 of the BDCA combine to specify the nature of assets which may be held by a business development company. I may be missing the point altogether, but it seems to me that these sections are not creating an exemption or any relief with respect to the nature of assets which may be held, but rather are establishing new standards with respect to portfolio and other assets for these new creatures called business development companies. From the standpoint of Narragansett and the nature of the assets it holds and which I expect it would expect to acquire in the future, the standards are not burdensome in any material degree. But, there seems to be a limitation on purchasing securities in a public offering by a small business, and I cannot understand why an SBIC should not be permitted to acquire small business stock whether it is issued to the public or only privately. Further, investments in cash equivalents are limited to government securities and high quality debt securities maturing in one year or less from the time of investment. Should Narragansett or any venture capital company necessarily be so limited?

B. Topping off the "snare and delusion" the SEC refers to as exemptive legislation is its efforts with respect to our old favorite, Section 17 of the '40 Act. Having last week read some general commentary on the SEC's proposed legislation before reviewing the actual proposal which you sent over, I was hopeful that the SEC would exempt companies like Narragansett from Section 17 altogether, as long as the independent directors and those without a financial interest in a transaction approve the otherwise prohibited transaction in accordance with the standards of the Act. No such luck! Instead, in Section 5 of the BDCA the SEC proposes to exempt from the Section 17 application process purchases and sales between a "non-controlling shareholder affiliate" and a business development company if a majority of the directors who are not interested persons and who have no financial interest in the transaction approve it on the basis of certain standards. This kind of transaction (i.e., one with a shareholder of the investment company) is only one of many kinds of transactions falling within the scope of Section 17. In fact, at Narragansett we encounter Section 17 most frequently (if not almost always) with respect to transactions between Narragansett and portfolio companies and transactions between two or more portfolio companies, not in transactions between Narragansett and non-controlling shareholders. Thus, the legislation would not really help Narragansett one iota in the Section 17 area. Further the statute defines "non-controlling shareholder affiliate" to exclude officers, directors, employees, investment advisors and similar "types", and I cannot picture Narragansett ever having a transaction with a 5%-or-more stockholder who is not one of those "types".

C. Also in the Section 17 area, Section 5 of the BDCA exempts from Section 17(a)(3) of the '40 Act loans to officers and employees to purchase securities of a business development company pursuant to an executive compensation plan if certain standards are met. But the legislation provides no relief from the necessity of obtaining approval under Rule 17d-1 for such a plan itself if the provisions of that Rule would otherwise apply (as they likely would). This relates to an age-old problem we have had with the SEC: the Commission regulates relief under Section 17(a) and forgets about needed companion relief under Rule 17d-1, or vice versa - at least the SEC forgets about it until we later discuss a practical problem with the staff and then we are reminded of the application of both provisions.

Very truly yours,



Benjamin P. Harris, III

Mr. LITTLE. He said, "When I heard there was something going on in this area I really thought we were going to get some significant relief. That is not the case."

Basically, we have never dealt personally in this area that the SEC is giving relief in. We do not intend to deal in that area and the result—from reading his comments you will see—doesn't do us any good.

The SEC, apparently, takes the position that the other problems caused by section 17 have already been cured by rule promulgated by the Commission. This is not the case.

Investment Company Act Rules 17a-6 and 17d-1 do provide conditional relief for some, but not all, affiliated transactions that are ensnared by the broad reach of section 17(a). But they are simply rules of the SEC and, as such, may be modified or revoked at any time.

In addition, rules 17a-6 and 17d-1 are complicated and vague in a number of significant respects which makes it difficult to determine when the limited relief they provide is available. For example, exemptions under rules 17a-6 and 17d-1 are available only where no officer, director, employee, investment adviser, member of an advisory board, depositor, promoter of, principal underwriter for or person controlling or under common control with the investment company, or any affiliated person of any of the foregoing persons, is a party to, or has had or will acquire a direct or indirect financial interest in a party to the transaction.

We have a spider web here essentially.

While the primary persons excluded from the exemptions afforded by these rules generally can be readily identified, identifying each and every one of the affiliates of those persons is not always such an easy task, given the 1940 act's unusually broad definition of affiliate.

The rules also fail to define what is meant by "direct or indirect financial interest." The only help given is a list of a few items that the SEC deems to be excluded from the meaning of the term "financial interest." There is no "de minimis" standard, knowledge test, or other similar practical limitation to help clarify what is meant by that term.

What is proposed by the chart by the SEC is just an inadequate relief under this area.

Very simply stated, we think publicly owned venture capital companies are going to have people who are disinterested members of the board of directors, very qualified to make judgments in this complicated area, who are going to look at these transactions.

Frankly, if these people make a judgment which is questionable and stand to be sued other than just their own personal integrity making them do the right thing, if they know they have the possibility of that suit hanging over them that obviously makes it more difficult.

Mr. SCHEUER. Are you near the end of your testimony?

Mr. LITTLE. I am getting there, sir.

I could go through all these things under section 17. I just want to say two things. One, extraordinarily complicated; second, can be much more adequately handled in a much more timely manner—

which is often important in our kind of investing—by a board of directors.

[Testimony resumes on p. 177.]

[Mr. Little's prepared statement follows:]



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STATEMENT OF ARTHUR D. LITTLE

Before the CONSUMER PROTECTION AND FINANCE SUBCOMMITTEE U.S. HOUSE OF REPRESENTATIVES

Good morning Mr. Chairman and Committee Members. I am Arthur D. Little, Chairman and Chief Executive Officer of Narragansett Capital Corporation of Providence, Rhode Island, the largest of the public small business investment companies. I am also President of the National Association of Small Business Investment Companies, the trade association for the SBIC industry. With me today is James L. Watts, Associate Director.

I am pleased to be appearing again before this Subcommittee to give my comments on securities proposals which would affect the venture capital industry. I am especially pleased that the Securities and Exchange Commission has joined the ongoing dialogue between our industry and the Congress by offering its own proposal for providing the venture capital industry with relief from portions of the securities laws.

In my previous appearance before this Subcommittee on November 7, 1979, I discussed some of the valuable services provided by the venture capital industry in general and SBIC's in particular, and I explained some of the impediments

placed in the way of their operations by the federal securities laws, especially the Investment Company Act of 1940. I will not repeat that testimony -- the fact that the SEC has offered legislation addressed to our problems indicates that the SEC finally admits that a problem exists and that the solution must be a legislative one. Rather, I wish to utilize this opportunity to discuss the approaches taken by the SEC bill and H.R. 7554, and to explain to this Subcommittee why we believe that H.R. 7554 represents a better approach.

CONTRASTING SCHEME OF REGULATION

The two bills on which this Subcommittee has focused its attention present contrasting approaches for dealing with a common problem. The SEC's bill makes the paternalistic regulatory scheme of the Investment Company Act of 1940 fully applicable to venture capital companies, while exempting such companies from a few of its more onerous provisions. A regulatory scheme, designed to meet problems of an earlier era, is thereby made applicable to a type of company which did not even exist at the time the Act was adopted.

H.R. 7554, on the other hand, has been tailored to meet the peculiar needs of the venture capital industry, providing shareholder protections which, unlike those of the Investment Company Act, do not frustrate the legitimate operation of a business. Unlike the scheme of the Investment Company Act and the bill prepared by the SEC, H.R. 7554 does not establish an intricate set of restrictions on the business activities and business judgment of the managers and directors of a venture capital company. Rather, it relies on the twin pillars of shareholder disclosure and independent director control, allowing the company to operate in a manner which makes sense in the business world rather than forcing it into a regulatory straightjacket and later out of business.

EXAMINATION OF SEC APPROACH

I'd like now to turn your attention to some of the problems the venture capital industry sees with the SEC's approach to our Investment Company Act problems. The first thing I want to say, however, is that although we strongly believe that the SEC bill would not solve the 1940 Act problems of the venture capital industry, it does represent significant movement from the Commission's earlier position and it shows the SEC's awareness that there is a need for change. To the extent that it represents an initial effort to draft acceptable legislation rather than the Commission's "bottom line" we believe that it can play a constructive roll in developing a legislative solution to the venture capital industry's problems. Just as H.R. 7554 has benefited from the comments of the SEC on earlier legislation drafted by industry and the congressional staff, we trust that the Commission will recognize that there were bound to be gaps in their first effort and will respond positively to the constructive criticism offered by the industry.

One of the most significant criticisms we have of the SEC bill is its definition of a venture capital company.^{1/} Without going into all the details, the SEC's bill basically requires that a venture capital company invest only in those companies which neither have their securities listed on a securities exchange nor have their securities listed on the Federal Reserve Board's margin list.

While these will, in general, be the types of companies in which venture capital companies invest, there are two basic problems with the SEC definition. First, the fact that a company has securities listed on a securities exchange or on the Fed's margin list does not mean it is an inappropriate recipient of financing from a venture capital company. There are many very small companies which happen to have their securities

^{1/} Although the SEC uses the term "business development company," for the sake of consistency we will refer to venture capital companies in discussing both the Commission's bill and H.R. 7554.

listed on an exchange or on the margin list. Furthermore, the fact that a company has its securities listed on an exchange does not mean it has ready access to the capital markets. Although there is a public market for a company's securities, the market is often too thin to allow a company to raise capital publicly when needed.

Moreover, venture capital companies do not only invest in very small companies with limited markets for their securities. They often invest in the innovations of more established businesses. Many venture capital companies specialize in investing in certain industries and may have businessmen, scientists and engineers on their staff with a great deal of expertise in those areas. These venture capital companies will look for companies with ideas for new products or processes but which need management assistance and more capital than they can generate internally or at favorable rates in the public markets. One or several venture capital companies will provide such a company with needed capital and the expertise to help it market its innovation. Such efforts can involve investments of as much as 30 million dollars in companies with assets of as much as twice that amount. Such investments would be barred by the SEC bill.

A second factor which the SEC has failed to take into consideration in drafting its definition is the need of a venture capital company for a source of income to cover operating expenses. The developing companies in which a venture capital company invests are generally unable to pay dividends for several years. In order to insure their ultimate survival and success, they must plow every dollar they make back into the business. Recognizing that they are unlikely to realize much income from their initial investments for several years, a venture capital company often must make other investments that will provide operating funds. Under the SEC's bill these investments would be limited to U.S. government securities and high quality debt securities with a maturity of less than one year.

To make such investments would not make business sense. While such instruments are the safest and most liquid of investments, these very factors also mean that they

produce the lowest rate of return. Faced with the task of meeting the SEC's investment criteria, a venture capital company would be faced with two alternatives, neither of which would be beneficial to shareholders. First, it could invest a larger portion of its assets in income-producing short term debt than it would be required to if it were free to invest in other types of securities for purposes of generating operating funds. This would leave less money available to fulfill its primary mission of furnishing venture capital to industry.

Second, it could require that the firms in which it invests issue debt securities as well as equity securities. While this is a common practice when investing in some industries, in many instances the investee company will be unable to start paying back investors for several years. Forcing it to pay interest to investors from the start may jeopardize its ultimate survival and the investment of the venture capital company.

A further difficulty with the Commission's definition is that it effectively precludes a company from obtaining pass through tax treatment under Subchapter M of the Internal Revenue Code. Commissioner Friedman recently noted before the Senate Subcommittee on Securities that the SEC's approach, by causing venture capital companies to register as investment companies, would allow them to make use of the pass-through provisions of Subchapter M. While we applaud and support the Commission's interest in giving venture capital companies favorable tax treatment, it must be pointed out that, due to the nature of their business, many venture capital companies are unable to meet the diversification requirements imposed by Subchapter M. However, the Commission's definition of a venture capital company would make it even more difficult for a venture capital company to qualify under Subchapter M. By requiring that the venture capital company make all its investments in short term government securities or securities acquired from a small company in a private placement, it is highly unlikely that a venture capital company could meet the requirement of Subchapter M (i.e. that half of its assets consist of cash items, government securities, or securities in companies

which represent less than five percent of the venture capital company's assets and which securities do not have more than ten percent of the voting rights of all securities issued by the investee company).

Another, problem with the SEC's bill involves the limited relief from the intricate maze of restrictions on affiliated transactions created under section 17 of the Investment Company Act. Section 17 forbids virtually all transactions between a venture capital company or its affiliates or controlling persons and any of the companies controlled by a venture capital company or affiliated with a venture capital company, and affiliates of any affiliates. By virtue of the broad definitions of the terms "controlling person" and "affiliate", section 17 effectively precludes anyone who has anything to do with a venture capital company from dealing with anyone else with any relationship to the venture capital company.

The SEC has, to some extent, ameliorated the harsh impact this section can have on the operations of an investment company. However, due to the breadth of section 17 and the limited nature of relief provided by Commission rules, compounded by the large number of uncertainties with those rules, section 17 still remains a complicated maze which often baffles the most sophisticated practitioners, let alone those who have not spent a lifetime studying its provisions.

The Commission's bill provides limited and inadequate relief from the regulatory nightmare created by section 17. It allows affiliates who are such solely by virtue of their owning five percent or more of the securities of a venture capital company to deal with investee companies controlled by the venture capital company, subject to the approval of the board of directors. The SEC, apparently, takes the position that the other problems caused by section 17 have already been cured by rules promulgated by the Commission. This is not the case.

Investment Company Act Rules 17a-6 and 17d-1 do provide conditional relief for some, but not all, affiliated transactions that are ensnared by the broad reach of section

17(a). But they are simply rules of the SEC and, as such, may be modified or revoked at any time. In addition, Rules 17a-6 and 17d-1 are complicated and vague in a number of significant respects, which makes it difficult to determine when the limited relief they provide is available and when it is not. For example, exemptions under Rules 17a-6 and 17d-1 are available only where no officer, director, employee, investment adviser, member of an advisory board, depositor, promotor of, principal underwriter for or person controlling or under common control with the investment company, or any affiliated person of any of the foregoing persons, is a party to, or has, had or will acquire a direct or indirect financial interest in a party to the transaction. While the primary persons excluded from the exemptions afforded by these rules generally can be readily identified, identifying each and every one of the affiliates of those persons is not always such an easy task, given the 1940 Act's unusually broad definition of affiliate.

The rules also fail to define what is meant by "direct or indirect financial interest." The only help given is a list of a few items that the SEC deems to be excluded from the meaning of the term "financial interest." There is no "de minimis" standard, knowledge test, or other similar practical limitation to help clarify what is meant by that term.

Finally, Rule 17d-1 places arbitrary limitations on the amount of an investment company's assets that may be involved in a transaction effected in reliance on the exemption afforded by that rule. (Transaction not qualifying for an exemption under either Rule 17a-6, Rule 17d-1 or the new exemption which would be provided by the SEC bill would, of course, be required to be submitted to the SEC for its prior approval. This is a costly and time-consuming process. In two recent instances in which Naragansett sought and obtained such SEC approval — both involving transactions which would not qualify for exemption under the SEC's rules or the provisions of the SEC bill — the costs of obtaining that approval, in terms of the legal fees alone, to say nothing of Naragansett's internal costs, were

\$20,000 and \$29,000 respectively. The proceedings each took several months to complete.)

