SMALL BUSINESS INVESTMENT INCENTIVE ACT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

H.R. 3991

A BILL TO AMEND THE SECURITIES ACT OF 1933 TO AUTHORIZE ISSUERS TO SELL CERTAIN SECURITIES TO ACCREDITED INVESTORS WITHOUT FILING A REGISTRATION STATEMENT UNDER SUCH ACT, TO AMEND THE INVESTMENT COMPANY ACT OF 1940 TO GRANT AN EXEMPTION FROM SUCH ACT TO CERTAIN ISSUERS WHICH ENGAGE IN THE BUSINESS OF FURNISHING CAPITAL OR PROVIDING FINANCING FOR BUSINESS VENTURES AND ACTIVITIES, AND FOR OTHER PURPOSES

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CONTENTS

SMALL BUSINESS INVESTMENT INCENTIVE ACT

WEDNESDAY, NOVEMBER 7, 1979

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 10 a.m., in room 2123, Rayburn House Office Building, Hon. James H. Scheuer, chairman, presiding.

Mr. Scheuer. This hearing of the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce will come to order.

We are considering today the Small Business Investment Incentive Act, H.R. 3991, whose author is Congressman Jim Broyhill of North Carolina.

Anybody who is at all familiar with the workings of our economy now knows of the dearth of investment capital available for small business.

The difficulty of small business entrepreneurs in aggregating capital has long been a source of concern, and in the last few months as prime has soared from 6, 7, 8 percent that has been customary for many years, to 15 percent, the preponderance of that impact has been on the small businessman and his ability to aggregate capital.

In efforts to make our country productive, Congress has looked into the business of the way the capital markets are providing capital.

They are not doing it terribly well for large business but doing it even worse for small business and has had a great deal of difficulty in aggregating capital for investment in new plant and equipment, research and development, even though recent investigations have shown that most new jobs come from small business and not from big business.

Two-thirds have reported new jobs come from this old pluralistic heterogeneous community of small business firms that are comparatively labor incentive and where expansion does provide jobs, so this is an urgent matter that has been made even more urgent by the development of the last few months in the changing conditions of the investment capital marketplace, so to speak.

The Member of Congress who has really taken the initiative in this matter is Congressman Broyhill from North Carolina, so I am going to take the liberty of turning the Chair over to him to conduct this hearing.

This is somewhat unusual for a committee chairman to turn over the Chair to a member of the minority, but Congressman Broyhill's record has been of such involvement in this matter, of such continuous thoughtfulness, fairness, equity, and evenhandedness, that I don't have the slightest doubt under his chairmanship the hearing will be successful and productive.

He has been an outstandingly fine colleague on this subcommittee with whom to work. We have had occasional disagreements on substantive matters, but as to his intellectual fairness and total integrity of his approach to congressional matters in committee affairs there has never been the slightest doubt, so it's a great pleasure for me to turn this hearing over to the Honorable James Broyhill of North Carolina.

Mr. BROYHILL [presiding]. Thank you very much, Mr. Chairman.

I wish it were possible that you could stay with us today, but I do understand that another emergency has come up requiring your presence in another part of the Capitol. I do appreciate the complimentary remarks of the chairman.

I just wish he could have seen fit to cosponsor this bill with me in this Congress as he did in the last Congress.

I am delighted to welcome my old friend, Mr. Loomis, here today. He has been a friend of mine for many years, going back into past Congresses when we worked out other amendments to the act.

We are here for somewhat different purposes. I am concerned about treatment of small businesses by our Federal Government in today's planning, and I am very concerned about the availability of venture capital for small businesses. And, of course, the Securities and Exchange Commission can and does play a key role in the availability of venture capital for small businesses. I am also concerned about the regulatory climate at the SEC and to what extent the agency has contributed to the inability of small business to provide money or to raise money in the capital markets.

There is a serious capital shortage for young businesses today, and I think it can be shown that there is a direct correlation between this factor and the demanding complexity of Federal securities regulations.

I am particularly sympathetic to the problems of small business. I feel that many of its problems are not of its own making, and that many of its difficulties can be traced right back to Washington.

I just don't like to see creative ability or innovation or hard work surrender to lawyers or accountants or redtape or paperwork. There was a recent study on small business financing by the National Association of Securities Dealers, and in that study we do find a very steep drop over the last 10 years in the number of first-time stock offerings, and we also find a similar drop in regulation A offerings, and we also find that the costs associated with those offerings is skyrocketing every year.

It seems to me that we are going to have to take some action to reverse this trend. Piecemeal regulatory adjustments are not sufficient, in my judgment. It seems to me that we should pass legislation similar to that that I have introduced in order to try a different approach.

I do note that, and I don't know if it is a coincidence or not, Mr. Loomis, it seems that the threat of legislation has spurred the SEC into action. I understand you have proposed rule 242 and, of course, that is an example of what I am talking about, because significant portions of H.R. 3991 are now found in proposed rule 242.

So to sum up, I repeat, I am concerned about the regulatory climate and to what extent this is drying up venture capital. I would be delighted to hear from you now as to what the SEC is planning to do with respect to those concerns that I have mentioned.

With objection the text of H.R. 3991 and an agency report thereon will be printed at this point in the record.

[Testimony resumes on p. 34.]

[The text of H.R. 3991 and an agency report thereon follows:]

96TH CONGRESS
1ST SESSION

H. R. 3991

To amend the Securities Act of 1933 to authorize issuers to sell certain securities to accredited investors without filing a registration statement under such Act, to amend the Investment Company Act of 1940 to grant an exemption from such Act to certain issuers which engage in the business of furnishing capital or providing financing for business ventures and activities, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MAY 8, 1979

Mr. BROYHILL introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

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A BILL

To amend the Securities Act of 1933 to authorize issuers to sell certain securities to accredited investors without filing a registration statement under such Act, to amend the Investment Company Act of 1940 to grant an exemption from such Act to certain issuers which engage in the business of furnishing capital or providing financing for business ventures and activities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Small Business Investment Incentive Act of 1979".

TRANSACTIONS INVOLVING LIMITED SALE SECURITIES AND ACCREDITED INVESTORS

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

"(A) The transaction is solely with one or more accredited investors or persons that the issuer reasonably believes to be accredited investors.

"(B) The security which is the subject of the transaction is a limited sale security.

"(C) There is no general advertising or general solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf.".

RESALE OF LIMITED SALE SECURITIES

SEC. 3. (a) Section 4(1) of the Securities Act of 1933 (15 U.S.C. 77d(1)) is amended by adding at the end thereof the following: "For purposes of this paragraph, any person who sells a limited sale security for his own account or for the account of any other person shall not be considered to be an underwriter with respect to such transaction if such sale is made to an accredited investor or to a person whom the seller reasonably believes to be an accredited investor.".

(b) Section 2 of the Securities Act of 1933 (15 U.S.C. 77b) is amended by adding at the end thereof the following new paragraphs:

"(15) The term 'accredited investor' means (A) a bank, insurance company, registered investment company, small business investment company licensed under the Small Business Investment Company Act of 1958, or person described in the last clause of section 3(c)(3) of the Investment Company Act of 1940, a fund, trust, or other account with respect to which a bank or insurance company exercises investment discretion, or a person who controls or is controlled by any such person, (B) any person who, on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial and business matters, or amount of assets under management, qualifies as an accredited investor under rules and regulations which the Commission shall prescribe, and (C) any other person who does not qualify as an accredited investor under such rules and regulations but who relies upon the investment advice of a person who does so qualify. As used in this paragraph, the term 'investment discretion' has the meaning given such term in section 3(a)(35) of the Securities Exchange Act of 1934.

"(16) The term 'limited sale security' means a security which bears a legend to the effect that such security may not be sold or otherwise transferred except to an accredited investor.".

RESALE OF RESTRICTED SECURITIES

SEC. 4. Section 2(11) of the Securities Act of 1933 (15 U.S.C. 77b(11)) is amended—

(1) in the first sentence, by inserting "(A)" immediately after "shall not include" and by inserting immediately before the period the following: ", or (B) a person engaging in a sale or other distribution of restricted securities if such person has been the beneficial owner of such securities for a period of not less than five years prior to the date of such sale or distribution"; and

(2) by inserting immediately before the period at the end of the second sentence the following: ", and the term 'restricted securities' means securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering".

LIABILITY IN PRIVATE OFFERINGS

SEC. 5. Section 12 of the Securities Act of 1933 (15 U.S.C. 77l) is amended by adding at the end thereof the following new sentence: "Notwithstanding the foregoing provisions of this section, a person who sells securities, in a transaction evincing a good faith attempt not to involve any public offering pursuant to section 4(2), shall not be liable to a purchaser of such securities in such transaction if all conditions set forth in section 4(2) or prescribed in rules and regulations of the Commission concerning such a transaction have been met with respect to such purchaser, and such purchaser may not bring a civil action for rescission of such transaction on the grounds that all such conditions have not been met with respect to all purchasers of securities in such transaction.".

EXEMPTION FROM INVESTMENT COMPANY ACT OF 1940

SEC. 6. Section 3(c)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(3)) is amended—

(1) by striking out "or" immediately after "guardian"; and

(2) by inserting immediately before the period at the end thereof the following "; or any issuer engaged principally in the business of furnishing capital or providing financing for business ventures and activities, purchasing securities of issuers for which no ready market is in existence, or reorganizing companies or similar activities (or any person that is organized and exists solely for purposes of holding securities in such an issuer), if at least 80 percent at cost of the securi-

ties held by such issuer (other than government securities, short-term paper, and other cash items) consist of securities which (A) were acquired directly from such issuer (including warrants or options acquired from such issuer) in a transaction or chain of transactions not involving any public offering or pursuant to the exercise of warrants or options acquired in such a transaction, (B) were received as a result of a reorganization or bankruptcy proceeding, or (C) were distributed on or with respect to any securities described in clause (A) or (B).".

EFFECTIVE DATE

SEC. 7. (a) The amendments made by this Act shall take effect on the date of enactment of this Act.

(b) The Securities and Exchange Commission shall, within 180 days after the date of enactment of this Act, prescribe such rules and regulations as may be necessary to carry out the amendments made by this Act.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

Aug. 9, 1979.

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

Re: H.R. 3991, the "Small Business Investment Incentive Act of 1979."

Dear Chairman Staggers:

In response to your request, I am enclosing a memorandum setting forth the Commission's comments on H.R. 3991. The Commission is deeply concerned with the ability of small businesses to raise capital. Indeed, as set forth in the enclosed memorandum, the Commission recently established an Office of Small Business Policy in our Division of Corporation Finance to put our small business initiatives on a permanent footing. That Office provided substantial assistance in preparing our comments on the Bill.

As explained in detail in the enclosed memorandum, in carrying out our commitment to support efforts to remove unnecessary burdens on capital formation by small business, we have undertaken rule changes under existing law which provide substantially the same access to capital for small businesses as would be provided by Sections 2 through 5 of the Bill; and we plan steps to meet concerns reflected in Section 6 of the Bill, consistent with appropriate investor protections. Thus, the Commission is already successfully embarked upon a course designed to achieve the Bill's objectives.

However, as we also discuss in the memorandum, the Bill as presently drafted is not confined in its scope to small businesses and unnecessarily removes all safeguards as to resale of restricted securities after five years. Also, we have substantial concerns about the breadth of the exclusion from investment company coverage provided by the Bill.

The views expressed here and in the enclosed memorandum are those of the Commission, and do not necessarily represent the views of the President. We are simultaneously sending copies of this correspondence 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 program of the Administration.

Thank you for giving us the opportunity to comment on the Bill. We would appreciate the opportunity to make further comments on the Bill if it is substantially modified in any respect. Please let me know if we can be of any further assistance.

Sincerely,

Harold M. Williams
Chairman

Enclosure

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION
TO THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
ON H.R. 3991

The Commission is pleased to have this opportunity to comment on H.R. 3991, the "Small Business Investment Incentive Act of 1979" (the "Bill"). Because the Bill addresses two different areas, our comments will discuss each area separately. Part I of our comments deals with Sections 2 through 5 of the Bill, which would amend the Securities Act of 1933 to authorize issuers to sell certain securities to "accredited investors" without filing a registration statement with the Commission pursuant to that Act. Part II of our comments discusses Section 6 of the Bill, which would amend the Investment Company Act of 1940 to exclude from the coverage of that Act certain issuers that, among other things, engage in the business of furnishing capital or providing financing for business ventures and activities.

The Commission is concerned that small businesses should have an adequate market to raise capital and that investors should not be unnecessarily impeded from purchasing securities of small businesses. In fact, the Commission has already embarked upon rulemaking changes which would achieve substantially the same improvement of access to capital for small business as the Bill.

At the same time, the Commission is charged with the responsibility of ensuring the integrity of the securities markets and of protecting investors. Therefore, although we strongly support the goals toward which the Bill is directed, we are concerned that as it is presently drafted it is unnecessarily broad in scope, and therefore we do not support the Bill in its present form. 1/

I. AMENDMENTS TO THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT OF 1933

A. Past and Current Commission Activities to Facilitate Capital Raising by Small Business

The Commission has for some time been examining steps which might be taken to facilitate capital formation by small businesses. In this regard, the Commission held public hearings in April and May of 1978 for the purpose of determining the extent to which the burdens imposed on small businesses may be alleviated consistent with the protection of investors. The hearings, which were held in Washington, D.C., Los Angeles, Denver, Atlanta, Chicago, and Boston, concerned the effects of the Commission's rules on the ability of small businesses to raise capital and the impact on small businesses of disclosure requirements under the federal securities laws.

A study of the record developed at the hearings indicates that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws. Insofar as the ability to raise capital is concerned, general economic conditions and the existing tax structure, particularly with respect to the capital gains tax, were reported to have the greatest impact. Thus, many witnesses expressed the view that, if a favorable change occurred in

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1/ To some extent, where appropriate, the following comments reiterate statements we submitted to your Committee on previous similar legislation in the 95th Congress: H.R. 9549, H.R. 10717 and H.R. 13032.

either of these factors, small businesses would not be substantially impeded by the federal securities laws from obtaining needed capital.

The witnesses did state, however, that a number of requirements under the federal securities laws are not justified as applied to small business. In response to these concerns, the Commission has undertaken a number of significant rule and form amendments, which are designed to ease the impact of the federal securities laws on small business capital raising.

Presently, Section 3(b) of the Securities Act authorizes the Commission to exempt any class of securities from the full-scale registration otherwise required by Section 5 of the Securities Act (15 U.S.C. 77e) 2/ if it finds that such registration is not necessary in the public interest or for the protection of investors because of the small offering amount or the limited character of the offering. On September 11, 1979, the Commission adopted an amendment to Regulation A 3/ to increase the aggregate offering price of securities that may be sold thereunder during a twelve month period from $500,000 to $1,500,000. 4/ This amendment followed Congressional action raising the aggregate amount of the small offering exemption specified in Section 3(b) of the Securities Act of 1933. The Commission also adopted an amendment to Regulation A to permit

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

3/ 17 CFR 230.251-264.

4/ Securities Act Release No. 5977 (September 11, 1979).

the use of a preliminary offering circular prior to the commencement of certain underwritten offerings thereunder. 5/ On September 8, 1979, the Commission adopted an amendment to Rule 146, concerning exemptions from registration for the private placements. 6/ The amendment modifies the disclosure requirements when an offering does not exceed $1,500,000 to allow disclosure of information prescribed by Schedule 1 of Regulation A rather than information which would be included in a registration statement. 7/

Last year the Commission amended Rule 144, 8/ the rule which sets forth guidelines for the resale of certain securities, and proposed amendments to that rule to: (1) relax the limitations on the amount of securities that can be sold under the rule; (2) permit sales under the rule directly to marketmakers; and (3) eliminate the requirement that sales under the rule be made only in brokerage transactions or directly with a marketmaker for sales of securities by estates, and their beneficiaries, who are not affiliates of the issuer of the securities. 9/ We further amended Rule 144 to permit non-affiliates under certain circumstances to disregard the volume limitation provisions of that rule. 10/

5/ Securities Act Release No. 6075 (June 1, 1979).

6/ 17 CFR 230.146.

7/ Securities Act Release No. 5975 (September 8, 1979).

8/ 17 CFR 230.144.

9/ Securities Act Release No. 5979 (September 19, 1978).

10/ Securities Act Release No. 6032 (March 5, 1979).

This year the Commission simplified registration and reporting procedures for small businesses through the adoption of Form S-18. 11/ This form is available to certain domestic and Canadian corporate issuers who are not subject to the Commission's continuous reporting requirements for the registration of securities to be sold for cash not exceeding an aggregate offering price of $5 million. The form calls for less narrative and financial disclosure than Form S-1, the standard registration form. The form may be filed with the regional offices of the Commission, in order to facilitate handling for the issuer. Also, issuers may include in their initial annual report information substantially similar to that included in their Form S-18 registration statement, pursuant to corresponding amendments to Form 10-K, the annual report form for certain publicly-held companies under the Securities Exchange Act of 1934.

In order to put its small business initiatives on a permanent footing, the Commission recently created the Office of Small Business Policy within the Division of Corporation Finance. In addition to the actions already undertaken, the Office of Small Business Policy is engaged in a review of additional amendments and new rules intended to facilitate capital formation by small business.

In short, the Commission has taken significant action in several areas covered by the Bill and has under consideration further amendments and new rules which may obviate the need for the statutory amendments embodied in the Bill. We believe the Commission should be allowed sufficient time adequately to evaluate the results of our rulemaking

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11/ Securities Act Release No. 6049 (April 3, 1979).

initiatives. Where we find that desirable improvements cannot be accomplished through the rulemaking process, the Commission will readily transmit appropriate legislative recommendations. In this regard, we are concerned that, while the apparent purpose of Sections 2 through 5 is to assist capital formation by small businesses, the exemptions from registration which those Sections would provide would be available to be used by any business, regardless of size, and regardless of the amount of capital funding involved, and would needlessly remove all safeguards on resale of restricted securities after five years.

In addition, as mentioned above, a preliminary study of the record developed at our recent public hearings indicates that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws. On the other hand, we believe that experience has shown that, over the past forty-six years, the full disclosure afforded investors by the federal securities laws has increased public confidence in the securities markets and facilitated capital-raising by businesses of all sizes in a beneficial manner.

Accordingly, we believe that the objective of assisting small business is best approached by the Commission's present pattern of timely, but careful, rulemaking.

B. Detailed Discussion of the Bill

(1) Section 2

Section 2 of the Bill would amend Section 4(2) of the Securities Act to provide an additional exemption from registration for transactions by an issuer solely with one or more "accredited investors" if the security sold is a "limited sale security" and there is no general advertising or solicitation in connection with the transaction. A "limited sale security" is defined in Section 3 as a security that bears a legend to the effect that it may not be sold or otherwise transferred except to an accredited investor. An "accredited investor" is defined in Section 3 to include: (a) certain specified institutional purchasers; (b) any person who, because of financial sophistication, net worth, knowledge and experience in financial and business matters, or amount of assets under management, qualifies as an accredited purchaser under rules prescribed by the Commission; and (c) any person who relies on the investment advice of an accredited investor. The institutional purchasers include "a bank, insurance company, [licensed] small business investment company" and certain trust funds and insurance company separate accounts. Section 2 of the Bill would amend Section 4(2) 4(2) to allow unlimited sales to certain institutional and other accredited investors.

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

The Office of Small Business Policy currently has under consideration a new rule which would treat sales to certain institutional buyers in a manner similar to the treatmemt afforded by the Bill. This new rule is being developed as an alternative to the Section 4(2) exemption and Rule 146 for small businesses and would alleviate certain concerns with

Section 4(2) and Rule 146 expressed by witnesses at our small business hearings. The rule would allow sales to an unlimited number of defined institutional purchasers and purchasers of large blocks and to 35 additional purchasers. The rule would differ significantly from the amendment contemplated by Section 2 of the Bill in that the rule would be promulgated pursuant to Section 3(b) of the Securities Act.

While the Commission has not yet proposed the new rule, our intention is to alleviate significantly the substantive problems encountered by small issuers under the Securities Act in attempting to raise capital in a nonpublic offering. In light of the Commission's ongoing initiatives, we believe that the adoption of an experimental rule that would allow the Commission to gain experience with the substantive changes under consideration is preferable to the addition of further statutory provisions at this time.

As noted above, the rule under consideration by the staff would allow sales to an unlimited number of institutional investors. Although our definition of institutional investor for this purpose has not been completed, we would point out that clause (C) of the definition of "accredited investor," in Section 3(b) of the Bill, which includes persons who rely on the investment advice of other accredited investors, appears overly broad. It may be that investors of the type described in clauses (A) and (B) of the definition can fend for themselves. But, merely because they could do so does not mean that persons whom they advise should be deprived of the protections of the registration provisions of the Securities Act. Pursuant to this provision, sales could be made to an unlimited universe of purchasers without the disclosures required under the Act or any other protections such as those which would be available when a fiduciary relationship exists.

(2) Sections 3(a) and 4(1)

Section 3(a) of the Bill would amend Section 4(1) of the Securities Act to provide that a person who sells a "limited sale security," or any person acting on his behalf, shall not be considered to be an underwriter with respect to such transaction if such sale was made to an accredited investor or to a person the seller reasonably believes to be an accredited investor. Pursuant to this amendment, unregistered "limited sale securities" may be resold by affiliates and non-affiliates of the issuer to any number of accredited investors.

Section 4(1) of the Bill would amend the definition of "underwriter" contained in Section 2(11) of the Securities Act to provide that that term shall not include a person engaging in a sale of securities if such person has been the beneficial owner of such securities for a period of five years or more. Consequently, affiliates as well as the non-affiliates of an issuer would be able to resell unregistered securities pursuant to the Section 4(1) exemption after a five year period.

We have some concern about removing all restrictions on sales by persons who are affiliated with issuers after five years of beneficial ownership. Section 2(11) of the Securities Act presently defines "underwriter" to mean

> "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in

the direct or indirect underwriting of any such undertaking * * *." 12/

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

Nevertheless, the Commission supports the basic intent of Sections 3(a) and 4(1) of the Bill, to alleviate the problem of secondary sales of securities issued by small businesses, except with respect to the resale of securities by affiliates. Although several factors were cited during our small business hearings as contributing to the problem of secondary sales of small business securities, the most commonly identified factors

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

were the resale restrictions imposed by Rule 144. As mentioned above, that Rule defines persons who are deemed not to be engaged in a distribution of securities, and therefore who are not underwriters for purposes of Section 4(1) of the Securities Act. Section 4(1) of that Act in turn exempts from the registration provisions of Section 5 of the Act all transactions by persons other than issuers, underwriters or dealers.

Rule 144 provided, at the time of our small business hearings, that affiliates and others selling securities subject to the Rule could sell, during a 6 month period, the lesser of one percent of the class outstanding or the average weekly trading volume. A majority of the witnesses that testified on this point at the hearings were of the view that this provision severely restricted their ability to attract capital because of the long period of time which was necessary to liquidate an investment. Thus, the witnesses believed that a relaxation of this provision of the Rule was essential to the ability of venture capitalists and other investors to recycle their investment into new enterprises.

The Commission has responded to these concerns by amending Rule 144 to allow sales not to exceed the greater of one percent of the class outstanding or the average weekly trading volume during a three month period. In addition, the Commission adopted an amendment to Rule 144 which permits non-affiliates under certain circumstances to disregard the volume limitation provisions of Rule 144 after a period of (1) three years, if the securities to be sold are those of a class which is either listed on an exchange or quoted on NASDAQ, an electronic interdealer quotation service; or (2) four years, if the securities to be sold are those of an issuer which files periodic reports under section 13 or 15(d) of the Securities Exchange Act of 1934.

In connection with our recent amendments to Rule 144, we have announced publicly that we are considering removal of the volume limitations in Rule 144 for the securities of non-reporting companies under certain circumstances. Moreover, the Office of Small Business Policy has under consideration further amendments to Rule 144 which would assist the resale of securities by affiliates.

The advantage of the Commission's approach in effecting these changes by the adoption of rules, rather than the enactment of additional statutory provisions, is that the Commission would retain its present flexibility to amend these rules in the future should conditions change or amendments become necessary to protect the interests of public investors. Consequently, while we do not oppose the substantive changes contained in Section 4(1) of the Bill, except for the provision with respect to resales by persons affiliated with the issuer, we suggest that a better method of implementing those changes is the one presently utilized by the Commission. 13/

(3) Section 5

Section 5 of the Bill would amend Section 12 of the Securities Act by adding a sentence which would, in the case of a transaction involving a "good faith attempt not to involve any public offering pursuant to Section 4(2)," deny recovery under Section 12 to a purchaser of securities if all conditions prescribed in Section 4(2) and in rules and regulations of the Commission have been met with respect to such purchaser.

13/ We have no comments on Section 4(2), defining "restricted securities".

Presently, there is absolute liability under Section 12(1) if an issuer offers or sells a security in violation of the registration provisions of Section 5. 14/ To establish a prima facie case under Section 12(1), the plaintiff need prove only (1) the purchase of the security, (2) from the defendant or from a person controlled by the defendant, (3) the use directly or indirectly of the required jurisdictional means, (4) that no registration statement was in effect, and (5) that the action was brought within one year from the date of the violation. 15/ The availability of the private offering exemption is an affirmative defense as to which the defendant has the burden of proof. 16/ Under present law, that exemption is unavailable unless the defendant can show not only that the requirements of Section 4(2) have been met with respect to all purchasers, but also that they have been met with respect to all offerees. 17/

The importance of this approach was emphasized by the Court of Appeals for the 10th Circuit in Lively v. Hirschfield (note 15, above). In that case, the court stated:

> "After the Ralston Purina case the emphasis in the decisions has been placed on the particular capabilities and information had by particular persons,

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14/ See, e.g., Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959).

15/ See, e.g., Lively v. Hirschfield, 44 F.2d 631 (10th Cir. 1971).

16/ Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. at 126 (1953).

17/ Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972); Securities and Exchange Commission v. Continental Tobacco Co. of S.C., Inc. 463, F.2d 137 (2d Cir. 1972); Hill York Corp. v. American International Franchise, Inc. 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfield, supra 440 F.2d at 632.

> buyers, plaintiffs or offerees. The Ralston Purina case required this examination of the individuals solicited to determine the nature of the offer, that is, to determine whether there was a public need for registration * * *."
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> * * *
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> "The standard must apply to all the offerees if the Ralston Purina case is to be meaningfully applied, and if the artificial classification of "buyers" is to be prevented from determining the nature of the offer in a private action such as this." 18/

Thus, under present law, the need for registration is viewed not only in terms of the particular private plaintiff but also with respect to all offerees and purchasers, i.e., with respect to the offering itself. In this connection, issuers have expressed concern that even if they make a good faith attempt to comply, a failure with respect to one unsophisticated offeree may allow a sophisticated purchaser to rescind a securities purchase or recover damages if he no longer owns the security. However, legislation is not necessary at this time and, in our judgment, is not the proper response to the problem. Our staff currently has under consideration amendments to Rule 146 which were suggested at the hearings, such as the inclusion of a "substantial compliance" or "good faith attempt" provision in the Rule, which would alleviate this and other concerns expressed regarding the Rule. As indicated above, the Commission believes that the flexibility provided by the rulemaking process is preferable generally to the proposed amendments that would rigidify the exemptive pattern, and that the Commission should be allowed sufficient time to take appropriate action through

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18/ 440 F.2d at 632-33.

the rulemaking proceedings recently initiated by its Office of Small Business Policy.

II. AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

Section 6 of the Bill would amend Section 3(c)(3) of the Investment Company Act of 1940 ("Act") to exclude from the definition of "investment company" entities which are apparently regarded as venture capital companies. In this regard, in its administration of the Investment Act, the Commission is also attempting to increase the ability of small businesses to raise capital. Indeed, as we recently announced, 19/ we are currently considering proposing a rule that would provide exemptive relief from all provisions of the Investment Company Act for certain business development companies whose securities are owned by substantial, sophisticated investors and which are organized and operated for the purpose of investing directly in relatively small and unseasoned companies in the developmental stage. Although it is not possible at this time to describe in greater detail the provisions of the proposed rule, 20/ we believe

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19/ Investment Advisers Act Release No. 680 (June 19, 1979). In that Release, the Commission proposed for public comment a new rule which would permit, under appropriate conditions, special performance-based fees to be paid to registered investment advisers to business development companies that invest in relatively small and unseasoned companies in the developmental stage. The purpose of the rule is to facilitate the flow of needed capital to small businesses without detrimentally affecting the investors who most need the protections of the Investment Advisers Act.

20/ We expect the Investment Company Act rule, including its definition of "business development company," to be consistent with and largely similar to whatever rule may ultimately be adopted as a result of Investment Advisers Act Release No. 680, note 19, *supra*.

that permitting the Commission to continue its present efforts to address and resolve the status of venture capital companies by rulemaking under the Investment Company Act would best accommodate the dual goals of protecting investors and helping small businesses. This is particularly true in view of our reservations, set forth in detail below, concerning Section 6 of the Bill.

A fundamental consideration in any attempt to fashion a solution to the venture capital problem is, in the Commission's view, the protection of investors. As Congressman Broyhill, a sponsor of the Bill, has stated, "protections must be provided for small, un-unsophisticated and vulnerable investors." 21/ Although the Bill's sponsors may believe that it would continue protection for those investors and would only remove unnecessary impediments confronting investors who are able to fend for themselves, 22/ we are concerned that Section 6 of the Bill is overbroad. It would have the effect of substantially reducing the protections that would otherwise be afforded small, unsophisticated and vulnerable investors as well as sophisticated and wealthy investors. This broad-brush diminution of investor protections would directly result from the amendment that would exclude investment companies described in Section 6 of H.R. 3991 from the Act and would thereby deny shareholders of those companies the Act's protections.

The Investment Company Act was enacted to eliminate the widespread abuses and failures to observe principles of fiduciary duties

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21/ 125 Cong. Rec. H 2860 (daily ed. May 8, 1979) (remarks of Representative Broyhill).

22/ Id.

that were uncovered in unregulated investment companies. As a result, the Act was structured to provide a comprehensive framework of regulation which, among other things, prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval, protects against management self-dealing, embezzlement, or abuse of trust, and provides specific controls to eliminate or mitigate inequitable capital structures. Other basic investor protections afforded by the Act include requirements that an investment company disclose its financial condition and investment policies and provisions for specific controls designed to protect against unfair transactions between investment companies and their affiliates. It is in large part because of these significant protections provided investors by the Act that the Commission has opposed provisions in numerous bills previously introduced in the Congress that would have exempted from the Act small business investment companies licensed by the Small Business Administration ("SBA"), notwithstanding their dual regulation by the SBA. 23/ For the same reasons, we do not believe that small unsophisticated investors should be denied the Act's protection in

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23/ See, e.g., Report of Comm. on Banking and Currency on S. 3651, Small Business Investment Act of 1958, S. Rep. No. 1652, 85th Cong., 2d Sess. 13 (1958): "The committee is convinced that it would not be wise to exempt [small business investment] companies outright from the securities laws. . . . [S. 3651] provides that, with one exception [dealing with capital structure], the Investment Company Act of 1940 shall apply to small-business investment companies just as it does at present to other investment companies. The committee was impressed by the testimony offered by the Chairman of the SEC that, in order to give adequate protection to investors, the Investment Company Act of 1940 should be applicable to small business investment companies."

this instance, 24/ where investors would not even have the limited benefits 25/ of SBA regulation.

Should the Congress, despite our strong belief that providing exceptions or exemptions from the Investment Company Act for venture capital companies should be left to rulemaking rather than legislative action, nevertheless wish to consider further Section 6 of the Bill,

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24/ It has been suggested that the Act was passed to regulate abuses "such as unscrupulous [investment company] managers who had large amounts of cash which could be quickly shifted and manipulated to the detriment of the outside investors," and that venture capital companies are distinguishable because of their supposedly illiquid investments, 125 Cong. Rec. H 2862 (daily ed., May 8, 1979) (Remarks of Representative Broyhill). However, the majority of abuses that Congress sought to prevent by enacting the Investment Company Act were not necessarily related to the liquidity of investment companies' security holdings. See generally Section 1(b) of the Act. Moreover, although it may have been true that in 1940 "there were virtually no venture capital firms in existence which were publicly traded," 125 Cong. Rec. H 2862, supra, we do not believe that "[h]ad there been such firms in existence it may very well have been discovered that the protections of the Investment Company Act of 1940 were unnecessary." Id. Rather, there is strong evidence to the contrary — that not only were the Act's protections viewed as particularly important to small, unsophisticated investors who might purchase interests in relatively risky "venture capital" companies, but also that regulation under the Act would in fact prove beneficial to those companies, enhancing public confidence in them. See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 286, 287, 562-63 (1940) ("Senate Hearings"). To the extent that the provisions of the Act might be inappropriate as applied to certain venture capital companies or other companies, Congress contemplated that the difficulties would be dealt with by use of the Commission's exemptive authority under Section 6(c) of the Act. That authority would be the basis for the anticipated rulemaking described earlier.

