STATEMENT OF WILLIAM L. CARY, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE SUBCOMMITTEE NO. 2 OF THE HOUSE COMMITTEE ON BANKING AND CURRENCY, ON H. R. 6672, 87TH CONGRESS, 1ST SESSION

AUGUST 2, 1961

Mr. Chairman and Members of the Committee:

I am William L. Cary, Chairman of the Securities and Exchange Commission, and I appear for the purpose of discussing H. R. 6672.

H. R. 6672 is a bill which would amend certain provisions of the Investment Company Act of 1940 and the Small Business Investment Act of 1958. The purpose of the bill is evidently to promote the growth and development of small business investment companies. The Commission has been sensitive to the Congressional intent to provide access to sources of capital for small business concerns, and has cooperated, within the framework of our Acts, to facilitate the growth of small business investment companies which have been established for this purpose. The Commission is in accord with the objective of legislation that would promote the development of small business investment companies, but, nevertheless, views certain provisions of H. R. 6672 as either undesirable or unnecessary.

I. Section 8 of the bill would amend by implication several provisions of the Investment Company Act of 1940. That section of the bill provides that nothing contained in the Investment Company Act ("the Act") or any other Act shall be construed as preventing a small business investment company from issuing "restricted stock options", and specifically authorizes the issuance of such options.

At present, Section 18(d) of the Act specifically prohibits long term warrants or options, and Section 23(a) specifically prohibits the issuance of securities for services. In addition, Section 23(b) prohibits a registered closed-end investment company from selling any common stock of which it is the issuer at a price below the current net asset value of such stock. These express prohibitions were embodied in the statute because of the abuses that had resulted in this area. The dangers inherent in the use of option warrants in the investment company context were made abundantly clear by the Commission's investment trust study which formed the basis for the statute. Indeed, the investment company industry itself recognized the need for the prohibition against options in the statute which was enacted with its endorsement.

Because of the various forms of abuse which can arise in this area the Congress determined that managerial compensation should take a more

direct, open, measurable and understandable form. Payment of compensation by an investment company for services rendered may be on a salary or a fee basis, but in either case it is precise and known and readily understood by the investor. On the other hand, options are a form of profit-sharing device as a result of which compensation of managers and promoters may bear no relationship to the services actually rendered and the equity of the public shareholder may be diluted to an unknown extent.

The use of restricted stock options, which are not transferable, does not materially reduce the potentialities for abuse inherent in stock options generally. The fact that an option is restricted would not eliminate a tendency to "watch the market" and to take speculative risks contrary to the interest of stockholders. A holder of a restricted stock option is concerned with the price fluctuation of the stock. To create in these companies, which are essentially speculative in nature, the opportunity for riskless profit flowing from a long-term call on the company's securities at a fixed price sets the stage for the development of serious conflicts of interest.

Furthermore, the danger of dilution of the equity of shareholders remains an intrinsic problem, and the existence of options, whether restricted or not, would introduce an additional complexity, speculative and uncertain in nature, into the capital structure of the issuer. These factors may create difficulty in appraisal and analysis of an issuer's securities and may impede

efforts to raise additional capital on reasonable terms, particularly where there are no statutory limitations on the amount of stock which may be subject to options. Thus the issuance of options could result in serious consequences to a developing enterprise and could interfere with its ability to generate sufficient funds to meet the needs of the small business concerns looking to it for financial assistance.

The unavailability of stock options has not impeded the investment company industry as a whole, which has grown from $2.5 billion of assets in 1940 to approximately $25 billion currently. In fact, the unavailability of stock options does not appear to have impeded the growth of small business investment companies. As of June 2, 1961, thirty-four small business investment companies proposing to make public offerings of their securities have registered with this Commission securities in the amount of $242,679,484 for public sale. There does not appear to be any reason, therefore, why it is more essential that small business investment companies, rather than investment companies generally, be permitted to issue restricted stock options.

The primary purpose of a small business investment company is to contribute original capital to small business concerns. Such a company is engaged in the business of investing and reinvesting in portfolio securities and in this respect is no different than any investment company. It is undoubtedly

the anticipation of a small business investment company that the securities in which it invests ultimately will become acceptable in the market place. It should be pointed out that the Investment Company Act itself contemplated the formation of companies, subject to the Act, which would supply original capital. Section 12(e) assumes that a company in the business of "furnishing capital to industry, financing promotional enterprises, /and/ purchasing securities of issuers for which no ready market is in existence," activities performed by a small business investment company, is an investment company. Several companies -- not qualified as small business investment companies -- of this general type have registered under the Act. In view of these factors, I believe that the prohibitions against the issuance of stock options by investment companies should continue to be applicable to all investment companies.

If, notwithstanding the considerations mentioned above, the Congress should determine to allow small business investment companies to issue restricted stock options, appropriate minimum safeguards against abuse should be incorporated in any legislation, or such legislation should grant to the Commission rule making power to accomplish the same purpose. For example, it would seem appropriate to impose limits on the total number of shares that may be optioned and also to limit the number that may be optioned to officers and directors as a class and to any one person; restrict the spread

between the exercise price of an option and the fair market value of the stock, as of the date of granting of the option, to an amount less than that presently permitted under Section 421 of the Internal Revenue Code; and prohibit the issuance of options to any officer or employee of a small business investment company who has any interest in, or receives compensation from, an investment adviser of the small business investment company.