The SEC's approach takes a statute which presumes that any affiliated transaction, broadly defined, is laced with fraud, and cuts through that statute narrow paths for venture capital companies and their affiliates to follow in conducting their business. Unless this Subcommittee and the Congress are operating under the presumption that transactions not authorized by the SEC are fraudulent, this approach is unnecessarily cumbersome and makes no sense. Rather than assuming that all transactions are likely to lead to fraud, it would be far better for Congress to specify those particular transactions which present the greatest likelihood of wrongdoing. Then, as is done in H.R. 7554, such transactions could either be prohibited or subject to the approval of independent directors.

Another problem we would like to bring to the Subcommittee's attention is that posed by section 23(b) of the Investment Company Act. This section forbids the sale of securities of an investment company at less than net asset value. The SEC bill grants a limited exemption from this provision by authorizing the sale of securities at less than net asset value in those instances when the securities are issued pursuant to the exercise of stock options or similar rights.

The Commission has failed to recognize the fact that when a venture capital company makes an offering of its own securities it must often do so at less than net asset value. While section 23(b) is relatively innocuous on its face, in that it merely requires shareholder approval to sell securities for a price below net asset value, I understand that the SEC has interpreted this provision as requiring detailed shareholder approval of virtually every aspect of an offering below net asset value, thus precluding the venture capital company or its underwriters from making necessary last minute changes in the terms of the offering to respond to changes in market conditions or to take advantage of favorable selling opportunities. We believe that the venture capital company and its

underwriters should be able to react to changing market conditions in issuing its securities without undue burden and in a manner which is most beneficial to the operations of the company and to its shareholders.

Our final criticism of the SEC bill is not addressed to any one section of the Investment Company Act. It has to do with the fact that, with the exception of parts of three sections, the SEC would place the entire regulatory burden of the 53 sections of the Investment Company Act on the backs of venture capital companies, all without feeling any obligation to justify the regulatory burden so imposed. Rather, the Commission staff and others who favor maintaining the status quo have indicated their belief that the industry has the burden of proving it cannot operate under a particular section of the Act and that special circumstances of the venture capital industry make that section less necessary with respect to the venture capital industry than with respect to the investment company industry. Then and only then would our industry be entitled to an exemption and the exemption would be tailored narrowly so as to reach only those areas where the industry met this considerable burden of proof.

We do not believe that this is an appropriate approach to government regulation of business and we do not believe it is the approach favored by this Congress or this Subcommittee. To view the regulation of the venture capital industry from such a perspective is to support regulation for regulation's sake.

Rather than putting our industry in the position of establishing that the Investment Company Act regulatory scheme is unnecessary with respect to venture capital companies, we feel that it is the responsibility of those who support regulation to show a need for it. To the extent that the SEC can show that any particular provision of the Investment Company Act is more necessary with respect to venture capital companies than with respect to other businesses, we think the Congress should seriously consider including it in the regulatory scheme established by H.R. 7554. But to make applicable all the provisions of the Investment Company Act without such a showing

would be a disservice to our industry, the business community in general, and, ultimately, the American people whose standard of living depends upon the availability of venture capital financing.

The Investment Company Act of 1940 is an anachronism that probably wouldn't get the votes of ten percent of the members of Congress if it were being proposed today. The Senate Subcommittee on Securities recently held hearings parallel to these at which a number of the preeminent members of the securities bar testified. None indicated a belief that the Investment Company Act is a good law. One witness, Mr. A.A. Sommer, Jr., a former SEC Commissioner and a member of the Federal Securities Code Advisory Group since its inception, indicated that in drafting the proposed Code the Investment Company Act was excluded because it was generally believed the Investment Company Act required extensive substantive revision while the primary purpose of the Code was to codify existing law. In his testimony Mr. Sommer stated, "it is fair to say that virtually all the advisors and consultants would favor significant change in the Investment Company Act" I dare say that it is unlikely that any of the witnesses appearing on behalf of the SEC would say otherwise.

Mr. Chairman, it has more than amply been demonstrated that the venture capital industry provides an invaluable service to our economy. It has also been amply demonstrated that the Investment Company Act precludes our industry's providing the sort of service to the American people that we could if we had room in which to operate effectively. I hope that you will give us that room by adopting meaningful legislation.

Mr. SCHEUER. May I ask you a question about your section 201 under H.R. 7554?

When I took legislative drafting at Columbia Law School more years ago than I care to think about, we talked about legal terms of phrases of the art. "Furnishing capital" is to my mind not a phrase of art. It is not a legal explanation. Maybe I am wrong. "New businesses"—what is a "new business"? You would have to tell me it is a business that has just gotten a charter or license or had one for 1 year or 10 years. What is a business just reorganized or in the development stage?"

What does that mean as a legal phrase of art? There are seven stages of mankind. We develop from birth to death as human beings. Shakespeare elaborated on that; and I suppose businesses are also in some kind of development they get born, they grow, they die. They were developing up, they were developing down.

What does it "mean in need of reorganization"? I can understand this being report language but I can't understand this being legislative language. I dare say you couldn't take a single business or a single executive branch or agency of the Federal Government or single committee of Congress and after intensive perceptive study say, "well, it is in need of organization".

I am sure this committee is very much in need of doing its business better and perhaps your resources are better as to members and staff.

I don't understand what that means in a piece of legislative drafting. The same thing with your phrase, "businesses which are unable to obtain capital in the public market on favorable terms". What does that mean legislatively "on favorable terms"?

You seem to be suggesting legislative language that would keep you in the law courts for the next month of Sundays describing what all these things mean.

Mr. LITTLE. I think there are a couple of answers to that. Most of these terms have firm meanings within this industry.

Second, a lot of the language is taken out of the 1940 act itself in terms of describing what we have done here.¹ Last, what we are talking about here is a purpose test. It is not the only test that you have to meet. You have to meet the asset test as well so it is not an either/or. It is an "and" kind of test.

Mr. LEMOV. May I add the SEC would have rulemaking power within the scope of the statutory definition to elaborate on that too.

Mr. FRIEDMAN. Thanks a lot.

Mr. LEMOV. Isn't that better than a purely arbitrary test which says that a number of companies, because they happen to be listed, automatically are excluded from a turnabout situation?

Mr. FRIEDMAN. If I thought it was better we would have drafted our statute that way.

Mr. LITTLE. There are a number of other areas within the Investment Company Act that are particularly bothersome. One of the areas particularly for a publicly owned company like ours, has to do with the offering of our shares at less than the net asset value, and if you look at almost all of the companies you will find there is usually some disparity there.

¹ See § 12(d) of Investment Company Act of 1940.

Mr. HALLORAN. If I could add a footnote on this paragraph (A) of section 201 that the chairman referred to. Mr. Chairman, one of the key phraseologies is "making available managerial assistance."

If you add that to any definition you are basically only talking about venture capital companies. I don't know of any other investment company structure that makes available that sort of managerial assistance.

We have added to our bill a definition of what we mean by managerial assistance in subsection 49. So I think once you add that to the legislation, you draw a litmus line which is hard to pass, of those which are venture capital companies and those which are not.

Mr. LITTLE. I would like to go back to a couple of basic issues here. All of you can read what I have in the paper.

One is basically as a public policy we ought to be doing everything we can to support people who are really supplying capital directly to businesses.

Mr. SCHEUER. Risk capital.

Mr. LITTLE. Risk capital and also providing the management assistance to these people, not just passively investing in the stock market.

Second, that what we have here is for our industry, since the start of American Research and Development in 1946, and our business for 20 years since 1960, trying to prove to the SEC and the Congress—and usually going to the Congress and then getting referred back to the SEC and never getting anywhere with them—that there really isn't need for this regulation.

I think this goes to the point you were making earlier. Is the Government really working at cross purposes with the best public interest? I firmly believe that you simply cannot protect every individual who is going to invest, that there are going to be people who some will win and who will lose some but to try to legislate people out of being stupid or just having bad judgment, I think is an impossibility.

We have been at this now in our industry—I can only speak for our industry—for 20 years. Very frankly, we think we do a hell of a job and we have some figures to show we do a hell of a job.

Mr. SCHEUER. Do you have any data to show the kind of innovations and new processes that you produced that would benefit society that have not been carried on by the major corporations because it was too risky or too precedent shattering or it would make people do things where they are a little uncomfortable?

It seems to me in this day and age—just taking the field of energy, there is a tremendous national need for innovation and risk taking in the field of energy. The seven sisters are not about to do a heck of a lot of that because they are perfectly comfortably fixed. They are in the oil and gas business and to the extent they can get in the coal business, fine, but they are not about to get into inventive ways of saving energy or alternative sources of energy.

It seems to me that small and medium sized businesses that have the talent and the zest for combat, the zest for innovation and adventure and daring may prove to be a major part of our answer in our questions for reducing our dependence on Persian Gulf oil, which is a pressing, overriding national interest at this time.

How do we liberate all that inventiveness that is sitting there in the American economy?

One of the ways of liberating it is to provide both management competence to perhaps a small entrepreneur who has a genius idea but doesn't have the infrastructure to carry it out, as well as the financial assistance to get it going, especially if it is a long-term development.

It seems to me in a time when expenditures for research and development are falling as a percentage of GNP at a time when innovation seems to be failing in our society or faltering, let us say, at a time when the drug industry percentage of new drugs being developed is far less than it used to be; at a time when there is a far lower level in new plant and equipment than we had before and is necessary and helpful now to our economy, it seems to me the Government ought to be doing everything we can to liberate the talent and liberate the capital that wants to get into doing new things better in inventive ways; in ways that depart from comfortable precedent.

It seems to me that investors who want to invest in high payoff, high risk ventures, should understand there is risk on the downside as well.

There are tremendous payoffs to our society as well as to the investors in encouraging these kinds of innovations by small and middle level businesses. The benefits of creativity and innovation and enhancing our level of investment in research development, to a society as a macro matter ought to be cranked into the computer.

I hope my friend, the Commissioner, is listening—as part of the benefits from lessening the level of burden on this little industry.

Mr. LITTLE. Let me respond to that point.

Mr. SCHEUER. We ought to try to achieve a more precise appraisal of costs and benefits. The costs are real, the benefits of liberating of not doing are real. I get back to the point that I made and I apologize for being a bore, who needs protection and what level of protection do they need?

Mr. LITTLE. I think there are a couple of points I would like to make. One, if you look at the bill as we have drawn it, I think you will see there are all kinds of protection and disclosure for public shareholders. I would like to address the first part of your remarks, however.

One of the things that is particularly bothersome for us in terms of making those newer, more innovative kinds of financing is that they take a tremendous amount of money. That usually means you have to have more than one venture capital source in a deal, we are looking at a deal at the moment that will take \$3½ million. Our maximum we can put into the deal is \$3.7 million. If the deal is successful, it will need a lot more income than that before it gets to the point where it can go public.

As soon as we get other venture capital, people into the field and you add the additional complication of having three or four actual financings, you make this whole section 17 area much more complex because you get more affiliates in there and you have to look at the fairness of the deal each time.

We practically can't turn around without saying, oh God, is that a section 17 application? We spent about \$200,000 last year on

section 17 applications just in legal fees, never mind our staff time or the time that we had to wait for the SEC to respond.

These kinds of companies can't wait those periods of time. They need to know now. Do you have the financing for us now? Never mind the SEC. We need the financing now.

Mr. SCHEUER. Mr. Commissioner, these are some very interesting public policy questions here we are addressing as well as details and mechanics.

Mr. FRIEDMAN. Let me see if I can set forth our perspective on these issues. We see as our primary mandate the effective functioning of the securities markets and the protection of investors which is an integral function of those markets. If people think they have been treated unfairly, they won't participate. Without trying to defend everything the Commission has been doing, on the whole the Commission has done a good job of that over the years.

We as an institution, and I as an individual during my 2 years at the Treasury and as a lawyer, have been deeply concerned about equity flows to small businesses. It is my personal view that what we are talking about is not going to have a significant impact under these economic conditions, but I may be wrong and we are certainly doing everything we can to try to make this sort of mechanism available.

We have no desire to protect investors against their bad investment judgments, assuming adequate disclosure is made. I think the difference between us and the industry is largely a matter of degree. I was interested in listening to Mr. Little's testimony because it seems to me his principal concern is with problems imposed by the Investment Company Act currently and under our bill in the section 17 area. I have to say that our reading of the combination of relief granted by the statute we propose and the two existing rules we have is quite different from his but we are quite open and would be happy to sit down and discuss that at greater length with him.

In principle we have no objection to codifying the two current rules under section 17. On the other hand, I think everyone agrees, including the Commission, that rule 17d-1 needs substantial additional work. Its drafting needs improvement. We would be happy to work on those issues. I think the Motion that the Commission would rescind, these rules after having sucked everybody in with a smaller statutory change is simply wrong, but we would be happy to codify if it makes a difference to somebody. It is important that the relief granted be seen as a whole.

We continue to be of the view—and I think this is an important substantive difference—when there are direct conflicts of interests involving officers and directors of the investment company, when they are themselves involved, that is an appropriate time for the Commission to remain involved.

Mr. SCHEUER. Is an appropriate remedy laying forth conflict of interest on the table so investors know that the guy who is up here is also down here? Then they can make their own appraisal based on perhaps their individual knowledge of the individuals involved as to whether that conflict of interest is real or technical or as to whether they are going to be taken advantage of.

Mr. FRIEDMAN. Once these become a public company and they have an ongoing investment program, investors are not in a position to make a judgment about that. The judgments are made when the investments are made.

Second, as I said earlier, because these companies are largely dealing with private placements, you don't know how these things are going to come out, and there is no public market mechanism by which to judge the prices at which these transactions take place. It is therefore very hard for an investor to make a judgment about what is going on.

Without discussing this in detail, section 10—which restricts the number of bank-affiliated directors an investment company may have—in part simply reflects the decisions that were made at the time of enactment of the Glass-Steagall Act. In terms of investing on margin, we don't think a company which says it is a venture capital company supplying capital to small businesses ought to be investing on margin. That is an entirely different kind of transaction. We are happy to sit down and talk about all these things.

Mr. SCHEUER. The Glass-Steagall Act was a long time ago, an entirely different kind of economic environment. I think there ought to be a comprehensive arrangement and an adjournment to our thinking.

Mr. FRIEDMAN. That is true but I don't know whether this is the point to do that.

By shifting the area in which the Commission gets involved with investment companies in terms of the section 17 area, and maybe section 18, I am persuaded that we can provide a degree of relief through our rules and through the statute, and certain changes are perhaps appropriate.

There are a variety of other provisions which basically created Federal standards. There is a provision imposing a Federal fiduciary duty on the management of investment companies and their advisers. There are Federal rights of action. There is a provision of the Investment Company Act making embezzlement from an investment company a crime.

Mr. SCHEUER. It ought to be.

Mr. FRIEDMAN. It ought to be a Federal crime. By shifting out of the Investment Company Act framework, many of these provisions become inapplicable to venture capital companies—I suppose we could sit down and negotiate about this and come out with a list of provisions from the Investment Company Act that would be applied to these new creatures that in some sense both of us could agree on but I ask the question: Have we really done something which is worthwhile?

You talk about deregulation, we would have then created a whole new regulatory framework with new defined materials. While a lot of these provisions would have been carried over they would have been carried over in slightly different ways so there will be a whole new body of law that develops.