25/ It is our understanding that the primary concern of the SBA is with the stimulation of small businesses through additional financing, and that the protection of investors is, at best, a secondary concern.

we have the following more specific comments concerning its provisions.

As mentioned above, Section 6 of the Bill would amend Section 3(c)(3) of the Investment Company Act to exclude from the definition of "investment company" entities which are apparently regarded as venture capital companies. 26/

Section 6 would apparently allow a venture capital company to be totally excluded from the Investment Company Act, if it meets the following conditions:

(1) it must be principally engaged in any one of three general business activities:

(a) furnishing capital or providing financing for business ventures and activities;

(b) purchasing securities of issuers for which no ready market is in existence; or

(c) reorganizing companies; and

26/ See 125 Cong. Rec. E 3160 (daily ed., June 22, 1979) (Remarks of Representative Luken). Section 6 provides an exclusion from the definition of "investment company" for: "any issuer engaged principally in the business of furnishing capital or providing financing for business ventures and activities, purchasing securities of issuers for which no ready market is in existence, or reorganizing companies or similar activities (or any person that is organized and exists solely for purposes of holding securities in such an issuer), if at least 80 percent at cost of the securities held by such issuer (other than government securities, short-term paper, and other cash items) consist of securities which (A) were acquired directly from such issuer (including warrants or options acquired from such issuer) in a transaction or chain of transactions not involving any public offering or pursuant to the exercise of warrants or options acquired in such a transaction, (B) were received as a result of a reorganization or bankruptcy proceeding, or (C) were distributed on or with respect to any securities described in clause (A) or (B)."

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(2) 80 percent at cost of the securities held by the company must generally be acquired directly from issuers in nonpublic transactions. 27/

Our concern with this section stems from the fact that it is so broadly drafted that it would exempt from the salutary regulatory provisions of the Investment Company Act not only companies that furnish capital to small and unseasoned businesses in the developmental stage, but also to many other companies for which there has been no showing of a need for any special treatment under the Act. 28/

27/ The various references in Section 6 to the term "issuer" create unnecessary confusion, since that term appears to be used in some instances to refer to venture capital companies (e.g., "any issuer engaged principally"), and in other instances to refer to the businesses in which venture capital companies are to invest (e.g., "securities which (A) were acquired directly from such issuer"). The ambiguity is especially confusing with respect to the parenthetical "or any person that is organized and exists solely for purposes of holding securities in such an issuer"; we assume that "issuer," as used in that clause, refers to a venture capital company. See note 32, infra.

28/ The description of businesses in which these venture capital companies are to engage may be modeled in part on Section 12(e) of the Investment Company Act. That Section provides a limited exception from the prohibition in Section 12(d)(1) of the Act against an investment company acquiring securities of another investment company. See In re American Research & Dev. Corp., 24 S.E.C. 481 (1946). Section 12(e) allows such a purchase if the investment company whose securities are acquired engages in "the business of underwriting, furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, and reorganizing companies or similar activities * * * ." However, it bears emphasis that Section 12(e) provides an exception for an investment company acquiring the securities of another investment company that is a venture capital company. It provides no exception

(footnote continued)

One type of investment company that currently accounts for a substantial portion of mutual fund industry assets is the money market fund, which invests in short-term money market instruments, such as Treasury Bills, certificates of deposit, and commercial paper. These funds may invest substantial portions of their assets in commercial paper purchased directly from issuers in nonpublic transactions. Yet nothing in Section 6 would preclude such companies from relying on the exclusion that it would provide from the Investment Company Act. This result, presumably unintended, is at least in part due to the fact that the Bill does not define the characteristics of the businesses which are the desired ultimate beneficiaries of Section 6. Thus, a money market fund whose portfolio consists of commercial paper acquired directly from issuers might argue that it was a venture capital company principally engaged "in the business of furnishing capital or providing financing for business ventures and activities," 29/ even though the issuers

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(footnote continued)

or exemption for the venture capital company. Indeed, Congress clearly contemplated that, unless some other exception or exemption were available, such companies would be subject to the Act. See, e.g., Senate Hearings, at 286. Moreover, Section 12(e), by its terms, requires the bottom-tier investment company to engage in all of the activities listed, whereas, by contrast, Section 6, in using the word "or" before the phrase "reorganizing companies" would seem to contemplate that engagement in any one of the specified activities and the satisfaction of the conditions set forth subsequently would entitle a company to rely on the Section 6 exception.

29/ It is unclear what difference of meaning is intended between "furnishing capital" and "providing financing." Similarly, we are unsure what "activities," as distinguished from business ventures, are contemplated as being within the Section.

might be corporations of considerable size. 30/ Other conventional investment companies might be able to make similar arguments under the proposed language if they engaged principally in acquiring stock or other securities in nonpublic transactions, even if the issuers of such securities were not small businesses. 31/

The Bill would also exclude issuers principally engaged in the business of "reorganizing companies or similar activities (or any person that is organized and exists solely for purposes of holding securities in such an issuer)." 32/ We are uncertain as to precisely what is contemplated by the phrase "reorganizing companies," and how fostering that activity furthers the purposes of the legislation. Furthermore, given the ambiguities we perceive to exist in the descriptions

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30/ In addition, Section 6 would permit investments in government securities, including Treasury Bills, to be excluded from the requirement that 80 percent of a venture capital company's securities must be acquired either directly from issuers, or as described in clauses (B) or (C) of that Section.

31/ The Commission, in administering the Investment Company Act, has encountered problems related specifically to registered open-end investment companies' holdings of restricted securities acquired in nonpublic transactions because of the requirement that open-end companies redeem their securities at net asset value at the request of the security holder and because of difficulties in valuing restricted securities. See Investment Company Act Release No. 5847 (October 21, 1969.)

32/ See also note 27 supra. The singular "such an issuer" in this parenthetical clause might be read literally to mean that a holding company which holds interests in more than one venture capital company would not be excluded by this provision from the Investment Company Act, although it is not clear whether such a result is intended. However, even if it holds securities in only one venture capital company, unless the holding company were primarily engaged, through at least a majority-owned interest, in the venture capital company's business, it should not be excluded from the Act. On the other hand, if the holding company were so engaged, the parenthetical clause would be unnecessary because the holding company would be excluded by present Section 3(c)(6) of the Act.

of the business activities described in Section 6, permitting companies to engage in "similar activities" would compound the interpretive difficulties inherent in the amendment.

Another problem is raised by Section 6. There is nothing to ensure that excluded issuers continuously engage in the activities that the Bill seeks to promote, other than the inference that may be drawn from the requirement that an issuer be "engaged" principally in one of the described businesses. Thus, a venture capital company that was initially excluded from the Investment Company Act by the amendment because it purchased "securities of issuers for which no ready market is in existence" could arguably continue passively to hold those securities (and exercise any warrants and options) long after those perhaps once small companies matured — indeed, it could hold those securities forever and remain free of the Act. For example, both earlier and later investors in an investment company fortunate and prescient enough to have acquired securities directly from Polaroid and IBM when they were in their early developmental stages might find themselves in the anomalous position of forever being deprived of the protections of the Investment Company Act, despite their ownership of shares in an investment company with a portfolio of "blue chip" securities that may be largely indistinguishable from the portfolios of many other regulated investment companies whose investors enjoy the full protections of the Investment Company Act. But, the purposes of the Bill are no longer furthered once an investment company has ceased providing capital for small businesses and merely passively holds securities purchased in the past.

A similar issue is raised by the fact that the requirement that the company hold at least 80 percent of its investments in securities of qualified issuers is keyed to the "cost" of the securities and not their value. This means that the company would still be exempt from all provisions of the Act even if the value of the 20 percent portion of the portfolio, which may be invested in securities of any issuer, increased so that those securities became the primary or even predominant portion of the company's investments.

In conclusion, although we support the goal of promoting small business, we have serious concerns about the provisions of Section 6 of the Bill. Moreover, we believe that the Commission's contemplated rulemaking under the Investment Company Act will serve adequately to alleviate any unnecessary impediments that Act might pose for venture capital activities without sacrificing necessary investor protections.

August, 1979

AR/ef/32

Mr. BROYHILL. Mr. Loomis, please proceed as you see fit.

STATEMENT OF HON. PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY SYDNEY H. MENDELSOHN, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, AND MARTIN E. LYBECKER, ASSOCIATE DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT

Mr. LOOMIS. Thank you, Mr. Chairman.

I welcome this opportunity to testify today on the Small Business Investment Incentive Act.

I will introduce the people with me.

On my left is Mr. Sydney H. Mendelsohn, the Director of the Division of Investment Management and, on my right, Mr. Martin E. Lybecker, the Associate Director of that Division.

On August 9, 1979, we submitted to your committee a detailed memorandum [see p. 10] with respect to our position on the bill. I have also submitted a prepared statement which basically is an update of our activities since August, and I would ask that that be included in the record.

Mr. BROYHILL. That will be included in the record [see p. 41] and if you would like to summarize, you may do so.

Mr. LOOMIS. First, I will discuss some of the steps which the Commission has already undertaken toward reaching the goal of the bill, the easing of regulatory restrictions on the raising of capital by small businesses.

Second, I will discuss the provisions of the bill which would amend the Securities Act of 1933 to deal with certain perceived problems for capital raising by small businesses.

Finally, I will discuss the special investor protection problems raised by the bill's proposed amendments of the Investment Company Act of 1940.

In brief, our position is that the bill in its present form is not needed because the goals can be accomplished—indeed, may already have been largely accomplished administratively—without further legislation. Moreover, we believe that the bill's exemptive provisions are too broadly drafted and if enacted would unnecessarily dilute important existing investor protections.

In this regard, it bears emphasis that removing investor protections too broadly or precipitously could ultimately have a negative effect on the ability of small businesses to raise capital if investor dissatisfaction results in loss of confidence in the securities.

Let me begin with my first point about recent Commission efforts to remove unnecessary constraints on the raising of capital by small businesses. In April and May of 1978, the Commission held hearings throughout the country to discover ways of alleviating burdens on the capital-raising function of small business, particularly those burdens associated with the Federal Securities laws.

I might interpolate that our concern that was expressed in those proceedings reflects a very real concern on our part, particularly on the part of our chairman, as to the capital raising needs of small business, not wholly in response to legislative incentives.

A study of the record developed at the hearings indicates that most of the problems faced by small businesses result from factors outside the scope of the Federal securities laws. Insofar as the ability to raise capital is concerned, general economic conditions and the tax structure, particularly the present capital gains tax, were reported by the people who appeared at those hearings, to have the greatest impact. Indeed, many witnesses expressed the view that if a favorable change occurred in either of these two factors, small business would not be substantially impeded by the Federal securities laws from obtaining needed capital.

The witnesses did state, however, that a number of requirements under the Federal securities laws are not justified as applied to small business. In response, the Commission has significantly amended several of its rules and forms in ways designed to ease the impact of the Federal securities laws on small business capital raising.

For example, the Commission, pursuant to congressional authorization, adopted an amendment to its rules increasing the aggregate amount of the small offering exemption from $500,000 to $1.5 million. Also, as part of the small offering exemption, the Commission adopted a rule permitting a modified offering circular to be used prior to the commencement of certain offerings.

This year the Commission adopted form S-18 which applies generally to small companies issuing securities for cash where the aggregate offering price does not exceed $5 million. This form calls for substantially less narrative and financial disclosure than does form S-1, the basic registration form.

This summer the Commission released for comment proposed rule 242, which the chairman referred to. If adopted, this rule would exempt from registration an offering of up to $2 million if the securities were sold only to institutional investors and no more than 35 individuals. The disclosure requirements under this rule would be minimal.

At the same time, the Commission has institutionalized its concerns regarding small business by establishing an Office of Small Business Policy in the divisional corporation. The purpose of this Office is to centralize current small business rulemaking initiatives and to establish a focal point for small business problems relating to the Federal securities laws.

The Office is headed by one of our most senior and dedicated professionals, Ms. Mary E. T. Beach, and is staffed by 8 to 10 staff members, including attorneys, accountants, and financial analysts.

Through this office, the Commission will participate in other Government and privately sponsored programs relating to small business. Already the Office is coordinating with the White House Conference on Small Business; the Joint SEC–HASD Study of Small Business Capital Formation; the NASD Joint Industry-Government Study on Small Business Financing; the Interagency Task Force on Domestic Policy; and the Joint SEC–NASAA Committee on Small Business Capital Formation.

Thus, to the extent that the Federal securities laws impact unduly on small businesses, the Commission has already moved significantly to relax these burdens. We believe that the administrative process is peculiarly well suited for this exercise.

The Commission has the staff, the initiative, and the program to create an appropriate regulatory environment in this area.

This leads me to my second point. While we believe it is desirable to give special attention to the capital-raising needs of small businesses, we do not believe that sections 2, 3, and 4 of the bill provide an appropriate approach. We have provided a more detailed discussion of our reasons for this position in our written comments, and I will summarize that discussion.

In general, we are concerned that the proposed amendments would provide overly broad and, in light of recent Commission initiatives, unnecessary exemptions from the registration provisions of the Securities Act.

More specifically, sections 2, 3, and 4 of the bill are directed at alleviating three barriers perceived as being raised by the Securities Act of 1933 to capital raising by small businesses.

First, the bill seeks to enlarge the private offering exemption in section 4(2) of the Securities Act.

Second, the bill seeks to facilitate secondary sales of securities by affiliates and persons who purchased securities in private offerings.

Third, the bill seeks to reduce the chance of liability for persons who sell in violation of the registration provisions of the Securities Act.

Section 2 of the bill would amend section 4(2) of the Securities Act so as to allow issuers to sell unlimited amounts of securities to certain institutional and other "accredited" investors.

Currently, section 4(2) of the Securities Act exempts transactions not involving a public offering from the registration provisions.

Rule 146, promulgated under the Securities Act, sets forth nonexclusive conditions that enable an issuer to qualify for an exemption under section 4(2).

As I mentioned before, the Commission recently proposed rule 242. This rule, if adopted, would treat sales to certain institutional buyers and other accredited investors in a manner similar to the treatment afforded such sales by the bill. This rule proposal was developed as an alternative to the section 4(2) exemption and rule 146 for small businesses and would alleviate certain concerns with section 4(2) and rule 146 expressed by witnesses at our small business hearings.

We are, however, concerned about the unduly broad definition of "accredited investors" in clause C of section 3(b) of the bill, which includes persons who rely on the investment advice of the accredited investors, described in clauses A and B.

It may be that investors of the type described in clauses A and B of the definition can fend for themselves. But this does not mean that persons advised by those persons should be deprived of the protections of the registration provisions of the Securities Act. Pursuant to clause C, sales could be made to an unlimited universe of purchasers without the benefit of the disclosures required under the Securities Act.

In light of the Commission's ongoing initiatives, we believe that the adoption of an experimental rule that would allow the Commission to gain experience with the substantive changes under consideration is preferable to the addition of further statutory provisions at this time.

Section 4 of the bill would, in effect, eliminate all restrictions upon the sale or distribution of restricted securities by any person, including affiliates of the issuer, if that person has held the securities for 5 years.

While we recognize, as was pointed out in our small business hearings, that the existing limitations on resale of restricted securities are viewed as creating a serious barrier to small business capital raising, we believe that section 4, as it applies to resales by affiliates, including controlling persons, goes too far.

The public has the same need for the protection afforded by registration whether the securities are distributed shortly after their purchase or after some length of time. Enactment of this provision would permit an individual or a small group of individuals to form a wholly owned company and, after operating it for 5 years, distribute their securities into the public.

The result would be the same as if the company had "gone public" directly, but without the important protections afforded by the disclosure requirements of the Securities Act. Indeed, section 4 would seem to permit someone to incorporate a company, purchase all of its stock for a nominal price, put the company "on the shelf" for 5 years, and then activate it and distribute its securities to the public without registration or disclosure.

Consequently, while the length of time that a person has been the beneficial owner of a security is obviously an important consideration in determining whether that person should be relieved of restrictions on resale, it should not be the sole standard.

Nevertheless, the Commission supports the basic intent of sections 3(a) and 4(1) of the bill, to alleviate the problem of secondary sales of securities issues by small businesses, by amending rule 144 to make it easier for nonaffiliates to sell securities purchased in earlier private offerings.

Section 5 of the bill would amend section 12 of the Securities Act by adding a sentence which would, in the case of a transaction involving a "good faith attempt not to involve any public offering pursuant to section 4(2)," deny recovery under section 12 to a purchaser of securities if all conditions prescribed in section 4(2) and in the Commission's rules have been met with respect to such purchaser.

Under present law, the private offering exemption provided by section 4(2) of the Securities Act is available only if the entire offering is made in compliance with that subsection.

Section 4 of the bill would, for purposes of civil liability, focus attention on compliance or the lack of it, as to each individual plaintiff. This responds to the concern of issuers that they may be liable to all purchasers because of a defect in the offering to a few. Nevertheless, we are not sure that this is the right answer.

The offering would still be in violation of the act, even though some or most of the purchasers could not successfully sue. If a substantial portion of the funds raised to finance the business had to be returned to plaintiffs who could show noncompliance as to them, those investors who could not recover might well feel they were treated unfairly since the company would not have the financing they expected.

In our judgment, this legislation is not needed at this time, since we can proceed administratively to deal with the problems, and the legislation may not be the best response. Our staff currently has under consideration amendments to rule 146 which were suggested at the hearings, such as the inclusion of a "substantial compliance" or "good faith attempt" provision in the rule, which would alleviate this concern expressed regarding the rule.

As indicated above, the Commission believes that the flexibility provided by the rulemaking process is preferable to the proposed amendments that would rigidify the exemptive pattern, and that the Commission should be allowed time to take appropriate action through rulemaking proceedings recently initiated by the Commission's Office of Small Business Policy.

Our final concern about the bill is its treatment of venture capital companies under the Investment Company Act of 1940. The Investment Company Act was enacted to eliminate the widespread abuses and failures to observe principles of fiduciary duties that were uncovered in unregulated investment companies.

As a result, the act was structured to provide a comprehensive framework of regulation which, among other things, prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval, protects against management self-dealing, embezzlement, or abuse of trust, and provides specific controls to eliminate or mitigate inequitable capital structures.

Other basic investor protections afforded by the act include disclosure and investment requirements and provisions for specific controls designed to protect against unfair transactions between investment companies and their affiliates.

Section 6 of the bill would amend section 3(c)(3) of the act to exclude from the definition of "investment company" entities which are apparently regarded as venture capital companies. In this regard, in its administration of the Investment Company Act, the Commission is also attempting to increase the ability of small businesses to raise capital.

Indeed, Commission rules already make it easier for SBIC's licensed by the Small Business Administration to remain exempt from the Investment Company Act.

We are currently considering, indeed the Commission proposed to issue for public comment yesterday, a rule, is described in more detail in my prepared statement, which would provide the same relief to a much broader range of business development companies, particularly where the securities of those companies are owned by substantial, sophisticated investors.

A fundamental consideration in any attempt to fashion a solution to the venture capital problem is, in the Commission's view, the protection of investors.

You have stated, "protections must be provided for small, unsophisticated and vulnerable investors." Although it is the apparent intention of the bill to continue protection for those investors and only to remove unnecessary impediments confronting investors who are able to fend for themselves, we are concerned that section 6 of the bill is overbroad. It would have the effect of substantially reducing the protections that would otherwise be afforded small, unsophisticated and vulnerable investors as well as sophisticated and wealthy investors.

Should the Congress, despite our belief that providing exceptions or exemptions from the Investment Company Act for venture capital companies should be left to rulemaking rather than legislative action, nevertheless wish to consider further section 6 of the bill, we have the following more specific comments:

Section 6 would appear to provide a complete exemption from the Investment Company Act for a company which would otherwise be an investment company, if it satisfied the following conditions:

(1) It is "engaged principally in the business of furnishing capital or providing financing for business ventures and activities," and

(2) "At least 80 percent of the securities held by such company, other than Government securities, short-term paper and other cash items" were acquired directly from the issuer of the securities in a transaction not involving any public offering.

This exemption is drafted so broadly as to include companies which in no sense are "venture capital" companies, as that term is commonly understood. This results from the fact that companies of all sizes and degrees of development frequently raise capital by what is known as private placements with financial institutions such as insurance companies and employee benefit funds.

Thus it would be entirely possible for a company to obtain exemption under section 6 even if invested primarily in securities of corporations included in the Fortune 500 and acquired in private placements. We see no reason why investors in such a company should be denied the safeguards of the Investment Company Act.

Similarly, a money market fund, which is an increasingly popular kind of investment company, could qualify for exemption under section 6 since such funds often invest in Treasury bills, certificates of deposit, and commercial paper which can be, and often is, purchased directly from the issuer in a private placement.

I understand that section 6 was primarily intended to exempt venture capital companies from the Investment Company Act, but section 6, as drafted, seems to go far beyond the venture capital field.

Section 6 would also include issuers principally engaged in the business of "reorganizing companies or similar activities, or any person that is organized and exists solely for purposes of holding securities in such an issuer." We are uncertain as to precisely what is contemplated by the phrase "reorganizing companies" and how fostering that activity furthers the purposes of the legislation.

Furthermore, given the ambiguities we perceive to exist in the descriptions of the business activities described in section 6, permitting companies to engage in "similar activities" would compound the interpretative difficulties inherent in the amendment.

In conclusion, I would like to reaffirm the Commission's strong desire to reduce unnecessary regulation affecting small business. We do not believe, however, that broad-reaching legislative exemptions are advisable at this point.

We believe the Commission has shown, through past and current efforts, that a flexible and imaginative regulatory approach is a preferable method of attaining the goals sought by the bill.

That completes my statement, and I will be glad to answer your questions, Mr. Chairman.

[Testimony resumes on p. 65.]

[Commissioner Loomis prepared statement follows:]

STATEMENT OF COMMISSIONER PHILIP A. LOOMIS, JR.
TO THE SUB-COMMITTEE ON CONSUMER PROTECTION AND FINANCE
OF THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
ON H.R. 3991

November 7, 1979

I am pleased to testify on behalf of the Securities and Exchange Commission on H.R. 3991, the "Small Business Investment Incentive Act of 1979" (the "Bill"). Because the Bill addresses two different areas, my testimony will discuss each area separately. Part I of my testimony deals with Sections 2 through 5 of the Bill, which would amend the Securities Act of 1933 to authorize issuers to sell certain securities to "accredited investors" without filing a registration statement with the Commission pursuant to that Act. Part II of my testimony discusses Section 6 of the Bill, which would amend the Investment Company Act of 1940 to exclude from the coverage of that Act certain issuers that, among other things, engage in the business of furnishing capital or providing financing for business ventures and activities.

The Commission is concerned that small businesses should have an appropriate market to raise capital and that investors should not be unnecessarily impeded from purchasing securities of small businesses. In fact, the Commission has already embarked upon rule-making changes which would achieve substantially the same improvement of access to capital for small business as the Bill.

At the same time, the Commission is charged with the responsibility of ensuring the integrity of the securities markets and of protecting investors. Therefore, although it strongly supports the goals toward which the Bill is directed, the Commission is concerned that as it is presently drafted it is unnecessarily broad in scope, and, therefore, we do not support the Bill in its present form. 1/

I. AMENDMENTS TO THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT OF 1933

A. Past and Current Commission Activities to Facilitate Capital Raising by Small Business

The Commission has for some time been examining steps which might be taken to facilitate capital formation by small businesses. In this regard, the Commission held public hearings in April and May of 1978 for the purpose of determining the extent to which the burdens imposed by the federal securities laws on small businesses may be alleviated consistent with the protection of investors. The hearings, which were held in Washington, D.C., Los Angeles, Denver, Atlanta, Chicago, and Boston, focused on the effects of the Commission's rules on the ability of small businesses to raise capital and the impact on small businesses of disclosure requirements under the federal securities laws.

A study of the record developed at the hearings indicates that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws. Insofar as the ability to raise capital is concerned, general economic conditions and the tax structure, particularly the present capital gains tax, were reported to have the greatest impact. Indeed, many witnesses expressed the view that, if a favorable change occurred in

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1/ To some extent, where appropriate, the following comments reiterate statements we submitted to your Committee on previous similar legislation in the 95th Congress: H.R. 9549, H.R. 10717 and H.R. 13032.

either of these two factors, small business would not be substantially impeded by the federal securities laws from obtaining needed capital.

The witnesses did state, however, that a number of requirements under the federal securities laws are not justified as applied to small business. In response to these concerns, the Commission has undertaken a number of significant rule and form amendments, which are designed to ease the impact of the federal securities laws on small business capital raising.

One of the most important of these amendments involves the Commission's exemptive authority relating to small offerings under Section 3(b) of the Securities Act. That section authorizes the Commission to exempt any class of securities from the full-scale registration otherwise required by Section 5 of the Securities Act (15 U.S.C. 773) 2/ if it finds that such registration is not necessary in the public interest or for the protection of investors because of the small amount of securities offered or the limited character of the offering. On September 11, 1978, the Commission adopted an amendment to Regulation A 3/ to increase, from $500,000 to $1,5000,000, the aggregate offering price of securities that may be sold thereunder during a twelve month period. 4/ This amendment followed Congressional action raising the aggregate amount of the small offering exemption specified in Section 3(b) of the Securities Act. The Commission also

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

3/ "Regulation A" is the name given to a series of rules adopted by the Commission under Section 3(b). 17 CFR 230.251-264.

4/ Securities Act Release No. 5977 (September 11, 1979).

adopted an amendment to Regulation A to permit the use of a preliminary offering circular prior to the commencement of certain underwritten offerings thereunder. 5/ On September 8, 1978, the Commission adopted an amendment to Rule 146, concerning exemptions from registration for private placements. 6/ The amendment modifies the disclosure requirements when an offering does not exceed $1,500,000 to allow disclosure of information prescribed by Schedule I of Regulation A rather than information which would be included in a registration statement. 7/

Last year the Commission amended Rule 144, 8/ the rule which sets forth guidelines for the resale of certain securities, and proposed amendments to that rule to: (1) relax the limitations on the amount of securities that can be sold under the rule; (2) permit sales under the rule directly to marketmakers; and (3) eliminate the requirement that sales under the rule be made only in brokerage transactions or directly with a marketmaker for sales of securities by estates, and their beneficiaries, who are not affiliates of the issuer of the securities. 9/ We further amended Rule 144 to permit non-affiliates under certain circumstances to disregard the volume limitation provisions of that rule. 10/

5/ Securities Act Release No. 6075 (June 1, 1979).

6/ 17 CFR 230.146.

7/ Securities Act Release No. 5975 (September 8, 1979).

8/ 17 CFR 230.144.

9/ Securities Act Release No. 5979 (September 19, 1978).

10/ Securities Act Release No. 6032 (March 5, 1979).

This year the Commission simplified registration and reporting procedures for small businesses through the adoption of Form S-18. 11/ This form is available to certain domestic and Canadian corporate issuers for the registration of securities to be sold for cash not exceeding an aggregate offering price of $5 million. The form calls for less narrative and financial disclosure than does Form S-1, the standard registration form. The form may be filed with the regional offices of the Commission, in order to facilitate handling for the issuer. Also, issuers may include in their initial annual report information substantially similar to that included in their Form S-18 registration statement, pursuant to corresponding amendments to Form 10-K, the annual report form for certain publicly-held companies under the Securities Exchange Act of 1934.

In order to put its small business initiatives on a permanent footing, the Commission recently created the Office of Small Business Policy within the Division of Corporation Finance. In addition to the actions already undertaken, the Office of Small Business Policy is engaged in a review of additional amendments and new rules intended to facilitate capital formation by small business.

In short, the Commission has taken significant action in several areas covered by the Bill and has under consideration further amendments and new rules which may obviate the need for the statutory amendments embodied in the Bill. We believe the Commission should be allowed sufficient time adequately to evaluate the results of our rulemaking

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11/ Securities Act Release No. 6049 (April 3, 1979).

initiatives. Where we find that desirable improvements cannot be accomplished through the rulemaking process, the Commission will readily transmit appropriate legislative recommendations. In this regard, we are concerned that, while the apparent purpose of Sections 2 through 5 is to assist capital formation by small businesses, the exemptions from registration which those Sections would provide would be available to be used by any business, regardless of size, and regardless of the amount of capital funding involved, and would needlessly remove all safeguards on resale of restricted securities after five years.

In addition, as mentioned above, a study of the record developed at our recent public hearings indicates that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws. On the other hand, we believe that experience has shown that, over the past forty-six years, the full disclosure afforded investors by the federal securities laws has increased public confidence in the securities markets and facilitated capital-raising by businesses of all sizes in a beneficial manner.

Accordingly, we believe that the objective of assisting small business is best approached by the Commission's present pattern of timely, but careful, rulemaking.

B. Detailed Discussion of the Bill

(1) Section 2

Section 2 of the Bill would amend Section 4(2) of the Securities Act to provide an additional exemption from registration for transactions by an issuer solely with one or more "accredited investors" if the security sold is a "limited sale security" and there is no general advertising or solicitation in connection with the transaction. A "limited sale security" is defined in Section 3 as a security that bears a legend to the effect that it may not be sold or otherwise transferred except to an accredited investor. An "accredited investor" is defined in Section 3 to include: (a) certain specified institutional purchasers; (b) any person who, because of financial sophistication, net worth, knowledge and experience in financial and business matters, or amount of assets under management, qualifies as an accredited purchaser under rules prescribed by the Commission; and (c) any person who relies on the investment advice of an accredited investor. The institutional purchasers include "a bank, insurance company, [licensed] small business investment company" and certain trust funds and insurance company separate accounts. Section 2 of the Bill would amend Section 4(2) to allow unlimited sales to certain institutional and other accredited investors.

We do not believe that such legislation is necessary. By way of background, we would point out that Section 4(2) of the Securities Act exempts transactions not involving a public offering from the registration provisions of the Act. Rule 146, promulgated under the Securities Act, sets forth non-exclusive conditions that would permit an issuer to qualify for an exemption under Section 4(2).

The Commission has recently proposed Rule 242, a new rule which would treat sales to certain institutional buyers in a manner similar to the treatment afforded by the Bill. This new rule is being developed as an alternative to the Section 4(2) exemption and Rule 146 for small businesses and would alleviate certain concerns relating to Section 4(2) and Rule 146 which were expressed by witnesses at our small business hearings. Rule 242 would allow sales to an unlimited number of defined institutional purchasers and purchasers of large blocks and to 35 additional purchasers.

Our purpose in proposing Rule 242 is to alleviate significantly the substantive problems encountered by small issuers under the Securities Act in attempting to raise capital in a non-public offering. In light of the Commission's ongoing initiatives, we believe that the adoption of an experimental rule that would allow the Commission to gain experience with the substantive changes under consideration is preferable to the addition of further statutory provisions at this time.

As noted above, Rule 242 would, if adopted, allow sales to an unlimited number of institutional investors. In our view, this is a more reasonable approach than that taken in clause (C) of the definition of "accredited investor," in Section 3(b) of the Bill. That clause seems overly broad because it includes persons who rely on the investment advice of accredited investors listed in clauses (A) and (B). It may be that investors of the type described in clauses (A) and (B) of the definition can fend for themselves. But this does not mean that persons advised by accredited investors should be deprived of the protections contained in the registration provisions of the Securities Act. Pursuant to this provision, sales could be made to an unlimited universe of purchasers without the disclosures required under the Act.

(2) Sections 3(a) and 4(1)

Section 3(a) of the Bill would amend Section 4(1) of the Securities Act to provide that a person who sells a "limited sale security," or any person acting on his behalf, shall not be considered to be an underwriter with respect to such transaction if such sale was made to an accredited investor or to a person the seller reasonably believes to be an accredited investor. Pursuant to this amendment, unregistered "limited sale securities" may be resold by affiliates and non-affiliates of the issuer to any number of accredited investors.

Section 4(1) of the Bill would amend the definition of "underwriter" contained in Section 2(11) of the Securities Act to provide that that term shall not include a person engaging in a sale of securities if such person has been the beneficial owner of such securities for a period of five years or more. Consequently, affiliates as well as the non-affiliates of an issuer would be able to resell unregistered securities pursuant to the Section 4(1) exemption after a five year period.