II. Section 10(a) of the bill is apparently intended to relieve small business investment companies from that part of Section 17 of the Act which prohibits a person from borrowing money from an affiliated investment company unless that person is controlled by the investment company or unless the transaction is exempted by Commission order. I should point out that the bill as drafted would not accomplish this purpose, since it seems to equate affiliation with the ownership of debenture bonds, although such ownership by itself does not result in affiliation.

Under the Act, affiliation would result from ownership of 5%, and control would be presumed from the ownership of more than 25%, of the voting securities of the small business concern by a small business investment company. 1/ Therefore, if a small business investment company were to own at least 5%, but less than 25%, of the voting securities of a small business concern, Section 17(a) would prohibit it from making loans to the small business concern.

1/ See Sections 2(a)(2) and 2(a)(9) of the Act.

The Commission has under consideration a proposed rule which would exempt loans from the prohibitions of Section 17 when affiliation exists only by reason of the ownership by a small business investment company of voting securities of a small business concern, and no affiliated person, promoter, or principal underwriter of the investment company has any financial interest in the small business concern, except indirectly through ownership of the securities of the investment company. Adoption of this rule would make it unnecessary to enact legislation to accomplish the same result.

III. Section 10(a) of the bill would permit a lending institution, affiliated with a small business investment company, to make loans to small business concerns in which such small business investment company has also invested. Section 17(d) of the Act now prohibits affiliated persons (such as a bank) from acting as principal to effect any transaction in which a registered investment company is a participant in contravention of such rules as the Commission may prescribe for the purpose of limiting or preventing participation by an investment company on a basis different from that of such other persons. Rule 17d-1, adopted under Section 17(d) of the Act, requires that before an affiliated person of a registered investment company may participate in such a joint enterprise, an exemptive order of the Commission must be obtained.

The Commission has under consideration a proposed amendment to Rule 17d-1 which would permit a bank to make loans to a small business concern in which a small business investment company affiliated with the bank has also invested, subject to the requirement that reports of such transactions be filed with the Commission. The rule would be effective for two years and it is the Commission's intention to reconsider this problem in the light of the information reported to determine whether the interests of investors would require any other treatment. The proposed rule is limited to banks, and, consequently, any other lending institution which is affiliated with a small business investment company would still be subject to the provisions of Rule 17d-1.

IV. Under Section 10(b) of the bill, a small business investment company would be permitted to obtain public funds through the issuance of senior debt securities, as permitted by regulation of the Small Business Administration, in addition to borrowing from the Small Business Administration. This section would amend Section 18(c) of the Act, which in effect provides that an investment company may have outstanding only one class of senior securities representing indebtedness. Since indebtedness to the Small Business Administration would not be of the same class as that issued to others, any such combinations of indebtedness would not now be permitted.

The Commission has under consideration a rule which would permit a small business investment company to issue senior securities representing indebtedness to the Small Business Administration and to other persons, provided that any such senior security issued or sold to a person other than the Small Business Administration does not have any preference as to assets and interest over any other outstanding senior security representing indebtedness. The relief that would be provided by this rule is not as broad as that proposed in the bill, but would obviate a major problem created under Section 18 of the Act.

V. Section 10(c) of the bill would amend Section 30(f) of the Act, which provides that any person who is the beneficial owner of more than 10% of any class of securities of which a registered closed-end investment company is the issuer, or who is an officer, director, member of an advisory board, investment adviser or affiliated person of an investment adviser of such an investment company, shall report changes in his beneficial ownership of securities of the investment company and shall be accountable to the investment company for profits realized through the purchase and sale, or sale and purchase, of such securities within a six-month period. Section 10(c) of the bill would relieve those persons from the requirement of accounting for such profits to the extent that the profits do not exceed 5% of the difference between the purchase and sales prices in such transactions within a six-month period.

Section 30(f) was adopted for the purpose of preventing the use of inside information for personal gain by short-term trading in securities issued by

closed-end investment companies. The Commission views the provisions of Section 30(f) as a most important and desirable prophylactic measure and opposes any proposed modification of those provisions. The public policy against insider trading enunciated in Section 30(f) also finds expression in Section 16 of the Securities Exchange Act of 1934, relating to securities traded on a national securities exchange, and in Section 17 of the Public Utility Holding Company Act of 1935, relating to securities of registered holding companies.

The 5% limitation on insider trading profits, which would be allowed by Section 10(c) of the bill, apparently is intended to cover trading profits by investment bankers who are represented on the board of directors of a small business investment company and who are making a market in the securities of the company. It is doubtful that the bill would accomplish this purpose and, furthermore, it is not limited to the class of persons which it apparently intends to exempt. No suggestion has ever been made to the Commission that relaxation of the provisions of Section 30(f) is necessary for any class of persons other than investment bankers in the situation described.

Even with respect to these investment bankers, there is no clear indication that it is necessary for them to adopt the dual role of conducting a

principal market for the securities of the company and, at the same time, being represented on the board. Absent a clear showing of necessity, such a dual role may be undesirable in view of the opportunities for over-reaching.

In any event, if a particular occasion should arise in which it can be demonstrated that it is necessary and appropriate in the public interest and consistent with the protection of investors and the purposes of the Investment Company Act to grant an investment banker an exemption from the provisions of Section 30(f), the Commission has the power to grant such an exemption, either conditionally or unconditionally, under Section 6(c) of the Act.