We won't know whether we will have created this new regulatory regime for a large group of companies, in which case it might make sense, or a small group, because we don't know what sort of response there will be to this change.

Our view is we ought to take the necessary steps and see what happens and if further changes are necessary, the Congress can take them and if they are not necessary, perhaps there is nothing more to do.

Mr. LITTLE. I would like to address a few points here. In 1963, just speaking about our industry, there were 30 publicly owned SBIC's with total private capital of \$350 million. There are now 14 publicly traded SBIC's with \$90 million in private capital.

I would submit to you that quite a large percentage of that drop has been due to the fact of the 1940 act, and people just find it absolutely impossible to deal with as a company doing venture capital business under this act. It really turns you into a pretzel.

The second thing that I would just ask you to listen to very carefully in the SEC's words is that they have a very difficult time letting anything go. It is only with a great deal of pressure that little nibbles are taken. Little nibbles are not good enough. We need some major changes here. We suggested major changes and in a way that we think are adequate and would give better investor protection here.

Mr. SCHEUER. I am concerned at the fact it takes \$250,000 of legal time for you to relate to one section of the law with the SEC. There is something wrong with the regulatory process that requires that amount of drainage of both capital and your executive time as well as the executive time of highpowered talented people working in the SEC.

Mr. FRIEDMAN. Those are the provisions we are changing. That is really the point whether you are satisfied with that or not. I think we can talk about it but I must say, Mr. Little, you really haven't read the rules.

We agree about that statement. We agree these companies ought not to have to come back to the Commission. But there is the one area involving directors, officers, employees, and controlling persons.

Mr. SCHEUER. The conflict of interest?

Mr. FRIEDMAN. Yes.

Mr. SCHEUER. There is a lot of thinking that is going to go on and I think everybody this morning is open minded and I think with the kind of talent and dedication that is represented at this table we ought to be moving toward an answer.

Mr. McMAHON. Just one question I would like to ask to Mr. Little and have Commissioner Friedman follow it up and then Mr. Halloran.

One of the differences is the definition of venture capital company as you see it and business development company as you see it. Could you tell us why that 20 percent cushion, namely, the 80-percent assets test, is so important to you.

Commissioner Friedman can by comparison indicate why 100 percent of assets, so to speak, is important to you as far as the definition because I see in overcoming the definitional problems we have taken a healthy step toward clearing the differences between the two bills and promoting similarities which might promote the passage of the bill significantly.

Without further ado, could you address that?

Mr. LITTLE. I think the basic thing that we see is another definition that a company will predominately do the kinds of things Congressman Scheuer was asking about. We find it to be a very tight straightjacket if you say it is like some of these things—you should never say never because you never can tell what is going to happen.

We just find if you define a term as solely, which means to me entirely, that you can have just some kind of small slip which again might get into a problem and all of a sudden the SEC comes back to you and says, you are no longer qualified as a venture capital company.

We think 80 percent is a very high test, relatively speaking, to the test that the IRS provides under subchapter 1 which is a 50-percent test. We went, in the drafting of our bill, particularly from our kind of company, from 60 percent to 80 percent. They made it tougher on us.

Mr. SCHEUER. Mr. Friedman?

Mr. FRIEDMAN. I guess I would say two things. First, I believe that under our approach, because we key the definition of business development company to the time of investment, we don't look at the portfolio, it isn't really possible to float out of compliance with the definition inadvertently.

Second, we simply think that if a company is going to be in substantial measure in the business of the making investments in widely traded securities then to that degree it really is an investment company and ought to be treated like any other investment company.

I am concerned about the notion that somehow they need to do regular investing or trading conceivably in order to generate enough income to fund current operations. That is always a problem in investment companies. We have tried to meet that by permitting unlimited investments in money market securities. Conceivably that window we have created ought to be expanded.

When you are really doing what a mutual fund does with a substantial portion of a venture capital company's portfolio then I think you have changed the ball game.

Mr. McMAHON. Don't you think by the very nature of venture capital you might have a significant writeoff at some time and you might slip over that percent—

Mr. FRIEDMAN. It can't happen. What our bill does is look at the original cost of all the investments in the portfolio so even though the value has gone way down, nothing changes.

Mr. McMAHON. Mr. Halloran.

Mr. HALLORAN. I think the response to section 12(b) of the 1934 act covers every national securities exchange—which is the American, Boston, Chicago, Cincinnati, Intermountain, Midwest, New York, Philadelphia, and Spokane. Those are the stock exchanges. It is not just the American and the New York.

So anything listed on those exchanges is out of the SEC definition of eligible portfolio investments.

As to the SEC exclusion of Federal Reserve Board margin listed securities, the list goes on for 1,250 companies. Why would a venture capital company invest in a company on one of those exchanges or on the OTC margin list? I think I can give you the

private venture capital company experience and perhaps that can be translated into the public venture capital company experience.

The investors in these funds expect their general partner to find developing technology situations. Those developing new technology growth situations may show up not only in privately held companies but sometimes show up in publicly held companies, in companies which are perhaps listed on one of these exchanges. For example, a venture capital company may have a scientist on its staff that is very interested in interferon. That may show up in a venture capital situation in a private company. It may also show up in an emerging publicly held company. The venture capital company will invest in both companies at once.

Their investors expect this. Therefore, I think that to say that there can be no investments in the case of the publicly held company—and I do understand that Mr. Friedman is suggesting opening up a window for the public company—is interfering to some extent with the venture capital process.

Mr. McMAHON. Thank you.

Mr. OPPER. Mr. Little's presentation included a kind of generic attack or reappraisal of the 1940 act. I am not quite so certain there are that many other industry groups that have suggested that it be abolished outright. I must say that the subcommittee has really not heard from any other industry representation, including the Investment Company Institute which have suggested an outright abolition of the act.

I do think we understand the difficulties that SBIC's and other venture capital companies have operating under the act. If I am not mistaken, there are approximately 40 registered SBIC's.

Mr. LITTLE. Thirty-two registered.

Mr. OPPER. So essentially these are the companies that we are talking about aside from the potential companies that would take advantage of one of the other of the two bills that we are considering today, this rather narrow sphere of venture capital type company.

During our last hearings the Commission submitted a rather lengthy document which has caused some concern suggesting that those small business investment companies that have been registered under the 1940 act have been involved in a disproportionate number of enforcement type cases by the SEC. To clear the air I would appreciate it if the Commission could provide some data.

How many companies are you talking about? What kind of enforcement actions are you talking about? Are they really substantive kinds of violations?

Mr. SCHEUER. What are the abuses, in other words?

Mr. FRIEDMAN. I have some data which we will submit. As I understand it, approximately 30 percent of the public SBIC's which are currently registered have been the subject of some type of administrative or injunctive actions.

Mr. SCHEUER. For what kind of reasons?

Mr. FRIEDMAN. Largely those have involved sections 17 (a), (b), and the antibribery provision in section 17(e). I don't know how they break down.

Mr. LEMOV. We understood there were four formal proceedings in 40 years. You are saying 25 percent of the SBIC's have been involved in an inquiry by the Commission.

Mr. LYBECKER. Thirteen out of the 188 litigation releases issued by the Commission involving investment companies generally since 1958 involved SBIC's. That means that, during the period of time since SBIC's were first created 7 percent of our official enforcement actions have involved SBIC's, while never exceeding an average more than 3 or 4 percent of the investment companies we have had registered under the act, so in that sense they are involved in a disproportionate amount of our resources.

Mr. SCHEUER. Let's get to the disproportionate amount of your resources. From what you have said, the whole thing seems to be de minimis because they are involved in less than 10 percent of your enforcement and less than 10 percent of your resources.

Mr. LYBECKER. Of the 13 litigation releases, SBIC's have been involved in.

Mr. SCHEUER. Out of 170.

Mr. LYBECKER. Yes; we have averaged between 5 years of initiation and termination in those cases. That is unusual in our experience. Usually it is much shorter, rarely exceeding 1 year. Almost all of those actions that have been brought against SBIC's have had to involve formal and protracted administrative procedures. As you know from your oversight experience most of the Commission's enforcement cases are settled, not contested.

SBIC's have been involved in a relatively large amount of enforcement activity over an extended period of time. It isn't as easy, I would suggest, as 7 percent of this and less than 5 percent of that. Viewed from the perspective of use of our enforcement resource, it has been significant.

To make the record complete with respect to Commissioner Friedman's earlier comment the comparison one would make is we have never had in excess of 68 registered investment SBIC's under our act and over 25 percent of those which have been registered have been involved in some sort of enforcement proceeding.

So in terms of comparison against that population, the number of enforcement cases we have brought formally against other kinds of investment companies has to be compared against that universe. We have at present over 1,300 investment companies and we have had to bring formal proceedings necessitating a litigation release against 188 in over 22 years. So that you have to compare cases we have brought against the size of population we have had registered with us.

That is what leads to the conclusion that SBIC's have been involved, compared against the entire base proportion, in a significantly higher proportion of enforcement proceedings than the investment company community generally.

Mr. SCHEUER. Those are numbers. I would want to know the kind of actions that were brought and what the result of those actions were and what kind of offenses they involved. It may be that this industry is being overregulated. I am not saying that it is. This is one of the items that we are discussing. The numbers without some kind of qualitative input as to who is protected against what and what is the current validity of that level of protection and all the

resources you are spending in it, I think has to be considered an open question at this point.

Mr. FRIEDMAN. We provided some information as an attachment to our memorandum but we would be happy to provide more.

Mr. SCHEUER. I think that would be helpful to give us the information you gave us but add a little more information on the substantive problems to which your enforcement actions were addressed, who was being hurt, and the benefits that were being achieved by the actions that you brought.

Mr. FRIEDMAN. Fine.

[Testimony resumes on p. 197.]

[The following letter was subsequently received for the record:]



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 23, 1980

The Honorable James H. Scheuer
Chairman
Subcommittee on Consumer Protection
and Finance
Committee on Interstate and
Foreign Commerce
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

In the course of my testimony for the Commission on various bills relating to venture capital before your Subcommittee on June 17, 1980, we referred to certain enforcement activities initiated by the Commission involving small business investment companies ("SBICs"). You requested that we provide additional information concerning these enforcement activities. Accordingly, I am pleased to submit to you a report prepared by the Commission's Division of Investment Management containing summaries of Commission injunctive actions, administrative proceedings and investigations involving SBICs currently registered with the Commission.

We hope that this report will assist the Subcommittee in its deliberations. Please let me know if we can be of any further assistance.

Sincerely,

Stephen J. Friedman
Commissioner

Enclosure

REPORT OF THE DIVISION OF INVESTMENT MANAGEMENT
SECURITIES AND EXCHANGE COMMISSION

There have been a number of enforcement actions brought against small business investment companies ("SBICs") registered under the Investment Company Act of 1940 ("Act"). It should be noted that since 1970 the Commission has not routinely inspected SBICs. Therefore, each of these post-1970 enforcement actions was begun on a "for cause" basis; our experience suggests that, if SBICs were routinely inspected, more enforcement cases would have resulted. Twelve of the 42 SBICs currently registered under the Act have been the subject of formal Commission enforcement action. Some of these cases have involved fraudulent conduct that was serious enough for the Commission to institute injunctive actions and take the unusual step of seeking the appointment of receivers to salvage some of the corporations' assets. These actions are discussed below.

In the first case concerning Puerto Rico Capital Corporation ("PRCC"), the Commission found the conduct of PRCC's officers and directors so inimical to the best interests of that company that it sought to bar such individuals from serving either PRCC or any other investment company in the future as an officer or director. In an action brought under Section 36 of the Act, the Commission asserted that the officers and directors had breached their fiduciary duty to PRCC by causing it, in violation of Section 17 of the Act, to invest in companies they owned or controlled, resulting in very substantial losses to PRCC. In settling this action, 1/ not only were the defendants enjoined from serving any investment company as an officer or director, but they also paid PRCC \$500,000. 2/

1/ Litigation Release No. 3308 (September 1, 1965).

2/ Litigation Release No. 4395 (August 13, 1969).

Blatant self-dealing was the basis for the Commission's injunctive action in the case against Illinois Capital Investment Corporation ("ICIC"). The Commission's complaint alleged that ICIC had been involved, directly or indirectly, in numerous affiliated transactions which had not received the statutorily required approval pursuant to Section 17(a) or 17(d) of the Act. Moreover, certain officers and directors were alleged to have caused ICIC to conceal violations of the Act in reports filed with the Commission and proxy solicitations sent to shareholders. 3/ The defendants were permanently enjoined from further violations of the Act. 4/

One example of the rapacious conduct which served as the foundation for the Commission's action against Advance Growth Capital Corporation ("Advance Growth") was a series of transactions involving development of real estate lots, which violated Section 17 of the Act. 5/ The Chairman of Advance Growth arranged for a portfolio company to purchase all of the undesirable lots and pay for all of the development while a real estate company, 79% owned by the chairman, was joint participant in the venture, but paid nothing for the developer's services and was not burdened with any of the undesirable land. 6/

In another equally reprehensible series of transactions, Advance Growth provided 100% financing for four years at low interest rates for the purchase by G.L. Service Corp. ("GL") of highly profitable assets from Advance Growth's portfolio company, Intermediates, Inc. ("Intermediates").

3/ Litigation Release No. 4699 (July 27, 1970).

4/ Litigation Release No. 4777 (October 9, 1970).

5/ SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972).

6/ Id. at 45-46.

GL was 20% owned or controlled by members of the chairman's family and 5% owned by two of Advance Growth's other directors. GL purchased tax certificates from Intermediates for half their real worth. Moreover, the interest rate on Advance Growth's loan to GL was originally 4%, and later increased to 7%, even though prevailing interest rates at the time were 14 1/2%. Finally, GL failed to make payments when due on its notes to Advance Growth, which had financed the transaction, and paid Advance Growth a total of only \$90,000 of the principal during a period when the certificates produced cash receipts of over \$217,000; during the same period that its note to Advance Growth was overdue, GL loaned more than \$150,000 to other companies controlled by the chairman. 7/

On the basis of these and numerous other transactions and practices 8/ harmful to Advance Growth, which (in the view of the Seventh Circuit Court of Appeals) "invariably came out second best," 9/ and were "indicative of conduct that tends to be overreaching," defendants were permanently enjoined from violating any of the Act's provisions.

In a case involving Capital Corporation of America ("CCA"), in addition to serious allegations involving the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, it was alleged 10/ that Barton Banks, in violation of Section 17(e) of the Act, abused his position as president of CCA and as the person responsible for making loan decisions by requiring prospective borrowers to retain him as an attorney

7/ See id. at 47-48.

8/ See id. at 49-51.

9/ Id. at 51.