We have some concern about removing all restrictions on sales by persons who are affiliated with issuers after five years of beneficial ownership. Section 2(11) of the Securities Act presently defines "underwriter" to mean

> "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in

> the direct or indirect underwriting of any such undertaking * * *." 12/

There is nothing in the statutory definition of an underwriter that places a time limit on a person's status as an underwriter. The public has the same need for the protection afforded by registration whether the securities are distributed shortly after their purchase or after some length of time. Indeed, enactment of this provision would permit an individual, or a small group of individuals to incorporate a company, purchase all of its stock for a nominal price, put the company "on the shelf" for five years, then activate it and distribute its securities to the public without registration. The result would be the same as if the company had "gone public" directly, but without the important protections afforded by the disclosure requirements of the Securities Act. Accordingly, while the length of time that a controlling person has been the beneficial owner of restricted securities is obviously an important consideration in determining whether a person is an underwriter, it should not be decisive. Unless the Commission retains its present ability to impose such conditions as are necessary to govern the amount of restricted securities that can be resold by persons who have beneficially owned such securities for more than five years, there would be no assurance that the exemption from registration afforded by Section 4(1) would be used only for routine trading transactions, as opposed to distributions by persons closely identified with the issuer who, under the present definition, are, and should be, considered underwriters.

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

Nevertheless, the Commission supports the basic intent of Sections 3(a) and 4(1) of the Bill, to alleviate the problem of secondary sales of securities issued by small businesses, except with respect to the resale of securities by affiliates. Although several factors were cited during our small business hearings as contributing to the problem of secondary sales of small business securities, the most commonly identified factors were the resale restrictions imposed by Rule 144. As mentioned above, that Rule defines persons who are deemed not to be engaged in a distribution of securities, and therefore who are not underwriters for purposes of Section 4(1) of the Securities Act. Section 4(1) of that Act in turn exempts from the registration provisions of Section 5 of the Act all transactions by persons other than issuers, underwriters or dealers.

Rule 144 provided, at the time of our small business hearings, that affiliates and others selling securities subject to the Rule could sell, during a 6 month period, the <u>lesser</u> of one percent of the class outstanding or the average weekly trading volume. A majority of the witnesses that testified on this point at the hearings were of the view that this provision severely restricted their ability to attract capital because of the long period of time which was necessary to liquidate an investment. Thus, the witnesses believed that a relaxation of this provision of the Rule was essential to the ability of venture capitalists and other investors to recycle their investment into new enterprises.

The Commission has responded to these concerns by amending Rule 144 to allow sales not to exceed the <u>greater</u> of one percent of the class outstanding or the average weekly trading volume during a three month period.

In addition, the Commission adopted an amendment to Rule 144 which permits non-affiliates under certain circumstances to disregard the volume limitation provisions of Rule 144 after a period of (1) three years, if the securities to be sold are those of a class which is either listed on an exchange or quoted on NASDAQ, an electronic interdealer quotation service; or (2) four years, if the securities to be sold are those of an issuer which files periodic reports under section 13 or 15(d) of the Securities Exchange Act of 1934.

In connection with our recent amendments to Rule 144, we have announced publicly that we are considering removal of the volume limitations in Rule 144 for the securities of non-reporting companies under certain circumstances. Moreover, the Office of Small Business Policy has under consideration further amendments to Rule 144 which would assist the resale of securities by affiliates.

The advantage of the Commission's approach in effecting these changes by the adoption of rules, rather than the enactment of additional statutory provisions, is that the Commission would retain its present flexibility to amend these rules in the future should conditions change or amendments become necessary to protect the interests of public investors. Consequently, while we do not oppose the substantive changes contained in Section 4(1) of the Bill, except for the provision with respect to resales by persons affiliated with the issuer, we suggest that a better method of implementing those changes is the one presently utilized by the Commission. 13/

13/ We have no comments on Section 4(2), defining "restricted securities".

(3) Section 5

Section 5 of the Bill would amend Section 12 of the Securities Act by adding a sentence which would, in the case of a transaction involving a "good faith attempt not to involve any public offering pursuant to Section 4(2)," deny recovery under Section 12 to a purchaser of securities if all conditions prescribed in Section 4(2) and in rules and regulations of the Commission have been met with respect to such purchaser.

Presently, there is absolute liability under Section 12(1) if an issuer offers or sells a security in violation of the registration provisions of Section 5. 14/ To establish a *prima facie* case under Section 12(1), the plaintiff need prove only (1) the purchase of the security, (2) from the defendant or from a person controlled by the defendant, (3) the use directly or indirectly of the required jurisdictional means, (4) that no registration statement was in effect, and (5) that the action was brought within one year from the date of the violation. The availability of the private offering exemption is an affirmative defense as to which the defendant has the burden of proof. 15/ Under present law, that exemption is unavailable unless the defendant can show not only that the requirements of Section 4(2) have been met with respect

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14/ *See*, *e.g.*, *Woodward* v. *Wright*, 266 F.2d 108, 115 (10th Cir. 1959).

15/ *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. at 126 (1953).

to all purchasers, but also that they have been met with respect to all offerees. 16/

The importance of this approach was emphasized by the Court of Appeals for the 10th Circuit in Lively v. Hirschfield. 17/ In that case, the court stated:

> "After the Ralston Purina case the emphasis in the decisions has been placed on the particular capabilities and information had by particular persons, buyers, plaintiffs or offerees. The Ralston Purina case required this examination of the individuals solicited to determine the nature of the offer, that is, to determine whether there was a public need for registration * * *.
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> * * *
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> "The standard must apply to all the offerees if the Ralston Purina case is to be meaningfully applied, and if the artificial classification of "buyers" is to be prevented from determining the nature of the offer in a private action such as this." 18/

Thus, under present law, the need for registration is viewed not only in terms of the particular private plaintiff but also with respect to all offerees and purchasers, i.e., with respect to the offering itself. In this connection, issuers have expressed concern that even if they make a good faith attempt to comply, a failure with respect to one unsophisticated offeree may allow a sophisticated

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16/ Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972); Securities and Exchange Commission v. Continental Tobacco Co. of S.C., Inc., 463 F.2d 137 (2d Cir. 1972); Hill York Corp. v. American International Franchise, Inc. 448 F.2d 680 (5th Cir. 1971).

17/ 440 F.2d 631 (10th Cir. 1971).

18/ Id. at 632-33.

purchaser to rescind a securities purchase or recover damages if he no longer owns the security. In our judgment, however, this legislation is not the proper response to the problem. The offering would still be in violation of the Act, even though some or most of the purchasers could not successfully sue. If a substantial portion of the funds raised to finance the business had to be returned to plaintiffs who could show non-compliance as to them, those investors who could not recover might well feel they were treated unfairly since the company would not have the financing they expected.

As indicated above, the Commission believes that the flexibility provided by the rulemaking process is preferable generally to the proposed amendments that would rigidify the exemptive pattern. For example, our staff currently has under consideration amendments to Rule 146 which were suggested at the hearings, such as the inclusion of a "substantial compliance" or "good faith attempt" provision in the Rule, which would alleviate this concern expressed regarding the Rule.

II. AMENDMENTS TO THE INVESTMENT COMPANY OF 1940

We are also concerned that the Bill would unnecessarily exempt certain types of companies from the Investment Company Act of 1940. Section 6 of the Bill would amend Section 3(c)(3) of the Investment Company Act of 1940 ("Act") to exclude from the definition of "investment company" entities which are apparently regarded as venture capital companies. In this regard, in its administration of the Investment Company Act, the Commission is also attempting to increase the ability of small businesses to raise capital. Indeed, as we recently announced, 19/ we are considering proposing a rule that would provide exemptive relief from all provisions of the Investment Company Act for certain business development companies whose securities are owned by substantial, sophisticated investors and which are organized and operated for the purpose of investing directly in relatively small and unseasoned companies in the developmental stage. The staff has proposed and the Commission will consider whether to publish for public comment certain amendments to Rule 3c-2 under the Investment Company Act. Like SBIC's, most venture capital companies rely on Section 3(c)(1) for exclusion from the Act. This section excludes from the definition of investment company certain issuers having specified characteristics, including that their outstanding securities are beneficially owned by not more than 100 persons. Beneficial ownership by a company is deemed to be beneficial ownership by one person if the company owns less than 10% of the issuer's voting securities. For purposes of this exclusion, however, beneficial ownership by a company of 10 percent or more of an issuer's outstanding voting securities is deemed to be beneficial ownership by the holders of that company's outstanding

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19/ Investment Advisers Act Release No. 680 (June 19, 1979). In that Release, the Commission proposed for public comment a new rule which would permit, under appropriate conditions, special performance-based fees to be paid to registered investment advisers to business development companies that invest in relatively small and unseasoned companies in the developmental state. The purpose of the rule is to facilitate the flow of needed capital to small businesses without detrimentally affecting the investors who most need the protections of the Investment Advisers Act.

securities. The triggering of this "attribution test" may cause an issuer, which would otherwise be excluded from that definition, to be considered an investment company for purposes of the Act. Presently, Rule 3c-2 under the Act treats under specified circumstances, a company's owning 10 percent or more of a licensed SBIC's outstanding voting securities to be beneficial ownership by one person. The Commission will consider whether to propose for comment a new paragraph (b) to Rule 3c-2 which would make available to all other issuers, including venture capital companies, the exemptive relief presently enjoyed only by SBIC's.

A fundamental consideration in any attempt to fashion a solution to the venture capital problem is, in the Commission's view, the protection of investors. As Congressman Broyhill, a sponsor of the Bill, has stated, "protections must be provided for small, unsophisticated and vulnerable investors." 20/ Although it is the apparent intention of the Bill to continue protection for those investors and to only remove unnecessary impediments confronting investors who are able to fend for themselves, 21/ we are concerned that Section 6 of the Bill is overbroad. It would have the effect of substantially reducing the protections that would otherwise be afforded small, unsophisticated and vulnerable investors as well as sophisticated and wealthy investors. This broad-brush diminution of

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20/ 125 Cong. Rec. H 2860 (daily e. May 8, 1979) (remarks of Representative Broyhill).

21/ Id.

investor protections would directly result from the amendment that would exclude investment companies described in Section 6 of H.R. 3991 from the Act and would thereby deny shareholders of those companies the Act's protections.

The Investment Company Act of 1940 was enacted to eliminate the widespread abuses and failures to observe principles of fiduciary duties that were uncovered in unregulated investment companies. As a result, the Act was structured to provide a comprehensive framework of regulation which, among other things, prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval, protects against management self-dealing, embezzlement, or abuse of trust, and provides specific controls to eliminate or mitigate inequitable capital structures. Other basic investor protections afforded by the Act include requirements that an investment company disclose its financial condition and investment policies and provisions for specific controls designed to protect against unfair transactions between investment companies and their affiliates. It is in large part because of these significant protections provided investors by the Act that the Commission has opposed provisions in several bills previously introduced in the Congress that would have exempted from the Act small business investment companies licensed by the Small Business Administration ("SBA"), notwithstanding their dual regulation by the SBA and by the Commission. 22/ For the same reasons, we do not believe that small unsophisticated investors should be denied the Act's protection in this instance, the investors would not have the benefits of SBA regulation.

Should the Congress, despite our strong belief that providing exceptions or exemptions from the Investment Company Act for venture capital companies should be left to rulemaking rather than to legislative action, nevertheless wish to consider further Section 6 of the Bill, we have the following more specific comments concernings its provisions.

As mentioned above, Section 6 of the Bill would amend Section 3(c)(3) of the Investment Company Act to exclude from the definition of "investment company" entities which are apparently regarded as venture capital companies. 23/

22/ See, e.g., Report of Comm. on Banking and Currency on S. 3561, Small Business Investment Act of 1958, S. Rep. No. 1652, 85th Cong., 2d Sess. 13 (1958): "The committee is convinced that it would not be wise to exempt [small business investment] companies outright from the securities laws * * * . [S. 3561] provides that, with one exception [dealing with capital structure], the Investment Company Act of 1940 shall apply to small-business investment companies just as it does at present to other investment companies. The committee was impressed by the testimony offered by the Chairman of the SEC that, in order to give adequate protection to investors, the Investment Company Act of 1940 should be applicable to small business investment companies."

23/ See 125 Cong. Rec. E 3160 (daily ed., June 22, 1979) (Remarks of Representative Luken).

Section 6 would apparently allow a venture capital company to be totally excluded from the Investment Company Act, if it meets the following conditions:

(1) it must be principally engaged in any one of three general business activities:

(a) furnishing capital or providing financing for business ventures and activities;

(b) purchasing securities of issuers for which no ready market is in existence; or

(c) reorganizing companies; and

(2) 80 percent at cost of the securities held by the company must generally be acquired directly from issuers in non-public transactions. 24/

Our concern with this section stems from the fact that it is so broadly drafted that it would exempt from the salutary regulatory provisions of the Investment Company Act not only companies that furnish capital to small and unseasoned businesses in the developmental

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24/ The various references in Section 6 to the term "issuer" create unnecessary confusion, since that term appears to be used in some instances to refer to venture capital companies (*e.g.*, "any issuer engaged principally"), and in other instances to refer to the businesses in which venture capital companies are to invest (*e.g.*, "securities which (A) were acquired directly from such issuer"). The ambiguity is especially confusing with respect to the parenthetical "or any person that is organized and exists solely for purposes of holding securities in such an issuer"; we assume that "issuer," as used in that clause, refers to a venture capital company. *See* note 32, *infra*.

mental stage, but also to many other companies for which there has been no showing of a need for any special treatment under the Act. 25/

One type of investment company that currently accounts for a substantial portion of mutual fund industry assets is the money market fund, which invests in short-term money market instruments, such as Treasury Bills, certificates of deposit, and commercial paper. These funds may invest substantial portions of their assets in commercial paper purchased directly from issuers in nonpublic transactions. Yet nothing in Section 6 would preclude such companies from relying on the exclusion that it would provide from the Investment Company Act. This result, presumably unintended, is at least in part due to the

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25/ The description of businesses in which these venture capital companies are to engage may be modeled in part on Section 12(e) of the Investment Company Act. That Section provides a limited exception from the prohibition in Section 12(d)(1) of the Act against an investment company acquiring securities of another investment company. See In re American Research & Dev. Corp., 24 S.E.C. 481 (1946). Section 12(e) allows such a purchase if the investment company whose securities are acquired engages in "the business of underwriting, furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, and reorganizing companies or similar activities * * * ." However, it bears emphasis that Section 12(e) provides an exception for an investment company acquiring the securities of another investment company that is a venture capital company. It provides no exception or exemption for the venture capital company. Indeed, Congress clearly contemplated that, unless some other exception or exemption were available, such companies would be subject to the Act. See, e.g., Senate Hearings, at 286. Moreover, Section 12(e), by its terms, requires the bottom-tier investment company to engage in all of the activities listed, whereas, by contrast, Section 6, in using the word "or" before the phrase "reorganizing companies" would seem to contemplate that engagement in any one of the specified activities and the satisfaction of the conditions set forth subsequently would entitle a company to rely on the Section 6 exception.

fact that the Bill does not define the characteristics of the businesses which are the desired ultimate beneficiaries of Section 6. Thus, a money market fund whose portfolio consists of commercial paper acquired directly from issuers might argue that it was a venture capital company principally engaged "in the business of furnishing capital or providing financing for business ventures and activities," 26/ even though the issuers might be corporations of considerable size. 27/ Other conventional investment companies might be able to make similar arguments under the proposed language if they engaged principally in acquiring stock or other securities in nonpublic transactions, even if the issuers of such securities were not small businesses. 28/

26/ It is unclear what difference of meaning is intended between "furnishing capital" and "providing financing." Similarly, we are unsure what "activities," as distinguished from business ventures, are contemplated as being within the Section.

27/ In addition, Section 6 would permit investments in government securities, including Treasury Bills, to be excluded from the requirement that 80 percent of a venture capital company's securities must be acquired either directly from issuers, or as described in clauses (B) or (C) of that Section.

28/ The Commission, in administering the Investment Company Act, has encountered problems related specifically to registered open-end investment companies' holdings of restricted securities acquired in nonpublic transactions because of the requirement that open-end companies redeem their securities at net asset value at the request of the security holder and because of difficulties in valuing restricted securities. *See* Investment Company Act Release No. 5847 (October 21, 1969.)

The Bill would also exclude issuers principally engaged in the business of "reorganizing companies or similar activities." 29/ We are uncertain as to precisely what is contemplated by the phrase "reorganizing companies," and how fostering that activity furthers the purposes of the legislation. Furthermore, given the ambiguities we perceive to exist in the descriptions of the business activities described in Section 6, permitting companies to engage in "similar activities" would compound the interpretive difficulties inherent in the amendment.

Another problem is raised by Section 6. There is nothing to ensure that excluded issuers continuously engage in the activities that the Bill seeks to promote, other than the inference that may be drawn from the requirement that an issuer be "engaged" principally in one of the described businesses. Thus, a venture capital company that was initially excluded from the Investment Company Act by the amendment because it purchased "securities of issuers for which no ready market is in existence" could arguably continue passively to

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29/ We are also troubled by the parenthetical phrase "(or any person that is organized or exists solely for purposes of holding securities in such an issuer)" which follows the language quoted in the text. The singular "such an issuer" in this parenthetical clause might be read literally to mean that a holding company which holds interests in more than one venture capital company would not be excluded by this provision from the Investment Company Act, although it is not clear whether such a result is intended. Even if it were to hold securities in only one venture capital company, unless the holding company were primarily engaged, through at least a majority-owned interest, in the venture capital company's business, it should not be excluded from the Act. On the other hand, if the holding company were so engaged, the parenthetical clause would be unnecessary because the holding company would be excluded (assuming present Section 3(c)(3) were to be amended by the Bill) by present Section 3(c)(6) of the Act.

hold those securities (and exercise any warrants and options) long after those perhaps once small companies matured — indeed, it could hold those securities forever and remain free of the Act. For example, both earlier and later investors in an investment company fortunate and prescient enough to have acquired securities directly from Polaroid and IBM when they were in their early developmental stages might find themselves in the anomalous position of forever being deprived of the protections of the Investment Company Act, despite their ownership of shares in an investment company with a portfolio of "blue chip" securities that may be largely indistinguishable from the portfolios of many other regulated investment companies whose investors enjoy the full protections of the Investment Company Act. But, the purposes of the Bill are no longer furthered once an investment company has ceased providing capital for small businesses and merely passively holds securities purchased in the past.

In conclusion, I would like to re-affirm the Commission's strong desire to reduce unnecessary regulation affecting small business. We do not believe, however, that broad-reaching legislative exemptions are advisable at this time. We believe that the Commission has shown, through past and current efforts, that a flexible and imagination regulatory approach is, by far, a preferable method of attaining the goals sought by the Bill.

BV/JM/32

Mr. BROYHILL. Do you see any significant differences between a large conglomerate that owns a number of businesses and, of course, they own, control, and are operating them, and a small venture capital firm that owns a minority interest in some small businesses and yet is required to have much more of a regulatory burden if it should go beyond a certain extent—number of stockholders, and so forth?

A large conglomerate would not have to register under the 1940 act, and yet its dealings are far greater, its exposure of potential loss to its stockholders is far greater—and still the regulatory burden might be more on this smaller firm.

Mr. LOOMIS. Are you referring to the Investment Company Act?

Mr. BROYHILL. Yes.

Mr. LOOMIS. And I assume that you are referring to section 3(c)(1), the fact that an exemption from the act is unavailable where a company has more than 100 shareholders?

Mr. BROYHILL. That is correct.

Mr. LOOMIS. I don't quite understand why a large conglomerate would not have more than 100 shareholders. They would be subject to the act if they were otherwise an investment company, yes. If they are not an investment company——

Mr. BROYHILL. No; they are investing in these businesses. Their investments happen to be much larger. They own control of them and they are operated. They own 80 percent or more.

Mr. LOOMIS. The point is that they are exempt from the Investment Company Act because they operate through wholly owned subsidiaries.

Mr. BROYHILL. That is correct, but what is the difference?

I fail to see the difference, because you say on one side you have a company that has billions of investors' funds that it is managing in effect, and it is not required to register under the 1940 act, that you take a venture capital firm with far smaller amounts which is attempting to help small businesses. Yet in order to get that capital together it has to go out and get over 100 investors, and it is required to undergo much more of a regulatory burden in order to make those investments.

Mr. LOOMIS. Mr. Mendelsohn would like to discuss that.

Mr. MENDELSOHN. Under section 3(a)(3), of course, the definition of investment securities is cut off at 50 percent in the case of majority-owned subsidiaries, so the typical conglomerate comes within that exception so that the securities issued by the companies that they own are not investment securities.

As I understand it, the Congress in 1940 felt that if a company owned more than 50 percent of another company, the first company was not investing in the second company so much as it was running the company, and the difference between the two situations we are discussing is resolved by distinguishing between those that are running companies and those that are investing in particular companies.

Mr. BROYHILL. I understand that, but what I don't understand is the philosophy that when you just have a minor investment in the company you require much more of a regulatory burden on that company.

Mr. LOOMIS. That is slightly inherent in the concept of an investment company. An investment company is thought of as an enterprise which invests in the securities as a passive investor holding only a modest amount of each company and creates a pool of securities in which the public is asked to invest on the basis of their investment advice.

Now, the conglomerate you talk of is an industrial company, and it just does not fall within the concept of investment companies or the purposes of the investment company.

Mr. BROYHILL. I understand that, and I understand the legal ramifications and technicalities here, but to me this doesn't seem to add up.

Frankly, in this venture capital industry, I am told that those venture capital firms do have substantial dealings with the companies in which they have invested; that is, sometimes almost on a day-to-day basis—perhaps for more successful ones the company doesn't have to look over its shoulder quite as often, but oftentimes those are not as successful—they are having to spend a great deal of time working with them.

I hope that they will bring them out of the woods and make them profitable, and so it is not necessarily a passive investment as it is an investment which is almost like a partnership.

Mr. MENDELSOHN. Mr. Broyhill, there is a section of the 1940 act, section 3(b)(2), in which a company is allowed to claim that through controlled companies—and, conceivably, if the venture capital company controlled it, not necessarily by the amount of stock, but rather running the company—it was in a business other than investing or reinvesting.

Now, the problem comes up that, if a venture capital company is in many businesses, section 3(b)(2) only allows the claimer of the exemption to group those similar businesses into one and say, yes, I am in the business of rubber making or this or that; and if it can show that his predominance is in running a business other than investing or reinvesting, it can file for an application and I would assume the Commission would grant the exemptive order.

If it is diversified or where it has a minority interest in a great many companies and it can't prove that it controls those companies, then the act recognizes that it is an investor rather than operating the business.

That is where the dividing line is. It would seem that your argument could be used with any company that is running a business that has more than 100 shareholders. I mean, one could ask the question why doesn't the Investment Company Act apply to those?

Of course, I think in 1940 the Congress attempted just to use an arbitrary line in determining where to cut off investing from running the business.

Mr. BROYHILL. Well, I view those venture capital firms as junior conglomerates, as a group of sophisticated investors who are putting their money into different businesses.

They may not be operating them and controlling them, but they are actually investing in management expertise or in someone who has a good idea or someone who has a plan or someone who has some past track record in a particular industry, so they are investing in them just as the conglomerates are doing in buying up control of businesses.

So it seems to me that maybe we are not communicating.

Mr. LOOMIS. We feel that the Investment Company Act, as Mr. Mendelsohn has explained, deals with people whose business is investing in minority interests in companies which they do not control. They are purely investors. Now, the venture capital companies are a little different in the way that they operate than the ordinary mutual fund because, as you know, as you say, they have a closer relationship with the portfolio companies and they usually specialize in smaller enterprises.

I think that I, personally, I cannot speak for the Commission, tend to agree that venture capital companies should have different treatment under the Investment Company Act in some respects. I don't think they should be completely exempted from the Investment Company Act, because there are various provisions which may be needed to protect the investors in the venture capital company who may not all be sophisticated investors.

Mr. LYBECKER. If I might, it is often true that the conglomerates have their exemption from the act tested quite seriously.

Both CNA and Loews had a fight before the Commission in 1974 in which they asked for some sort of declaratory judgment to be rendered on the investment company status of Loews, and currently a number of articles have been published in the financial press regarding Sharon Steel and the activities of Victor Posner.

He would be the kind of person, it is frequently alleged to us, whose his activities are largely those of an investor, and he is not really interested in operating any companies at all.

The point Commissioner Loomis is making, since we are talking about some sort of continuum of passive investment to running a company, is that we are constantly being tested on that definition in section 3 with conglomerates also. I would like you to understand that the other side is not free from question either.

Mr. BROYHILL. Well, let me get to another point or two.

Let me ask you to what extent the 1940 act applies to foreign venture capital?

Mr. MENDELSOHN. As a matter of fact, under section 7(d) of the act, it is very difficult for a foreign investment company to operate in the United States. It must come in and prove that the United States would be able to exercise jurisdiction over it almost to the same extent that we would over a domestically organized investment company.

There are very few foreign investment companies operating in the United States, and I know of no registered foreign venture capital company operating in the United States.

Mr. BROYHILL. Are there any exemptions like this where the foreign investor is not necessarily operating in the United States but he has made his investment in the United States?

Mr. MENDELSOHN. Oh, I would not be surprised at all if that happened, where unregistered foreign venture capital companies supplied money to small businesses. I can only say I don't have any specific figure.

Mr. BROYHILL. Those transactions would not be regulated?

Mr. MENDELSOHN. The foreign venture capital companies would be regulated if they had made a public offering in the United States.

Mr. LOOMIS. If I may interrupt, as Mr. Mendelsohn says, it is very difficult for a foreign investment company to operate as an investment company in the United States, because the provisions of the act make it almost impossible for that to happen.

On the other hand, an investment company of any type located abroad, which doesn't sell any of its own securities to Americans, can buy and does invest in shares of American companies.

Mr. BROYHILL. Has there been any reduction in the amount of time that it takes to approve a transaction with an affiliate that is required under the act to file an application? I understand that these transactions are prohibited although there are ways you can get them approved; but it takes months and months to get the approval.

Mr. MENDELSOHN. Let me say we are taking an entirely different approach, Mr. Chairman.

Since early 1978 we have established a study group in the division which has recommended to the Commission numerous exemptive rules. Those rules are promulgated on the principle of codifying all of the applications that have previously been before the Commission and been approved, so a person may follow the rule and thereby not have to file an application at all.

Now, I have before me a copy of all of those rules that we have so far either proposed to the Commission for comment or that have been adopted by the Commission.

If you wish, I can make this an exhibit.

Mr. BROYHILL. If you would, we will hold the record open at this point for inclusion of that list.

We won't, of course, include all of the rules themselves, but at least list them.

[The list referred to information follows:]

Rules, Rule Proposals and Interpretive Releases Developed by the Investment Company Act Study Group as of November 16, 1979

Rule, Rule Proposal or Interpretive Release	Subject Matter	ICA Release Number(s)	Date(s)
Rule 14a-3 Rule 19b-1(c) Rule 22c-1(a)(1) and (b)(2)	unit investment trust start-up exemptions	proposed 10545 adopted 10690	January 19, 1979 May 15, 1979
Rule 10f-3	purchases from affiliated syndicates	proposed 10592 adopted 10736	February 13, 1979 June 14, 1979
Rule 17e-1	affiliated brokers' receiving OTC commissions	rescission proposed 10606 rescinded 10740	February 27, 1979 June 20, 1979
Rule 17e-1	affiliated brokers' receiving stock exchange commissions	proposed 10605 adopted 10741	February 27, 1979 June 20, 1979
Rule 17a-6	transactions with portfolio affiliates	proposed 10698 adopted 10826	May 16, 1979 August 13, 1979
Rule 17d-1(d)(6)	reorganizations of portfolio companies	proposed 10699 adopted 10890	May 16, 1979 October 4, 1979
Rule 17d-1(d)(7)	joint insurance policies	proposed 10700 adopted 10891	May 16, 1979 October 4, 1979
Rule 22c-1(b)(1)	pricing of redeemable securities	proposed 10545 re-proposed 10691 adopted 10827	January 19, 1979 May 15, 1979 August 13, 1979
Rule 2a-6 Rule 15a-4	exemptions for certain investment advisers and principal underwriters	proposed 10809	August 6, 1979
Rule 17a-8 Rule 17d-1(d)(8) Rule 22c-1(a)(2) Rule 22d-4 Rule 22d-5	mergers and consolidations involving registered investment companies	proposed 10886	October 3, 1979

Rule, Rule Proposal or Interpretive Release	Subject Matter	ICA Release Number(s)	Date(s)
Rule 3c-2	definition of beneficial ownership	proposed 10938	November 13, 1979
Rule 3a-1	certain prima facie investment companies	proposed 10937	November 13, 1979
Rule 3a-2	transient investment companies	proposed 10943	November 16, 1979
Rule 3a-3	certain investment companies owned by companies which are not investment companies	proposed 10944	November 16, 1979

Mr. MENDELSOHN. These exemptive rules have done a great deal for the administration and the processing of applications that do come before the Commission because it has eliminated a great number of applications, so I would say right now that we generally comment on an application within 30 days; and, of course, the ball then is thrown to the applicant's court to come forward with the answers to those comments.

Now, I would say the majority of our applications, and I am speaking from memory now, are processed without going to the Commission by delegated authority of the division within 60 days.

Mr. LYBECKER. Yes, sir.

Mr. MENDELSOHN. Within 60 days of filing. I think you have to consider the number of applications that have been eliminated and many of them, particularly rule 17a-b which eliminates all applications having to do with downstream affiliates.

These were the things, I think, that the venture capital companies and the SBIC's opposed, this type of application where they were dealing with portfolio affiliates, for example, giving them new money, renegotiating deals with companies that they owned 5 percent of and which, as far as the protection of investors to the venture capital company, there was obviously no chance of the portfolio company overreaching SBIC.

Well, starting in 1978, we recognized that it was not necessary or appropriate to have each such transaction reviewed by the Commission so we recommended that the Commission adopt amendments to rule 17a-b to eliminate the need to grant individual exemptive orders for downstream affiliate transactions.

Mr. BROYHILL. Now, is that 60 days average time or best time?

Mr. MENDELSOHN. I would say it was average. I would say that there are sticky applications that may well take a long time, and I would be misleading the chairman if I said otherwise.

Mr. LOOMIS. Sometimes if they are very controversial you have to go to a hearing and all of that, and then it does take time.

Mr. BROYHILL. I don't want to get back into my argument a minute ago, but on a number of these transactions, a large conglomerate would not have to come to you to get permission to make those transactions?

Mr. MENDELSOHN. No question, but I think, Mr. Chairman, there is a mystique about this act which I think may be unwarranted and that is in its present form, considering the exemption rules that we have promulgated right now with respect to 17, the insider transactions, is what we are dealing with in applications now: transactions in which an officer or a director or a 5-percent shareholder or a controlling person has a financial interest in that transaction apart from the investment company.

There is a conflict of interest in that area, and it is in this area that the Commisson has retained jurisdiction to review individual transactions, and I can't answer, in all honesty, I can't justify also exempting our review of these transactions other than what I have already done with respect to the conglomerates and the venture capital.

I can say that the type of transaction we are now reviewing is a transaction that may not be necessary at all with respect to a venture capital company. In other words, the president of a venture capital company does not have to have a personal piece of the action in a particular transaction.

If he withdraws from that transaction, it would go through without our review; so, as I say, I cannot differentiate between a conglomerate and a venture capital, but where we do have jurisdiction we have eliminated what I would call the technical violation that we used to review.

Mr. LYBECKER. If I could supplement that just for a moment, in addition to the rules that Mr. Mendelsohn will show you the list of, we have under my responsibility for the Investment Company Act study been considering a number of other rules that we would like to work on this fall and over the winter.

One of them is something involving what has been called de minimis transactions. The type of situation Mr. Mendelsohn described still wouldn't be a major concern to the Commission if the transaction was in readily available securities where there was an obvious price that the directors could refer to, so the opportunity of overreaching on behalf of any particular person was very, very slight. But ones that are left over we will have to work on after the study has gotten through that phase, and would be the type of transaction he referred to, where there is no fixed agreement about the price, and it's not clear that the transaction is in the investment company's best interest absent the personal financial interest of the officer, director, or controlling person.

Mr. BROYHILL. Mr. Loomis, one more question. I understand there is a section in the proposed new securities code that deals with a transaction between affiliated persons, and apparently it does ease up the burden of seeking the prior approval.

Has there been any conversation between you and Mr. Loss as to this particular part of the new securities code, and have you come up with any conclusions that you could share with us?

Mr. LOOMIS. Mr. Lybecker has been working in this area.

Mr. LYBECKER. With all respect to the Chair, it's a ticklish problem because the ALI Federal Securities Code hasn't officially been considered by the Commission.

They have not rendered any approval of it. Our remarks will be limited to the staff level, and we have discussed the rule 17a-6 analog in the ALI Code with Professor Loss.

When he first began working on the ALI Code, Professor Loss focused on the 1933 and 1934 act problems, and the Investment Company Act wasn't something he started working on until the middle 1970's.

At that time both the approval of the Commission and of the division that was handling the Investment Company Act matters was a little different than, I think, the philosophy you have heard Mr. Mendelsohn express about granting broad exemptive relief and creatively using our rulemaking authority under the Investent Company Act, so there was among the industry and others a substantial interest in trying to improve the administration of the Investment Company Act. And they all petitioned Mr. Loss privately to find some way to change section 17 so that it would be less burdensome.

They couldn't agree amongst themselves after having worked on it with the cooperation of the staff for a considerable period of time. They discovered that they couldn't agree amongst themselves on what should be a prohibited joint transaction, and the only relief they were actually able to agree to amongst themselves, again without any official support from the Commission, involved transactions involving upstream affiliates. And the particular arrangement that Professor Loss was able to work out would exempt transactions involving downstream affiliates and persons who have no more than a 5-percent interest in the transaction that is going on downstream.

I think that is probably an overly broad way to handle the problem. In our view, there are more discreet ways to handle the problem, and we have in the rule 17a-6 rulemaking tried to attack those particular problems. The approach Professor Loss used was to exempt the transaction entirely.

The approach we have been using, and we are fortunate the Investment Company Act is unique in the Federal securities laws and among all of the statutes affecting financial institutions in having substantial exemptive power that we can use, and also the unusual advantage of having a quasi-self-regulatory organization literally represented on the board of an investment company. The approach we have used in the Investment Company Act rules is to direct our attention at a discrete problem, identify the conflict of interest and the standards which should be used in evaluating the problem, and impose responsibility for addressing that problem on the disinterested directors of the investment company.

Professor Loss, approach would leave someone who relied on that section in the ALI Code, and went ahead and did that transaction, open to potential civil liability whether or not there had been overreaching.

The approach we use gives the disinterested directors a test, which they are supposed to use, as well as procedures and recordkeeping, to address the particular problem and as a result, in my view, there is a substantial likelihood that, if someone protested an investment company transaction under the scheme we are using, there would be a very good likelihood the investment company could succeed in the initial stages of such litigation on a motion to dismiss.

Under Professor Loss' scheme, the transaction would not be set up in any particular way, so a trial court wouldn't be able to avoid going to the merits on whether there had been overreaching.

Most investment companies don't have, with very few exceptions, and the Allegheny/IDS group is one of the few, major holders of investment company shares.

Venture capital companies are unique in having financial institutions that hold their shares, and that is an unusual problem in our experience, one that we have to deal with only in the context of venture capital companies. Schematically, if an insurance company or a bank were an upstream owner of the venture capital company shares and we imposed the same sort of affiliate transaction review requirement that we would on an investment company, we would probably catch all of the portfolio securities that the financial institutions own.

That would be an impossible task for anyone to sort out, and it would be a very difficult task for us to grant exemptive relief for.

However, and I hope this is not speaking out of turn, we have been dealing with one of the people scheduled to testify later in your hearings, Mr. Heizer and his attorneys, in processing a draft application they intend to file for exemptive relief under the Investment Company Act, and we have worked out an approach to the upstream affiliate problem under section 17 that goes well beyond what we have done for all registered companies to take care of those problems inherent in venture capital companies.

Is this responsive to your question?

Mr. BROYHILL. I think it is, and I will have to review the record to see if we need any other questions here.

Mr. MENDELSOHN. The ALI Code, as I understand it, cuts off what I would call the nominal affiliates like officers, directors, and employees, and I am afraid that that cuts just a little too high because I could give you, for example, one situation not involving a venture capital company, but where a trader making about $23,000, hardly a control person, was able to get himself into a position to be given extraordinarily good prices for his own personal account from the brokers who were trading with a very large complex. It is a form of a kickback or bribery.

Obviously, I would hate to have a person like that read out of the statute. A person who was in such an influential position, an analyst in a complex or even a venture capital company, could for his own private gain recommend a particular company as a good prospect and even file a report that the board of directors would approve. That report might in fact be false or misleading and, nevertheless, I think the code might read him out, so I think the code has gone a little too far in that area.

Mr. BROYHILL. OK; let me move to another area.

Mr. Chairman, Mr. Williams testified before our committee on a similar bill last year, and at that time he mentioned that the Commission and the Department of Commerce jointly undertook a program which was called a criminal technology incentives program.

As I understand it, the purpose of that program was to monitor capital markets which apply financing to small technology-based firms.

What have been the results of the program that was initiated some 2 years ago?

Mr. LOOMIS. I think we better reply to that separately. I know it is going along, but I couldn't give you an informed status of it.

Mr. BROYHILL. Would the Commission consider raising the 3(b) exemption up to $5 million or perhaps $10 million?

Mr. LOOMIS. The statutory limit is——

Mr. BROYHILL. It is $2 million now.

Mr. LOOMIS. It is $2 million, I believe. We can't go beyond the statutory limit.

Mr. BROYHILL. Would you recommend raising that? I am thinking about the inflationary factors that have occurred in the past 5 years that would make the amount of $2 million relatively low compared to what it was a few years ago.

Mr. LOOMIS. Yes; well, it might be useful, but I suspect we feel that above the $2 million level, rather than having an exemption we prefer, as we are proposing to do, to simplify requirements for transactions, say, between $2 million and $5 million.

Mr. BROYHILL. Now, some have advocated that the SBIC's be regulated by the Small Business Administration. Do you feel that the Small Business Administration has the capability, staff and the background to carry out a program of investor protection?

In other words, please give us your views as to the relative ability of the SEC to do that job, to carry out that function as opposed to giving it to the SBA?

Mr. LOOMIS. I don't want to speak in any way critically of a sister agency, but the SBA's focus is all on trying to get capital provided to small businesses. That is what they are for, and that is what they are about in this program.

Consequently, they have not focused very much on the protection of investors in a company that supplies capital to small businesses. The emphasis has been on the small businesses.

I am not sure that they have the experience or the staff to enable them to do investor protection work as well as we do it.

Mr. BROYHILL. Mr. Mendelsohn?

Mr. MENDELSOHN. Mr. Chairman, to an extent I think the SBA finds themselves in a conflict of interest. Many times they act as a guarantor, and many times that particular role is in direct conflict with investor protection. In other words, they are a shareholder, a senior security holder as against the common stock of an SBIC, so in approving transactions they have a tendency to look to their own protection. It is natural; it's human.

Mr. BROYHILL. Those are all the questions I have.

Mr. Opper?

Mr. OPPER. Thank you, Mr. Broyhill.

I would like to direct a few questions to section 6 of the bill which would exempt venture capital companies from the Investment Company Act of 1940.

Presumably in granting any exemption from the 1940 act, one must weigh the benefits to issuers and venture capitalists against the need for public investor protection.

Commentators have suggested that the investor remedies that would still be available under the 1933 and 1934 act would sufficiently supplant whatever protections might be lost under the 1940 act. I know the Commission does not agree.

Mr. Loomis, perhaps you and Mr. Mendelsohn and Mr. Lybecker might suggest what kinds of protections the 1940 act provides the unsophisticated investor and why its retention may be necessary.

Mr. LOOMIS. Well, the point is there are other adequate remedies for investors aside from the remedies, the controls of the Investment Company Act. There are problems with that as some of the cases have shown.

The courts have become somewhat more strict with private actions based under the antifraud provisions of the securities laws. They tend to require scienter, intent to defraud, and thus these remedies are not quite as effective for an investor as the regulatory controls of the Investment Company Act which make it unlawful, whether you have an illegal motive or not, to do certain things where there is a conflict of interest.

Mr. MENDELSOHN. There is another basic difference. Under the Investment Company Act, the Commission can inspect the records of an investment company. Under the 1933 act, they cannot.

Now, the enforcement cases that we have developed, by and large, the majority of them have been through the inspection process so that we can get to violations that we never could get to unless they became a part of the public scandal under the 1933 or 1934 act.

Mr. OPPER. So you feel there is a substantial prophylactic effect for the investor?

Mr. MENDELSOHN. Yes.

Mr. OPPER. The exemption proposed in section 6 would be limited to venture capital companies. I think we probably all agree that it would certainly facilitate their operations if this regulatory burden were completely removed.

On the other hand, is there any reason to believe that unsophisticated investors in venture capital companies have any less need for the 1940 act protections than investors in other kinds of mutual funds?

Mr. LOOMIS. In the first place, while I gather that section 6 was intended to provide an exemption only to small venture capital companies, the language is so broad that it would include companies that were investing in the securities of General Motors, if they got them in a private placement.

That is one of the problems I see with it. Although venture capital companies vary, many of them are composed of highly sophisticated people, and where that is the case there is more an opportunity for justification for exemption.

On the other hand, a venture capital company, I suppose, there is no reason why it could not appeal to the general public for capital, and if it did there might be a problem because, while venture capital companies are a very desirable type of business operation because of their usefulness to small business, it is, nevertheless, true that running a venture capital company is a fairly high risk operation.

The small businesses don't always succeed and, consequently, if you are going to grant exemptions you have to consider what kind of venture capital companies you are granting them to, and that is why we are more disposed to provide exemptions for venture capital companies where their shareholders are sophisticated investors and substantial investors.

Mr. MENDELSOHN. Rule 3c-2, the rule that was proposed yesterday, is a very significant rule for venture capital companies, because for the first time we are making sure that companies will not be counted which are greater than 10-percent shareholders, for purposes of section 3(c)(1). In other words, if they buy more than 10 percent of the voting securities of a venture capital company, they will only be considered as one in counting to 100. Previously, if they had purchased more than 10 percent in a venture capital company, all of the shareholder of that investing company would be counted.

Now, we have extended the exemption to provide that, as long as the investing company doesn't commit more than 5 percent of their own capital, they will only be considered to be 1 shareholder so, consequently, going back to that 100 share test, we could now have 99 institutions into a venture capital company with untold amounts of capital to contribute, just as long as each one of them contributed 5 percent or less of their own capital.

I think this should be a very big help to venture capital companies.

Mr. LYBECKER. The rule now applies only to SBIC's. To make sure—looking at it from the standpoint of investors like Citi-Bank, Chase Manhattan Bank, or the Prudential Insurance Co.—that we don't overlap the SBIC and venture capital markets, the Commission is proposing to grant the relief for venture capital and other companies in a separate paragraph; so, viewed from the standpoint of the rule, Chase Manhattan Bank could put 5 percent of its assets into a variety of SBIC's and put an additional 5 percent of its assets into a variety into venture capital companies.

We didn't want to make the universel of venture capital money which is available to be shared or be divided up on some arbitrary basis. We left each industry with their own shot at the total investment pot.

Mr. OPPER. Your testimony indicates some concern about the definition of venture capital company contained in section 6, particularly that it might inadvertently include any number of investment vehicles that are not generally recognized as venture capital companies.

Do you have any suggestions or thoughts on how we may fashion a definition for a venture capital company?

Mr. LOOMIS. That is rather difficult because, as I say, they vary, but I would think that speaking generally a definition which spoke in terms of the type of securities they invested in, that is securities of small companies, or securities of companies that are, say, not listed on major exchanges or on NASDAQ, where the company you are investing in is really not a small developing company.

You could draw lines in that direction and, as has been suggested in connection with rule 3c–2, you could also draw lines in terms of the types of people who invest in the venture capital company, that they be substantial investors and not unsophisticated people.

Mr. MENDELSOHN. Recently the Commission proposed rule 205–3 under the Investment Advisers Act for venture capital companies' advisers seeking incentive fees. We attempted to define venture capital companies. We call them business development companies, and we did come up with a definition.

That definition, of course, is open to comment, and we received quite a few comments on it, and we are in the process now of attempting to come up with our own definition in view of the comments of what we call a business development company, venture capital.

Mr. OPPER. I would like to quickly turn to proposed rule 242.

One of the comments we have received is that it does not provide for resale by accredited investors, as defined by the rule, to other accredited investors without application of various provisions of the securities laws.

Do you have any thoughts on why such an amendment to proposed rule 242 may or may not be appropriate?

55-753 O - 80 - 6

Mr. LOMMIS. It might be. I have not personally yet seen all of the comments on 242, but it sounds like a proposition that we would have to consider.

Mr. OPPER. Two years ago Congress gave the Commission authorization to raise the regulation A ceiling to $2 million. To date the Commission has only granted an exemption under regulation A to the amount of $1.5 million.

What are the prospects of increasing that ceiling to $2 million?

Mr. LOOMIS. I think it might well happen, though I don't know of any immediate rule. We wanted to have some experience with regulation A above the prior statutory $500,000 level. We want to have some more experience with what types of regulation A we are getting at the million and a half level before we see if there are any problems before we move to $2 million.

I think we will move to $2 million in due course, particularly if inflation keeps on this way.

Mr. OPPER. Similarly, regulation E, which is SBIC's counterpart to regulation A, presently retains its old ceiling of $500,000?

Has the staff given any consideration to raising that ceiling?

Mr. LOOMIS. What?

Mr. OPPER. One of the subsequent witnesses—we have the benefit, without being clairvoyant, of knowing what they are going to say, having seen copies of their testimony—suggests that the exemption for SBIC's, which I believe was described as regulation E, is presently $500,000, and that ceiling has not been raised commensurate to the regulation A ceiling.

Mr. MENDELSOHN. As a practical matter, Mr. Opper, regulation E was, I think, used once or maybe twice in the whole history of the 1940 act, even when $300,000 was big money.

It is just not being used. It has never been used, nor have we had any real conversations with the industry asking to raise it. There is a reason for that, and the reason is for an initial offering, before an investment company can initially offer its securities under the Investment Company Act, it has to file a registration statement under the 1940 act.

Regulation E is available only with respect to an offering under the 1933 act, as you know and, therefore, since most of the material is combined by reference, there is no real advantage at this particular moment for the small business investment company to use regulation E.

Mr. OPPER. It has also been observed in order to avoid application of the Investment Advisers Act of 1940, that the number of investors in venture capital companies usually is limited to less than 15.

Is it necessary to apply the Investment Advisers Act for venture capital companies merely because the number of investors exceeds 15?

Mr. MENDELSOHN. Well, the question comes up as to whether for purposes of section 203(b)(3) an investment adviser is advising 1 client or 15 clients in a venture capital company. Now, our position at the staff level has been that, where the adviser runs out and holds himself out as an adviser and brings people together and they are joining the organization simply because a "Mr. Adviser" is the investment adviser, tentatively at least we count the number of people in the organization.

Where an organization which is already organized would go to a person not holding himself out to the public as an adviser, and ask him to be an adviser, we would take the position that that person is only advising one client. Therefore, there would be no registration.

But, as to whether or not an adviser to a venture capital company should be regulated, my view is that he should be, because he is in a tremendous position of conflict, and the Investment Advisers Act, particularly section 206 and its antifraud provisions, and the bookkeeping provisions, should apply to him.

I think we would be very willing to consider certain exemptive rules or exemptive provisions pursuant to an application with respect to custodians. Obviously, you cannot have a separate custodianship for each advised client, if they are all grouped in a pool. But with respect to the antifraud provisions, with respect to bookkeeping, I think that we ought to have regulatory power over those people.

Mr. LYBECKER. If I could supplement, it also depends on how the venture capital companies are organized. Your question presumes there is an external investor advisor. To the extent that the venture capital company or any SBIC is organized so that there is an external adviser, then the regulatory issue is posed. But it is my understanding that a number of the venture capital and small business investment companies are organized as corporations with internal management. And there is a lot of good reason for that if for no other reason—and of course it's the reason why the Commission has always looked with favor on internalized management in the mutual funds context—it cuts down on the kinds of conflicts of interest that we are forced to deal with and regulate under the Investment Company Act.

In particular, the bill that Mr. Broyhill is the sponsor of clearly seems to contemplate that the kind of entity that he is addressing is a company that would be a closed-in fund, one that is not making a public offering but is managing the proceeds and is managed by internal management.

It's not clear that the Advisers Act question is raised with respect to all venture capital companies and all small business companies.

Mr. OPPER. I might add, perhaps consistent with the definition of accredited investors, which the Commission at least in proposal form seems to be contemplating, it might be fruitful to consider whether or not persons who qualify under that standard really need the protections of the Advisers Act, if you are willing to suggest that the registration provisions of the Securities Act need not be applicable.

Mr. MENDELSOHN. Well, as you know, we recognized in proposed rule 205-3 with respect to incentive fees that, if investors in a venture capital were limited to $150,000 minimum, these types of sophisticated people could pretty much fend for themselves, and if they wanted to consent to an incentive fee, that was up to them.

On the other hand, when you get down to very unsophisticated investors, they have a hard time understanding what an incentive fee is and what the ramifications of such a fee are.

Mr. OPPER. Last September in the hearings that this subcommittee held Congressman Eckhardt and Congressman Broyhill encouraged the Commission and the SBIC industry to work together to attempt to resolve the various kinds of problems that these small companies have encountered under the 1940 act.

Mr. Little in his prepared testimony suggests that these efforts have been barren and terminated.

Do you agree with that assessment?

Mr. MENDELSOHN. I agree that we have had no negotiations. We are willing to discuss with the industry any reasonable arrangement for exemption. We would hold conferences with them at their behest at any time mutually convenient.

Mr. LYBECKER. To the extent that we have had discussions since last December with Ray Garrett and lawyers from his law firm, they—as I understand it—were generally representing the interests of SBIC's, and the particular proposals that were put before us from December through April all involved some sort of industrywide exemption from the Investment Company Act, whether through industrywide rulemaking or industrywide application. However, the report of those meetings that has been circulated states our view it would be very difficult to do any exemption on an industrywide basis because we do not have a record which supports that. But we would be more than willing, and our experience with Ray Garrett and the Heizer Corp. demonstrates this, we would be more than willing to talk with the SBIC's about any exemptive relief that the record can support.

It's extremely difficult to do rulemaking without a preexisting, adequate record, and we are prohibited from exhaustive contact with people during the prerulemaking phase. During the comment period, after a rule has been proposed, is the easiest time to collect evidence, for reasons that are hard to understand.

Sometimes people feel that the best kinds of comments, and this is the only window the Commission really has on an industry in a forum that is publicly available, is to attack the rule, rather than provide the type of helpful, insightful kinds of comments that would help the staff redraft what has been proposed.

After the rulemaking period is over, the *Home Box Office* case prohibits us from any kind of ex parte contact.

One of the major disappointments that we have experienced with the Advisers Act rule, and Mr. Mendelsohn can speak more directly to this, is that most of the comments we received were of such a generalized nature.

They were saying, more or less, we simply hate the rule rather than helping us try to develop a good definition of business development company or dealing with the investor protections concerns that we have a legitimate right to be concerned about. And that leaves us, as staff members, in a very difficult position in going back up to the Commission and making recommendations for responsible adjustments to a proposed rule.

We have to say to Commissioner Loomis and his colleagues, they hated the rule. It's clear they hated it, but we will have to use our own best judgment about what it is that should be changed. The only thing we can do is ask for the rule to be reproposed and have additional comments on it.

As a process, that is a very expensive, time consuming, and a very difficult procedure for us to go through. The practical fact is, if members of the industry who are affected by the rule proposals don't comment specifically and responsively on them, the Commission is left in much of the same position you are in, Mr. Broyhill, when you propose legislation and people oppose it for reasons you can't understand.

Mr. BROYHILL. In order to save some time, it would be very helpful to the subcommittee if we could have some comments for the record on a suggestion contained on page 15 of Mr. Arthur Little's testimony wherein he suggests a compromise solution to the 1940 act problem—specifically in exchange for an ongoing exemption from the act, an agreement to comply with foreign investor protection requirements.

I am requesting that the Commission review those suggestions and submit for the record its reaction to the proposal. We will hold the record open for this information.

Mr. OPPER. I think it's generally recognized that one of the difficulties the small enterprises have had in floating their securities offerings publicly is the residue of investor adverse reaction to the hot issues market in 1968 and 1969.

The Commission had extensive hearings on that market where the securities of unseasoned and highly speculative companies were sold under rather high-pressure tactics to the public. With the collapse of that market, the statistics reflect that a substantial number of individual security holders have withdrawn completely from the securities equity market.

I am just wondering, given the kinds of restraints that would be lifted under this bill, particularly with respect to the free sale of restricted securities after a 5-year holding period, and perhaps with the lifting of all applications of the 1940 act to venture capital companies, if we might want to focus on whether or not we could actually be replanting some of the seeds that have actually made necessary the hearings that we are engaged in today.

Do you have any comments on that?

Mr. LOOMIS. I remember the hot issue markets when they were going on. There, I think, it was a matter of investors psychology and reaction. Investors in those times were very optimistic, and they would think that they were very interested in buying stock of small enterprises that were reported to be very good buys and then it turned out that they were not, and a lot of people got burned, as you say.

I have some concern, and maybe I will have to write you later about it, in relating that phenomenon to this bill, but certainly it was an indication that in certain areas investors were not adequately protected.

Mr. MENDELSOHN. I think, with respect to the Investment Company Act, I can say that investors do invest in normal investment companies, mutual funds, with the idea that they are investing in a regulated industry. I think that there is some justification for that confidence. There hasn't been a real scandal in the investment company business, a pervasive scandal, in the administration of the act since 1940.

Now, it may be there just happens to be more honest people in the investment company business, which I doubt, but it seems to me that the Investment Company Act has provided a lot of investor protection that gives an aura of confidence to investors. I am afraid if we are denied the right of inspection and the right to peruse transactions with individuals that, conceivably, we may well have a scandal in the venture capital area that will dry up investments even by sophisticated investors.

Obviously, nobody can tell, but I feel that there is this aura of confidence which is generated by the idea that the Commission does have regulatory power over the investment company industry.

Mr. BROYHILL. Mr. McMahon?

Mr. McMAHON. I have one question directed toward Commissioner Loomis and it is directed toward your concern about lifting the ban on securities, restricted securities, in a resale after 5 years.

It appears that your philosophy is that you want individuals, namely venture capitalists, to undertake risks, but you limit them from reaching the rewards and they are permanently locked into these investments.

Don't you have confidence in your residual regulatory power to define further what the rules would be on the release of these securities after 5 years?

Mr. LOOMIS. We are sympathetic to releasing these restraints, in a reasonable time, maybe less than 5 years for people who are simply investors, who went into this venture as an investment.

We are troubled, however, by further lifting the restraints on resale on the part of people who are in control of the company or who manage it.

Mr. McMAHON. Can't you even develop regulations for people who are in control of the company?

Mr. LOOMIS. The problem there is the hot issues problem as an example of that kind of thing. People who buy into a company or own it, then when they thought the market conditions were right they would want to get rid of it without the safeguards to the public of registration.

I do feel that there is an important line to be drawn between resales by people who acquired securities as investments and allowing controlling people of companies that had no market to remember to go public, so to speak, without registration.

Mr. McMAHON. Thank you.

Mr. BROYHILL. Thank you very much, Mr. Loomis.

We appreciate your responses today, and we will hold the record open for the information requested.

[The following correspondence was received for the record:]

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SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
WASHINGTON, D.C. 20515

November 30, 1979

Honorable Philip A. Loomis, Jr.
Commissioner
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Dear Commissioner Loomis:

In connection with your testimony before our Subcommittee on the Small Business Investment Incentive Act (H.R. 3991) on November 7, 1979. I have one request. In connection with the proposal that venture capital companies be exempt from the provisions of the Investment Company Act of 1940, I understand that your staff has recently prepared a memorandum of the Commission's experience with small business investment companies under the Act.

I am requesting, at your earliest convenience, that you submit for the record that memorandum or the pertinent parts thereof and any necessary additional explanation.

With every warm best wish,

Yours,

James H. Scheuer
Chairman

FO:mar

OFFICE OF
THE COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

REC'D CP&F SUB.

JAN 3 1980

Honorable James H. Scheuer
Chairman
Subcommittee on Consumer Protection and Finance
Committee on Interstate and Foreign Commerce
House of Representatives
Washington, D.C. 20515

Dear Chairman Scheuer:

In response to your request, I am pleased to transmit excerpts of the report of the Commission's Division of Investment Management on venture capital companies and the Investment Company Act of 1940. The report is an updated version of a draft dated October 3, 1979. Certain portions of the prior draft which deal with specific matters not relevant to your request have been omitted. As you know, this is a staff report which has not been reviewed by the Commission.

Please do not hesitate to contact me or members of our staff if you have any further requests or comments.

Sincerely,

Philip A. Loomis, Jr.

Philip A. Loomis, Jr.
Commissioner

DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION
EXCERPTS FROM REPORT ON VENTURE CAPITAL COMPANIES
AND THE INVESTMENT COMPANY ACT OF 1940

III. The Exclusion of Venture Capital Companies from the Investment Company Act

A. Introduction

The Investment Company Act was enacted to eliminate the widespread abuses and failures to observe principles of fiduciary duties that were uncovered in unregulated investment companies. As a result, the Act was structured to provide a comprehensive framework of regulation which, among other things, protects against management self-dealing (sections 17 and 23), embezzlement (section 37), or abuse of trust (section 36), provides specific controls to eliminate or mitigate inequitable capital structures (section 18), and prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval (section 13). Also, in furtherance of the national public interest as expressed in section 1(b) of the Act and in the interest of investors, the Act imposes certain restrictions on who can serve as an officer or director of an investment company and on affiliations of directors (sections 9 and 10), requires shareholder approval of advisory contracts and accountants (sections 15 and 32), specifies certain books and records which must be maintained and which are subject to Commission inspection (section 31), contains certain reporting standards (rule 30d-1) and proxy solicitation requirements (rule 20a-2) that have no counterparts in the Securities Exchange Act of 1934, requires disclosures regarding cash distributions (section 19), and provides that certain contracts violative of the Act's provisions may be voided (section 47(b)). Other provisions shield investment company shareholders from additional abusive practices (sections 12 and 16). Although the foregoing briefly summarizes some of the most important protections provided by the Investment Company Act, we believe the Act's safeguards warrant description in greater detail because of arguments which have been made that these protections are expendable with respect to investors in venture capital companies.

B. Analysis of the Investment Company Act's Fundamental Protections

(1) Conflicts of Interest and Fiduciary Duties

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

Absent section 17: 23/ (i) affiliated persons could buy securities

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23/ It should be noted, however, that the Commission has adopted rules 17a-6 and 17d-1, 17 CFR 270.17a-6, .17d-1 (1978), which, among other things, exempt from the provisions of section 17 certain transactions which otherwise would be prohibited absent a favorable Commission order for each such transaction. Those exempted transactions, while literally within the ambit of section 17, do not present the opportunities or abuse the section was designed to prevent.

and property from, sell securities and property to, and borrow money from, a venture capital company without any finding by the Commission that the transaction is fair and reasonable (section 17(a)); (ii) affiliated persons could enter into joint transactions with venture capital companies which were more advantageous to the affiliated persons than to the company (section 17(d)) -- for example, affiliated persons of a venture capital company could say, "the company we manage will lend you money if you will retain our business advisory service," or directors could have their venture capital company lend money to companies in which they had financial interests; (iii) affiliated persons of a venture capital company could demand and be paid compensation for the purchase or sale of any property to or for such company, (section 17(e)) -- for example, a finder's fee might be demanded and paid to an officer of a venture capital company by another company to whom the venture capital company is making a loan; 24/ (iv) affiliated persons could have custody of liquid, transferable venture capital company assets (section 17(f)); (v) no adequate bonding would be required to protect the company against larceny and embezzlement by its officers or employees (section 17(g)); and (vi) there could be indemnity agreements under which directors or officers of venture capital companies would be protected against any liability to the company or its shareholders by reason of their willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of their offices (section 17(h)). It should be emphasized that this

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24/ See e.g., In re Capital Corp. of America, Investment Co. Act Release No. 9024 (Nov. 12, 1975).

lengthy litany of potential overreaching and unfair transactions is not hypothetical; such transactions are the subject of frequent inquiries, investigations, administrative proceedings, and enforcement actions, and a number of related cases are described in the section immediately following. 25/ Not all section 17 transactions are, of course, unfair or involve overreaching, and many proposed transactions do receive favorable orders from the Commission after its careful review. The point is that section 17 is not merely a caution against serious problems observed only in 1940 — it has current relevance, and our experience under section 17 clearly indicates that it currently provides material investor protections.

Other provisions of the Act are also extremely important to investors. Absent the carefully drafted restrictions imposed by section 23, shares of a venture capital company could be issued for services or for property other than cash or securities, or sold to favored persons at prices below current net asset value, and shares could be repurchased only from favored shareholders.

Section 36(a) of the Act authorizes the Commission to bring an action in the proper United States District Court if it believes that persons serving an investment company in certain capacities — including officer, director, investment adviser or principal underwriter — have engaged in the past five years or are about to engage in an act or practice constituting a breach of fiduciary duty involving personal misconduct. If the Commission's allegations are proven, the court may

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25/ See section III(C) infra.

enjoin such person from serving an investment company in any or all capacities and award other appropriate relief. Section 36(b) explicitly provides that an investment company's investment adviser has a fiduciary duty with respect to the receipt of compensation for services and payments of a material nature. This section also authorizes the Commission or a shareholder of the investment company to bring a court action if it believes this duty has been breached. The provisions of section 36 are very important since they codify in the Act the fiduciary obligations of an investment company's officials and authorize Commission and shareholder actions if these obligations are breached. 26/ We believe that the existence of section 36, amended in 1970 to provide for litigation by the Commission or by shareholders acting as private attorneys general, serves as a valuable deterrent to improper conduct by investment company officials.

(2) Capital Structure

Excessive borrowings and the issuance of excessive amounts of senior securities can, for various reasons, be inimical to the best interests of

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26/ See, e.g., Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976); Moses v. Burgin, 445 F.2d 369 (1st Cir.), cert. denied sub nom. Johnson v. Moses, 404 U.S. 994 (1971). See also Burks v. Lasker, 99 S. Ct. 1831 (1979) (section 36 applies to all acts of officers and directors). Certain other provisions in section 36 allow a court of law to give such consideration as it deems appropriate to actions by the board of directors of the investment company regarding the advisory services, thereby allowing deference to be given to good faith determinations of a board.

an investment company's shareholders. 27/ To prevent related abuses, section 18 of the Act places certain limitations upon the issuance of senior securities by investment companies.

(3) Fundamental Policies

Section 13 prohibits an investment company from engaging in certain acts, including changing from an open-end company to a closed-end company or vice versa, or from a diversified company to a non-diversified company, 28/ deviating from its stated policies in respect of certain types of activities, or ceasing to be an investment company, without the consent of a majority of its outstanding voting securities. This statutory arrangement avoids the situation in which security holders have the fundamental nature of

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27/ For example, small changes in a company's portfolio securities prices may result in disproportionate changes in the company's net asset value. See generally Investment Co. Act Release No. 10666 (April 18, 1979) (statement of policy regarding implications under Act of reverse repurchase, firm commitment, and standby commitment agreements entered into by registered investment companies); Securities Exchange Act Release No. 15974 (June 26, 1979) (order settling administrative proceedings involving reverse repurchase agreements entered into by California Fund for Investment in U.S. Government Securities, Inc. by imposing sanctions upon certain persons who were, among other things, prohibited from association with any investment company for a period of time). An adviser whose fee was 3% of the assets under management would be able to charge $300,000 for services rendered to a venture capital company with assets of $10,000,000. The adviser's fee would increase proportionately, i.e., by $60,000, if the adviser persuaded the company to borrow (e.g., by issuing warrants or debentures) an additional $2,000,000 — money which the adviser might well feel pressured to invest quickly, and perhaps not as prudently as would be the case in other circumstances.

In addition, a company's investment adviser may be able to purchase securities — possibly unsuitable securities — to increase its advisory fee (typically calculated as a percentage of the assets held by the company) by causing the company to unnecessarily borrow by issuing senior securities, resulting in excessive leverage.

28/ See Investment Company Act § 5(b) (defining diversified and non-diversified companies).

their investment or the company's investment policies changed drastically and unilaterally by insiders without their approval.

(4) Directors and Other Affiliated Persons

Sections 9 and 10 of the Act afford investment company shareholders certain protections with respect to the persons who will occupy key positions with the investment company or its related entities. Section 9(a) prohibits persons who have, among other things, been convicted of any felony or misdemeanor involving the purchase or sale of a security or arising out of their conduct as a broker, dealer or investment adviser from serving in various capacities with an investment company, including as an officer, director, investment adviser, or employee. Section 9(b) authorizes the Commission to hold hearings and bar persons from serving in specified capacities with or for an investment company if they have, among other things, willfully violated or willfully aided or abetted violations of the federal securities laws. Without section 9, investment companies could come under the control of malefactors. Moreover, in an effort to prevent an investment company from being dominated and perhaps operated in the interests of individuals who have a financial interest in the company's operation (beyond that held by an ordinary shareholder), section 10 of the Act requires that at least 40% of the members of the board of directors of most investment companies be persons who are not interested persons 29/ of the investment company, its investment adviser, or its principal underwriter.