10/ Investment Company Act Release No. 8152 (December 27, 1973).

to prepare documents in connection with loans made by CCA. The Commission proceeding resulted in Banks being suspended from serving any registered investment company for 90 days, the vice-president of CCA being suspended for 60 days and these two individuals paying CCA \$25,000. 11/

On October 31, 1972, the Commission issued an order for administrative proceedings under Section 9 of the Act involving Creative Capital Corporation ("CCC"), Comac Company, its investment adviser, and certain directors of CCC, alleging that these individuals had engaged in gross misconduct or gross abuse of trust in carrying out their responsibilities to CCC. In particular, in violation of Section 17(d) of the Act, they had caused CCC to lease, at Comac's behest, office space on which Comac had previously been refused a lease. This transaction resulted in a \$295,377 loss by CCC when Comac was unable to fulfill its commitment to sublet the office space. In a second instance of self-dealing which violated Sections 17(d), 36 and 36(a) of the Act and Rule 17d-1 thereunder, it was alleged that Comac caused CCC to loan \$285,000 to a portfolio company on terms disadvantageous to CCC so that the portfolio company could meet a contractual commitment Comac was unable to fulfill. In settling this proceeding, 12/ the directors were barred from serving any registered investment company in various capacities, including as an officer, director or investment adviser, and were barred from association with any broker-dealer or investment adviser. Finally, one of the directors who was an attorney and another who was an accountant agreed not to appear or practice before the Commission.

11/ Investment Company Act Release No. 9024 (November 12, 1975).

12/ Investment Company Act Release No. 7791 (April 26, 1973).

On March 22, 1979, the Commission issued a report on its investigation of Greater Washington Investors, Inc. ("GWII") ^{13/} setting forth the Commission's views on certain aspects of GWII's operations. The Commission was concerned that GWII used valuation procedures for its portfolio securities which substantially overstated the value of the securities. For example, GWII in certain instances valued the restricted securities held in its portfolio at the same market value as freely marketable securities issued by the same company, a practice which was clearly inconsistent with the guidelines set forth in Accounting Series Release 113 (October 21, 1969) and 118 (December 23, 1970). In the case of other portfolio securities for which there was no public trading market, GWII's valuation failed to adequately reflect the serious financial problems these portfolio companies were experiencing. The failure resulted in valuations which were overly optimistic and underestimated the difficulties facing the portfolio companies. In addition, the Commission believed that GWII became overly leveraged through the issuance of senior securities in violation of Section 18 of the Act. GWII revised its procedures so that they were consistent with the Commission's views.

In addition to these public enforcement actions against SBICs registered under the Act, there have been at least six other instances, discussed below, in which the Commission staff initiated a preliminary investigation or sought and received from the Commission a formal order of investigation and the attendant subpoena authority in order to pursue these matters because of their concern that improper conduct had occurred affecting an SBIC. While these investigations did not result in the Commission's either bringing an injunctive action, instituting an administrative proceeding or issuing a report of investigation

^{13/} Securities Exchange Act Release No. 15673.

pursuant to Section 21(a) of the Securities Exchange Act, these investigations did uncover improper conduct. The decisions to close these investigations, however, were generally made because the improper conduct had ceased and either there had been no harm to the SBIC or the harm which had occurred was not of a magnitude to justify devoting scarce Commission resources to pursuing an administrative proceeding or injunctive action. 14/

An investigation of SBIC A 15/ concerning possible violations of Sections 17(e) of the Act and conduct actionable under Section 36 centered on certain activities of an attorney who was president and a director of the SBIC. The attorney received a 1% fee from all of SBIC A's borrowers, ostensibly for legal services rendered in connection with the portfolio financings. The investigation also looked into a questionable transaction whereby a portfolio company, of which SBIC A was a creditor, was reorganized and as a result of that reorganization SBIC A became an equity holder of the reorganized company. For his role in this reorganization, the attorney was paid \$9,674 in legal fees and was authorized to receive, though in fact he never received, a warrant to purchase 20,000 shares of the reorganized company.

An investigation of SBIC B indicated that SBIC B had engaged in certain transactions which violated the self-dealing prohibitions in Sections 17(a) and 17(d) of the Act, had violated Section 13(a)(3) of the Act by deviating from its fundamental policy concerning the percentage of its assets it would invest in one company and had carried at cost certain investments which

14/ As we indicated in our recent testimony, the Commission has allocated a substantially disproportionate amount of its enforcement effort in the investment company area to cases involving SBICs.

15/ We have referred to these companies by letter out of deference to the non-public character of the original investigations.

could have been more realistically valued. However, the investigation did not uncover any breaches of fiduciary duty and the case was closed once it was determined that SBIC B was prepared to take appropriate corrective action with respect to the violations which were discovered.

An investigation of SBIC C was undertaken based on information obtained during a routine inspection of SBIC C which indicated that it had overvalued its portfolio securities, paid excessive interest rates on borrowings from affiliates, and had violated its fundamental investment policy regarding the amount which could be invested in one company. In addition, it appeared that SBIC C had a board of directors which exceeded the Act's limitations on the number of interested persons who can serve on an investment company's board, thereby casting doubt on the validity of the board's approval of matters such as the company's investment advisory contract. Finally, SBIC C had issued senior securities apparently in violation of the prohibitions in Section 18 of the Act. This case was closed after the staff concluded that further enforcement activity was not justified in light of the time, effort and personnel costs which would have been required.

The Commission issued a formal order of investigation based on information which indicated that SBIC D and an affiliated bank may have engaged in transactions violating Sections 17(a) and 21(b) of the Act. The investigation documented that an affiliated person of SBIC D had knowingly sold securities to SBIC D, borrowed money from SBIC D and that SBIC D had loaned money to an affiliated bank. The facts clearly indicated that the violations had occurred,

but did not demonstrate any scheme to defraud the fund nor any damage to the fund as a result of these transactions. In addition, the record indicated that the improper activity had ceased. Therefore, a proceeding was not recommended although the staff noted that these situations had substantial potential for overreaching.

A preliminary investigation was made of SBIC E because of possible violations of Section 17 of the Act arising from two series of business dealings. The investigation documented that the fund's legal counsel received fees from portfolio companies for legal services rendered on behalf of the fund - such services included placement of investments by the fund in these small businesses, revision of terms in such investment contracts, and disposition by the fund of investments in these businesses. A second area of concern was the repayment by portfolio companies of outstanding loans owed by these companies to subsidiary banks of the bank holding company which organized the fund. The investigation was concluded without recommendation for an administrative proceeding following clarification of the law firm's role in the fund's investment activity and evidence of disclosure on the practice of repayment of bank loans by the portfolio companies.

Indications from the Organized Crime Strike Force that certain shareholders and creditors of SBIC F had direct or indirect affiliations with organized crime, combined with an inferential offer of inducement to a Commission compliance examiner to compromise his official responsibilities prompted an investigation of this company. The investigation did not uncover any violations which warranted

further enforcement activity with respect to the Federal securities laws.

While some of the cases discussed above may have involved violations of the general antifraud provisions of the federal securities laws, in general we do not believe that the antifraud provisions of the Securities Exchange Act, nor the limited remedies that might be available under the Securities Act, can realistically be viewed as adequate substitutes for the much more extensive protections available under the Act. See generally Securities Act Sections 12(2) and 17(a); Exchange Act Section 10(b) and rule 10b-5. For example, a private plaintiff seeking relief under rule 10b-5 may be required to show that: he is either a purchaser or seller of the securities in question, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); the defendant acted with scienter in perpetrating the fraud, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); and there is some element of deception and not simply corporate mismanagement or unfairness, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977). Perhaps most importantly, Section 17 of the Act provides for Commission review of proposed transactions in situations where, because of conflicts of interest, there may be overreaching. The Securities Act and Exchange Act provide bases for relief after the fact, entailing possibly expensive and protracted litigation, as the case of Wright v. Heizer Corporation, 560 F.2d 236 (7th Cir. 1977), cert denied., 434 U.S. 1066 (1978), illustrates.

Mr. SCHEUER. We have a rollcall vote. I am going to have to leave in 7 minutes and I have an appointment with the Speaker so I cannot come back.

Mr. LEMOV. The key thing is what types of issues those 13 releases in 40 years related to. If they were technical, minute violations where the staff was, perhaps, spinning their wheels, they prove nothing.

Mr. SCHEUER. Maybe they are and maybe they are not. We have asked them to give us that information.

Mr. LEMOV. We reviewed four formal cases which we found in the reports. We would be pleased to submit for the record a summary of them. They are largely technical violations.

[Testimony resumes on p. 211.]

[The reports referred to were subsequently received for the record:]

LEIGHTON CONKLIN LEMOV AND JACOBS

M E M O R A N D U M

TO: Honorable James H. Scheuer
Chairman, Subcommittee on Consumer Protection and Finance

FROM: Leighton Conklin Lemov and Jacobs, Chartered

DATE: July 1, 1980

RE: Alleged Abuses by Small Business Investment Companies

INTRODUCTION

The SEC has indicated that the history of abuses by small business investment companies indicates a continuing need for the protections provided by the Investment Company Act of 1940.^{1/} It is the purpose of this memorandum to examine the four civil proceedings relied upon by the SEC to determine whether they support the SEC's conclusion.

ILLINOIS CAPITAL INVESTMENT CORPORATION

Materials Examined^{2/}

We have examined SEC Litigation Releases Nos. 4699 and 4777. These releases report the filing of civil proceedings in the United States District Court for the Northern District of Illinois and the consent decree which terminated that litigation.

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- 1/ Hearings on H.R. 3991 Before the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, 96th Cong., 1st Sess. 95 (1979); Hearings on H.R. 10717, H.R. 13032, and H.R. 13765 Before the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, 95th Cong., 2nd Sess. 33 (1978).
- 2/ In all cases we have relied on the SEC's reports supplied to the House Subcommittee on Consumer Protection and Finance as well as the listed materials. See Id.

Discussion

In its complaint the SEC alleged that Illinois Capital Investment Company ("ICIC") and five affiliates of ICIC violated sections 17(a), 17(d) and 21(b) of the Investment Company Act of 1940. In addition it was alleged that ICIC submitted false proxy materials to shareholders and false reports to the SEC by failing to disclose these violations of the Investment Company Act.

The alleged violation of section 17(a) involved the sale of a piece of improved property by ICIC to an attorney who was affiliated with ICIC.^{3/} In addition, a brokerage firm whose president was director of ICIC entered into 12 securities transactions with ICIC.

The violation of section 21(b) involved ICIC's making salary and travel advances to its president.

The violation of section 17(d) involved a joint transaction (the 12 securities transactions) between ICIC and a corporation that was owned and controlled by a person who was vice-president and a director of ICIC.

All defendants consented to an order enjoining them from further violations of the Investment Company Act of 1940.

Analysis

Apart from the fact that the alleged activities are proscribed by the Investment Company Act of 1940, it is not apparent that any of these activities were detrimental to the interests of shareholders or involved overreaching of ICIC or its shareholders. That the activities did not involve any breach of fiduciary duty owed by insiders to shareholders is further supported by the fact that the SEC did not allege that any of these

^{3/} There is no indication of the manner of affiliation.

activities violated section 36 of the Act, which prohibits insiders from breaching their fiduciary duty to the company.

It is unclear how this case supports the SEC's contention that the protections of the Investment Company Act of 1940 are needed by shareholder of a small business investment company. That Act is intended to protect shareholders from overreaching by insiders by forbidding virtually all transactions between the registered investment company and affiliated persons unless the SEC approves the transaction. In this instance it appears that the transactions were harmless and not the type the 1940 Act was intended for. The only adverse effect on shareholders would appear to be the legal expenses incurred as a result of the SEC's bringing suit.

The SEC's claims to the contrary, this case appears to support an exemption from the Investment Company Act with appropriate Securities Exchange Act disclosure. If ICIC had been subject to the reporting and proxy requirements of the Securities Exchange Act of 1934, it would have been required to describe to shareholders and the SEC any transactions involving ICIC or its subsidiaries in which any of its officers or directors had a direct or indirect material interest.^{4/} The SEC would also have full authority to adopt any additional disclosure requirements it believes would be appropriate for venture capital companies.^{5/} Thus shareholders would have been fully informed of the transactions involved and, if they believe these amounted to a breach of fiduciary duty owed to ICIC by its directors and officers, they could have sought appropriate judicial remedies.

ADVANCE GROWTH CAPITAL CORPORATION

Materials Examined

We have examined the decision of the court of appeals in SEC v. Advance Growth Capital Corporation^{6/} and a report by the law firm of Avery, Hodes, Costello and Bur-

^{4/} 17 C.F.R. §§ 229.20 Item 4(f), 240.14a-101 Item 7.

^{5/} See, e.g., 17 C.F.R. § 240.14a-101 Item 6(c).

man into the abuses alleged in that case. The report was the result of an independent investigation ordered by the district court upon remand.

Discussion

This case involved a request for injunctive relief brought by the SEC against Advance Growth and the chairman and president of that company. In its complaint the SEC alleged that defendants violated the provisions of sections 17(a), 17(d), 34(b) and 36 of the Investment Company Act of 1940 in numerous transactions between Advance and its affiliates.

The district court ruled that while sections 17(a) and 17(d) of the Investment Company Act had been violated, the violations were inadvertent and not disadvantageous to Advance Growth. It therefore refused to issue an order enjoining further violation of the Investment Company Act.

On appeal the Seventh Circuit Court of Appeals overturned the district court's decision and required the entry of an order permanently enjoining all defendants from violating the provisions of the 1940 Act. The court indicated that, in light of the fact that the individual defendants were lawyers and were constantly given notice by the SEC that they were in violation of the Act, it could hardly be claimed that their violations were inadvertent. Furthermore, the court stated that there were substantial indications that a number of the transactions involved were disadvantageous to Advance Growth.

On remand the district court appointed Avery, Hodes, Costello and Burman, a Chicago law firm, as special counsel to conduct a thorough investigation and, on the basis of court records, independent examination of company files, and interviews with appropriate persons, to report to the court and the SEC as to those transactions which might form a basis for litigation by Advance Growth to recover for violations by affiliates of the Investment Company Act for breaches of fiduciary duty. The resulting 60 page

6/ 470 F.2d 40 (7th Cir. 1972).

report recommended litigation with respect to some of the transactions while rejecting litigation as to others. It suggested that damages be requested in the amount of \$318,000.

Advance Growth was organized in 1961, as an SBIC with a capitalization of about \$6,500,000. As a result of bad investments and excessive management salaries, benefits and expense accounts, Advance Growth was deeply in the red by 1963.

Defendants Giachini and Murphy, who owned a substantial amount of the stock of Advance Growth, were disturbed about this situation and formed a group of stockholders who successfully took control of the company. Giachini and Murphy, who took control of management respectively as chairman of the board and president/director, then sought to revitalize Advance Growth:

The new management began its program to rejuvenate Advance Growth by eliminating directors' fees and officers' salaries and benefits. They also moved the offices from Chicago into less expensive quarters in the suburb of Maywood, Illinois. All of the company's staff and office expenses were absorbed by the new officers' law firm. Giachini and Murphy also expended a great deal of time and effort traveling about the country attempting to salvage as much as possible from the unprofitable loans made by prior management. As a result of the dramatic cuts in operating expenses, coupled with a somewhat fluctuating increase in income since Giachini and Murphy gained control, Advance Growth has gradually reduced its large deficit and achieved some degree of financial stability — especially in comparison with its condition under prior management.