29/ Investment Company Act § 2(a)(19) defines the term "interested person."

(5) Advisory and Other Contracts

Section 15 of the Act provides investment company investors with certain protections designed to ensure that the investment company is not overreached in connection with the negotiation of its underwriting and advisory contracts. These provisions have proved to have been especially important where essential investment management or administrative services are performed by persons employed by external entities, as is the case with most registered investment companies and many limited pertnerships with corporate general partners. The advisory agreement must be written, and approved initially by a majority of the investment company's shareholders (and thereafter approved at least annually by shareholders or the disinterested directors serving on the investment company's board), describe precisely the adviser's compensation, provide for its termination without penalty on not more than sixty days' notice, and provide for its automatic termination upon assignment. Without these protections, a venture capital company's contract for investment advice could be entered into without shareholder approval, be extended indefinitely without approval of the board of directors, be terminable only upon payment of a penalty, and be transferred to a new advisory organization without shareholder knowledge or approval.

(6) Inspections, Recordkeeping and Reports

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

A collateral effect of excluding venture capital companies from section 31 would be that, if a venture capital company were generally subject to Commission inspections under section 31, such a company might violate one or more of the few provisions of the federal securities laws which would remain applicable to it without those violations necessarily coming to the Commission's attention. Indeed, a venture capital company might be subject to the Act by reason of its noncompliance with the conditions required for it to be able to rely upon any exclusion provided by legislation, yet without any inspections by the Commission of that company as provided by section 31 the Commission might not become aware of that unregistered investment company. 30/ In addition, unlike the broad range of flexible remedies that are usually available in instances in which a registered investment company violates provisions of the Act, far less flexibility would exist where a venture capital company, either deliberately or inadvertently, failed to satisfy any condition required

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30/ But see also Investment Company Act § 42(a):

> The Commission may make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of the [Act] or of any rule, regulation, or order [t]hereunder, or to determine whether any action in any court or any proceeding before the Commission shall be instituted under this [Act] against a particular person or persons, or with respect to a particular transaction or transactions.

55-753 O - 80 - 7

by legislation for exclusion from the Act: unless some other exclusion or exemption were available, prompt registration ordinarily would be required. Prompt registration under the Act would carry with it the concomitant duty of complete compliance with all of the Act's provisions, including conditions which may require that the company operate or be structured immediately in a manner differing greatly from its present form. 31/

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

In connection with the solicition of proxies, the rules under the Securities Exchange Act of 1934 do not have a requirement comparable to rule 20a-2 under the Act regarding information to be furnished to the solicited shareholder pertaining to a company's investment adviser and the investment advisory contract.

Section 19 of the Act makes it unlawful to pay certain cash distributions other than from certain sources without such payment being

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31/ See, e.g., Investment Company Act § 18 (capital structure).

accompanied by a written statement which adequately discloses the source or sources of such payment. This thwarts the deception of investors as to the source of their income.

(7) Voidable Contracts

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

(8) Other Provisions

Other sections of the Act provide further protections for venture capital company and investment company investors. Control of venture capital companies could be unduly concentrated through pyramiding or inequitable methods of control, absent section 12 of the Act. In addition, but for sections 16 and 32 of the Act, persons could serve as venture capital company directors without being elected by, or serve as accountants with their selection being ratified by, shareholders.

C. Relevant Civil Proceedings

While we are 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. 32/ In particular, small business investment companies ("SBICs") 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. Some of those actions, representative of the abuses that may be encountered — and permitted if venture capital companies were excluded from the Investment Company Act — are discussed below.

In an action involving Puerto Rico Capital Corporation ("PRCC"), an SBIC registered under the Investment Company Act, the Commission sought to enjoin several of the company's officers and directors from further violations of the Act, and to bar those individuals, pursuant to section 9 33/ of the Act, from serving PRCC or any other investment company as officers, directors, or in any of several other capacities. 34/ Among other things, the Commission alleged that the defendants breached their fiduciary duties to PRCC, 35/

32/ Of course, venture capital companies, like other investment companies, may not be subject to the Act because some other exclusion or exemption is available. For example, section 3(c)(1) excludes from the Act any investment company whose securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.

33/ See pp. 15-16 supra.

34/ Litigation Release No. 3308 (Sept. 1, 1965).

35/ See Investment Company Act § 36.

causing PRCC to invest in companies they owned or controlled, resulting in substantial losses to PRCC. The defendants also caused their affiliated companies to borrow money from, as well as sell securities to and purchase securities from, PRCC.

In addition, they also effected transactions in connection with a joint enterprise or joint arrangement in which PRCC was a participant, without the prior Commission approval required by section 17(d) of the Act. The Commission subsequently entered into a settlement in which the defendants agreed to pay PRCC $500,000 and were enjoined from various conduct, including serving any investment company in certain capacities, including officer or director. 36/ The facts of this case illustrate the dangers of eliminating the protections provided by the Investment Company Act.

In another action 37/ the Commission filed a complaint in federal district court alleging violations of the Act by Illinois Capital Investment Corporation ("ICIC"), an SBIC registered under the Act, and five affiliated persons of ICIC. ICIC's president, who was also a director of the company and controlled 30% of its common stock, was alleged to have borrowed money in the form of salary and travel advances from the company in violation of sections 17(a) and 21(b) of

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36/ Litigation Release No. 4395 (Aug. 13, 1969).

37/ Litigation Release No. 4699 (July 27, 1970).

the Act. 38/ The complaint also alleged that ICIC's affiliates had caused numerous transactions, involving the sale or purchase of securities or other property, to be effected between themselves or their affiliates, and ICIC or its affiliates, in violation of section 17(a) of the Act. Certain other joint transactions were also allegedly entered into in violation of section 17(d). Moreover, certain officers and directors were alleged to have caused ICIC to conceal violations of the Act in reports the company filed with the Commission and proxy solicitation materials sent to shareholders. An order was subsequently entered permanently enjoining all defendants from further violations of the Investment Company Act. 39/ Many of the transactions which were found to have violated the Act in the ICIC case would be permissible if venture capital companies were excluded from the relevant provisions of the Investment Company Act.

In SEC v. Advance Growth Capital Corp. 40/ an action was brought against Advance Growth, an SBIC registered under the Act, and the chairman of its board of directors, as well as one other individual who served as the company's president and as director. The Commission alleged violations of Act

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38/ Section 21(b) makes it unlawful for any registered investment company to lend money or property to any person if the company's policies do not permit such a loan or the person controls or is under common control of the company. Section 17(a) also generally prohibits loans not permitted by section 21(b).

39/ Litigation Release No. 4777 (Oct. 9, 1970).

40/ 470 F.2d 40 (7th Cir. 1972).

sections 17(a), 17(d), 34(b) (concerning untrue and misleading reports) and 36 (for gross abuse of trust or gross misconduct by investment company officers and directors) as a result of certain transactions between Advance Growth and various affiliated persons. 41/ In one series of transactions involving development of real estate lots, the chairman arranged for a portfolio company of Advance Growth to purchase all of the undesirable lots and pay for all of the development, whereas a realty company in which the chairman had a 79% interest was a joint participant in the venture but paid nothing for the developers' services and did not have to purchase any of the undesirable land. 42/

In a different series of transactions, Advance Growth provided 100% financing for four years at low interest rates for the purchase at cost of highly profitable assets from its portfolio company, Intermediates, Inc. ("Intermediates"), by G. L. Service Corp. ("GL"), an affiliate of Advance Growth which 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 at a price based on their cost plus interest even though they were worth approximately twice as much. Moreover, the interest rate was originally 4%, and later increased to 7%, even though interest rates of 14 1/2% were being quoted during the same period. Finally, GL failed to make payments

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41/ Section 36 was amended in 1970 to change the applicable standard from "gross abuse of trust" to breach of fiduciary duty involving personal misconduct. See pp. 12-13, supra.

42/ 470 F.2d 40, at 45-6.

when due on its notes to Advance Growth, which had financed the transaction, and paid it 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. 43/

On the basis of these and numerous other transactions 44/ and practices 45/ harmful to Advance Growth, which "invariably came out second best," 46/ and "indicative of conduct that tends to be overreaching," defendants were permanently enjoined from violating any of the Act's provisions.

One final case is particularly noteworthy as an example of transactions which may be effected between venture capital companies and their affiliates. The case of Wright v. Heizer Corporation 47/ arose out of a series of five transactions 48/ between Heizer Corporation ("Heizer"), a venture capital company not registered under

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43/ See id. at 47-48.

44/ Defendants were also found to have violated section 34(b) of the Act by filing false and misleading annual reports. See id. at 51-52.

45/ See id. at 49-51.

46/ Id. at 51.

47/ 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978).

48/ Those transactions are described in the Seventh Circuit's opinion at 241-45, and in the lower court's opinion, 411 F. Supp. 23, 26-30 (N.D. Ill. 1975).

the Investment Company Act, 49/ and International Digisonics Corporation ("IDC"), a company in which Heizer had invested.

In its opinion, the Seventh Circuit Court of Appeals assumed that Heizer was entitled to act solely in its own interest in dealing with IDC's management in the first three of the five disputed transactions; at those times Heizer was a lender to, and shareholder of, IDC, but did not control the company and was not represented on its board. 50/ However, by the time of the fourth transaction, Heizer had gained voting control of IDC and had placed two of its officers on IDC's board. As the court pointed out, it therefore stood in a fiduciary position with respect to IDC; when it chose to continue its participation in communications to shareholders in connection with amendment of IDC's charter in order to permit consummation of the fourth transaction, Heizer could no longer act solely in its own interests. The court found that Heizer nevertheless breached its duty to IDC's shareholders, "failing to disclose any of the material facts concerning the transaction." 51/

49/ At the time, Heizer apparently was relying upon the exclusion provided by section 3(c)(1) of the Investment Company Act. Section 3(c)(1) generally excludes from the definition of investment company any issuer whose securities are beneficially owned by not more than one hundred persons and which is not making a public offering of its securities.

50/ 560 F.2d at 248.

51/ Id. Plaintiffs based their action upon the antifraud provisions of rule 10b-5, 17 CFR § 240.10b-5 (1978), under the Securities Exchange Act of 1934. Inasmuch as Heizer was not a registered investment company at the time, the Investment Company Act's protections were, of course, unavailable; had Heizer been subject to the Act at the

(footnote continued)

The fifth transaction centered upon a pledge of IDC's well-established and profitable subsidiary. Heizer controlled three of the four members of IDC's board for purposes of the pledge transaction. Under the circumstances, the court concluded that Heizer was obligated to disclose the material facts concerning the transaction to the independent shareholders, but did not fulfill this obligation: "shareholders were first informed of the general terms of the pledge and the reasons therefor two months after the transaction." 52/ In its discussion of this transaction the court highlighted some of the conflicts in which Heizer became enmeshed — thereby illustrating why the Commission's

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51/ (footnote continued)

time of the transactions, it appears that the abusive transactions could not have been effected unless approved pursuant to an application for an exemptive Commission order, after a thorough review of all relevant facts and circumstances. See pp. 10-12 supra. However, in general we do not believe that the antifraud provisions of the Exchange Act, nor the limited remedies that might be available under the Securities Act, can be realistically viewed as adequate substitutes for the much more extensive protections available under the Investment Company Act. See generally Securities Act §§ 12(2), 17(a), 15 U.S.C. §§ 77l(2), 77q(a) (1976); Exchange Act § 10(b), 15 U.S.C. § 78j(b)(1976); rule 10b-5, supra. 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 Investment Company 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 Heizer litigation illustrates.

52/ 560 F.2d at 249.

impartial review of certain transactions 53/ between venture capital companies and their affiliates is so important:

> Heizer forgets that, in view of its conflict of interest, once it chose to deal with IDC, it had an obligation under state law to structure the transaction in a manner consistent with its duty to "protect and preserve the corporation. . . . maintain[ing] a high standard of loyalty to [it]." In light of this obligation, its attempt to divorce its role as a creditor from its role as a fiduciary, in a transaction that required its consent in both capacities, cannot succeed. Allowing such a sleight of hand would render a fiduciary's duty of fair dealing meaningless whenever the corporation he served was in financial straits, because he could defend his conduct, as Edgar Heizer did on the witness stand in this case, by arguing that in his role as a fiduciary he was powerless to resist the demands he himself had made in his role as a creditor. 54/
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> [Edgar] Heizer stated: "Well, it's very hard, as you know, to separate your hats, but the way I had to look at it from Heizer Corporation's standpoint first, it was totally justified that we have security.
>
> "Then, wearing my IDC hat as a director, I don't have very much choice. . . . I knew what Heizer Corporation would do if I didn't agree to give the security to Heizer Corp." 55/

53/ As noted earlier, see note 23 supra, the Act does not provide for review of all transactions between investment companies and affiliated persons, but only of those transactions which present opportunities for abuse because of the conflicting interests of the parties involved. Thus, rule 17a-6 under the Act was recently expanded to permit all investment companies — and not just SBICs and venture capital companies, as previously had been permitted — to effect transactions with companies whose securities they owned without filing applications requesting preapproval from the Commission if no other affiliated person was a party to or had a financial interest in the transaction. Investment Company Act Release No. 10828 (Aug. 13, 1979).

54/ 560 F.2d at 250-51 (footnote and citations omitted).

55/ Id. at 251 n.14 (citation omitted).

As the circuit court observed: "The District Court in the case at bar, while characterizing Heizer's conduct in the fourth and fifth transactions as 'rapacious,' made no other findings concerning defendant's mental state in failing to disclose. The record, however, indicates that defendant's omissions were at least reckless." 56/

The district court's relief 57/ with respect to the fourth transaction consisted of returning the parties to the status quo ante. The pledge obtained in the fifth transaction was voided. 58/ Heizer

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56/ Id. at 251. The court of appeals continued:

> Heizer's conduct in the fifth transaction also bespeaks a reckless disregard of its duty to disclose. Heizer must have been aware that the pledge was for its own benefit and thus would arouse a great deal of opposition on the part of IDC's common shareholders. Yet it consciously decided, through Heizer counsel, not to take the proposal to the shareholders. The effect of this decision was to insure that at least [one of the plaintiffs], who no longer had a representative on IDC's board of directors, would not learn of a transaction admittedly designed, in part at least, to discourage its suit until after its consummation. We think this is a case for the application of the reasoning of the district court, adopted by this court in [a prior case]:
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> > "'[B]linded by a conflict of interest, [defendant] wantonly ignore[d] evidence of the unfairness of [the] securities transaction to the corporation and therefore fail[ed] to disclose this evidence to those shareholders whose interests lie with the corporation.'"

Id. at 252, citing Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (7th Cir. 1972).

57/ In determining the fate of certain loans by Heizer to IDC in connection with the fourth and fifth transactions the court characterized the series of transactions as a "heads-I-win-tails-you-lose" proposition. Id. at 254.

58/ We note in this connection that under Investment Company Act section 47 agreements made in violation of the Act may be voided.

appealed as too vague that portion of the district court's decree permanently enjoining it "from entering, directly or indirectly, into any transaction with IDC except for such terms and conditions as shall be fair and equitable." 59/ The court of appeals amended the decree so as to enjoin Heizer from failing to disclose material facts concerning future transactions, and from entering into any transactions with IDC unless approval was obtained from a majority of shareholders other than Heizer, or the transaction "has been found to be fair and equitable" by a court having jurisdiction. 60/ Had Heizer been subject to the Act, the litigated transactions would have required a Commission finding that, among other things, the terms of the transactions "are reasonable and fair and do not involve overreaching on the part of any person concerned" 61/ — virtually the same standard as imposed by the court

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59/ 560 F.2d at 255. Compare Investment Company Act § 17(b) (standards of Commission's review of proposed transactions between investment companies and their affiliates include whether "reasonable and fair and do not involve overreaching").

60/ 560 F.2d at 255-56.

61/ Investment Company Act § 17(b). At the time of the litigated transactions, exemptive rule 17a-6 permitted certain venture capital companies (and SBICs) to enter into transactions with their portfolio companies which would otherwise require the filing of an application, but only if certain persons, such as officers and employees, had no financial interest in the transaction. It is our understanding, however, that at the time of the Heizer transactions certain employees, pursuant to management incentive compensation agreements, had financial interests such that an application would have been required. Rule 17a-6 has recently been expanded to permit any investment company to enter into transactions with portfolio affiliates without filing an application, providing certain conditions are satisfied. Investment Co. Act Release No. 18828 (Aug. 13, 1979).

after lengthy litigation. 62/

We believe the foregoing demonstrates that the investor protections of the Act are significant and material, and should not be dismissed lightly as unnecessary, unduly complex, or burdensome. It is in large part because of these significant protections that the Commission has opposed, and Congress has been persuaded not to enact, provisions in numerous bills previously introduced in the Congress that would have exempted from the Act small business investment companies licensed by the Small Business Administration ("SBA"), notwithstanding their dual regulation by the SBA. 63/ For the same reasons, we do not believe that small, unsophisticated investors should be denied the Act's protection in

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62/ The fourth transaction between Heizer and IDC took place in 1971. In 1972, a complaint, subsequently amended twice, was filed. A year later, while the case was pending, the fifth transaction was effected. Although in 1978, seven years after the fourth transaction, the United States Supreme Court finally denied certiorari in the case, thus putting an end to the central controversy described in the text, related litigation continued afterwards, and quite possibly will linger on for some time. See Heizer Corp. v. Ross, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,926 (7th Cir., July 10, 1979) (litigating right of contribution for damages resulting from primary case).

63/ See, e.g., Report of Comm. on Banking and Currency on S. 3651, Small Business Investment Act of 1958, S. Rep. No. 1652, 85th Cong., 2d Sess. 13 (1958):

> The committee is convinced that it would not be wise to exempt [small business investment] companies outright from the securities laws. . . . [S. 3651] provides that, with one exception [dealing with capital structure], the Investment Company Act of 1940 shall apply to small-business investment companies just as it does at present to other investment companies. The committee was impressed by the testimony offered by the Chairman of the SEC that, in order to give adequate protection to investors, the Investment Company Act of 1940 should be applicable to small business investment companies.

this instance, 64/ where investors would not even have the limited benefits 65/ of SBA regulation.

64/ It has been suggested that the Act adopts a paternalistic approach based upon the theory that the companies for which the act was designed — mutual funds and closed-end investment companies — consist of large pools of cash and highly liquid assets and their shareholders should therefore have special protections, but that venture capital companies are distinguishable because of their supposedly illiquid investments. However, the majority of abuses that Congress sought to prevent by enacting the Investment Company Act were not necessarily related to the liquidity of investment companies' security holdings. See generally section 1(b) of the Act. Similarly, it has been suggested that inappropriate regulatory provisions of the Act are applicable to venture capital companies because the definition of 'investment company in the act is so broad that it includes venture capital companies even though these companies do not operate like mutual funds or traditional closed-end investment companies in many respects. However, we believe that inclusion of venture capital companies within the Act's provisions was not the result of any oversight or unintended overinclusiveness of the definition of "investment company." Rather, it reflected a carefully considered — and, we believe, patently correct — decision by the Congress, following an exhaustive study of investment companies, that not only were the Act's protections viewed as particularly important to small, unsophisticated investors who might purchase interests in relatively risky "venture capital" companies, but also that regulation under the Act would in fact prove beneficial to those companies, enhancing public confidence in them. See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate on Banking and Currency, 76th Cong., 3d Sess. 286, 287, 562-63 (1940) ("Senate Hearings"). To the extent that the provisions of the Act might be inappropriate as applied to certain venture capital companies or other companies, Congress contemplated that the difficulties would be dealt with by use of the Commission's exemptive authority under section 6(c) of the Act. That authority would be the basis for the anticipated rulemaking described earlier.

65/ It is our understanding that the primary concern of the SBA is with the stimulation of small businesses through additional financing, and that the protection of investors is, at best, a secondary concern.

That a legislative action is not only inappropriate but also generally unnecessary is borne out by the staff's recent experience with Heizer Corporation. That company, which describes itself as a venture capital company, and has over $200 million in assets, 66/ recently has been exploring with the Commission's staff the possibility of registering under the Act and filing an application for exemptive relief from certain of its provisions. 67/ As a result of those discussions, we believe that Heizer is considering requesting partial exemptions from limited provisions of the Act, with appropriate conditions. Those provisions concern: (i) section 18, dealing with the issuance of senior securities (of which Heizer has several different classes; Heizer also plans to recapitalize in some as yet undecided manner); (ii) section 23(b), which generally prohibits closed-end investment companies from selling their common stock at a price below the current net asset value unless: pursuant to an offering to a class of its stockholders; with the consent of a majority of its common stockholders;

66/ Heizer Corporation's assets currently are composed primarily of exchange-listed securities of relatively mature issuers. Heizer's considerable size is somewhat at odds with the contention that the Act has prevented venture capital firms from growing to a size where they can provide capital to struggling young enterprises.

67/ Heizer has previously made public the existence of, and many details concerning, the discussions with the Commission's staff described in the text. It should be noted that Heizer's descriptions of those matters do not necessarily accurately reflect the staff's views of what transpired, nor has this matter yet officially been brought before the Commission for its consideration.

or pursuant to a Commission rule or order; and (iii) sections 17(a) and 17(d), from which only very limited specific exemptions were regarded by the company as necessary, beyond the exemptive relief afforded by rules already adopted pursuant to sections 17(a) and 17(d), to deal with potential problems involving transactions with non-controlling "upstream" affiliates.

Congress of the United States
House of Representatives
Committee on Interstate and Foreign Commerce
Room 2125, Rayburn House Office Building
Washington, D.C. 20515

REC'D CP&F SUB.
NOV 29 1979

November 27, 1979

Commissioner Phil'p A. Loomis
Securities and Exchange Commission
500 N. Capitol Street
Washington, D.C. 20549

Dear Commissioner Loomis:

It was a pleasure to hear you testify on the Small Business Investment Incentive Act (H.R. 3991) during the hearings held November 7, 1979. Your helpful comments and constructive criticism are always welcome. As you know, the hearing record has been left open until a later date for the purpose of follow-up questions on certain issues raised at the hearings. Included herewith are several questions for the purpose of clarifying some of the issues that have been raised. Would you kindly reply at your earliest convenience.

Sincerely,

Jim Broyhill

James T. Broyhill
Member of Congress

Enclosure

cc: Congressman James Scheuer
Chairman Harold Williams
Franz Opper

1. In the _Federal Register_ promulgation on Rule 242, you indicate that the authority for the rule is contained in Section 3(b) of the 1933 Act. Is this the sole basis on which you could promulgate Rule 242 or is there other authority in statutes administered by the SEC that could also be used to promulgate Rule 242?

2. What is your comment on the proposal to lift restrictions on the resale of restricted securities provided the SEC is given rulemaking authority for investor protection purposes?

3. During the November 7 hearings of our Subcommittee, you stated that you felt "...venture capital companies should have different treatment under the Investment Company Act...". Does the SEC currently agree with your views and, if so, in what respects?

4. In the same session, Mr. Mendelsohn stated that he felt that the average SEC response time for affiliated transaction approval requests had been greatly decreased recently. Please advise as to exactly what the approval time has been for such requests over the past year.

5. During our hearing, there was concern that the definition of a venture capital company in H.R. 3991 had some deficiencies, and language along the lines of two Senate bills, S. 1533 and S. 1940, was recommended. Please inform us as to your position on the definitions in those bills and whether those definitions, coupled with the additional venture capital company restrictions in the bills, would still leave areas open for potential abuse.

OFFICE OF
THE COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

REC'D CP&F SUB.
JAN 23 1980

JAN 23 1980

JAN 21 1980

The Honorable James T. Broyhill
Committee on Interstate and Foreign
Commerce
Washington, D. C. 20515

Dear Congressman Broyhill:

Please find enclosed my responses to the questions raised in your letter of November 27, 1979 concerning certain issues related to H.R. 3991. Also enclosed are copies of several relevant Commission releases. Please let me know if you have any questions or if you would like me to provide you or the Committee with any additional information.

Sincerely yours,

Philip A. Loomis

Philip A. Loomis, Jr.
Commissioner

Enclosures

(1) Most of the testimony taken at the Commission's hearings on Small Business in 1978 concerned the problems encountered by small businesses in using the present exemptive rules under the Securitis Act of 1933 (the "Act") to raise needed capital. In particular, Rule 146, the "safe-harbor" rule promulgated under Section 4(2) of the 1933 Act was often cited as causing substantial problems for smaller issuers, because of the provisions of the Rule which require an issuer to make a determination as to the financial sophistication and wealth of the offerees and purchasers; e.g. do all of the purchasers have such knowledge and experience in financial and business matters that they are capable of evaluating the risks of the investment ("sophistication") and are they able to bear the economic risk of the investment ("wealth"). That rule defines certain transactions as not involving a public offering within the meaning of Section 4(2) of the Act.

In an attempt to cure the problems raised at the hearings, the Commission decided to proceed under Section 3(b) for two primary reasons. First, the Commission's lack of broad exemptive powers under the Act coupled with judicial interpretations of Section 4(2) of that Act make it unclear as to whether or not the Commission can dispense with the "sophistication" or "wealth" tests embodied in Rule 146, even though the issue has never been litigated. However, the legal authority to eliminate such requirements is clear under Section 3(b) since if the Commission finds in effect that registration of a class of securities is not necessary in the public interest and for the protection of investors, it may exempt such securities from registration solely by reason of the size of the offering. Accordingly, Rule 242 promulgated under Section 3(b), which has just recently been adopted by the Commission, permits the unregistered sale of securities to an unlimited number of institutional investors with no mandated information requirements (relying on the ability of such persons to ask for and receive material information from the issuer), and to a limited number of individuals (thirty-five) without requiring the issuer to make the subjective determination of sophistication, but with an information requirement similar to that found in Form S-18.

Second, the Commission, cognizant of its statutory responsibility to protect investors and thereby insure the integrity of the investment market, felt that any Rule designed to provide small businesses more flexibility in raising capital without complying with the registration provisions of the 1933 Act, should be in the nature of an experiment which is carefully monitored for possible abuse. Consequently, the Commission decided to proceed under Section 3(b), with the limited amounts prescribed therein, as comporting better with the notion of an experimental rule.

I have enclosed a copy of Rule 242, as adopted by the Commission, for your information.

(2) The Commission has on several occasions amended Rule 144, the rule which sets forth guidelines for the resale of certain securities, in an attempt to alleviate some of the problems of secondary sales of small business securities. Specifically, Securities Act Release No. 5979 (September 19, 1978)(43 FR 43709) amends Rule 144 to (1) relax the limitations on the amount of securities that can be sold under the Rule; (2) permit sales under the Rule directly to market makers; and (3) eliminate the brokerage or market maker transaction requirement with respect to sales of securities by estates and beneficiaries thereof who are not affiliates of the issuer of the securities. Securities Act Release No. 6032 (March 5, 1979)(44 FR 15610) further amended Rule 144 to permit non-affiliates under certain circumstances to disregard the volume limitation provisions of rule 144 after a period of (1) three years, if the securities to be sold are those of a class which is either listed on an exchange or quoted on NASDAQ, or (2) four years, if the securities to be sold are those of an issuer which files periodic reports under Section 13 or 15(d) of the Securities Exchange Act of 1934.

The Commission has indicated that it will consider extending the no volume limitation concept to non-reporting companies. In addition, the Office of Small Business Policy is considering recommending to the Commission further amendments to Rule 144 in light of the recent adoption of Rule 242. Therefore, the Commission believes that it has sufficient rulemaking authority to alleviate the problems of secondary sales that H.R. 3991 is designed to provide.

3. You have asked whether the Commission concurs with my views regarding whether venture capital companies should have different treatment under the Investment Company Act. I believe the Commission has already demonstrated that under certain circumstances venture capital companies should receive specific exemptive relief from the registration or regulatory provisions of the Investment Company Act. Indeed, as part of the Division of Investment Management's investment company reexamination of the pattern of regulation, it recently recommended and the Commision published for comment four rules (or amendments to rules) affecting the status of certain issuers under the Investment Company Act. For your convenience, I am enclosing copies of Investment Company Act Release Nos. 10937 (Nov. 13, 1979), 10943 (Nov. 16, 1979), 10944 (Nov. 16, 1979), 10938 (Nov. 13, 1979) proposing Rules 3a-1, 3a-2, and 3a-3, and amendments to Rule 3c-2.

Section 3(c)(1) of the Act excludes from the definition of investment company an issuer whose outstanding securities (other than short-term paper) are beneficially owned by no more than 100 people and which is not making and does not propose to make a public offering of its securities. This section is intended to exclude from regulation under the Investment Company Act those private holding companies and private investment companies which are not within the Act's purview. See Hearings on H.R. 1065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess., at 102 (1940) (testimony of David Schenker, Chief Counsel of the Commission's Investment Trust Study). For purposes of Section 3(c)(1), beneficial ownership by a company is considered to be beneficial ownership by one person; except that, if a company holds 10% or more of the outstanding voting securities of the issuer, beneficial ownership will be attributed to the holders of the owning company's outstanding securities (other than short-term paper). Nonetheless, the Commission has adopted Rule 3c-2 under the Act to deem ownership by a company of 10% or more of the voting securities of certain small business investment companies to be, under specific circumstances, ownership by one person. Most venture capital companies and small business investment companies rely on Section 3(c)(1), as augmented by Rule 3c-2, for exclusion from the registration requirements of the Investment Company Act. The proposed amendments to Rule 3c-2 would extend the exemptive relief from the attribution provisions in Section 3(c)(1) currently available only to SBIC's also to venture capital and other private investment companies.

The Commission also recently amended Rule 17a-6. Previously, 17a-6 exempted transactions between SBICs and their portfolio affiliates from the traditional application process discussed more extensively in the response to question 4. The amendment to Rule 17a-6 broadened extensively the exemptive relief from the prohibitions of Section 17(a) for all registered investment companies, including registered licensed small business investment companies. Rule 17a-6 would now permit any registered investment company to enter into transactions with controlled or non-controlled portfolio affiliates without submitting an application for Commission prior approval, so long as no person serving as an employee, officer or director of the investment company also participated in the transaction. In our view, the most significant passages in the legislative history of Sections 17(a) and (d) involve the interaction of the investment company and its upstream affiliates. See Investment Company Act Release No. 10698 (May 16, 1979) at 6-7 n.4. Moreover, economic logic suggests that the greatest opportunities for abuse and overreaching lie in transactions between an investment company and its upstream affiliates. Under Rule 17a-6, the full investor protections of the Act would still prevail with respect to those transactions. However, and even though Section 17(a) of the Act expressly covers and prohibits all transactions with downstream affiliates, the Commission determined to adopt the amendments to Rule 17a-6 because it believes the protections of the Act should not be applied to the shareholders of an industrial company merely because, by happenstance, its securities were owned by a registered investment company; and because it believed there was little likelihood that an affiliate of an investment company could overreach it or a portfolio affiliate of the investment company which neither the investment company nor the affiliate could control.

These two examples, I believe, indicate that the Commission will respond affirmatively to persuasive arguments for exemptive relief from the registration or regulatory provisions of the Investment Company Act, and already has done so in the instance of venture capital and small business investment companies.

4. You have asked what the approval time has been for applications filed by investment companies involving transactions between or with registered investment companies and affiliated persons thereof. Our records indicate that, during this past calendar year applications filed under Sections 17(b) or Rule 17d-1 under the Investment Company Act of 1940 have been noticed for public comment, on average, 53 days after they have been received, and the orders exempting such transactions have been issued, on average, 26 days after the application was published for public comment. As you know, all applications for exemptive relief under the Investment Company Act must be noticed for public comment by any interested person before the Commission can issue the exemptive order. See Investment Company Act Section 40(a), 15 U.S.C. §80a-39(a). Because we must give a reasonable time for comment by interested persons, a notice period of several weeks is usually unavoidable. And additional time is often required after an initial filing for amendments needed to reflect staff concerns.

Most applications filed under Sections 17(b) or Rule 17d-1 do not raise new or unique questions which the full Commission must discuss and decide. Rather, for those applications which do not raise new or unique legal or policy questions the Commission has delegated administrative authority to issue orders granting exemptive relief to the Director of the Division of Investment Management. About eighteen months ago, the Division of Investment Management organized an Investment Company Act Study Group, responsible to an Associate Director and the Director of the Division, to consider the regulatory scheme applicable to investment companies. One of its two tasks was to identify those areas of the Division's work on applications which are routine and repetitive, and could be treated satisfactorily by rulemaking. Those rules would "codify" the existing patterns of exemptive relief routinely granted by the Division through orders issued pursuant to delegated authority; after the rules were adopted, any investment company which satisfied the conditions in the rules could initiate and complete transactions without having to seek and obtain prior approval from the Commission or its staff.