In spite of these efforts, Advance Growth's capital was severely impaired in 1965 and the SBA filed suit seeking the appointment of a receiver. That suit was dismissed in 1966 upon the sale of certain assets which cured Advance Growth's capital impair-

7/ S.E.C. v. Advance Growth Capital Corp., 470 F.2d 40, 44(7th Cir. 1972).

ments.^{8/} Shortly thereafter the SEC filed its suit in this matter alleging a number of the company's transactions were in violation of the 1940 Act.

In its report to the court the special counsel examined the legal basis for a suit for damages by Advance Growth. The special counsel noted that the mere fact that section 17 of the Investment Company Act had been violated did not create a basis for recovery. Rather, it would be necessary to show that there had been a breach of fiduciary duty owed by those insiders who had divided loyalties. The special counsel concluded that the standards established under Illinois state law would govern whether Advance Growth could recover — insiders with divided loyalties would have the burden of establishing that the transaction was fair in light of the facts available to them at the time of the transaction. Unlike directors where there is no conflict of interest, they could not cloak themselves in the business judgement rule.

It should be noted at this point that certain questionable representations concerning this case were made to the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce by the SEC in its memorandum submitted to that Subcommittee on January 3, 1980.^{9/} Concerning a land transaction involving affiliates of Advance Growth the SEC implies that Advance Growth was thoroughly disadvantaged by the overreaching of an affiliated company controlled by Advance Growth's chairman.^{10/} The special counsel's Report of Examination which goes into the transaction in great detail, however, presents a far different picture, indicating

8/ It should be noted that the sale which cured Advance Growth's capital impairment and was required by the SBA forms the basis of part of the SEC's claim and represents about 20 percent of the amount of the claim for damages recommended by the court appointed special counsel.

9/ Hearings Before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce on H.R. 3991, 96th Congress, 1st Sess. 84 (1979).

10/ Id. at 99.

that it was highly questionable whether Advance Growth could establish that it was overreached in spite of the fact that under relevant state law its chairman would have the burden of establishing his good faith.^{11/} Likewise, the SEC fails to disclose the fact that the sale at cost of "highly profitable assets" was forced by the SBA and resulted in a substantial loss to the affiliate who allegedly overreached Advance Growth.^{12/} Thus, the SEC memorandum contains serious omissions of material facts and is misleading to a person relying on it in order to judge whether the Advance Growth proceedings indicate a need for Investment Company Act "protections."^{13/}

Analysis

The history of Advance Growth presents a compelling argument for the exemption of venture capital companies from the Investment Company Act of 1940 and the substitution of a regulatory scheme which requires full disclosure to shareholders but does not require prior SEC approval of each transaction.

Giachini and Murphy certainly provided Advance Growth with services of far more value to Advance and its shareholders than the amounts they improperly diverted from the company. However, as the special counsel noted, this fact does not fully exonerate them:

We have given no effect, in evaluating the specific dealings under review, to the apparent fact that Giachini and his associates took over management of Advance at a time when it was near financial failure and succeeded in preventing such failure and restoring it to relatively healthy financial status, all without taking substantial compensation or salaries and while providing legal services without cost. We do not deem such considerations to be of direct legal significance to

11/ Report of Examination at 36 - 43.

12/ Compare Hearings, n.9 *supra* 99-100 with Report of Examination, 23-35.

13/ In light of the fact that all materials are available in SEC files, it would seem not too difficult to meet the Hochfelder requirement of scienter.

the specific issues under review. However, they do tend to negate a general conclusion of a venal intent to apply Advance assets for personal gain and may affect the weight which a court might otherwise give to a presumption or inference of unfair dealing.^{14/}

Although Giachini and Murphy did, at great personal expense and effort, pull Advance Growth back from the brink of insolvency, this does not justify their dealings with the company. Yet the Investment Company Act of 1940 proved to be ineffective in protecting the shareholders of Advance Growth. While the SEC was able to obtain an injunction forbidding further violations of the Investment Company Act, the only meaningful relief for shareholders (i.e., the return of money that was lost due to overreaching of the company) was available under state corporate law.

A far more effective means of dealing with a situation such as that surrounding the Advance Growth case would have been through the enforcement of the disclosure provisions of the Securities Exchange Act of 1934. Under current rules, every transaction referred to by the court of appeals and discussed in the special counsel's Report of Examination would have to have been disclosed to shareholders in a proxy statement or information statement. If it deemed information as detailed as that contained in the Report of Investigation necessary for an understanding of the material aspects of the transactions, management could have been required to supply each shareholder with such detailed information. The shareholders could then decide what action to take.^{15/}

14/ Report of Examination 59.

15/ Informed shareholders would have had far more flexibility than the SEC. If, for instance, they believed that, overall, Giachini and Murphy had been valuable to Advance Growth, they could simply adopt a resolution requiring less self-dealing and better record-keeping in connection with transactions with affiliates (under 17 C.F.R. § 240.14a-8 any one shareholder could require such a resolution be included in management's proxy). If more forceful action were deemed appropriate, shareholders could attempt to take control as Giachini and Murphy had done due to prior management's abuses. Finally, any shareholder could sue Giachini and Murphy on behalf of the corporation for breach of their fiduciary duty, as noted in the

Finally, if the April 23, 1980 revised version of H.R. 6723 were in effect, it is doubtful whether the more questionable transactions would ever have taken place. Under proposed section 7A(a) of the Investment Company Act, a majority of the board of directors would have been required to be disinterested persons. Under proposed section 7A(b) a majority of those disinterested directors and a majority of directors without an interest in the particular transaction would have to have approved each transaction on the basis that:

(A) the terms thereof, including the consideration to be paid or received, are reasonable and fair to the shareholders or beneficial owners of the eligible venture capital company and do not involve overreaching of the company or its shareholders or beneficial owners by another party; and

(B) the ownership or purchase is not contrary to the interests of the shareholders or beneficial owners of the eligible venture capital company and is consistent with the policy of the company as recited in its articles of incorporation and any other documents made available to the shareholders or beneficial owners generally.^{16/}

Any person who violated that provision, either by failing to obtain approval or improperly giving approval, would be liable to persons injured as a result of such violation.^{17/} Under such circumstances it is likely that the parties to the transaction and the directors would at least take a long look at such a proposed transaction before entering into it.

special counsel's report of examination.

16/ Proposed § 7A(b) of the Investment Company Act of 1940.

17/ Proposed § 7C(a) of the Investment Company Act of 1940. It should be noted that, in many instances, this may result in greater liability than would result today from a failure to obtain SEC approval of a transaction which violates section 17. If an affiliate enters into a transaction with an investee company without approval and the transaction, although fair at the time it is consummated, turns out poorly for the investee company, that company and the venture capital company would be injured as a result of the violation, thus giving them a right to recover damages. Such strict liability is not presently available for violations of section 17.

CREATIVE CAPITAL CORPORATION

Materials Examined

We have examined Investment Company Act of 1940 Release No. 7791, April 26, 1973 (concerning settlement of administrative proceedings), and the proxy materials for the annual meetings of shareholders of Creative Capital Corporation held on October 28, 1969, May 4, 1971, May 12 1972, and September 11, 1973.

Discussion

The administrative proceedings involved allegations that several directors of Creative Capital, who controlled the corporation through their ownership of a bank and an investment partnership that owned controlling blocks of stock of Creative Capital, caused the company to enter into transactions with affiliates in violation of section 17 of the Act, and that these transactions involved gross misconduct or gross abuse of trust within the meaning of section 36 of the Act. The SEC also alleged that an investment adviser of Creative Capital violated section 15(a) of the Act by serving as investment adviser without a written contract complying with the provisions of that section, and that the proxy materials sent to shareholders between October, 1967 and May, 1972 were materially untrue and misleading.^{18/}

^{18/} It should be noted that the three directors who were subject to the SEC consent order had resigned from their offices on August 10, 1970. The other party to agree to the consent order, Comac Company, the investment adviser and a partnership in which the three directors had an interest, had been in bankruptcy for at least one year as of the date of the consent order. There is further information indicating that the individuals named in the consent order were in poor financial condition. Thus, it is uncertain whether these parties agreed to the consent order because they could not successfully defend on the merits or because they could not afford the continuation of the proceedings. It is unknown whether the SEC was successful in its claim against the remaining respondents, including Creative Capital's president, who entered a general denial of the Commission's claim.

Two transactions were alleged to violate section 17 of the Investment Company Act of 1940. The first involved a loan to American Home Towns, Inc., ("AMHT") a company in which Creative Capital owned 49 percent of the common stock. The loan was made for the purchase of a trailer park which had been brought to the attention of AMHT by an affiliate of Creative Capital, Comac Company. A 50 percent subsidiary of Comac was to manage the property. In addition, Comac agreed to find a purchaser for the trailer park or to purchase it itself if AMHT wished to sell out within five months.

AMHT attempted to exercise this option, but Comac defaulted on its obligation. AMHT apparently sold the trailer park at a loss, but ultimately repaid the loan from Creative Capital. Although the transaction apparently worked out poorly for AMHT, there is nothing available which indicates any overreaching by any affiliates or controlling persons of Creative Capital.

The second transaction involved a 20-year lease by Creative Capital of office space in New York City. Comac was to sublet 80 percent of the space, but never was able to use any of it. Creative Capital had to pay the landlord for release of the lease and while Comac agreed to indemnify Creative Capital for 80 percent of its losses, it appears that, due to the financial plight of Comac and its partners, it was unable to do so. Although the transaction certainly appears to have been in violation of section 17 of the Investment Company Act, and it did turn out poorly for Creative Capital, there is no indication that it involved any overreaching of Creative Capital.

The violation of section 15(a) of the Investment Company Act appears to have resulted solely from the failure to enter into a written investment advisory contract with Comac. There is no indication that Comac was paid an excessive amount for its services or that the transaction otherwise involved any overreaching by affiliates or control persons of Creative Capital.

ANALYSIS

The Creative Capital proceedings appear to demonstrate nothing beyond the fact that the SEC has little difficulty in extracting agreement to a consent order from per-

sons who are in financial difficulty. The SEC began its administrative proceedings in October, 1972, two to four years after the dates of the transactions on which the proceedings were based. Information concerning these transactions had been disclosed to shareholders at least a year and a half before the SEC began its investigation. The persons who ultimately entered into a consent agreement with the SEC had, in the wake of their financial difficulties, left Creative Capital more than two years prior to the commencement of the administrative proceedings. The fact that those who chose to contest the allegations made by the SEC ultimately prevailed, while those who could not afford to do so were permanently enjoined from having any association with any broker-dealer, investment adviser, or investment company, merely seems to indicate that the broad swath cut by the Investment Company Act of 1940 can lead to unfortunate and perhaps unfair results for the unsuccessful.

PUERTO RICO CAPITAL CORPORATION

We were unable to obtain any relevant materials concerning Puerto Rico Capital Corporation beyond that information available in the SEC submissions to the House Subcommittee on Consumer Protection and Finance. There is, therefore, no basis on which the statements or conclusions of the SEC in connection with that litigation can be analyzed.

CONCLUSION

In its submission to both the House Subcommittee on Consumer Protection and Finance and the Senate Subcommittee on Securities, the SEC stated:

While we were concerned with the need to aid the capital-raising efforts of small business, this goal should not be accomplished in a manner which would cause substantial dilution of protections of members of the public whose funds would be invested in venture capital companies. The Commission's experience in enforcing the federal securities laws reinforces our conclusion that investment companies should not be excluded from compliance with the act solely because they

engage in "venture capital" activities. In particular, small business investment companies ("SBICs"), some of which may engage in activities sufficiently within the Bill's definition of venture capital company to permit them also to rely upon the proposed exclusion from the Investment Company Act, have had a number of enforcement actions brought against them. Some actions have involved serious fraudulent misconduct, 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 investors in such companies.^{19/}

Setting aside the accuracy of the Commission's assertion that the above-discussed actions "involved serious fraudulent misconduct," it is not apparent how the Commission's enforcement experience has indicated any benefits flowing from the Investment Company Act of 1940 to the shareholders of SBICs. How, for instance, were the shareholders of Advance Growth aided by the 1940 Act when the only effective relief was available under state law? What benefit was provided to shareholders by the SEC's action against Illinois Capital Investment Company for transactions not even alleged to have involved any overreaching? How did the SEC's ability to extract a consent order from former directors and a bankrupt former investment adviser provide any benefit to shareholders of Creative Capital who had been given full disclosure of the transactions several years before?

If the SEC believes that, because of the nature of the assets and operations of SBICs or venture capital companies, they are somehow particularly susceptible to overreaching by affiliates or control persons, the SEC has full authority under the Securities Exchange Act of 1934 to require more extensive disclosure, both to the SEC and to shareholders, than is available with respect to other companies. Armed with such information, either the SEC or shareholders could, irrespective of the applicability of the Investment Company Act of 1940, bring action against such persons with respect to transactions involving overreaching of the company or fraud. Their only loss would be their inability to act where the transactions are fair. This does not seem to represent such a great loss of shareholder protections, particularly when weighed against the cost of compliance with the Investment Company Act and its chilling effect on the development of new venture capital.

19/ Hearings, n. 9 supra 95-96.

Mr. OPPER. I have a question for Mr. Halloran that deals with the concept of the private venture capital company which appears in the bill. This is H.R. 7554. As I read that, it would permit a private venture capital company, without falling under the provisions of the Investment Company Act of 1940, to have as many accredited investors, 100, 500, 10,000, if you will, as it can find. Is this the purpose of that provision?

Mr. HALLORAN. Are you talking about the Investment Company Act of 1940?

Mr. OPPER. Right.

Mr. HALLORAN. The private venture capital company would permit its interests to be sold to accredited investors, just like any other company, is this not right?

Mr. OPPER. The interests in a private venture capital company could be sold to accredited investors or nonaccredited investors, but in order to gain the 1940 act exemption, it would have to come within the definition of eligible venture capital company.

Mr. HALLORAN. So that once it reached over 100 shareholders—

Mr. OPPER. Once it reached over 100 shareholders, it would be entitled to the exemption from the Investment Company Act of 1940, provided that—

Mr. HALLORAN. It met the test of an eligible venture capital company and complied with section 202 of the bill H.R. 7554.

Mr. OPPER. Yes, provided it met all the same standards as any other company.

Mr. FRIEDMAN. Actually it would not have to register under section 12 of the 1934 act if it had 100 shareholders, so there is a gap between the 1934 act and the 1940 act for registration status when it crosses the 100 shareholder point.

Mr. HALLORAN. That is incorrect. In order to gain the exemption from the 1940 act, you in effect would have to voluntarily register under section 12 of the 1934 act—see section 202 of the bill—H.R. 7554—making that a condition to the use of the 1940 act exemption.

Ms. WASHINGTON. My questions are specifically addressed to title 1 of H.R. 7554. Unlike H.R. 7491, the industry bill seems to contain some rather broad revisions to the private placement transaction exemption, the section 211 definition of “underwriter” and the section 121 strict liability provisions of the Securities Act of 1933, and I have three problems that I would like to throw out on the table for all three of you to address. The first one is that sections 101 and 102 seem to embody a lot of the accredited investor concepts in the recently adopted rule 242. Unlike H.R. 7554, however, rule 242 can be easily modified or rescinded if significant abuses develop, or if the investment marketplace proves to be adversely affected by a resulting active but restricted trading market that might be created, and I would like your comments on that.