To discover which types of applications were routine and repetitive, the Investment Company Act Study Group assigned an attorney and a financial analyst to analyzing, categorizing and evaluating all of the applications filed with the Commission from 1973 through August 1978. That time frame was selected somewhat arbitrarily to: (a) reflect current investment trends (emphasis on no-load income-oriented funds); capture a good-sized slice of administrative experience (five years);

and utilize efficiently our own scarce manpower resources (a five-to-sixth month project). Briefly, that review revealed that a large proportion of Investment Company Act applications involved: financial and commercial transactions with affiliated persons subject to Section 17.

Since Fall of 1978, the Commission has published for comment or adopted a substantial number of rules which effect this part of the Division's Investment Company Act Study Group's mission. Attached for your convenience is a schedule prepared by the Division which lists all the rules developed by its Study Group. As you will note, the rules have addressed the principal areas of concern to applicants, including six rules under Section 17. The amendments to Rule 17a-6 are especially important because they permit any investment company to engage in transactions with any of its portfolio companies — transactions which, in the past, could not have been effected without the Commission's prior approval in the form of an exemptive order. As a consequence, most routine Section 17 transactions will not in the future be subject to any Commission pre-clearance or "processing" time. It should be clearly emphasized, however, that those Section 17 transactions which fall outside these new exemptive rules or amendments would still be subject to Commission pre-clearance. And it should be expected that those residual Section 17 transactions probably have the greatest potential for the types of abuses which Congress expected the Commission to evalute closely before granting its approval. It follows, then, that the average "processing" time for those residual Section 17 transactions may well increase (and appropriately so) beyond the averages experienced during this past year that were reported above.

5. You have asked whether the definitions of "venture capital company" in S.1533 and S.1940, with the additional restrictions in those bills, are improvements on the definition in H.R. 3991, and whether those definitions, coupled with the additional restrictions in those bills, would still leave areas open for potential abuse.

While the Commission has been asked to comment on S.1533 and S.1940, it has not yet responded to that request; it is not possible, therefore, for me to provide you with the Commission's analysis of the questions you ask. Moreover, I believe it would be inappropriate for me, as an individual Commissioner, to comment personally on bills pending in the Senate before the Commission has reached its definitive conclusions with respect to those bills. Nonetheless, my own preliminary review of S.1533 and S.1940 suggests that the definitions of venture capital company in those bills do share many of the defects which were pointed out in my testimony for the Commission on H.R. 3991. Also, my own preliminary review of S.1533 and S.1940 suggests that the additional restrictions in those bills would not be sufficient to address all the regulatory problems and potential abuses which the Commission has experienced with small business investment companies, which tend to operate in a manner similar to venture capital companies.

When the Commission does comment on those bills, I will have copies of the comments sent promptly to you.

Mr. BROYHILL. At this time I would like to ask Mr. Arthur D. Little, president-elect of the National Association of Small Business Investment Companies, if he would come forward.

I would like to ask Mr. Russell L. Carson to appear with him jointly and we will ask Mr. Little to give his testimony, then Mr. Carson, and then we will ask questions of both.

Gentlemen, we have taken more time than we anticipated this morning. If you do want to summarize your statements, they will appear in the record, and at this time I will recognize Mr. Little for whatever comments he would like to give.

STATEMENTS OF ARTHUR D. LITTLE, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COS., ACCOMPANIED BY JAMES L. WATTS, ASSOCIATE DIRECTOR; AND RUSSELL L. CARSON, ON BEHALF OF NATIONAL VENTURE CAPITAL ASSOCIATION, ACCOMPANIED BY DANIEL T. KINGSLEY, EXECUTIVE DIRECTOR, NVCA

Mr. LITTLE. Thank you, Mr. Chairman.

Mr. BROYHILL. If you would, both of you introduce your associates.

Mr. LITTLE. I will get to that, sir.

Just a couple of comments on the SEC testimony.

First of all, as to the question Mr. McMahon asked, we last year suggested to the SEC when they were in the process of releasing rule 144 that people who are affiliates in our sense, such as a venture capital investor who might, for instance, start off owning 40 percent of a company in which we had invested, have the opportunity after a 5-year period to sell a higher limit of the stock than what the SEC had proposed.

The problem as we see it is, under their proposals, as long as we remain an affiliate it could take us 12, 15 years to sell our interest in the company through rule 144; and once we get down to below a certain level of share holdings, if the management of the company we're investing in does not want to sell or go public, then we are simply in a position where the only thing that we have left to do, if they don't feel like they want to buy us out, is just dribble the stock out.

We find that to be quite a difficult thing to live with. We have made a suggestion to the SEC on that matter.

In regard to the negotiations between the SBIC industry and the SEC, I think again I would like to point out that those discussions really were headed by Mr. Heizer and Ray Garrett and his group and, of course, Mr. Heizer and the Heizer Corp. are in the SBIC business, and they were really representing our industry in those discussions.

I am Arthur D. Little, president and chief executive officer of Narragansett Capital Corp., which is the largest of the publicly held small business investment companies. I am also president-elect of the National Association of Small Business Investment Cos., which is the trade association for our industry, and I will within a few days become president of the organization for the upcoming year.

With me today from our association staff is James Watts, associate director.

I am pleased to be before this subcommittee and to give my comments regarding H.R. 3991, the Small Business Investment Incentive Act, which has the cosponsorship of the overwhelming majority of subcommittee members.

Although I would like to comment in detail about all of the sections of this bill, I will, for the sake of time, comment only briefly about some sections of the bill and concentrate on section 6, which relates to the Investment Company Act of 1940.

My detailed feelings and those of our trade association are outlined in the written comments which have been entered into the record [see p. 134].

Before getting into the legislation before us, however, I would like to comment briefly on the place of smaller businesses in the American economy as well as explaining a little bit about how the SBIC program operates.

SBIC's are privately formed, privately capitalized, and privately managed venture capital firms. In return for agreeing to invest only in small businesses and to abide by the regulations of the Small Business Administration, SBIC's are permitted to borrow Treasury funds up to a maximum leverage rate of 4 to 1.

Since SBIC private capital is subordinated to the Government leverage, the private investor loses 100 percent before the Government loses a nickel. There is no pro rata sharing as in certain other types of Government sponsored programs.

Also, the leverage funds which are provided through the Federal Financing Bank carry a rate equal to the cost of money to the Treasury plus one-eighth of 1 percent. Over the history of the SBIC program, the direct loss to the Government from the SBIC program has been miniscule when compared to the dollars of funding provided.

When assessing losses and gains, however, it is the superficial analysis which looks only at direct impact. Our association has always known that the real benefit of SBIC investments comes from the growth and vigor we help produce in the companies in which we invest. Until this year, however, a comprehensive study of that growth had never been conducted.

Various studies over the years have shown how small companies can grow faster and generate greater economic activity than mature corporations. In my written testimony I have cited studies on this subject done by the Massachusetts Institute of Technology, the SBA, and the American Electronics Association.

All these studies are fine, but none comprehensively analyzes what is happening within the SBIC's portfolios. Recognizing the need for such a comprehensive analysis, the executive committee of our association last year authorized such a study.

The accounting firm of Deloitte, Haskins & Sells generously volunteered to compile and keypunch data and to provide computer programing services. We then conducted a nationwide search for a known and respected economic analyst to oversee the study and interpret the results. Our final choice for that task was the firm of Arthur D. Little, Inc.

Let me assure the subcommittee, however, that the similarity in names is nothing more than coincidence. Arthur D. Little, Inc.

clearly did provide us with the best proposal of any of the firms or individuals we contacted.

Although the results of our comprehensive survey are still being compiled, I am in the position to release for the first time today some preliminary results. The full preliminary memorandum of results from Arthur D. Little, Inc., is attached as an addendum to this testimony [see p. 151].

You should refer to the table on page 4 of my written testimony, this growth table showing SBIC financed companies far outstripping all small business in most categories.

Rather than going through that table, I would just let you examine that at your leisure.

Before getting into the specifics of H.R. 3991, I would like to compliment the Securities and Exchange Commission on its efforts over the last year in the area of small business financing.

During the last year the Commission liberalized rule 144 and raised the regulation A offering ceiling to $1.5 million following Congress action to raise the statutory ceiling of section 3(b) of the Securities Act of 1933, under which regulation A is promulgated.

Since the hearings of last year the Commission has made other efforts to ease the burdens of the securities laws on small companies. Primary among these innovations have been the adoption of form S-18 for offerings of less than $5 million, and the new proposed rule 242, which would incorporate some of the changes embodied in H.R. 3991.

Also, the Commission has established the Office of Small Business Policy. We are very pleased that the Commission has made changes in the rules and regulations which affect smaller companies and we are tremendously gladdened by the fact that the SEC has indicated a continuing interest in our problems.

We feel, however, that while the Commission has taken positive steps in the proper direction, a couple of great leaps forward are still necessary. Also, we are keenly aware that problems exist in other areas which affect small business capital formation. Certainly the tax laws are key, as evidenced by the reduction in the capital gains tax of last year and the resulting increase in venture capital financing.

We do not feel, however, that because there may be many venture capitalists wishing to make public offerings that such phenomenon will automatically create a demand for the securities of their companies. We do strongly feel, however, that when the market factors are correct, the securities laws should not present insurmountable obstacles, or even aggravating impediments.

At times the latter do exist; occasionally, the former. This is strongly evidenced by the fact that, even though tax laws and securities regulations have been improved, the recently concluded White House Conference on Small Business field hearings nonetheless listed capital formation overwhelmingly as the top priority—and tax and securities provisions were listed as major impediments in the capital formation area.

Now getting specifically to the bill. Accredited investor sales—sections 2 and 3 of H.R. 3991 would establish a new category of investors known as accredited investors and affect purchases they make. Such investors would not be bound by the private offering restrictions under section 4(2) of the Securities Act of 1933, or rule 146. The logic is that such investors are able to fend for themselves and do not need the protections of the private placement rules which currently exist.

Our association feels that there is great logic in this concept in that excessive or duplicative protections merely waste time and money. Accredited investors know what information they want from a company when they are planning to purchase the company's securities. Such investors will conduct their own due diligence so as to uncover problems which may exit. An expensive private placement memorandum is in those cases completely unnecessary.

The Commission has recently proposed a new rule 242, which would adopt the accredited investor concept put forth in H.R. 3991. Our association compliments the Commission for taking this initiative and supports, in concept, proposed rule 242. The rule, however, is deficient in at least two respects.

First, the $2 million ceiling would limit the usefulness of the rule very severely. Indeed, many of the larger deals which are currently syndicated between and among accredited investors—that is, precisely those investments rule 242 should be directed toward—would not be able to make use of the rule.

For example, the overnight package delivery service, Federal Express—which has been phenomenally successful since it went public in April of last year—required three rounds of venture capital financing totaling close to $30 million before the company was viable enough to go public. We believe the Federal Expresses of the future should be able to avail themselves of the more simple procedures which the accredited investor concept would introduce.

Although the Commission has criticized H.R. 3991 for being too broad in its accredited investor application, in that it would allow quite large offerings to be made, we feel that common sense economics and not an artificial gap should dictate a ceiling. Some offerings need more than $2 million, and in cases such as Federal Express more than $10 million or $20 million. At some point, however, common sense dictates a public offering since it is always better to have freely tradable public market securities. Our association feels that a market will be a much more efficient allocator than will a $2 million, or any other size, ceiling.

The second deficiency in the proposed rule is that it does not allow resales to be freely made to other accredited investors but rather locks securities into the unattractive provisions of rule 144. Again we go back to this problem of letting people invest and put the money into small business but restricting them from getting it out. Our association feels that this is completely unnecessary since if accredited investors are able to fend for themselves, they should be allowed to trade limited-sale securities freely between and among themselves.

Indeed, we hope that an active secondary market may be established among accredited investors so as to provide a degree of liquidity above that which restricted securities currently have. Such a market would reduce the pressures on small companies to make premature public offerings to provide their original investors with some liquidity, and would more easily allow investors to diversify and balance their portfolios.

We understand that statutory changes may be necessary to cure the deficiencies which we find in proposed rule 242 and we urge the subcommittee to make such changes.

Finally, the Commission has criticized H.R. 3991 for allowing persons not otherwise qualifying as accredited investors to be treated as such if they rely upon the advice of an otherwise qualified accredited investor. We have no strong position on that provision and would accept its deletion if the subcommittee feels that such action is in the best interest of investor protection.

Resale of restricted securities—section 4 of H.R. 3991 would eliminate resale limitations on restricted securities if the holder of such securities had been the beneficial owner for a period of not less than 5 years prior to the date of sale or distribution. Our association strongly supports that provision and feels that it would be extremely helpful to our industry.

The changes in rule 144, which doubled, and in some cases more than doubled, the amount of securities which may be sold under rule 144, have been extremely helpful to our industry and we again compliment the Commission for taking that action. Resale restrictions were also later removed completely after a 3- or 4-year holding period, depending upon how the securities are traded, for nonaffiliates of an issuer. The problem our industry still faces, however, is in the resale restrictions currently imposed on affiliates.

Venture capitalists invest for the long term and they clearly have "investor" intent. They seek to maximize their return, so they would certainly not dump securities on the market and drive the price down. Therefore, lifting resale restrictions after a 5-year holding period for venture capital companies would not harm other public shareholders.

There is some concern that affiliates, relying on their insider information may indeed sell out their positions upon knowledge of problems the investee company could be about to encounter but of which the public does not yet have knowledge. There are other provisions of the securities laws, however, to protect against such actions and our association feels that it is unwise and economically hurtful to impose restrictions upon all affiliated investors for an indefinite period of time in order to provide an extra layer of protection against some unscrupulous individual who may at some time in the fututre perpetrate an unlawful act.

Since the SEC feels that the bill would unnecessarily remove all safeguards on restricted stock and therefore is too broad, we might suggest limiting the provision in some way to only venture capital companies. One suggestion might be along the lines of S. 1940 introduced October 25 by Senator Gaylord Nelson and four members of the Senate Banking Committee. S. 1940 lifts resale restrictions after a 5-year holding period for venture capital companies as defined in the bill. We feel that such a compromise, if necessary, would logically solve the problem that venture capital investors have long been suffering under rule 144.

Liability in private offerings. Section 5 of H.R. 3991 would limit the availability of a rescission action in private offerings to only plaintiffs who had been denied protections under current law affecting private placements unless there were evidence of fraud on behalf of the person or persons offering the securities.

Our association feels that forcing an entire offering to fail if the offeror of securities fails the test as to only one purchaser is a dangerously high standard to impose. While we agree that the current law does have a prophylactic effect, we feel that the consequences are unjustly harsh.

The Commission has said, however, that it currently is working on amendments to rule 146 which would include a "substantial compliance" or "good faith attempt" provision. Our association, realizing that this is a complex and controversial area of the law, is willing to wait for the Commission's action in hope that the problem can thus be ultimately solved to the satisfaction of all parties.

I would like to deal now with section 6 of H.R. 3991. As a general comment, the 1940 act is a monster. First, and perhaps most importantly, it is unintelligible. It isn't that it is just complicated. It is unintelligible. Even people who have spent their entire careers dealing in securities legislation are unable to say clearly what certain sections of that act say. By that I am specifically referring to people such as Ray Garrett, a former SEC Commissioner.

Second, from a venture capital company point of view, the 1940 act simply does not fit. It was intended to regulate mutual funds, which operate in a way extraordinarily different from venture capital companies.

Section 6 of the bill would exempt venture capital companies from the definition of investment company under section 3(c)(3) of the Investment Company Act of 1940. I cannot overstate the importance of relieving venture capital companies from this burden.

This month's issue of Venture magazine in "Wall Street Takes An Interest in SBIC's" states:

> The U.S. securities laws, some investors complain, seem bent on helping the rich get richer. Enacted in the name of investor protection, they prevent most all but the wealthiet and most sophisticated investors from enjoying the risks—and thus making the killings—in purchasing private offerings of startups and other unseasoned companies.

The article goes on to explain that about the only way small fry can participate in new ventures is through ownership of shares of one or more of the few publicly traded SBIC's left in existence.

Mr. BROYHILL. Could I interrupt to ask a question? Are you arguing here or let's say encouraging unsophisticated investors to make speculative investments?

Mr. LITTLE. My next sentence was going to address that point. We happen to agree with the SEC that the small investor should be protected, but the effect of the 1940 act is to keep venture capital companies, particularly those who have available to them well seasoned and professional management, from going public. There is no way for the small investor, or there is very little way for the small investor to invest in the kinds of well-run professionally managed venture capital companies, because there just aren't very many around, and there is a good reason there aren't very many around, and that is the 1940 act.

We do not feel that the small investor should directly make the kinds of investments that we make, because they are risky. They are something that takes a good deal of time.

A venture capital company as opposed to a mutual fund is not a passive investor in most cases. It takes work to work for these portfolio companies, and we don't feel that the small, unsophisticated investor should have the burden of the kind of risk that investing in some of these companies directly would suggest.

What I am suggesting is that if you take off some of the burdens of the 1940 act, or get rid of the 1940 act altogether as far as venture capital companies are concerned, that there would be more vehicles for people, for the small fry, if you will, to share in some of the gains that can be made from this kind of investing.

Last year this subcommittee heard considerable evidence of the problems that venture capital firms face under the 1940 act. I could recite a variety of war stories on this subject, but that really might take all day. Suffice it to say—and this answers a question, Mr. Broyhill, that you brought up earlier dealing with advance approvals for affiliated transactions—that we have had a matter pending under section 17 of the 1940 act.

This is an application under section 17, for exemption by the Commission. That application was put in in August of 1978. We recently completed a section 17 application that was filed—let me make sure I get my dates right now—on March 28 of this year, and the SEC acted in what we thought to be a very prompt manner, given our history of dealing with them, and that matter came out of the Commission on June 29. That is a 3-month period.

I would have to seriously debate the SEC talking about 60 days. I mean if we can get a section 17 application in, and get it processed within 90 days, we regard ourselves and our lawyers and the SEC as having done an extraordinarily quick job.

Our association feels that at this point most rational persons agree that the problems are severe and something should be done about them. The problem is that there is disagreement as to what is the solution. In hearings last year, you and Congressman Eckhardt expressed concern about the problem, and since then the industry representatives have worked with the SEC in an attempt to devise a solution to the problem. Our association feels we have made no headway. As my testimony will show, the industry has exhausted its administrative remedies.

We realize that the SEC opposes any industry exemption, and we firmly believe that their position is unreasonable. A large part of the problem is that the SEC simply does not understand the venture capital industry. An example of the complete lack of understanding of the problem on behalf of the Commission is the definition of business development company—the SEC's term for venture capital company—which was used in the proposed rule under the Investment Advisers Act which was recently proposed by the Commission and was overwhelmingly opposed in comments to the Commission from outside sources.

One of the comments that was made by the gentleman from the SEC was that on this particular issue of the Investment Advisers Act, they got a very virulent reaction against this particular suggestion, and that they did not get any suggestions, positive suggestions, and that that frustrated them. Well, I would suggest that they also mention to you, sir, that you would be frustrated if you got that same kind of reaction, too. I would suggest on another piece of legislation if you got that kind of reaction, you just drop the piece of legislation.

The reason they got such a bad reaction on that, and the reason they didn't get any positive comments, was that from our industry's point of view, and I think many other people's point of view, it was just such a bad job that the best thing to do was just get that out of the way, and then start over fresh.

We urge Congress at this time to take the independent initiative to once and for all decide the question of Investment Company Act regulation of venture capital companies. Unfortunately, due to the repeated assurances of the Commission, the issue has not adequately been addressed by the Congress. This has been true throughout the history of the small business investment company program. In their comments on H.R. 3991, the SEC refers to the Banking Committee report on the 1958 SBIC legislation, indicating the committee was convinced that it would not be wise to exempt small business investment companies outright from the securities laws.

However, that comment referred to the Securities Act of 1933, and the Trust Indenture Act of 1939, not the 1940 act. That committee report added that the Investment Company Act of 1940 should apply to SBIC's with one exception, obviously needed due to the capital structure of leveraged small business investment companies. The question of total exemption was not sufficiently addressed, however, since the Banking Committee was assured that any problems which may arise, especially in areas where the jurisdiction of the SBA and the SEC overlap, could be taken care of by the Commission using its exemptive powers under section 6(c) of the Investment Company Act.

Now let's keep score here. That is one.

Later, when SBIC's made public offerings and ran into terrible problems under the Investment Company Act, SEC Chairman William Cary again assured the Congress that the issue would be taken care of by the SEC. Again the Commission failed to do so. That is two.

Following that, in March of 1968, after several years during which the SEC failed to take any action on the problem, our association began its 3-year, 2-month journey through formal administrative proceedings, a journey which was explained with documentation during this subcommittee's hearings on September 27 and 28 of last year. Under that hearing we won a favorable decision from the hearing examiner, only to have it reversed 3 to 2 by vote of the Commission. That is three.

We look to the testimony tomorrow of Mr. Heizer of the Heizer Corp. as another indication that the Commission is once again failing to address the problem squarely. That is four.

All indications our association has received point to the fact that we will receive little if anything at all for our efforts. The Heizer Corp. will report that it has spent enormous sums of money directly or indirectly on the Investment Company Act of 1940. And that is just to be certain not to fall under that act, and not to comply with it, since the Heizer Corp. is still privately held. A problem our industry faces, however, is that SBIC's and most other venture capital companies are, due to the economics of the industry, relatively small.

Their investments are made in small companies, and the number of portfolio companies tends to be small, because portfolio companies need individualized attention, and that type of attention is not easily delegated. Therefore it is only in the case of a rare company as large as the Heizer Corp. that the large amount of money has been spent can be spent.

In addition, the trade groups have similar limitations since the amounts spent by the Heizer Corp. already exceeds the entire annual budgets of the National Venture Capital Association and our association.

To add insult to injury, the SEC in its comments indicates that 1940 act regulation indeed may be beneficial to venture capital firms due to the fact that public confidence is enhanced by such regulation. First of all, we reject outright any representation that the Investment Company Act of 1940 is needed to insure public confidence in public venture capital firms.

Our association does want to maintain adequate investor protection, and obtain relief from the Investment Company Act. Our suggested compromise is to exempt venture capital companies while retaining certain protections which the 1940 act provides. Specifically, we would suggest for an exempted venture capital company:

One, registration and reporting under the Securities Exchange Act of 1934, regardless of whether or not otherwise required.

Two, a majority of disinterested directors on the board of the venture capital company.

Three, no ownership of portfolio company securities by officers, directors and controlling persons of the venture capital company.

Four, treating securities held by the venture capital companies as if they were purchased privately, even if those securities had been purchased in the public markets.

The National Association of SBIC's and others appearing before you today feel that the time for Congress to act on our Investment Company Act problem is long overdue. We have repeatedly come to Congress for legislative relief and been shunted back to the SEC for administrative relief which has been promised but never forthcoming, on at least those four occasions that I mentioned.

Two things should be clear to this subcommittee from my testimony: One, that impediments should be removed from companies that finance smaller businesses, because these small businesses are so important to our economy. Two, that more people should be allowed the opportunity to invest in professionally managed public venture capital companies. These things will not take place unless this subcommittee addresses the issue legislatively and provides the adequate relief that the venture capital industry so richly needs and deserves.

Our final request deals with two minor provisions relating to an Investment Company Act exemption. First, regulation E, the SBIC counterpart to the regulation A offering, is currently still at the $500,000 level. We ask that the subcommittee encourage the raising of the regulation E offering ceiling to the $2 million maximum currently allowed under the Securities Act of 1933.

The answer that the SEC gave when we talked about that particular area was that never had regulation E been used much anyway. If you have to face the 1940 act, it is really no great surprise to me that people didn't use regulation E. I think certainly if we can dismiss some of the problems under the 1940 act or get rid of it altogether, that increase in the regulation E limit should go through.

Second, we request that in conjunction with the Investment Company Act of 1940 exemption, a provision be included to insure that a company which needs to stay registered under the Investment Company Act of 1940 for tax reasons be allowed to do so. It is the intention of our association to seek a minor amendment to section 851 of the Internal Revenue Code which will allow venture capital companies exempt from the Invesment Company Act of 1940 but otherwise meeting the diversification requirements of subchapter M of the tax code, to retain their subchapter M tax treatment.

In summary, the National Association of Small Business Investment Companies maintains that H.R. 3991 would provide a giant step in the direction of venture capital formation. Our association knows that the additional freeing-up of private purchase and resale provisions under the Securities Act of 1933 combined with the major decision to exempt venture capital firms from the Investment Company Act of 1940 would allow many more dollars to be channeled into small growth-oriented-type companies. That is certainly a worthwhile objective.

While we strongly support liberalization under the 1933 act and the 1940 act, we do not want to do away with investor protection. Indeed, such action would be against our interests in the long run. We feel, however, that there is certainly a balancing test between investor protection and venture capital formation. The priorities are currently way out of balance. Our association stands willing and eager to work with this subcommittee toward a solution to these security problems which plague venture capital.

Mr. Chairman, I thank you for the opportunity to appear here today. I would be happy to respond to any questions that you may have.

[Testimony resumes on p. 177.]

[Mr. Little's prepared statement and attachment follows:]

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
618 WASHINGTON BUILDING • TELEPHONE (202) 638-3411
WASHINGTON, D. C. 20005

STATEMENT OF

ARTHUR D. LITTLE, PRESIDENT-ELECT

Before the

CONSUMER PROTECTION AND FINANCE SUBCOMMITTEE

U.S. HOUSE OF REPRESENTATIVES

November 7, 1979

Good morning Mr. Chairman and Committee Members. I am Arthur D. Little, President and Chief Executive Officer of Narragansett Capital Corporation, the largest of the public small business investment companies. I am also President-elect of the National Association of Small Business Investment Companies, the trade association for the SBIC industry, and I will within a few days become President of the organization for the upcoming year. Our Association represents the overwhelming majority of small business investment companies both in terms of assets and number. With me today from our Association staff is James L. Watts, Associate Director.

I am pleased to be before this Subcommittee and to give my comments regarding H.R. 3991, the Small Business Investment Incentive Act, which has the cosponsorship of the overwhelming majority of Subcommittee members. Before getting into the details of the legislation before us, however, I would like to comment briefly on the Small Business Investment Company Program and explain how it operates.

SBICs are privately formed, privately capitalized and privately managed venture capital firms. In return for agreeing to invest only in small businesses and to abide by the regulations of the Small Business Administration, SBICs are permitted to borrow Treasury funds up to a maximum leverage rate of 4-to-1. All private capital is at risk so that the discipline of the private sector is strictly imposed. That means that since private capital is subordinated to the government leverage, the private investor loses 100% before the government loses a nickel. There is no pro rata sharing as in certain other types of government sponsored programs. Also, the leverage funds which are provided through the Federal Financing Bank, carry a rate equal to the cost of money to the Treasury plus one-eigth of one percent. Over the history of the SBIC program, the direct loss to the government from the SBIC Program has been miniscule when compared to the dollars of funding provided.

When assessing losses and gains, however, it is the superficial analysis which looks only at direct impact. Our Association has always known that the real benefit of SBIC investment comes from the growth and vigor we help produce in the companies in which we invest. Until this year, however, a comprehensive study of that growth had never been conducted.

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

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

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

A more recent study which was conducted by the American Electronics Association showed that among AEA members, which included young, intermediate and mature corporations, the employment growth rate for companies between five and ten years old was 55 times the rate in mature companies. It also found that for every $100 of equity capital invested in young companies founded between 1971 and 1975, those companies generated, spent or paid in 1976 alone:

- $70 in exports,
- $33 on research and development,
- $15 in federal corporate income taxes,
- $15 of personal income tax revenues, and
- $ 5 in state and local taxes.

All these studies are fine, but none comprehensively analyzes what is happening within the SBIC's portfolios. Recognizing the need for such a comprehensive analysis, the Executive Committee of our

Association last year authorized such a study. The accounting firm of Deloitte, Haskins and Sells generously volunteered to compile and key punch data and to provide computer programming services. We then conducted a nation-wide search for a known and respected economic analyst to oversee the study and interpret the results. Our final choice for that task was the firm of Arthur D. Little, Inc. Let me assure the Subcommittee, however, that the similarity in names is nothing more than coincidence. Arthur D. Little, Inc. clearly did provide us with the best proposal of any of the firms or individuals we contacted.

Although the results of our comprehensive survey are still being compiled, I am in the position to release for the first time today some preliminary results. The full preliminary memorandum of results from Arthur D. Little, Inc. is attached as an adendum to this testimony. For purposes of illustration at this time, however, I am including the following growth table showing SBIC financed companies for outstripping all small business in most categories:

A COMPARISON OF THE GROWTH OF SBIC PORTFOLIO COMPANIES
WITH THE GROWTH OF ALL SMALL COMPANIES*

Year of Initial Financing:	PRE-1972		1972-1975		1976-1977	
	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES**	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES**	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES**
Employment	296%	29%	99%	24%	48%	8%
Sales	596	76	207	43	81	16
Profits	899	144	565	61	52	53
Assets	462	48	137	30	92	13
Federal Corporate Taxes	549	111	319	67	35	71

(Footnotes on following page)

*For SBIC's, growth rates are measured from the year prior to SBIC financing to the most recent fiscal year. For small companies in general, the comparison is from 1970, 1972 and 1976, to 1978.

**For financial measures, manufacturing corporations with less than $5 million in assets. For employment, all corporations with less than 100 employees.

Source: Federal Trade Commission, Quarterly Report of Manufacturing Corporations and U.S. Bureau of the Census, County Business Patterns.

SECURITIES LAWS GENERALLY

Before getting into the specifics of H.R. 3991, I would like to compliment the Securities and Exchange Commission on its efforts over the last year in the area of small business financing. Shortly before the hearings held during September of last year by this Subcommittee, the Commission liberalized Rule 144 and raised the Regulation A offering ceiling to $1.5 million following Congress' action to raise the statutory ceiling of Section 3(b) of the Securities Act of 1933 under which Regulation A is promulgated. Since the hearings of last year the Commission has made other efforts to ease the burdens of the securities laws on small companies. Primary among these initiatives have been the adoption of form S-18 for offerings of less than $5 million, and the new proposed Rule 242 which would incorporate some of the changes embodied in H.R. 3991. Also the Commission has established the Office of Small Business Policy, a decision which was announced for the first time by SEC Chairman Harold Williams in his address before the White House Conference on Small Business Regional Conference in New York City on April 5th of this year. We are very pleased that the Commission has made changes in the rules and regulations which affect smaller companies and we are tremendously gladdened by the fact that the SEC has indicated a continuing interest in our problems.

We feel, however, that while the Commission has taken positive steps in the proper direction, a couple great leaps forward are still necessary. Also, we are keenly aware that problems exist in other areas which affect small business capital formation. Certainly the tax laws are key, as evidenced by the reduction in the capital gains tax of last year and the resulting increase in venture capital financing. We also realize that in addition to incentives we need investor interest. The classical economist J. B. Say hypothesized that "supply creates its own demand". We do not feel, however, that because there may be many venture capitalists wishing to make public offerings that such phenomenon will automatically create a demand for the securities of their companies. We do strongly feel, however, that when the market factors are correct, the securities laws should not present insurmountable obstacles, or even aggravating impediments. At times, the latter do exist; occasionally, the former. This is strongly evidenced by the fact that, even though tax laws and securities regulations have been improved, the recently concluded White House Conference on Small Business field hearings nonetheless listed capital formation overwhelmingly as the top priority. Tax and securities provisions were listed as major impediments in the capital formation area.

ACCREDITED INVESTOR SALES

Sections 2 and 3 of H.R. 3991 would establish a new category of investors known as "accredited" investors and affect purchases they make. Such investors would not be bound by the private offering restrictions under Section 4(2) of the Securities Act of 1933, or Rule 146. The logic is that such investors are able to "fend for themselves" and do not need the protections of the private placement rules which currently exist.

Our Association feels that there is great logic in this concept in that excessive or duplicative protections merely waste time and money. Accredited investors know what information they want from a company when they are planning to purchase the company's securities. Such investors will conduct their own "due diligence" so as to uncover problems which may exist. An expensive private placement memorandum is in those cases completely unnecessary.

The Commission has recently proposed a new Rule 242 which would adopt the accredited investor concept put forth in H.R. 3991. Our Association compliments the Commission for taking this initiative and supports, in concept, proposed Rule 242. The Rule, however, is deficient in two respects.