The other problem is that the basic intent of section 103 appears to be to avoid the resale restrictions of rule 144 and alleviate the problems of secondary sales of securities which are issued by small businesses, except with respect to resales by affiliates. To that end, if you look at section 103, it amends the crucial “underwriter” definition in section 211 of the Securities Act to provide that a

person other than the issuer acting on his own behalf or for another person other than the issuer shall not be considered to be an underwriter with respect to the sale of a security, if the sale is made to an accredited investor or to a person whom the seller reasonably believes after reasonable inquiry to be an accredited investor.

While the basic intent of this section seems to be supportable the mechanism chosen seems to set up a tiered class of investors outside the protections of the act, without any apparent concern for the probable and possible impact on the efficiency of the marketplace. I would like that addressed.

Section 104 of H.R. 7554 would amend the liability provisions of section 12 of the Securities Act in two respects where there has been a good faith attempt not to involve any public offering pursuant to section 4(2). First, it would deny recovery under section 12 to a purchaser of securities if all conditions in section 4(2) or rules and regulations thereunder have been met with respect to that purchaser, and, second, such purchaser may not sue to rescind the transaction on the grounds that all conditions have not been met with respect to all purchasers. This section is apparently intended to avoid (1) strict liability under section 12(1) for offers or sales in violation of section 5, and (2) the present law surrounding the availability of section 4(2) which looks not only to the particular private plaintiff, but also to all the offerees and purchasers, i.e., to the totality of the offering.

I want to know why in your judgment section 104 is a proper way to address this perceived problem.

Mr. LITTLE. Would you go back and just remind us what the first question was.

Mr. FRIEDMAN. You don't need to go through it. I heard it.

Ms. WASHINGTON. The first question was addressed to sections 101 and 102, which is quite similar to rule 242, but unlike rule 242, it is not in any kind of flexible condition that can be easily modified or rescinded if there are significant abuses, or if the investment marketplace is adversely affected by the resulting active but restricted trading market that might be created. I wanted to know why you thought that this was necessary or desirable.

Mr. FRIEDMAN. As you pointed out, section 101 picks up some of our rule 242. I suppose we have two comments on that.

One, rule 242 is very new. It became effective in February of this year and so far 31 notices have been filed under 242, we think that is really an inadequate experience on which to base a legislative judgment. I mean 242 was adopted and I must say I was a private lawyer then, I thought it presented an enormously creative step for a regulatory agency. The Commission said that it was an experiment and it wanted to assess the results. I think we have not had enough time to do that yet.

Second, 242, unlike section 101 and unlike some of the provisions in the other bills, has no limit at all on the amount of securities that can be sold under it, although it does prohibit general advertising, and I think that it would be the Commission's view that it is simply too soon to take that very significant step. That is particularly true in light of section 102, which permits unlimited new sales to accredited investors.

There are resales by one institution to another. For example, in the case of institutionally placed debt securities it is not at all uncommon, and indeed it is perfectly possible with equity securities as well for an investor to find a new purchaser for his interest. On the other hand, there is a big difference between that and creating what could be a separate market composed of institutions and large investors, which could be a public market. I mean one could easily see a new kind of third market developing, in which the securities firm would make markets in these kinds of securities for accredited investors.

While I cannot say that the Commission has made a judgment against that, I think that we feel that that is a profoundly significant step in which questions of the implications for the liquidity of the markets which your questions suggested have to be considered, in which its implications for the attitude of individual investors, who would be completely excluded from this, have to be considered. And as a conceptual matter, its implications for the way the Securities Act is administered have to be considered. So that for all these reasons, I think we prefer to go slowly. There is a linkage between section 101 and 102, because 101 permits very large, potentially very large quantities of securities to be sold, which would then conceivably find their way into this market.

Those are issues which have to be considered very, very seriously. And they raise questions which are really external to this debate. That is the point involved, questions that have not been the subject of any extensive hearings or discussions.

Now with respect to reasonable belief, this is an area in which the Commission has been devoting some attention, and we are trying to explore whether it is an area in which it may make sense for us to proceed by rule or otherwise here, but it is important to recognize that in the 1933 act area, the prophylactic effect of absolute rules has had a very important impact on the administration of the securities laws, and has tended to produce more disclosure to investors, a great deal more care in the private offering process. Now, I think in the private offering the Commission has taken important steps, in rules 242, 146, although to a lesser extent in others, to provide increasing relief. I think that is a process which will continue, but I believe we would be quite concerned about a legislative step which would abrogate that liability quickly.

Mr. McMAHON. Would either of you gentlemen care to respond as to why you think that these provisions are necessary?

Mr. HALLORAN. Let me say first that the Commission's activities in rulemaking under the 1933 act in my opinion have been most beneficial to venture capital; for example, rule 242, certain amendments to rule 146, there is a suggestion now that 3(b) be raised to \$5 million.

Mr. FRIEDMAN. In H.R. 7693 also?

Mr. HALLORAN. There are steps that indicate an awareness on the part of the Commission that something has to be done in this area, an awareness which I am sorry has not existed in the 1940 acts, the Investment Advisors Act and the Investment Company Act. We wish that that awareness could be translated over to those other acts, and perhaps it will soon and perhaps the Commission's own bill is an evidence that that awareness is now growing. But we

are here to consider how we can remove regulation where it is not needed. I think Chairman Scheuer said who needs the protection, and surely we are now regulating in situations where people do not need protection. The thrust of sections 101, 102, and 103 is that the accredited investor does not need these protections. In other words, that the costs of regulation outweigh the benefits of it in the case of the accredited investor, and that were you to remove regulation from selling securities to the accredited investor, under the circumstances set forth in sections 101, 102, and 103, we do believe that this would promote venture capital.

Now there are several reasons for that. Under the existing situation, for example, rule 242 is limited to \$2 million every 6 months. Rule 242 as I say again is a significant advancement, but when Federal Express was formed, when Intel was formed, when so many of these companies which are now large companies were formed, the initial placement was more than \$2 million, \$4 million, or \$6 million. It was \$30 million, so rule 242 while it is an advancement unfortunately does not go far enough. Who are the investors in Federal Express and Intel? A lot of them were accredited investors and the question is do we need the protections of the 1933 act.

Mr. FRIEDMAN. But those investments were made. We are talking about removing impediments to the flow of capital. Those investments were made without the extension.

Mr. HALLORAN. They were made under a situation where a document, for example, was produced which looked very much like a registration statement. It was a document produced under rule 146. It was a very long and detailed document, which we call an offering memorandum. Now rule 146 produced this result. The court decisions produced this result, the *Hayden Stone* case and others, and the cost of producing that document seems to be unnecessary in the case of the accredited investor, so one of the purposes of these sections is to say that if the transaction is solely with accredited investor, you put a legend on the security, you do not advertise, and that the investor can fend for himself without the need for this documentation.

With respect to section 104, this is designed to remove what I would have to consider is perhaps the worst example of the interorem effect of the securities laws, and that is if you have one bad investor, that is, somebody who is not a qualified investor for a private placement, your whole private placement is subject to rescission. That has bothered attorneys for years, and it has bothered clients for years, because they have had difficulty getting opinions in subsequent private placements where there is something wrong with the first private placement. It results in the placement of a contingent liability on their balance sheet.

The SEC, when you file a registration statement, requires disclosure of all private placements within the last 3 years. Then they get interested in whether all those private placements were bona-fide private placements and if you find one bad apple in one private placement you may have a big contingent liability in your balance sheet.

The sole purpose of section 104 is to say that the rescission right is limited to that investor, and I have yet to hear a good argument

as to why that should not be the law. That is the thrust of section 104 of the 1933 act amendments.

I should also mention that when the Commission adopts rule-making such as rule 242, it is interesting that it leaves out one segment of the industry, and that is the partnerships. I think the SEC is considering moving in this direction this summer, but rule 242 is solely limited to the corporate enterprise, and I can tell you there are a number of situations, venture capital situations, which start out in partnership form, where the research and development costs are passed through, and there are real estate investments which are in that area, and I think that that is another purpose of this bill, to try to open up the exemptions to apply not only to corporate issuers but to partnership issuers.

Mr. LITTLE. After that wonderful summation by Mr. Halloran, I would be foolish to try to add anything to it.

Mr. OPPER. I would like to ask two hopefully expeditious questions. One followup on Mr. Halloran's observation on rule 242 not including partnerships. Is this something, Mr. Friedman, that the staff or the commission is now considering?

Mr. FRIEDMAN. That was a conscious decision made by the Commission. I think that the staff is reviewing that decision, but under rule 242 it is a little early, because we have only had a few months experience, and it would be a mistake for me to promise quick action in that area. We have had a significant number of enforcement cases that involve partnerships. Now I think that there is nothing about the partnership form that lends itself to violations of the securities laws other than that the flow-through tax treatment which the partnership forms affords, provides a new wrinkle to the Commission of all those transactions. It permits investments to be sold, for example, as tax shelters, and it is in those areas that there have been some significant problems. Now I do not mean to suggest in the least that the Commission is condemning all partnerships. It is just that we see some need to go more slowly in that area, trying to assess our experience under rule 242, and perhaps to expand in due course.

Mr. OPPER. The other deals with the often criticized section 47 of the Investment Company Act which as I understand it would void any contracts made in violation of any statute, rule, provision, rule or regulation under the Investment Company Act of 1940. Some commentators have suggested that the effects are rather draconian. As I understand it, there is a Federal circuit court decision which perhaps ameliorates the effect of that provision, but I am curious as to why the Commission, in its legislative proposal, did not suggest a cure for that provision.

Mr. FRIEDMAN. First I think it is worthwhile considering that that language appears also in the Public Utility Holding Company Act and in the Securities Act of 1934, so that in making these exchanges I think we would have to focus more broadly on that.

Second: In the context of the Investment Company Act, that provision is addressed to a very specific set of problems. There are a variety of places in which the act prohibits contractual arrangements from being entered into, except through certain procedures, including approval by the independent directors and shareholders in the case of the investment advisory contract and approval by the

Commission in the section 17 area. There are other examples. There was a very strong feeling that it ought to be made clear that those unapproved contracts are void, that they cannot be enforced. Indeed there are cases, at least one case, in which a person on the other side of an investment advisory contract sought to enforce that contract even though the statutory provisions had not been observed. So that I think we would be most reluctant to simply drop it out for that reason as well. It does not make sense in this area.

Third, although it is a very scary provision when you read it. I do not think the Commission, as an institution, is aware of significant problems that it has created, so those are the reasons we did not address that. And there are cases which in effect prevent it from being used against an investment company—prevent someone else from voiding a contract to the disadvantage of the investment company.

Mr. OPPER. Do any of the other panelists have any comment?

Mr. LITTLE. The only comment that I wondered about is the use of the word "void," to me is as you phrase it, draconian. If you are going to have to do something like that, why not reversible or some language like that. I have often asked my staff why the use of the word "void," which means does not exist, which means somebody keeps the money and somebody else cannot enforce the contract. It is strange I think.

Mr. McMAHON. One question. Should investment type companies be able to invest in insurance companies, trucking companies, real estate development companies, oil and gas, leaseholding companies? It seems that there are a number of prohibitions that were injected into the SEC's version of the bill, and I wonder if Commissioner Friedman could respond to that first, and then have the other witnesses respond.

Mr. FRIEDMAN. The drafting of the bill represented a judgment on our part. The cross reference is a very broad one. It is very clear to me that in our view venture capital companies should not be investing in financial intermediaries, for example. I would have significant questions about the other range of things enumerated in the statute, but if a compelling need can be shown for that, that is, that they fit within this general framework, then I think we would be happy to sit down and talk about it.

Mr. LITTLE. Is the bill drafted in such a way that it specifically—I have not focused on that—specifically prevents those things? I do not have much problem myself, speaking selfishly, with the financial intermediary thing because we are not allowed to do that by SBA regulation anyway. Why we should not be able to invest in a trucking company or an oil and gas leasing company I cannot imagine.

Mr. McMAHON. No, I was just asking the question are those particular entities inappropriate for investment company investments.

Mr. LITTLE. I do not think. Again I think it is interference with the free market system.

Mr. FRIEDMAN. Wait a minute, you keep saying this and you have said it about six times. We are not interfering with anything. What we are saying is if you want this special treatment for

publicly held companies—we are not talking about the classic venture capital business, which is privately held. Then we want to begin by targeting the area in which these investments are going to be made. The thing that has driven these hearings, the thing that has driven interest in these provisions, has been the need to increase the flow of capital to smaller businesses, broadly conceived, and when you start talking about financial intermediaries and other things like that you are talking about something that is very different.

Mr. LITTLE. What is the matter with me financing a trucking company in Rhode Island?

Mr. FRIEDMAN. I am going to have to beg off on the trucking company.

Mr. LITTLE. I will not argue with you about financial intermediaries, again because from our point of view it is a dead issue. Mr. Halloran may argue with you but you know there are lots of others. Basically what you are trying to do is invest in people who know how to use capital well, whether that is a trucking company or whether it is an oil and gas leasing company, if they know how to use their capital well so the eventual outcome is, again to go to Mr. Scheuer's issue of the energy situation. You know, why we should be prevented from doing that kind of thing I just simply cannot understand.

Mr. HALLORAN. I think we would agree that a venture capital company should not invest in another investment company, and to the extent that these provisions are designed to prevent them from investing in their investment companies, that is satisfactory. I do not think we should have the pyramiding of fees and fee structures as a result of that. Nevertheless a number of the items listed in sections 3(c)(2) through 3(c)(13) have in fact been the subject of venture capital investments. Trucking companies, small banks, insurance companies, and that sort of thing. I have talked to the private venture capital industry. They have been the subject of venture capital investment, not very heavy venture capital investment but they have existed.

So far as oil and gas companies that engage in oil and gas leasing or are interested in leases, I would think that the SEC would take that out of the bill. I think in light of what the chairman said, that that should be a desirable public policy goal, to allow at least venture capital into the energy area, and I would think that that section ought to be deleted, and I believe that is 3(c)(9) of the act.

With respect to common trust funds, 3(c)(3), if you want to leave that out, that is fine. Nonprofit organization, 3(c)(10), that is fine. 3(c)(11), employee stock pension or profit sharing plans, that is fine. 3(c)(12) and 3(c)(13) are fine, so we are saying that 3(c) (10), (11), (12) and (13) are fine. The rest I think we ought to reconsider.

Another example, and I would be interested in the commissioner's views on this, is that they do not want us to have venture capital investments in underwriters and brokers, which is 3(c)(2). My understanding is that one of the concerns of the commission was the fading from the scene of the regional broker, and I am wondering whether the concern of the commission regarding the regional broker could not be alleviated in part by venture capital investments in setting up brokers. I do not think we have a strong

feeling about that. If it has to be deleted it has to be deleted but I am wondering if we are running at counter purposes.

Mr. McMAHON. Mr. Rosenblat has a statement.

Mr. FRIEDMAN. Yes, I just want to interject something. I submit, No. 1, when you are talking about financial intermediaries that none of the purposes of this act are served by such investments. Second, while we are concerned about the status of regional brokers we are also concerned about a whole lot of other things. It does not mean that this statute is designed to meet those concerns.