First, the $2 million ceiling would limit the usefulness of the Rule very severely. Indeed, many of the larger deals which are currently syndicated between and among accredited investors -- i.e. precisely those investments Rule 242 should be directed towards -- would not be able to make use of the Rule. For example, the overnight package delivery service, Federal Express, which has been phenomenally successful since it went public in April of last year, required three rounds of venture capital financing totaling close to $30 million before the company was viable enough to go public. We believe the Federal Expresses of the future should be able to avail themselves of the more simple procedures which the accredited investor concept would introduce.

Although the Commission has criticized H.R. 3991 for being too broad in its accredited investor application in that it would allow quite large offerings to be made, we feel that common sense economics and not an artifical cap should dictate a ceiling. Some offerings need more than $2 million, and in cases such as Federal Express more than $10 or $20 million. At some point, however, common sense dictates a public offering since it is always better to have freely tradeable public market securities. Our Association feels that a market will be a much more efficient allocator than will a $2 million, or any other size, ceiling.

The second deficiency in the proposed Rule is that is does not allow resales to be freely made to other accredited investors but rather locks securities into the unattractive and illiquid position currently thrust upon restricted securities. Our Association feels that this is completely unnecessary since if accredited investors are able to fend for themselves, they should be allowed to trade "limited sale securities" freely between and among themselves. Indeed, we hope that an active secondary market may be established among accredited investors so as to provide a degree of liquidity above that which restricted securities currently have. Such a market would reduce the pressures on small companies to make premature public offerings to provide their original investors with some liquidity, and would more easily allow investors to diversify and balance their portfolios.

We understand that statutory changes may be necessary to cure the deficiencies which we find in proposed Rule 242 and we urge the Subcommittee to make such changes.

Finally, the Commission has criticized H.R. 3991 for allowing persons not otherwise qualifying as accredited investors to be treated as such if they rely upon the advice of an otherwise qualified accredited investor. We have no strong position on that provision and would accept its deletion if the Subcommittee feels that such action is in the best interest of investor protection.

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RESALE OF RESTRICTED SECURITIES

Section 4 of H.R. 3991 would eliminate resale limitations on restricted securities if the holder of such securities had been the beneficial owner for a period of not less than five years prior to the date of sale or distribution. Our Association strongly supports that provision and feels that it would be extremely helpful to our industry.

The changes in Rule 144 which doubled, and in some cases more than doubled, the amount of securities which may be sold under Rule 144 have been extremely helpful to our industry and we again compliment the Commission for taking that action. Resale restrictions were also later removed completely after a three or four-year holding period, depending upon how the securities are traded, for non-affiliates of an issuer. The problem our industry still faces, however, is in the resale restrictions currently imposed on affiliates.

Venture capitalists invest for the long-term and they clearly have "investor" intent. They seek to maximize their return, so they would certainly not dump securities on the market and drive the price down. Therefore, lifting resale restrictions after a five-year holding period for venture capital companies would not harm other public shareholders.

There is some concern that affiliates, relying on their insider information may indeed sell out their positions upon knowledge of problems the investee company could be about to encounter but of which the public does not yet have knowledge. There are other provisions of the securities laws, however, to protect against such actions and our Association feels that it is unwise and economically hurtful to impose restrictions upon all affiliated investors for an indefinite period of time in order to provide an extra layer of protection against some unscrupulous individual who may at some time in the future perpetrate an unlawful act.

Since the SEC feels that the bill would unnecessarily remove all safeguards on restricted stock and therefore is too broad, we might suggest limiting the provision in some way to only venture capital companies. One suggestion might be along the lines of S. 1940 introduced October 25th by Senator Gaylord Nelson and four members of the Senate Banking Committee. S. 1940 lists resale restrictions after a five-year holding period for venture capital companies as defined in the bill. We feel that such a compromise, if necessary, would logically solve the problem that venture capital investors have long been suffering under Rule 144.

LIABILITY AND PRIVATE OFFERINGS

Section 5 of H.R. 3991 would limit the availability of a rescision action in private offerings to only plaintiffs who had been denied protections under current law affecting private placements unless there were evidence of fraud on behalf of the person or persons offering the securities.

Our Association feels that forcing an entire offering to fail if the offeror of securities fails the test as to only one offeree is a dangerously high standard to impose. While we agree that the current law does have a prophylactic effect, we feel that the consequences are unjustly harsh.

The Commission has said, however, that it currently is working on amendments to Rule 146 which would include a "substantial compliance" or "good faith attempt" provision. Our Association, realizing that this is a complex and controversial area of the law, is willing to wait for the Commission's action in hope that the problem can thus be ultimately solved to the satisfaction of all parties.

INVESTMENT COMPANY ACT EXEMPTION

Section 6 of H.R. 3991 would exempt venture capital companies from the definition of Investment Company under Section 3(c)(3) of the Investment Company Act of 1940. I cannot overstate the importance of that section of the bill.

This month's issue of Venture magazine in "Wall Street Takes An Interest in SBICs" states:

> "The U.S. securities laws, some investors complain, seem bent on helping the rich get richer. Enacted in the name of investor protection, they prevent most all but the wealthiest and most sophisticated investors from enjoying the risks -- and thus making the killings -- in purchasing private offerings of start-ups and other unseasoned companies."

The article goes on to explain that about the only way "small fry" can participate in new ventures is through ownership of shares of one or more of the few publicly traded SBICs left in existence.

The problems venture capital firms suffer under the Investment Company Act of 1940 are well documented.[1] Our Association feels that at this point most rational persons agree that the problems are severe and something should be done about them. Where the disagreement lies, however, is in the solution.

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[1]We refer primarily to the hearings of the Consumer Protection and Finance Subcommittee on September 27 and 28 of last year and documentation produced pursuant to those hearings.

Many Small Business Investment Companies have struggled with the Investment Company Act of 1940 including my company, Narragansett Capital Corporation, which was formed publicly in 1960. In hearings of last year, Congressmen Broyhill and Eckhardt expressed concern about the problem and since then industry representatives have worked with the SEC in an attempt to devise a solution to the Investment Company Act problem. Our Association feels that we have made no headway. The industry has exhausted its administrative remedies.

We realize the SEC opposes any industry exemption, and we firmly believe that their position is unreasonable. An example of the complete lack of understanding of the problem on behalf of the Commission is the definition of business development company (the SEC's term for venture capital company) which was used in the proposed Rule under the Investment Advisors Act which was recently proposed by the Commission and was overwhelmingly opposed in comments to the Commission from outside sources. The comments to the Commission from the National Venture Capital Association and from our Association as well as other parties proved that the Commission does not have a realistic vision of how to even <u>define</u> a venture capital company, much less understand how they work.

We urge Congress at this time to take the independent initiative to once and for all decide the question of Investment Company Act regulation of venture capital companies. Unfortunately, due to the assurances of the Commission, the issue has not been adequately addressed by Congress in the history of the Small Business Investment Company program.

The Comments of the SEC on H.R. 3991 indicate that the Congress has squarely addressed the issue. On page 17 of its comments, the SEC indicates that the Senate Banking Committee when writing the original SBIC legislation concluded that it would not be wise to exempt SBICs "outright from the securities laws".[2] If one reads the Banking Committee report in context, however, it is clear that the Committee was referring directly to the Securities Act of 1933 and the Trust Indenture Act of 1939 when it stated that it would be unwise to "exempt such investment companies outright from the securities laws".[3]

The Committee Report adds that the Investment Company Act of 1940 should apply to SBICs with one exception which was obviously needed due to the capital structure of leveraged Small Business Investment Companies. The question of total exemption was not sufficiently addressed, however, since the Banking Committee was assured that any problems which may arise, especially in areas where the jurisdiction of the SBA and the SEC overlap, could be taken care of by the Commission using its exemptive powers under Section 6(c) of the Investment Company Act.[4]

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[2]"Memorandum of the Securities and Exchange Commission to the House Committee on Interstate and Foreign Commerce on H.R. 3991," Page 17, footnote 23, August 20, 1979.

[3]Report of the Committee on Banking and Currency on the Small Business Investment Act, S. 3651, Senate Report No. 1652, 85th Congress, 2d Sess. 13 (1958).

[4]"Statement of Edward N. Gadsby, Chairman, Securities and Exchange Commission", Hearings Before A Subcommittee of the Committee on Banking and Currency, United States Senate, on S. 3651 (and related bills), 85th Congress, 2d Sess. 239, April 28, 1958.

Later, when SBICs made public offerings and ran into terrible problems under the Investment Company Act, SEC Chairman William Cary again assured the Congress that the issue would be taken care of by the SEC.[5] Again the Commission failed to do so.

In March of 1968, after several years during which the SEC failed to take action on the problem, our Association began its three year, two month journey through a formal administrative proceeding which was explained, with documentation, during this Subcommittee's hearings on September 27 and 28 of last year. We won favorable decision from the Hearing Examiner only to have it reversed by a 3-to-2 vote of the Commission.

We look to the testimony today of Mr. Heizer of the Heizer Corporation as evidence that the Commission is once again failing to address the problem squarely. All indications our Association has received point to the fact that we will receive little if anything at all for our efforts. The Heizer Corporation will report that it has spent enormous sums of money directly or indirectly on the Investment Company Act of 1940. And that is just to be certain to avoid falling under that Act, and not to comply with it, since the Heizer Corporation is still privately held!

Others connot do what Heizer has, however, since SBICs and most other venture capital companies are, due to the economics of the industry, relatively small. Investments are made in small companies and the number of portfolio companies also tends to be small since

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[5]Report of the Committee on Banking and Currency on the Small Business Investment Act Amendments of 1961, Senate Report 22 No. 801, 87th Congress, 1st Sess. 3 (1961).

those portfolio companies need individualized attention and that type of attention is not easily delegated to staff. Therefore, it is only in the case of a rare company as large as Heizer Corporation that the large amount of money which has been spent, can be spent. In addition, tne trade groups have similar limitations since the amount spent by the Heizer Corporation already exceeds the entire annual budgets of the National Venture Capital Association and our Association combined.

To add insult to injury, the SEC in its comments indicates that 1940 Act regulation indeed may be beneficial to venture capital firms due to the fact that public confidence is enhanced by such regulation. First of all, we reject outright any representation that the Investment Company Act of 1940 is needed to insure public confidence in public venture capital firms. But even if it were, is regulating an industry out of existence insuring confidence?

Our Association wants to maintain adequate investor protection <u>and</u> obtain relief from the Investment Company Act. Our suggested compromise, if this Subcommittee feels a compromise is needed, is to exempt venture capital firms while retaining certain protections which the 1940 Act supposedly provides. Specifically, we would suggest for an exempted venture capital company:

> (1) registration and reporting under the Securities Exchange Act of 1934 regardless of whether or not otherwise required,
>
> (2) a majority of disinterested directors on the board of the venture capital company,
>
> (3) no ownership of portfolio company securities by officers, directors and controlling persons of the venture capital company, and
>
> (4) treating all securities held by the venture capital company, regardless of how acquired, as if purchased privately.

The National Association of SBICs and others appearing before you today feel that the time for Congress to act on our Investment Company Act problem is long overdue. The Commission has not provided and will not provide adequate relief and our case is more than "ripe" for Congressional review and action. We ask in the strongest way we know that the Subcommittee please address the issue legislatively and provide the adequate relief that the venture capital industry so much needs and deserves.

REGULATION E; ALTERNATIVE REGISTRATION

Our final request of the Subcommittee deals with two minor provisions relating to an Investment Company Act exemption. First, Regulation E, the SBIC counterpart to the Regulation A offering, is currently still at the $500,000 level. We ask that the Subcommittee encourage the raising of the Regulation E offering ceiling to the $2 million maximum currently allowed under Section 3(b) of the Securities Act of 1933.

Second, we request that in conjunction with the Investment Company Act of 1940 exemption, a provision be included to insure that a company which needs to stay registered under the Investment Company Act of 1940 for tax reasons be allowed to do so. It is the intention of our Association to seek a minor amendment to Section 851 of the Internal Revenue Code which will allow venture capital companies exempt from the Investment Company Act of 1940 but otherwise meeting the diversification requirements of Subchapter M of the tax code, to retain their Subchapter M tax treatment. Such action will ultimately cure the registration problem. In the interim, however, those companies have need to remain registered.

CONCLUSION

In summary, the National Association of Small Business Investment Companies maintains that H.R. 3991 would provide a giant step in the direction of venture capital formation. Our Association knows that the additional "freeing-up" of private purchase and resale provisions under the Securities Act of 1933 combined with the major decision to exempt venture capital firms from the Investment Company Act of 1940 would allow many more dollars to be channeled into small growth-oriented type companies. That is certainly a worthwhile objective.

While we strongly support liberalization under the 1933 Act and the 1940 Act, we do not want to do away with investor protection. Indeed, such action would be against our interests in the long run. We feel, however, that there is certainly a balancing test between investor protection and venture capital formation. The priorities are currently out of balance. We urge the Subcommittee to correct that situation.

Finally, we realize that changing the securities laws will not solve all the problems which plague venture capital. That all the solutions do not lie in the realm of the securities law, however, is not justification for an abdication of our responsibility. There are problems which need to be addressed and must be addressed. Our Association stands willing and eager to work with this Subcommittee toward a solution to those securities problems which plague venture capital.

Mr. Chairman, Subcommittee members, I thank you for the opportunity to appear before you today and I will be happy to respond to any questions you may have at this time.

MEMORANDUM **DRAFT**

To: A.G. Gols | Case. | Date Oct. 24, 1979 | Page: 1

cc: Robert Allsop (NASBIC)
James Watts (NASBIC)

Subject. Preliminary Results of SBIC Portfolio Company Survey

This memorandum summarizes some preliminary conclusions drawn from NASBIC's SBIC portfolio company survey. It will be the basis of Bob Allsop's presentation of preliminary study results to the NASBIC convention in Phoenix on November 10th. At our meeting with Bob Allsop and Jim Watts in Cambridge on October 29th, we will discuss the memorandum and how it can be incorporated into a presentation.

This memorandum should be considered preliminary in that it represents our initial impressions from the data rather than a detailed analysis. The late receipt of the data output from General Electric Time-Sharing (not all the data has been received at the time this memo was written) precluded our analyzing the data in detail, and allowed us to comment only tentatively on the representativeness of the data in the survey. Our final memorandum to NASBIC will analyze the survey data in greater detail and will comment in more detail on the representativeness and reliability of the data.

There are five sections to this memorandum. The first section briefly summarizes the scope and objectives of the study. The second section summarizes the major study conclusions. Section III describes the approach used to obtain the data for the analysis, and Section IV contains a more detailed discussion of the study's conclusions on economic impact. Section V presents data on the number of companies receiving SBIC financing and the amout of financing they received.

From Edward Dlott Bldg./Room 35/177 Ext 3171

I. Scope and Objectives

The primary objective of the NASBIC data survey is to evaluate some major contributions of the SBIC's to the national economy. There has been a general lack of information on the accomplishments of the SBIC program. Providing information on the economic impact of SBIC's can fulfill two purposes:

(1) It can furnish information on the program which can be useful in providing congressional and administrative testimony in support of continued growth in the Government's program of financing SBIC's activities. In discussions of the SBIC program with Congressional and Executive staff, one of the recurring themes is the lack of information on how well the program works.

(2) It can provide the industry with knowledge of how well it is doing and possibly identify areas where legislative or executive action may be called for.

The data for the analysis was obtained from questionnaires sent to the SBIC's requesting data on certain financial/economic measures for their portfolio comapnies.

II. Conclusions

Out of about 6,000 portfolio companies receiving SBIC funding, approximately 600 returned information requested in the questionnaire. These companies have received approximately $280 million in SBIC funds since their first financing. The contributions these portfolio companies have made to the U.S. economy as measured by selected indicators for the time period from the year prior to each company's initial SBIC financing to its most recent fiscal year include the following:

Employment	-	35,000	Jobs
Payroll	-	$344	million
Sales	-	$2.0	billion
Pre-Tax Profits	-	$146	million
Assets	-	$1.3	billion
Federal Corporation Taxes	-	$47	million
State & Local Taxes	-	$12	million
R&D Expenditures	-	$39	million
Net Worth	-	$384	million

To illustrate the relative significance of the economic contributions of the SBIC portfolio companies, we have calculated the percentage change in certain key economic impact measures for portfolio companies and compared them to the change in the same measures for the general population of all small business companies. (See Table 1.) The comparison shows that for each of the five measures, the growth rate for SBIC-portfolio companies far exceeded the growth rate for all small companies. For example, SBIC portfolio companies that received their initial SBIC financing prior to 1972, had a growth in employment of 296%, as measured for the period from the year prior to the initial financing to the most recent fiscal year for which information was available, while employment for all small companies grew by only 29%. Similarly,

TABLE 1

A COMPARISON OF THE GROWTH
OF SBIC PORTFOLIO COMPANIES WITH
THE GROWTH OF ALL SMALL COMPANIES*

	PRE-1972		1972-1975		1976-1977		1978-1979	
	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES **	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES **	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES **	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES **
Employment	296%	29%	99%	24%	48%	8%	41%	NA
Sales	596	76	207	43	81	16	68	NA
Profits	899	144	565	61	52	53	63	NA
Assets	462	48	137	30	92	13	60	NA
Federal Corporate Taxes	549	111	319	67	35	71	101	NA

*For SBIC's growth rates are measured from the year prior to SBIC financing to the most recent fiscal year. For small companies in general, the comparison is from 1970, 1972 and 1976, to 1978.

**For financial measures, manufacturing corporations with less than $5 million in assets. For employment, all corporations with less than 100 employees.

Source: Federal Trade Commission, Quarterly Report of Manufacturing Corporations and U.S. Bureau of the Census, County Business Patterns.

SBIC portfolio companies that received their initial SBIC financing in 1976 or 1977 had a 92% increase in assets compared with a growth of only 13% for all small companies. Figure 1 contains a graphic representation of the employment comparison. Table 2 shows the increase for all the impact measures.

III. Approach

The study evaluates the economic impact of SBIC's by examining the economic performance of the companies in which SBIC's have a loan or equity interest -- i.e. the so-called portfolio companies. Economic performance is measured by the percentage change in the following financial/economic impact measures.

- Sales
- Gross Payroll
- Federal Corporation Income Taxes
- State and Local Taxes
- Research and Development Expenditures
- Pre-Tax Profits
- Total Assets
- Long-Term Debt
- Net Worth

These measures were selected as the basis for the analysis because:

- data for most of the measures were found to be more readily available from portfolio company financial statements than other data;
- the measures have generally accepted definitions, which help assure the comparability of the data across portfolio companies; and

TABLE 2

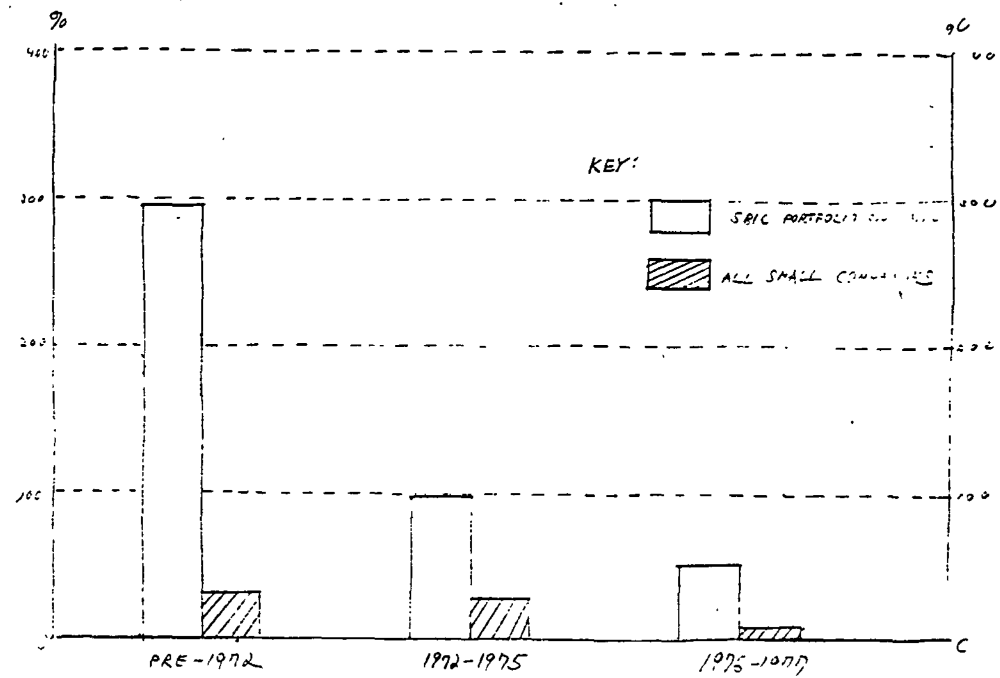
CHANGES IN ECONOMIC PERFORMANCE MEASURES FROM YEAR PRIOR TO INITIAL SBIC FINANCING TO THE MOST RECENT FISCAL YEAR FOR SBIC PORTFOLIO COMPANIES BY YEAR OF INITIAL SBIC FINANCING

(Dollar Amounts in Thousands)

	Pre-1972		1972-1975		1976-1977		1978-1979		Total	
	Increase	Percent Increase	Increase	Percent Increase	Increase	Percent Increase	Increase	Percent Increase	Increase	Percent Increase
Employment	16,164	296%	$ 11,186	99%	4,591	48%	2,991	41%	34,932	213%
Gross Payroll	$149,018	485	$104,768	144	$ 57,882	69	$ 32,854	61	$344,522	142
Sales	$865,278	596	$642,612	207	$327,845	81	$179,876	68	$2,015,611	179
Profits	$ 62,447	899	$ 68,340	565	$ 7,318	52	$ 8,277	63	$146,382	667
Assets	$543,850	462	$418,325	137	$217,197	92	$128,641	60	$1,308,013	410
Federal Corporate Taxes	$ 22,514	549	$ 12,717	319	$ 6,694	85	$ 4,994	101	$ 46,919	224
State & Local Taxes	$ 6,132	1,125	$ 4,670	316	$ 2,206	75	$ (576)	(34)	$ 12,432	187
Research & Development	$ 19,813	801	$ 10,697	100	$ 5,071	39	$ 3,122	63	$ 38,703	124
Net Worth	$195,063	729	$131,802	251	$ 38,929	88	$ 18,498	36	$384,292	986

FIGURE

EMPLOYMENT GROWTH FOR SBIC PORTFOLIO COMPANIES COMPARED WITH THE EMPLOYMENT GROWTH OF ALL SMALL COMPANIES



- The measures offer easily understandable and generally acceptable indicators of economic impact that can be conveniently presented to executive and legislative policy-makers in support of NASBIC efforts to illustrate the economic benefits of the SBIC program.

To provide better insight into the variety and significance of the changes in the financial/economic impact measures, the data for each measure are also organized along portfolio company groups of certain:

- asset sizes
- employment sizes
- industries
- regions
- types of SBIC financing
- ages of companies at time of financing

Thus, by using the above classifications of portfolio companies typical questions which the study can answer might be: How much employment growth occurred in portfolio companies in X region? In companies of a certain age or size? In companies in certain industries? Section IV which follows will illustrate how such questions can be answered from data in the survey.

A questionnaire requesting the data on financial/economic impact measures and categories of portfolio companies was designed by Arthur D. Little, Inc., in conjunction with NASBIC staff and officers (Attached). The questionnaire was pre-tested by the NASBIC Executive Committee to assure the availability of data, to identify difficulties in obtaining it, and to assure the clarity of the questions. Questionnaires were sent to all SBIC's with instructions to complete one for each portfolio company by using data in their files, or by obtaining the data from the portfolio companies. The completed questionnaire data were received and processed by Deloitte Haskins and Sells, according to the data aggregation and analysis format developed by Arthur D. Little, Inc.

During the initial study design, we had to decide whether to send the questionnaires directly to the portfolio companies or the SBIC's. Deloitte Haskins and Sells (DHS) compiled a mailing list of the 6,000 SBIC portfolio companies using data obtained from the Small Business Administration. However after discussion with NASBIC staff and officers, it was decided that a mailing directly to portfolio companies would produce a negligible response because most companies would have little incentive to devote the time and effort to complete the questionnaires. The SBIC's on the other hand had greater incentives to complete the questionnaires by using data they can obtain from the portfolio companies or have in their own files because of the Associations interest in the sponsorship of this study.

The fact that we received only a 10% response using the SBIC's to obtain the data reflects the fact that in many cases, considerable time and effort was required to complete the questionnaires, especially for SBIC's with many portfolio companies. The 10% return also indicates that the response rate from a direct portfolio company mailing would likely have been unsatisfactory. However, in our opinion, the 10% return rate provides a reasonable sample size to establish a fair degree of confidence in the representativeness of the aggregate data for each financial/economic impact measure. Nevertheless final conclusions about the representativeness of the data disaggregated by portfolio company grouping must await further analysis of specific statistical measures that were designed to help gauge the reliability of the data, but which have not yet been received.

Deloitte Haskins and Sells reviewed the questionnaires as received to identify erroneous data, and processed the individual questionnaires so as to eliminate duplication in instances of multiple SBIC funding where more than one SBIC completed a questionnaire for the same portfolio company.

IV. Detailed Conclusions

In the discussion of the study approach in Section IV, it was pointed out that the organization of the data along certain portfolio company groupings provides additional insight into the significance of the change in the economic/financial impact measures. Tables 3-5 organize the data on changes in employment for six groupings of portfolio companies. Using the asset size breakdown of portfolio companies as an example, Table 3 shows that 24 portfolio companies that received their initial SBIC financing in 1976 or 1977 had assets of more than $2.5 million. These 24 companies had an increase of 873 employees (14%) for the period between the year prior to their initial SBIC financing and the most recent fiscal year. The following major conclusions drawn from Tables 3-5 are:

TABLE 3

INCREASE IN EMPLOYMENT FROM YEAR BEFORE INITIAL SBIC FINANCING TO THE MOST RECENT FISCAL YEAR FOR PORTFOLIO COMPANIES BY CATEGORY

	Initial Financing Pre-1972			Initial Financing 1972-1975			Initial Financing 1976-1977			Initial Financing 1978-1979			Initial Financing Total		
	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies
Asset Size $															
0 Assets	3,587	---%	37	2,121	---%	34	2,524	---%	56	1,422	---%	43	9,654	---%	170
Less than 250,000	942	460	11	492	104	31	167	76	28	58	23	26	1,659	144	96
250,000-1 million	8,410	727	26	3,523	219	38	396	31	34	335	52	53	12,664	269	121
1 million-2.5 million	1,830	120	15	1,509	92	23	626	37	23	541	61	13	4,506	78	74
2.5 million +	1,395	58	12	3,542	47	37	873	14	24**	636	12	18	6,446	30	91
TOTAL*	16,164	296%	101	11,187	99%	163	4,586	48%	165	2,992	41%	123	34,929	104%	552
Employment Size															
0 Employees	3,530	---%	35	2,121	---%	34	2,527	---%	57	1,425	---%	44	9,605	---%	170
Less than 20 employees	717	739	13	2,140	531	41	300	76	45	256	33	36	3,413	283	135
20-49 employees	3,014	680	15	1,432	148	32	427	51	27	129	28	15	5,002	185	89
50-99 employees	2,403	220	18	1,690	105	23	-20	-3	10	410	44	12	4,483	103	63
100 or more employees	6,500	170	20	3,803	46	33	1,357	18	28	771	14	17	12,431	49	98
TOTAL*	16,164	296%	101	11,186	99%	163	4,591	48%	167	2,991	41%	124	34,932	104%	555

*Totals may vary slightly across portfolio company groupings because some of the questionnaires used in the analysis lacked data on employment and assets.

**Example referred to in the text.

TABLE 4

INCREASE IN EMPLOYMENT FROM YEAR BEFORE INITIAL SBIC FINANCING TO THE MOST RECENT FISCAL YEAR FOR PORTFOLIO COMPANIES BY CATEGORY

	Initial Financing Pre-1972			Initial Financing 1972-1975			Initial Financing 1976-1977			Initial Financing 1978-1979			Initial Financing Total		
	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Compa.
Industry															
Agriculture, Forestry Fishing	0	0%	0	0	0%	1	8	160%	2	0	0%	0	8	67%	3
Mining	0	0	0	902	205	4	5	6	1	28	8	3	935	110	8
Contruction	53	96	1	90	27	2	45	30	3	254	6,350	6	442	82	12
Transportation	638	293	55	258	51	79	184	73	68	1	0	47	1,081	73	249
Wholesale Trade	488	141	8	92	33	10	105	113	11	125	34	7	810	74	36
Retail Trade	3,762	1,306	5	1,146	177	9	521	155	8	255	109	4	5,684	378	26
Finance Insurance & Real Estate	211	103	6	689	741	28	38	14	44	2	9	35	940	161	113
Manufacturing	8,809	223	5	5,273	77	6	3,194	48	5	1,850	38	1	19,126	83	17
Services	1,886	536	19	2,893	170	21	491	58	25	230	27	18	5,500	147	83
Other	555	310	3	-108	-23	4	0	0	0	246	237	3	693	92	10
TOTAL*	16,402	297%	102	11,235	99%	164	4,591	48%	167	2,991	41%	124	35,219	102%	557
Type of Financing															
Debt	269	71%	9	906	59%	35	404	49	47	165	70%	29	1,744	58%	120
Debt with Equity	3,360	232	26	2,612	47	37	1,827	55	31	1,112	39	28	8,911	67	122
Equity	7,622	445	21	2,817	170	22	720	51	20	791	35	14	11,950	170	77
Debt and Debt with Equity	90	0	2	441	74	9	518	168	10	45	75	7	1,094	113	28
Debt and Equity	2,132	305	13	1,594	165	31	534	31	38	623	88	21	4,883	120	103
Equity and Debt with Equity	1,851	206	24	2,628	380	24	367	22	15	139	39	12	4,985	139	75
Debt, Equity and Debt with Equity	602	315	5	109	48	4	221	86	6	116	15	13	1,048	72	28
TOTAL*	15,926	297%	100	11,107	98%	162	4,591	48%	167	2,991	41%	124	34,615		553

*Totals may differ across portfolio company groupings because some of the questionnaires used in the analysis lacked data on industry, employment and type of financing.

TABLE 5

INCREASE IN EMPLOYMENT FROM YEAR BEFORE INITIAL SBIC FINANCING TO THE MOST RECENT FISCAL YEAR FOR PORTFOLIO COMPANIES BY CATEGORY

	Initial Financing Pre-1972			Initial Financing 1972-1975			Initial Financing 1976-1977			Initial Financing 1978-1979			Initial Financing TOTAL		
	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies	Employment Increase	Percent Increase	Number of Companies
Location															
Northeast	9,092	365%	44	3,739	146%	42	1,239	95%	46	540	20%	29	14,610	161%	155
Southeast	317	373	12	1,020	104	24	634	48	19	199	31	18	2,170	72	73
North Central	5,929	444	7	2,114	48	27	289	7	33	350	30	29	8,700	78	96
South Central	302	126	25	2,822	148	48	620	204	47	572	128	17	4,316	149	137
West	514	39	13	1,491	99	22	1,809	79	28	1,322	58	31	5,136	70	94
TOTAL	16,164	296%	101	11,186	99%	163	4,591	48%	167	2,991	41%	124	34,932	104%	555
Age at Time of Initial Financing															
0 - 2	8,906	1,296%	44	2,859	504	50	2,056	111	72	1,239	837%	52	14,060	462%	218
2 - 5	3,303	300	19	4,083	119	40	352	24	30	516	54	30	8,254	118	119
5 - 10	1,405	94	19	1,241	63	28	1,211	57	25	934	34	26	4,791	58	98
10+	2,550	117	19	3,003	56	45	972	24	40	302	9	16	6,827	46	120
TOTAL	16,164	296%	101	11,186	99%	163	4,591	48%	167	2,991	41%	124	34,932	104%	555

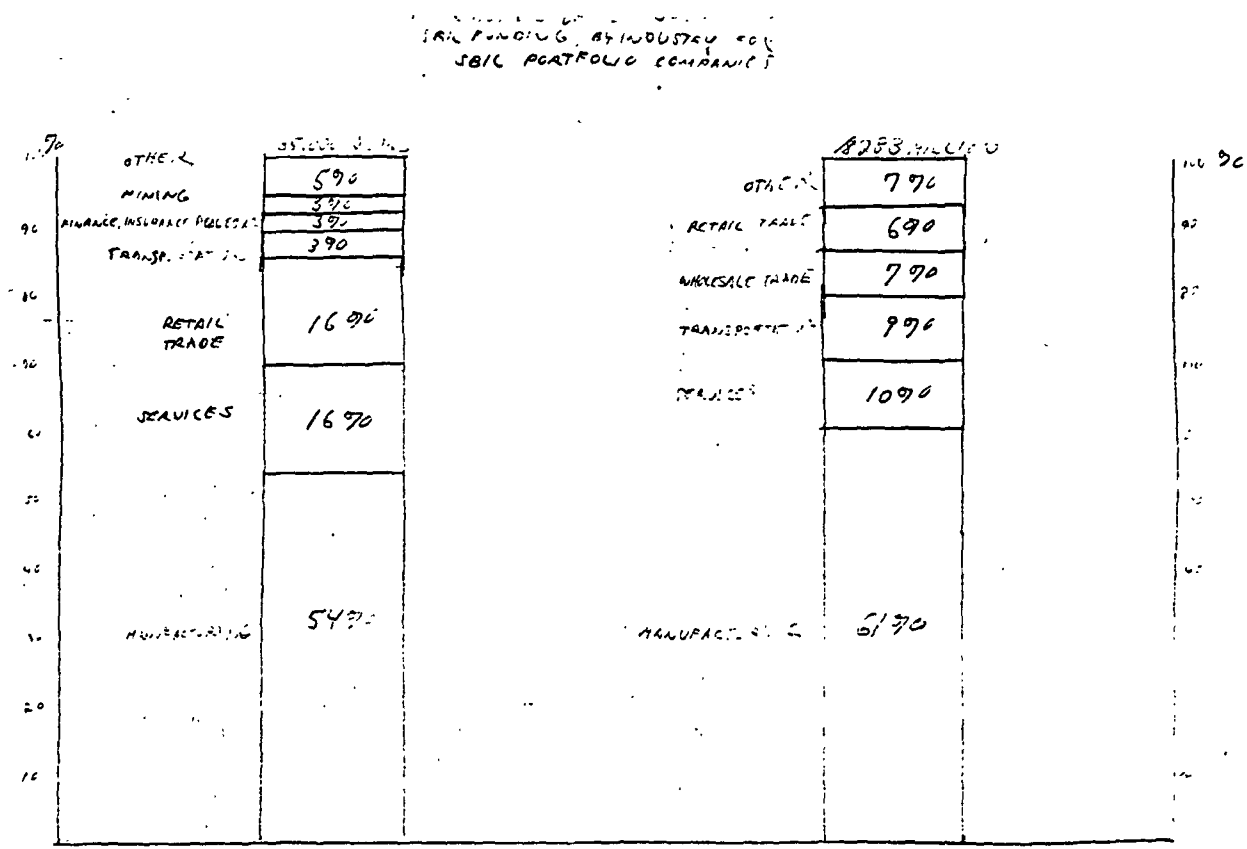
- As expected the largest percentage increase in employment occurred primarily in the portfolio companies that were less than two years old at the time of their initial SBIC financing, (Table 3 and Table 5.)