Third, I would like to ask Alan Rosenblat, assistant general counsel to the Commission, to deal with this question of section 3(c) and the cross references, because he tells me that all of us including me have misunderstood the reach of those provisions.

Mr. ROSENBLATT. Yes, I think what you have to keep firmly in mind is that 3(c)(3) excludes from the definition of investment company only those companies which initially come within the broad definition. So that with, for example, the exclusion in section 3(c)(7), of "any company which is subject to regulation under section 214 of the Interstate Commerce Act"—which are trucking companies—that exclusion, in terms of the structure of the statute, applies only to trucking companies which would otherwise be investment companies, because they invest primarily in securities. There is a historical reason for that: there were some railroad holding companies and some trucking companies that indeed would have been viewed as investment companies under the Investment Company Act because they were primarily investing in securities, and Congress exempted those from the definition of investment company, because their activities, including investments and the issuance of their own securities were very substantially regulated by the Interstate Commerce Commission. Thus the exclusion in our proposal from the definition of an eligible company portfolio is directed only to financial intermediaries and not operating businesses.

Mr. OPPER. Thank you. With that the hearing is now adjourned.

[The following statements and letter were received for the record:]

Statement of John D. Ellsworth
Submitted to
Subcommittee on Consumer
Protection and Finance
of the House Committee on
Interstate and Foreign Commerce
June 17, 1980

I am Chairman of the Legislative and Regulatory Committee of the Real Estate Securities and Syndication Institute (RESSI), an affiliate of the NATIONAL ASSOCIATION OF REALTORS®. I appreciate this opportunity to comment for the record on pending amendments to the laws administered by the Securities and Exchange Commission.

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,700 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is in excess of 725,000 persons actively engaged in sales, brokerage, management, counseling, and real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums.

There are approximately 2,500 members of RESSI, most of whom are REALTORS® who own real estate brokerage businesses. As part of their real estate sales activities, RESSI members bring groups of people together to buy investment real estate. This process is typically known as "real estate syndication" and, as such, is subject to the regulatory jurisdiction of both the Securities and Exchange Commission and any state securities agency where the investment interests are sold.

As Chairman of RESSI's Legislative and Regulatory Committee of RESSI, and through my private law practice, I am made aware regularly of the concerns of REALTORS^o whose activities make them subject to securities regulation.

The concern of these small businessmen is not directed towards attempting to avoid or dilute their disclosure responsibilities to investors. They, and their counsel, do want to reduce the uncertainty of qualifying for an available exemption from registration. They want to minimize the costs associated with the disclosure process. They want to be able to raise sufficient funds to accomplish the particular investment objective at hand. Recognizing that they must compete with others seeking the same sources of capital, they therefore wish that such competition be on a fair basis under equal treatment by the securities regulators.

For this reason, RESSI strongly supports the Administration's bill, H.R. 6580, known as the "Small Business Issuers' Simplification Act".

- This bill provides an exemption from registration for securities sold to any "accredited investor", as defined in the bill. This bill's registration exemption is available to any issuer who can meet its standards. Recently SEC has promulgated its Rule 242, which is somewhat similar to H.R. 6580. However, Rule 242 specifically does not apply to partnerships, although this is the primary form in which group real estate investments are held.

- H.R. 6580 has no specified disclosure requirements. Accredited investors, as defined in the bill, are recognized as generally being

able to obtain any relevant disclosure information from the issuer. Furthermore, those using the exemption would still be expected to make appropriate disclosure so as to avoid liability under the anti-fraud provisions of the securities laws.

- There is no requirement in the bill that the issuer must show each investor to be "sophisticated" in order for it to obtain the exemption. The sophistication requirement found under the SEC's private placement exemption provisions is a major cause of uncertainty and additional cost for the issuer.

- H.R. 6580 has no limit on the amount of funds the issuer can raise.

While we recognize that your present Subcommittee hearings are focused upon H.R. 7491, the SEC's draft of legislation amending the 1940 Investment Company and Investment Advisors Acts, we bring to your attention this Small Business Simplification Act, as proposed by the Administration, in the expectation that the Senate will consider it along with these venture capital measures. We urge you also to consider adding these provisions to any changes voted out by your Subcommittee.

In addition, while supporting the SBA's bill, we respectfully suggest it could be improved through at least one revision. We see no need to bar the advertising of the offering. The small issuer should be able to canvass the potential market of accredited investors as widely as possible. Furthermore, accredited investors, by definition, have the ability to obtain from the issuer the same information as is contained in a registered offering, which can be advertised.

NATURE AND SCOPE OF INDUSTRY

The real estate industry is one of our greatest national assets and is responsible for a large portion of this country's gross national product. In contrast to the size of the industry at large, however, the size of the individual businesses which comprise the real estate industry is small. For example, 91 percent of our members have nine or less persons employed or associated with them. Furthermore, there is no predominance by larger firms -- the top nine percent of firms account for only 20 percent of the business conducted by our membership. Further, each business created to own investment property is itself small. Additionally, our business is one of the most regulated sectors of the national economy. In addition to SEC regulation, every aspect of the acquisition, development, improvement, sale and management of land is regulated by a combination of local, state and federal agencies.

For real estate syndications, the principal type of issuer is the limited partnership. This form of entity combines the advantages for investors of limited liability, centralized management and no tax consequences at the partnership level. Most limited partnership offers in real estate investment are made non-publicly so as to avoid the burdensome costs and delays typically associated with a registered, public offering.

RECENT SEC ACTIONS DISCRIMINATE AGAINST REAL ESTATE

Most real estate syndicators have viewed with dismay two recent actions by the SEC which directly and pointedly discriminate against issuers that are partnerships.

We fail to understand why the SEC has chosen to discriminate against the real estate industry by making our industry compete unfairly for precious capital. We have asked the SEC numerous times, through various means, to explain their reasoning, to no avail. When this happened the first time, more than two years ago, we did not turn to Capitol Hill. But now there have been two exemptive provisions approved by the SEC (and a report made on the "progress" achieved under one of these) without any justification or explanation yet from the SEC as to the Commission's deliberate exclusion of partnerships.

We are referring to the SEC's adoption of Form S-18 and its promulgation of Rule 242. In adopting Form S-18 in 1979, the SEC viewed itself as responding to the complaints of a variety of small issuers to the effect that the normal registration process was overly expensive and time-consuming, when applied to the circumstances of most small issuers. Form S-18 is a shortened registration form; the requirements for expensively prepared audited financial statements has been relaxed and the Form may be filed for review by the SEC at its regional offices as well as the national office in Washington, D.C.

However, without ever articulating a reason, the SEC excluded partnerships from the application of Form S-18. Even though the form was viewed as an experiment by the SEC, only corporate issuers are allowed to use it, thus precluding the gathering of any data base on the usefulness of the form for partnership offerings.

The SEC next promulgated Rule 242 in 1980. This Rule, which is basically a relaxation of the private offering Rule 146, permits an

issuer to sell an offering to an unlimited number of qualified purchasers and without the need to meet any standards as to the levels of sophistication of any purchaser. The Rule constitutes a significant, favorable development for certain small issuers; unfortunately partnerships were again excluded.

More recently, the SEC published an internally-prepared study on the use of Form S-18 after one year's experience. The study found that S-18 had virtually supplanted the other registration forms in the eyes of the small issuer. Unfortunately, no mention was made concerning expansion of this experimental form to include partnerships.

ENDORSEMENT OF ADMINISTRATION'S INITIATIVE

It is with this background in mind that the NATIONAL ASSOCIATION OF REALTORS® and RESSI have endorsed the Small Issuers' Simplification Act. H.R. 6580, like Rule 242, identifies "accredited investors," using the same identifying criteria, and, as to them, requires no mandated disclosure, sophistication standards, or restrictions on the number who may purchase an offering. Most importantly for REALTORS®, H.R. 6580 would be available to all issuers, including partnerships.

H.R. 6580 is an administration bill sponsored by the Small Business Administration. A. Vernon Weaver, Administrator of the SBA, testified before the Senate Securities Subcommittee recently. He noted that the SEC was opposed to including partnerships under the coverage of the bill. Mr. Weaver candidly stated that he could not understand the reason for the SEC's opposition, particularly in light of the fact that

purchasers would be well equipped to choose between the type of issuing entity, be it a corporation or a partnership.

We ask your Subcommittee to add the principal provisions of H.R. 6580 to any legislation approved this year for several basic reasons. First, it is a useful piece of legislation that will assist the small issuer while not detracting from the continuing protection the securities laws afford the investing public. Second, passage of H.R. 6580 will be a clear Congressional directive to the SEC that it is not to use its power to engage in arbitrary and discriminatory action against any class of issuers, especially when such action has the effect of economic policy-making by handicapping the real estate syndication industry in the competitive quest for investor capital.

Thank you for the opportunity to present our views.

STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE SUBCOMMITTEE ON CONSUMER
PROTECTION AND FINANCE OF THE
HOUSE COMMITTEE ON INTERSTATE AND
FOREIGN COMMERCE
ON H. R. 6723 AND RELATED BILLS

June 11, 1980

This statement is submitted by the Investment Company Institute, which is the national association of the mutual fund industry. The Institute's membership includes 522 open-end investment companies (mutual funds) registered with the Securities and Exchange Commission under the Investment Company Act of 1940, and 150 investment advisers to its mutual fund members, many of whom provide investment advisory services to clients in addition to investment companies. In addition, the Institute's membership includes 25 associate members which serve exclusively as investment advisers to non-investment company clients. A substantial portion of the assets managed by investment advisers registered under the Investment Advisers Act of 1940 are managed by these Institute members and associate members.

The Institute's statement is limited to Section 206 of H. R. 6723. Other sections of H. R. 6723 and the other bills before this subcommittee are restricted to matters affecting venture capital companies and other small businesses. However, Section 206 of H. R. 6723 would affect a major change in legislation relating to all investment advisers, including the Institute's investment adviser members and associate members, by providing for private rights of action under the Investment Advisers Act of 1940.

In 1979, the Supreme Court held in Transamerica Mortgage Investors, Inc. v. Lewis, 100 S. Ct. 242, that there is no private right of action under Section 206 of the Investment Advisers Act of 1940. The Securities and Exchange Commission recently invited public comments with regard to a number of issues relating to investment advisers, including specifically the question: "Should the Advisers Act be amended to permit private suits for damages for violations of Section 206 of the Advisers Act [15 U.S.C. 80b-6]?" (SEC Release No. IA-717, dated April 4, 1980, at pages 6-7, a copy of which is attached hereto as Exhibit A). Public comments on the SEC's release are not due until August 4, 1980. The Institute has submitted a letter of comments to the SEC requesting an indefinite extension of the comment period until the Commission has issued a report based on the information contained in the thousands of Form ADVs which the SEC has required advisers to file. (A copy of the Institute's letter of comments is attached hereto as Exhibit B).

The Institute respectfully submits that the important issues raised by Section 206 of H. R. 6723 should not be decided as a part of legislation basically relating to venture capital companies and small businesses. Further, we believe that it would be inappropriate to take legislative action in this area until the SEC has received public comments on Release No. IA-717 and has decided whether to submit legislative recommendations to Congress concerning possible amendments to the Investment Advisers Act of 1940. The fact is that even before the Trans-america decision there were relatively few private actions brought under the Advisers Act. It may well appear that the creation of a federal cause of action is unnecessary and that advisory clients are adequately protected under state law.

The Institute therefore respectfully requests that Section 206 be deleted from H. R. 6723. We would be pleased to provide any additional information requested and to meet with the subcommittee or its staff to discuss this matter.

Attachments

EXHIBIT A

SECURITIES AND EXCHANGE COMMISSION
[Release No. IA-717; File No. S7-830]

Solicitation of Public Comments Concerning Issues to be Considered in
Connection with the Investment Advisers Act Study

AGENCY: Securities and Exchange Commission.

ACTION: Solicitation of Public Comments.

SUMMARY: The Securities and Exchange Commission today announces that
the Division of Investment Management ("Division") is requesting
public comments relating to the nature and scope of issues to be
considered by the Division in the course of its study of the Invest-
ment Advisers Act of 1940.

DATE: Comments should be received on or before August 4, 1980.

ADDRESSES: 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. S7-830. All comments received will be available for
public inspection and copying in the Commission's Public Reference
Room, 1100 L Street, N.W., Washington, D.C.

FOR FURTHER INFORMATION CONTACT: Michael J. Eizelman, Esq. (202-272-
2079), Office of Investment Adviser Regulation, Division of Investment
Management, Securities and Exchange Commission, 500 North Capitol
Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: For some time, the Commission has been
aware of a need to reevaluate its investment adviser regulatory
program in light of the growth of the advisory industry and the

increasing variety and complexity of the services provided by investment advisers. In 1976, the Commission supported legislation which would have, among other things, empowered the Commission to prescribe standards of minimum professional qualifications and financial responsibility for investment advisers. The legislation was reported favorably by the Senate Committee on Banking, Housing and Urban Affairs but was not voted upon by the full Senate. 1/

Thereafter, the Division established the Office of Investment Adviser Regulation ("Advisers Office") in December, 1978. In addition to being responsible for the day-to-day administration of the Investment Advisers Act of 1940 ("Advisers Act"), including responses to interpretive and no-action requests under the Advisers Act, the Advisers Office is conducting a comprehensive study of the current regulatory scheme applicable to investment advisers.

Partly for the purpose of obtaining additional information concerning the investment advisory industry the Commission, in January of 1979, adopted certain revisions to Form ADV, the application for registration as an investment adviser. 2/ At that time,

1/ S. Rep. No. 94-910, 94th Cong., 2d Sess. (1976). The House version of the legislation, H.R. 13737, was reported to the House Committee on Interstate and Foreign Commerce by the Subcommittee on Consumer Protection and Finance but was not considered by the full Committee.

2/ Investment Advisers Act Release No. 644 (January 30, 1979) [44 FR 7870, February 7, 1979].

the Commission also adopted new Rule 204-3 [17 CFR 275.204-3] under the Advisers Act (the "Brochure Rule") to require that specified disclosure be made to current and prospective advisory clients, and adopted new Form ADV-S, a short annual supplement to Form ADV.

In June, 1979, the Commission issued for public comment a proposed rule which would provide an exemption from Section 205(1) [15 U.S.C. 80b-5(1)] of the Advisers Act to permit registered investment advisers to business development companies to receive performance-based fees. 3/ That proposed rule was intended in part to remove a possible impediment to the flow of capital into new and developing companies.

Subsequently, in July of 1979, the Commission adopted new Rule 206(4)-3 [17 CFR 275.206(4)-3] under the Advisers Act delimiting the circumstances under which an investment adviser may make a cash payment to a person who refers clients to, or solicits clients for, the adviser. 4/

The Commission anticipates that, as the Division's review of the Advisers Act continues, additional rulemaking under that statute will take place in the future. However, some of the issues to be considered by the Division might result in recommendations which can be implemented only if Congress amends the Advisers Act. Before the

3/ Investment Advisers Act Release No. 680 (June 19, 1979) [44 FR 37470, June 26, 1979].

4/ Investment Advisers Act Release No. 688 (July 12, 1979) [44 FR 42126, July 18, 1979].

Division makes any decision as to whether it should recommend legislation to amend the Advisers Act, it seems appropriate to invite public comment concerning issues which might result in legislative recommendations. The issues presently under consideration are set forth below.

Some, but not all, of these issues are ones which were considered in connection with the 1976 proposed legislation. For example, one of the most important issues under consideration is whether one or more self-regulatory organizations should be established to prescribe and administer requirements under the Advisers Act, and whether membership in such a self-regulatory organization can and should be made mandatory for investment advisers. 5/

It is envisioned that in the investment advisory industry several self-regulatory organizations could develop to take account of various specialized segments of the industry. For example, different self-regulatory organizations might interest financial planners, pension consultants, and investment managers to investment companies. This would be in contrast to the self-regulatory system presently applicable to broker-dealers. Although Section 15A of the Securities Exchange Act of 1934 [15 U.S.C. 78o-3] does not by its terms limit broker-dealer self-regulation to the National Association of Securities Dealers, Inc. ("NASD"), for economic reasons the NASD has become

5/ The 1976 proposed legislation would have authorized and directed the Commission to make a study of the appropriateness of establishing one or more self-regulatory organizations.

the sole registered national securities association for broker-dealers. The same economic factors may account, at least in part, for the fact that the majority of broker-dealer firms have chosen to become members of the NASD. To the extent that different economic considerations might apply with respect to the investment advisory industry, it seems possible that self-regulation in that industry can be effective only if membership in at least one of the self-regulatory organizations which might come into existence is made mandatory.

The Division invites public comment with respect to the following areas of inquiry, as well as any other matters which interested persons believe should be considered in connection with the Division's evaluation of whether to recommend legislation to amend the Advisers Act:

(1) Should authority to prescribe and administer requirements under the Advisers Act be vested in one or more self-regulatory organizations? Should rulemaking powers be vested in such self-regulatory organizations with oversight by the Commission? For example, should such organizations be authorized to prescribe rules of conduct? Should membership in at least one such organization be mandatory or should an investment adviser be allowed to choose, as an alternative, direct regulation by the Commission? Is there any constitutional impediment to making membership in a self-regulatory organization mandatory?

(2) Should minimum professional qualification standards be established under which investment advisers would be required to submit to a test or examination or to meet standards of training and experience in the investment advisory field? Should any such standards vary with respect to advisers who provide different types of services and have different types of clients? Should professional qualifications be prescribed by one or more self-regulatory organizations or should such qualifications be prescribed by the Commission?

(3) Should specific financial responsibility requirements for investment advisers be established? Should any such standards differ for various segments of the investment advisory industry? For example, should the standards apply to those investment advisers which exercise discretionary authority with respect to advisory accounts or have custody or possession of securities or funds of their clients but not to those which only provide impersonal investment advisory services such as advisory newsletters? In conjunction with, or in lieu of, financial responsibility standards, should bonding requirements be prescribed? Should financial responsibility standards be prescribed by one or more self-regulatory organizations or should such standards be prescribed by the Commission?

(4) Should the Advisers Act be amended to permit private suits for damages for violations of Section 206 of the Advisers Act

[15 U.S.C. 80b-6]? 6/

(5) Should any of the exclusions from the definition of investment adviser provided by Section 202(a)(11)(A)-(E) of the Advisers Act [15 U.S.C. 80b-2(a)(11)(A)-(E)] be modified?

(6) Should any of the exceptions from the investment adviser registration requirements contained in Section 203(b) of the Advisers Act [15 U.S.C. 80b-3(b)] be modified? For example, in light of developments in the securities market, specifically the increase in securities not traded on national exchanges, should the intrastate exception contained in Section 203(b)(1) [15 U.S.C. 80b-3(b)(1)] be eliminated?

(7) What measures, if any, should be taken to eliminate unnecessary regulatory burdens and achieve more uniform and consistent regulation of investment advisers?

By the Commission.

George A. Fitzsimmons
Secretary.

April 4, 1980.

6/ See Transamerica Mortgage Investors, Inc. v. Lewis, 100 S. Ct. 242 (1979).

EXHIBIT B

Investment Company Institute

1775 K STREET N. W., WASHINGTON, D. C. 20006

(202) 293-7700

MATTHEW P. FINK
GENERAL COUNSEL

April 23, 1980

George A. Fitzsimmons
Secretary
Securities and Exchange Commission
Washington, D.C. 20549

Re: Solicitation of Public Comments Concerning Issues to be
Considered in Connection with the Investment Advisers
Act Study (Release No. IA-717; File No. S7-830)

Dear Mr. Fitzsimmons:

Public comments on Release IA-717 are not due until August 4, 1980. The Investment Company Institute* is submitting comments at this early date since we believe that the Commission's approach, exemplified by the release, to possible changes in the regulatory scheme applicable to investment advisers is defective. The release assumes the existence of problems which need solutions. It gives every sign as having been proposed as a regulatory shortcut to avoid the arduous process of factual analysis which should precede the expression of views on the issues raised in the release.

In the release the Commission invites comments on a number of the most major policy issues, including: the creation of self-regulatory organizations; the establishment of minimum professional qualification standards; the establishment of financial responsibility requirements; amendment of the Advisers Act to permit private rights of action; modification of the present exclusions in the Act from the definition of investment adviser; modification of any present exceptions from the Act's registration requirements; and measures to eliminate unnecessary regulatory burdens and achieve more uniform and consistent regulation.

* The Investment Company Institute is the national association of the mutual fund industry. The Institute's membership includes 150 investment advisers to our mutual fund members, many of whom provide investment advisory services to clients in addition to registered investment companies, and 25 associate members which serve exclusively as investment advisers to non-investment company clients. A substantial portion of the assets (both of investment companies and of other clients) managed by registered investment advisers are managed by these Institute members and associate members.

The Institute and its investment adviser members and associate members can, of course, attempt to respond to these important issues based on their individual situations and their visceral reactions. However, we are deeply concerned that the Commission will take these responses, meld them with its own views and develop regulatory and legislative programs. But programs based on emotion and theory are not substitutes for those based on facts. We believe that it would be far more preferable if the investment advisory industry (and the Commission) had the benefit of a basic information source which laid out the fundamental characteristics of this large and heterogeneous industry. Such a data bank already exists. And it is in the Commission's possession.

In 1977, the Commission proposed a broad expansion of registration Form ADV precisely in order "to seek additional information about registered advisers and the basic characteristics of the investment advisory industry" and "because the information is relevant to decisions about the Commission's regulatory program."* In its comment letter, the Institute urged the Commission to conduct a full-scale survey of the industry which could form the basis for a logical regulatory program, rather than cluttering up registration Form ADV with general industry survey questions.**

The Commission did not follow our suggestion. Instead, in 1979, the Commission greatly expanded Form ADV precisely in order "to provide the Commission with information concerning the basic characteristics of the advisory industry that should be useful in facilitating the Commission's efforts to impose its regulatory effort regarding investment advisers."***

* Release No. IA-602, dated July 21, 1977, at pages 2-3 and 8.

** Institute letter of comment, dated September 30, 1977, on Releases Nos. IA-601 and 602. In fact, the Institute has been urging the Commission to follow such a logical program since 1975, when the Commission first proposed requiring investment advisers to provide clients with written disclosure statements. See Institute letter of comment, dated June 13, 1975, on proposed Rule 206(4)-4.

*** Release No. IA-664, dated January 30, 1979, at page 6. Release No. IA-717, notes at page 2: "Partly for the purpose of obtaining additional information concerning the investment advisory industry the Commission, in January of 1979, adopted certain revisions to Form ADV, the application for registration as an investment adviser."

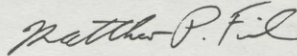
The Institute's investment adviser members and associate members, as well as thousands of other investment advisory firms, were put to significant burden and expense in amending their Form ADVs in order to provide the Commission with detailed information regarding the industry. While we believed that the Commission had collected this information in an illogical fashion (through a greatly expanded Form ADV rather than a special survey of the industry), we did believe that, at last, the Commission had obtained detailed information regarding the investment advisory industry. This data could form the basis for a further specialized study and ultimately for a comprehensive Commission report on the basic characteristics of the industry setting forth possible regulatory problems and possible solutions. Indeed, this is precisely the procedure the Commission has followed for over forty years whenever it has proposed major changes to the federal securities laws. The original Investment Company and Investment Advisers Acts were based on a detailed and lengthy Commission study, and the 1970 amendments to those Acts resulted from similar studies, including the 1962 Wharton School Study of Mutual Funds and the Commission's 1966 Report on Public Policy Implications of Investment Company Growth.

However, it now appears that the Commission has not in fact prepared a report based on the detailed information furnished by thousands of investment advisers on expanded Form ADV. Indeed, it does not appear that the Commission has even prepared a summary of the information set forth in the expanded Form ADVs. Instead, the Commission now is blandly requesting comments on a wide number of major policy issues, without utilizing or making public the key information in its possession.

We submit that the approach set forth in Release No. IA-717 represents a perfect case of putting the regulatory cart before the horse. Intelligent and careful analysis of possible problems in the regulation of the investment advisory industry and possible solutions to those problems can only be made, by both the Commission and the industry, on the basis of hard factual information. The irony is that the Commission presently has this very information in its possession, in the form of the completed Form ADVs which were required to be filed by investment advisers, in the Commission's own words, "to provide the Commission with information concerning the basic characteristics of the advisory industry that should be useful in facilitating the Commission's efforts to improve its regulatory effort regarding investment advisers."

We therefore recommend that the Commission indefinitely postpone the comment period on the broad public policy issues raised in Release No. IA-717 until the Commission has prepared and issued a report based on the information set forth in the Form ADVs filed with the Commission. We submit that for the Commission to solicit public comments and then to try to formulate legislative and regulatory programs, without first publishing such a report, constitutes the very worst type of regulatory procedure. It is directly contrary to the orderly and logical processes which the Commission has followed in the past whenever it has considered major changes in the federal securities laws.*

Very truly yours,

A handwritten signature in cursive script, reading "Matthew P. Fink".

Matthew P. Fink
General Counsel

* Page 2 of Release No. IA-717 notes that in 1976 Congress declined to enact legislation sponsored by the Commission which would have made major changes in the Investment Advisers Act, including empowering the Commission to prescribe standards of minimum professional qualifications and financial responsibility. We believe that Congress' action may have been based, at least in part, on the Commission's failure to prepare such a detailed study and report.

Re: H.R. 6723

Statement on Behalf of

STANDARD & POOR'S CORPORATION

to the
Subcommittee on Consumer Protection and Finance
of the
House Committee on Interstate and Foreign Commerce

June 13, 1980

This statement is submitted on behalf of Standard & Poor's Corporation, an investment adviser registered under the Investment Advisers Act of 1940, as amended, (the "Act") in opposition to Section 206 of H.R. 6723. No reference is made to any other section of said Bill.

Said section would provide a private right of action for a violation of any provision of, or any rule or regulation under, the Act. It would overrule the Supreme Court decision in Transamerica v. Lewis, 100 Sup. Ct. 242, 62 L. Ed. 2d 146; decided November 13, 1979, insofar as that case held that there was no private right of action under Section 206 of the Act, the general fraud provision. That case did recognize the existence of a private right of action under Section 214 of the Act, involving rescission of contracts fraudulently obtained.

Section 206 of the Bill is clearly of sufficient importance that its provisions should be part of an overall review

of the entire Act, with the objective of achieving a coordinated pattern, and not some single patch of legislation. The treatment of a full review is supported by the activities of the Securities and Exchange Commission ("SEC") in publishing, on April 4, 1980, Release No. IA-717 requesting comments from industry involving a thorough-going review of the Act, including private rights of action. As stated, if the Act is to be amended, it should be as part of a coordinated pattern and not some isolated act. For example, the proposed legislation would impose liability for a violation of "any rule or regulation" thereunder. Does this apply to every rule or regulation previously adopted? If so, should they not be reviewed first? How about future rule changes under Section 211A of the Act?

We point out, briefly, that the proposed amendment to the Act may not be necessary as a further protection to investors. There is no question but that state and common law permit a private right of action by an investor against his investment adviser, whether for fraud or negligent management. The amendment would create additional private remedies where there are already existing remedies under state law.

Because of the title of the Bill and the position of Section 206 therein, it was only recently that that section became known to members of the industry. There just has not been adequate time in which to address this section in the depth that it deserves.

We understand that the primary objective of the Bill, namely, the formation of venture capital, presents somewhat of a priority. We can only point out that Section 206 of the Bill has no relevance to that priority. However, if the objectionable portion is to be adequately treated, then it should be afforded proper time and attention which would, of course, detract from consideration of the primary objective of the Bill.

In sum, we urge that Section 206 of H.R. 6723 be deleted therefrom.



SECURITIES INDUSTRY ASSOCIATION

490 L'Enfant Plaza East, S.W., Washington, D.C. 20024 • (202) 488-4664

June 23, 1980

Chairman James H. Scheuer
Representative Matthew J. Rinaldo
Subcommittee on Consumer Protection and Finance
Committee on Interstate and Foreign Commerce
3275 House Office Building Annex No. 2
U. S. House of Representatives
Washington, D.C. 20515

Dear Chairman Scheuer and Mr. Rinaldo:

We would like to take this opportunity to express our support for H.R. 7397, which would increase the small offering exemption from registration and reporting requirements under the Securities Act of 1933 from \$2 million to \$5 million.

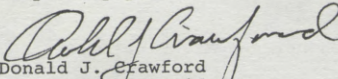
SIA represents approximately 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of securities regulations on investment decisions by corporations, investors and issuers.

The rate of inflation effects all segments of the American economy including the capital markets. The costs of raising capital for all business has increased and these increases are particularly burdensome on small business. Each year the amount of capital necessary to finance even small new ventures climbs. Consequently, the current statutory limit for the small offering exemption under Section 3(b) of the Securities Act of 1933 is once again becoming so low that it is not economically feasible to use this financing vehicle. This is in spite of the increase enacted in 1978.

With rising costs associated with registration and the related reporting requirements, offerings made pursuant to the provisions of Section 3(b) of the Securities Act of 1933 and the regulations thereunder may not be able to raise enough capital to reach the point at which a company realized a sufficient net return from its venture into the new issue market to achieve its goals. H.R. 7397 would remedy this problem by raising the level of exemptions to permit issuers to market up to \$5 million of equity offerings in a calendar year. This change would insure that issuers wishing to avail themselves of the Regulation A offering will be able to offset the costs of registration with a smaller percentage of the gross offering proceeds than would be otherwise possible. Hence, more money will remain to finance the opening or expansion of the business.

H.R. 7397 is a no-cost method of enhancing the potential for capital-raising in precisely that portion of the economy where it would do us the most good: small business. Several recent studies have indicated that the small business sector of the economy is responsible for creating the largest share of both technological innovation and jobs. Legislation of this nature will assist this critical segment of our economy.

Very truly yours,


Donald J. Crawford
Senior Vice President

DJC:lsm

cc: Mr. Franz Oppen
Mr. James McMahon

[Whereupon, at 12:35 p.m., the hearing was adjourned.]