- Employment growth in absolute terms is fairly well distributed among small and large companies. For example, of the 35,000 new jobs created, 11,313 (nearly one-third) was provided by companies with assets below $250,000 and 10,955 by companies with assets more than $1 million. (Table 3.)

- 15,000 of the 35,000 new jobs created (43%) were found to be in companies that were less than two years old at the time of their initial SBIC financing. These companies had the highest growth rate in employment, averaging 462%. (Table 5.).

- 42% of the employment growth occurred in companies located in the Northeast. (Table 5.)

- More than half of the 35,000 new jobs were in manufacturing companies, with retail trade and services each accounting for 16% of the total (Table 4.). A comparison of industry categories in terms of employment growth and amount of SBIC financing received shows that manufacturing companies account for a smaller percentage of employment growth than of total SBIC financing, while for retail trade and services, the share of employment growth is greater than the share of total SBIC financing. (See Figure 2.) This result would be expected since retail sale and services tend to be labor intensive activities.


SBIC PORTFOLIO COMPANIES
OTHER
MINING
FINANCE, INSURANCE
RETAIL TRADE
SERVICES
5%
3%
3%
3%
16%
16%
54%
OTHER
RETAIL TRADE
WHOLESALE TRADE
7%
6%
7%
9%
10%
61%
%

- Most of the growth in employment in both percentage and absolute terms was in companies that had received their initial financing prior to 1972. The result was expected because the change in employment is measured from the year preceeding the initial SBIC financing to the most recent fiscal year. Thus because pre-1972 companies have the longest time period for measuring the change in employment, they have the largest growth.

In addition to the foregoing observations on the economic/financial impact measures, the following conclusions can also be drawn from the survey data.

Foreign Sales

- Foreign sales are not significant for the companies in the survey. Only 70 companies had foreign sales, and foreign sales accounted for only 5.8% of total sales (See Table 6).

- Of the 70 companies having foreign sales, 63 were engaged in manufacturing. The $166 million in foreign sales by manufacturing companies accounted for 90% of the total $184 million in foreign sales for all companies in the survey.
- Foreign sales are increasing at a greater rate than domestic sales.
- Companies in the Northeast account for much of the foreign sales -- 31 of the 70 companies and $112 million of the $184 million in foreign sales (61%).

TABLE 6

FOREIGN AND TOTAL SALES
OF SBIC PORTFOLIO COMPANIES
BY YEAR OF INITIAL SBIC FINANCING

(Dollar Amounts in Millions)

	Pre-1972		1972 - 1975		1976 - 1977		1978 - 1979	
	Companies	Amount of* Sales	Companies	Amount of* Sales	Companies	Amount of* Sales	Companies	Amount of* Sales
Foreign Sales	21	$ 83	24	$ 48	16	$ 22	9	$ 30
Total Sales	106	1,010	173	953	173	333	122	445
Percent Foreign of Total Sales	20%	8%	14%	5%	9%	3%	7%	7%

*Most recent fiscal year

Mergers and Acquisitions

- The questionnaire requested an estimate of the approximate percentage of employment growth that resulted from mergers and acquisitions. The data show that most of the employment growth in SBIC portfolio companies has been internally generated. Mergers and acquisitions account for less than 10% of the total employment growth for companies in the survey (see Table 7).

- Most of the gains from mergers and acquisitions occurred in the larger size companies.

Leverage Buyouts

Leverage buyouts received special attention in the analysis. A leverage buyout can be defined as a funding for which 50% or more of the dollars flow to a third party (e.g. for the purchase of assets or stock) rather than to the portfolio concern being financed. Since leverage buyout companies for the most part did not exist prior to the year of initial SBIC financing, the questionnaire requested data for the first fiscal year following the financing. The data led us to conclude that:

TABLE 7

EMPLOYMENT GROWTH DUE TO
MERGERS AND ACQUISITIONS

Year of Initial SBIC Financing	Employment Growth	% Change	% of Growth Due to Mergers and Acquisitions
Pre-1972	16,164	296%	10%
1972-1975	11,186	99	8
1976-1977	4,591	48	3
1978-1979	2,991	41	1
Total	34,932	104	7

- Leverage buyouts account for only a small percentage of the companies included in the survey (7%) and a small percentage of the total SBIC financing received by SBIC portfolio companies (9%). (See Table 8.)
- Leverage buyouts companies account for less than 10% of the growth of SBIC portfolio companies in terms of employment, sales, assets and profits.
- Leverage buyout companies grew at a slower rate than all portfolio companies.

V. Characteristics of Companies Receiving SBIC Financing

The organization of the survey data according to category of portfolio company allows for generalizations about the types of companies receiving SBIC financing. Table 9 summarizes the data by showing the number of companies and total amount of SBIC financing by portfolio companies in specific category groupings. The following conclusions can be drawn from the survey results show on Table 9.

Asset Size

- The largest number of companies receiving SBIC financing was in the zero asset size category -- i.e. startup. companies (170 companies, 31% of the companies in the survey).
- The largest amount of SBIC financing, however, went to companies in the largest asset size category -- i.e. more than $2.5 million in assets. Companies in this category accounted for $116.1 million in SBIC financing, which is equal to about half of the SBIC financing received by all companies in the survey; only 16% of the companies in the survey fell in this asset size category. (See Figure 3.)

OF PORTFOLIO COMPANIES
SIZE

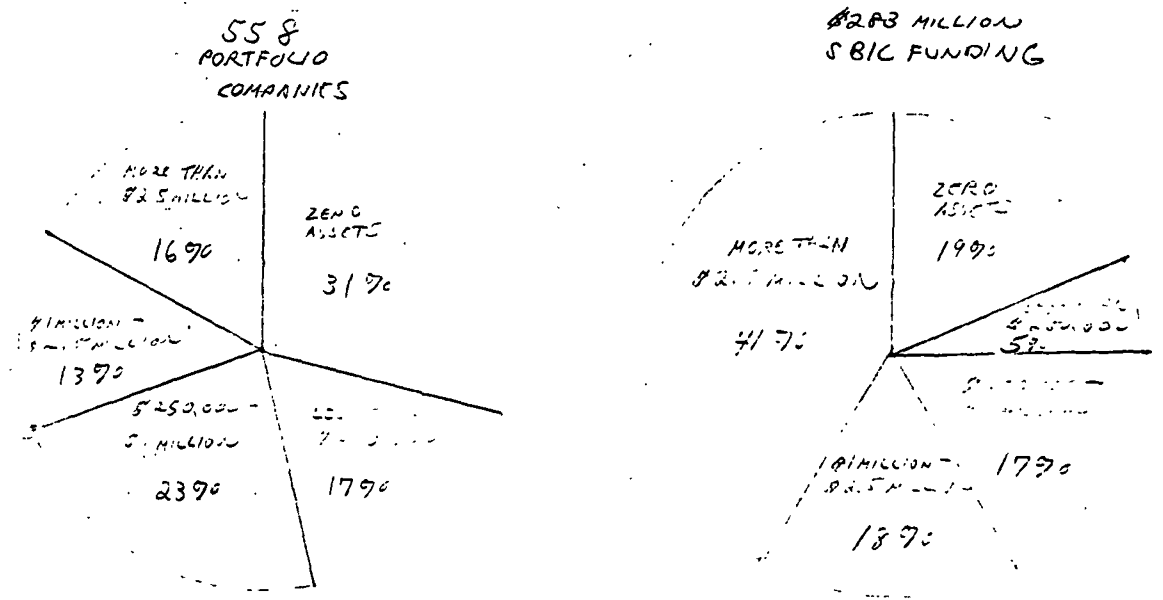


TABLE 8

LEVERAGE BUYOUT COMPANIES
AS A PERCENT OF ALL PORTFOLIO COMPANIES
(Dollar Amounts in Millions)

	Total SBIC Portfolio Companies	Leverage Buyout Portfolio Companies	% Leverage Buyout of Total
Number of Companies	555	38	7%
Total Amount of SBIC Financing	$283.3	$30.1	9%
Employment-Pre-Financing	33,539	4,441	13%
Employment-Most Recent Fiscal Year	68,471	5,551	8%
Increase	34,932	1,110	3%
% Increase	104%	25%	-
Sales-Pre-Financing	$1,127.2	$204.0	18%
Sales-Most Recent Fiscal Year	$3,142.8	$402.0	13%
Increase	$2,015.6	$198.0	9%
Percent Increase	179%	97%	-
Profits-Pre-Financing	$22.0	$13.9	63%
Profits-Most Recent Fiscal Year	$168.3	$22.3	13%
Increase	$146.3	$ 8.4	6%
Percent Increase	66.7%	61%	-
Assets-PreFinancing	$827.7	$137.2	17%
Assets-Most Recent Fiscal Year	$2,180.8	$230.0	11%
Increase	$1,353.1	$ 92.8	7%
Percent Increase	150%	67%	-

TABLE 9

CHARACTERISTICS OF COMPANIES RECEIVING SBIC FINANCING

(Dollar Amounts in Thousands)

PORTFOLIO COMPANY CATEGORIES	Number Of Companies	Total Amount OF SBIC Financing
ASSETS*		
0	170 (31%)	$ 53,032 (19%)
Less than $250,000	96 (17)	16,035 (6)
$250,000-$1 million	127 (23)	47,777 (17)
$1 million-$2.5 million	74 (13)	50,536 (18)
More than $2.5 million	91 (16)	116,143 (41)
EMPLOYEES*		
0	170 (31%)	$ 52,858 (19%)
Less than 20	135 (24)	36,523 (13)
20-49	89 (16)	38,418 (13)
50-99	63 (11)	49,018 (38)
More than 100	98 (18)	106,777 (38)
INDUSTRY *		
Agriculture, forestry & fishing	3 (1%)	$ 1,326 (0%)
Mining	8 (1)	4,943 (2)
Construction	12 (2)	2,097 (1)
Manufacturing	249 (45)	173,027 (6)
Transportation	36 (6)	24,761 (9)
Wholesale Trade	26 (5)	20,607 (7)
Retail Trade	113 (20)	15,858 (6)
Finance, Insurance, Real Estate	17 (3)	6,864 (2)
Services	83 (15)	28,881 (10)

TABLE 9 Continued

CHARACTERISTICS OF COMPANIES RECEIVING SBIC FINANCING

	Number Of Companies	Total Amount Of SBIC Financing
TYPE OF FINANCING		
Debt Only	120 (22%)	$22,776 (8%)
Debt/Equity	122 (22)	59,534 (21)
Equity Only	77 (14)	45,635 (16)
Debt & Debt/Equity	28 (5)	12,329 (4)
Debt & Equity	103 (3)	66,952 (9)
Equity & Debt/Equity	75 (18)	49,826 (18)
Debt, Equity, Debt/Equity	28 (5)	26,222 (9)
LOCATION		
Northeast	155 (28%)	96,206 (34%)
Southeast	73 (13)	30,254 (11)
South Central	96 (17)	21,487 (7)
North Central	137 (25)	73,565 (26)
West	94 (17)	61,812 (22)
AGE OF COMPANY AT TIME OF FINANCING		
0-2	218 (39%)	81,228 (29%)
2-5	119 (21)	58,206 (20)
5-10	98 (18)	62,119 (22)
10+	120 (20)	81,711 (29)

*Prior to the year of initial SBIC financing.

Employment Size

- As was the case for asset size, the largest number of companies receiving financing was in the zero employment category -- i.e. startup companies -- 170 companies, 31% of the total.

- Portfolio companies in the largest employee size category -- more than 100 -- accounted for $106.8 million, or more than 38% of the total SBIC financing received by companies in the survey, although comprising only 18% of the companies in the survey.

Industry

- Manufacturing was the dominant industry category with manufacturing accounting for 45% of all the portfolio companies receiving financing and 61% of the total SBIC financing received by all portfolio companies in the survey.

- Retail trade was the next most significant category in terms of number of companies, with 113 companies (20% of the total), while companies in the "services" category were the next most significant in terms of amount of financing, receiving $28.9 million -- 10% of the total financing received by companies in the survey.

Year of Initial SBIC Financing

- The distribution of portfolio companies by year of initial financing shows that most of the portfolio companies included in the Survey received their financing in recent years. For example, although the SBIC program has been in existence since 1959, only 111 (19%) of the companies in the survey received their initial financing prior to 1972, while 131 companies (22%) received their initial financing since 1978. This distribution may indicate that there is a rapid turnover of companies included in SBIC portfolios, or alternatively, that because of the difficulty in obtaining data for older portfolio companies, the response rate was poorer for the older companies than for the recently financed companies.

Mr. BROYHILL. Thank you, Mr. Little.

I now recognize Mr. Russell L. Carson, a general partner with Welsh, Carson, Anderson & Co.

STATEMENT OF RUSSELL L. CARSON

Mr. CARSON. With me today is Mr. Daniel Kingsley, who is executive director of the National Venture Capital Association. The National Venture Capitol Association strongly supports the enactment of H.R. 3991. Passage of the bill would eliminate several artificial impediments to the free flow of capital into the small business sector and would benefit all concerned at minimal risk to the public.

In the current era of concern about excessive costs, both direct, and indirect of Government regulation, H.R. 3991, is very timely as it addresses the elimination of regulation by the SEC of transactions among parties who neither want nor need SEC protection.

Sections 2 and 3 of the bill which allow unlimited sales to accredited investors will remove some of the uncertainty surrounding what constitutes a private placement transaction and also eliminate arbitrary constraints on the number of purchasers who may participate in a placement. I do, however, have two suggestions on this portion of the bill.

First of all, the definition of an accredited investor includes banks, insurance companies, SBIC's, pension funds or persons who meet financial and experience criteria set forth in rules to be prescribed by the SEC. Since the venture capital industry accounts for a very important percentage of the private placement activity that occurs in the small business sector of the economy, I think it would be appropriate to specifically include professional venture capital firms in the list of accredited investors. Of the 78 firms that are presently members of the National Venture Capital Association, 49 are entities other than those specifically described as qualifying as accredited investors.

Second, a limited sale security is defined as one which bears a legend to the effect that it may not be sold or otherwise tranferred except to an accredited investor. I think it would be appropriate to expand the legend to specifically include sales or transfers under any provisions of the Securities Act of 1933 or any currently active rules and regulations of the Securities and Exchange Commission. While I assume that this is the intent of the bill, it would be reassuring to see it spelled out specifically since a security which could, in perpetuity, only be sold to an accredited investor would have limited liquidity and thus be limited in its value.

Section 5 of the bill addresses a much needed reform in the current law, limiting the right of recission in a transaction only to the purchaser who improperly purchased securities. Under current law all purchasers in a transaction have the right to rescind if any one purchaser was improperly included in the transaction. From personal experience I can state that the current law has been a serious problem for smaller, less sophisticated issuers who have inadvertently violated the SEC rules and then must either abandon a placement or go through a costly and time-consuming rescission offer to all purchasers.

Finally, section 6 of the bill, which would remove venture capital firms and SBIC's from the restrictions of the Investment Company Act of 1940, is an amendment which is long overdue. History has proven that it is virtually impossible for a publicly owned firm engaged in the business of making direct investments in smaller businesses and participating in the direction of those businesses to operate under a set of rules designed for a mutual fund. The natural result is that no new publicly owned venture capital firms have come into existence in the past 10 years and the number of publicly owned firms that were created in prior years has been diminishing due to liquidation or acquisition. If it is a valid national policy to encourage the flow of capital to smaller businesses, then artificial barriers such as the 1940 act which eliminate the public's participation in the venture capital process must be either modified or abolished.

In closing, I would like to thank the sponsors of H.R. 3991 for their interest in the problems of small business financing. I have noticed a direct correlation between your interest and a sudden responsiveness on the part of the SEC to the problems of our industry. If you accomplish nothing else, you have generated meaningful debate on the issues and have created an awareness on the part of the SEC that it must keep up with the times. Thank you.

[Mr. Carson's prepared statement follows:]

STATEMENT OF
RUSSELL L. CARSON
GENERAL PARTNER
WELSH, CARSON, ANDERSON & COMPANY
BEFORE THE
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
U.S. HOUSE OF REPRESENTATIVES
NOVEMBER 7, 1979

Good Morning Mr. Chairman. I am Russell L. Carson, a General Partner of Welsh, Carson, Anderson & Co., which is a Limited Partnership formed in March 1979 for the purpose of making venture capital investments in small to medium sized businesses. The Partnership has total capital in excess of $33 Million which was contributed by four General Partners and fourteen sophisticated Limited Partners. Prior to my present affiliation I was President of Citicorp Venture Capital, a wholly owned subsidiary of Citicorp and one of the largest institutional venture capital sources. I am here today to express the views of the National Venture Capital Association, a trade association which represents most of this country's professional venture capital firms. As a final bit of background, I should add that I had the opportunity to testify before this Subcommittee in September 1978 on the merits of H.R. 10717, a predecessor to the present bill.

The National Venture Capital Association strongly supports the enactment of H.R. 3991. Passage of the bill would eliminate several artificial impediments to the free flow of capital into the small business sector and would benefit all concerned at minimal risk to the public. It bears repeating that the companies which are financed by the venture capital industry tend to pursue technological innovation, create new employment opportunities and generate incremental federal tax revenues. The federal government is the primary beneficiary of the venture capital process and should have the greatest interest in enlarging its scope.

In the current era of concern about the excessive cost, both direct and indirect, of government regulation, H.R. 3991 is very timely as it addresses the elimination of regulation by the SEC of transactions among private parties who neither want nor need SEC protection.

Sections 2 and 3 of the Bill which allow unlimited sales to "accredited investors" will remove some of the uncertainity surrounding what constitutes a private placement transaction and also eliminate arbitrary constraints on the number of purchasers who may participate in a placement. I do, however, have two suggestions on this portion of the Bill.

First of all, the definition of an "accredited investor" includes banks, insurance companies, SBICs pension funds or persons who meet financial and experience criteria set forth in rules to be prescribed by the SEC. Since the venture capital industry accounts for a very important percentage of the private placement activity that occurs in the small business sector of the economy, I think it would be appropriate to specifically include "Professional Venture Capital Firms" in the list of accredited investors. Of the 78 firms that are presently members of the National Venture Capital Association, 49 are entities other than those specifically described as qualifying as accredited investors.

Secondly, a "limited sale security" is defined as one which "bears a legend to the effect that it may not be sold or otherwise transferred except to an accredited investor." I think it would be appropriate to expand the legend to specifically include sales or transfers under any provisions of the Securities Act of 1933 or any currently active rules and regulations of the Securities and Exchange Commission. While I assume that this is the intent of the Bill, it would be reassuring to see it spelled out specifically since a security which could, in perpetuity, only be sold to an accredited investor would have limited liquidity and thus be limited in its value.

Sections 2, 3 and 4 of the Bill would all reduce legal cost to the issuer, expand the potential sources of capital for the issuer and give greater liquidity to the purchaser of the issuer's securities. While not major deviations from the current law, they should be helpful in making more capital available on better terms to smaller, more innovative businesses.

Section 5 of the Bill addresses a much needed reform in the current law, limiting the right of recission in a transaction only to the purchaser who improperly purchased securities. Under current law all purchasers in a transaction have the right to rescind if any one purchaser was improperly included in the transaction. From personal experience I can state that the current law has been a serious problem for smaller, less sophisticated issuers who have inadvertently violated the SEC rules and then must either abandon a placement or go through a costly and time consuming recission offer to all purchasers.

Finally, Section 6 of the Bill, which would remove venture capital firms and SBICs from the restrictions of the Investment Company Act of 1940, is an amendment which is long overdue. History has proven that it is virtually impossible for a publicly-owned firm engaged in the business of making direct investments in smaller businesses and participating in the direction of those businesses to operate under a set of rules designed for a mutual fund. The natural result is that no new publicly owned venture capital firms have come into existence in the past ten years and the number of publicly-owned firms that were created in prior years has been diminishing due to liquidation or acquisition. If it is a valid national policy to encourage the flow of capital to smaller businesses, than artificial barriers such as the 40 Act which eliminates the public's participation in the venture capital process must be either modified or abolished.

In closing, I would like to thank the sponsors of H.R. 3991 for their interest in the problems of small business financing. I have noticed a direct correlation between your interest and a sudden responsiveness on the part of the SEC to the problems of our industry. If you accomplish nothing else, you have generated meaningful debate on the issues and have created an awareness on the part of the SEC that it must keep up with the times. Thank you.

Mr. BROYHILL. Mr. Carson, what has been your experience with respect to seeking prior approval from the SEC in affiliate transactions?

Mr. CARSON. We have had no experience at all, Mr. Broyhill. My firm is a limited partnership which is exempt from regulation by the SEC. Deliberately so, I might add.

Mr. BROYHILL. What about your association?

Mr. CARSON. I think the general experience has been that firms have found it to be very unresponsive. The SEC's concept of what a fair period of time is to make a decision is just totally different from that of the normal businessman. I think most of us as businessmen are used to making decisions either on the spot or within 2 or 3 days. To try and deal with an agency whose definition of doing a good job is making a decision in 60 days is just beyond our comprehension. I think certainly most firms like mine don't want to get involved in that kind of problem.

Mr. BROYHILL. Do you have any other comments on that question, Mr. Little? You have had some comments before.

Mr. LITTLE. I think the only other comment that I would make is that from time to time, and this is really the hidden part of the problem as far as section 17 of the 1940 act is concerned, there are various things that we have considered doing with our portfolio companies over a period of time that we have simply abandoned, because our lawyers say to us, "No, that will require a section 17 application." Given the length of time it takes for section 17, the reasons for taking a particular action may have been passed by the time that you would be allowed to do it.

The only other thing that I would say is that during the last 2 years section 17 applications have cost Narragansett Capital respectively $78,000 and slightly more than $100,000 a year to process. Just to point out to the Commission that if those things did not have to be done in our case, that would be an additional 10 cents a share dividend for all of our shareholders.

Mr. BROYHILL. Mr. Opper, do you have any questions?

Mr. OPPER. On the staff level we have had some difficulty, I think as the private sector as well as the Commission has had, in structuring an appropriate definition of a venture capital company. The definition in section 6, the Commission suggestions, creates a loophole big enough to drive a money market fund through, and perhaps other kinds of companies. I don't think that that was the intention of the drafters.

The problem we might be having is defining a generally accepted definitional structure of a venture capital company. Would either of you gentlemen want to provide some input as to the kinds of activities that a venture capital company is as a traditional matter engaged in, so we can begin to understand the parameters of its activities, and perhaps define the term more precisely?

Mr. LITTLE. Yes; I think the thing that we are really trying to get at here is really people who are in the business—let me go back. One of the problems I think that the Commission has is the degree of fineness of the net that they want to have to catch the bad guys. I would propose to you, first of all, that you are never going to catch all the bad guys, and I would also propose to you that there are always going to be a few bad guys around, so the Commission wants to write a definition that precludes any possible wrongdoing, and I think if you do indeed throw the money market kind of thing in there, that is not what we have in mind either.

What we are talking about really is companies that habitually provide capital, and not just on a one-time-a-year basis kind of thing, but as a constantly ongoing business to companies where they really are directly financing that company, and where particularly those are the kinds of companies that are not traded on any of the national exchanges.

Now some of my other association members might have a little problem with me throwing out the NASDAQ list, but really with the money market fund, you are pretty much talking about people who are pretty creditworthy, even though they really are buying the securities directly from the issuer. That is really not what we have in mind. We are really trying to get at companies that do not have access to capital markets other than through people like ourselves.

Mr. CARSON. I think—if I could just add two thoughts to that—two principal characteristics of a venture capital firm are that its investment is primarily in equity securities. I think maybe you could include that term in the definition that is in the bill, equity securities being common stock, preferred stock or subordinated debt, but essentially risk securities.

I think, second, a venture capital firm is oriented towards realizing capital gain returns. I don't know whether that is an appropriate addition to the definition or not, but it clearly is not a vehicle that is seeking its return entirely through current income. Its objective is in appreciation of the securities in which it invests and it acquires those on a private basis primarily.

Mr. OPPER. Should there be anything in the definition which talks about involvement of the management of the venture capital company in the affairs of the portfolio company?

Mr. CARSON. I think you just cannot define it that way. The SEC made a stab at this in their proposed revision of the Investment Advisers Act. I think they basically just missed the boat in terms of understanding what the industry is. You cannot define it as an industry where you always own more than 10 percent of the companies that you invest in or that you always sit on the board of directors or you are always involved in the management. It is just too broad a statement. It doesn't apply to most operations.

Mr. OPPER. I guess the problem is even if we were to conclude that the definition should include companies of the type that are not listed on exchanges, that we create an incentive merely to establish a mutual fund with a portfolio of unlisted companies, which fund then would find an exemption from the 1940 act even though it wasn't doing the kinds of things we generally accept as a venture capital company.

Now I suppose that is the problem that we continually have to wrestle with.

Mr. CARSON. Isn't it worth taking a look at the question of what is the worst thing that could possibly happen if that does happen? You wind up with a mutual fund that may not be subject to the 1940 act. I think you can define it closely enough so that that is not going to happen very much, but that fund is still subject to all of the other restrictions of the SEC. It is subject to all of the State laws, all of our regulations, regarding insider transactions. It seems to me that for lack of a semantic definition here, we are doing considerable harm to an industry, trying to protect the public from something that it doesn't really need to be protected from.

Mr. OPPER. What I am suggesting is that in addition to venture capital companies we would be creating an incentive to structure companies solely for the purpose of avoiding the 1940 act, which companies by their very nature would be highly speculative, whereas other companies whose portfolios are made up of listed securities or more seasoned securities would fit neatly within the 1940 act and be regulated that way. I would just raise the question as to whether or not that is a desirable result. It is clearly one that we will have to continue to consider, and we certainly would welcome comments along these lines continuously from the industry, to help structure the appropriate kind of definition.

Mr. Carson, your company is not registered with the SEC, and is indeed a venture capital company.

Mr. CARSON. Right.

Mr. OPPER. How many investors do you have, and what is the nature of your investors?

Mr. CARSON. We have 14 investors, 14 limited partners, who put up between $1 million and $4 million each. The nature of those investors is five are major corporations that would all be Fortune 500 corporations who made direct investments. We have three corporate pension funds, two bank trust departments, two large insurance companies, a large endowment fund, college endowment fund, and a very wealthy family that has a substantial net worth, but obviously from that list none of those are people that either want or need the protection of the SEC in making a decision as to whether we are a valid investment vehicle for them.

Mr. OPPER. Will there come a time when you will have to make a decision as to whether or not to liquidate the company or to fall under the 1940 act umbrella?

Mr. CARSON. Effectively we have already made that decision. The partnership has a 10-year life to it, and that is done deliberately, because we cannot expand the partnership. We cannot take any more partners without running afoul of the Investment Advisers Act, and our partners want liquidity, so the only alternative is to provide a self-liquidating membership.

Mr. OPPER. Was that provided at the outset of the establishment of the company?

Mr. CARSON. Yes.

Mr. OPPER. Are there any tax incentives for doing that?

Mr. CARSON. Yes, the tax incentives are substantial, in that as a partnership there is only one level of taxation. When the partnership realizes a gain the tax is paid by the partners, as opposed to if we were in corporate form, the corporation would have a tax liability and then the partners would each have a tax liability when distributions were made.

Mr. OPPER. Is it fair to say most venture capital companies are structured that way, as limited partnerships, with a relatively well-defined lifespan?

Mr. CARSON. I think probably the majority of the members of the National Venture Capital Association would be limited partnerships.

Mr. OPPER. If you felt, particularly at the inception when your company was being organized, that you would not be facing a 1940 act problem, would you have structured the company any differently? Would there have been any incentive for your initial investors to have so structured it?

Mr. CARSON. I think the biggest difference would have been—I think it relates in our case more to the Advisers Act than the 1940 act. We were very conscious of the fact that the Advisers Act contains a prohibition against incentive compensation, and the whole incentive for myself and my partners to leave the jobs that we had and form the partnership was to get incentive compensation.

Therefore, under no circumstances would we put ourselves in a position where at some point that could be taken away from us, so our principal impediment was the Advisers Act and we did in fact turn away a number of investors who wanted to invest, but would have taken us over the limit or would have invested moneys that were smaller than what we could afford to take.

Mr. LITTLE. Could I just throw in a comment based on bringing up the subject of incentive compensation. We, last year at Narragansett, formulated an incentive compensation plan that was based on no incentive compensation being paid until after our shareholders had all received at least $1 a share of dividends, and then after the dollar had been met, the dollar bogey, if you will, had been met, as dividends went up from there, then there would be a prorata although considerably smaller sharing in the form of incentive compensation by the management group.

We had planned to actually have this in the form of a formalized plan, and what we found was that because of the 1940 act, we were not able to have a plan, because that would be a profit-sharing plan with affiliates of the company. So now instead of having our people have the firm knowledge of knowing what goes on, we had to abandon that completely, and just go on an ad hoc basis. It is just another example of the kind of nonsense that goes on with this act.

Mr. OPPER. Mr. Little, you in response to Mr. Broyhill's question about whether or not by lifting the 1940 act exemptions, and going back to the quote from Venture magazine, "making the killings in the market available to perhaps unsophisticated investors," whether we might be jeopardizing some of their protections, you suggested that what we really ought not be doing is be depriving these investors of well-seasoned and experienced management.

I guess the question that raises, how can we be certain that the kind of management that these investors would be provided would be well seasoned and experienced? What is there to insure that these standards would be maintained, particularly if we removed the 1940 act exemption?

Mr. LITTLE. Just a couple of general comments. First of all, I think you have to rely—you can't legislate out stupidity. If my son, for instance, was going to go public with a venture capital company, and raise $10 million, and a bunch of people wanted to back him to do that, I would not regard them as backing a 14-year-old as being a very smart thing to do, because he has no background. Under the 1933 act, you would find that any company going public would of course have to disclose the backgrounds of the people who are involved, and I think the public then ought to be able to make a judgment as to whether those people are qualified.

There have been enough people in the industry, in the venture capital industry now, and there are enough people who very well might think that a public venture was something that would be something that they would like to do, to be able to have kind of a pool of people who would people these venture capital companies, so I think you really have to rely on the disclosure parts of the 1933 act, and then I think you have to let people make their judgment. That is basically what it is.

Mr. OPPER. I might just suggest that, although we cannot legislate out stupidity, what Congress seems to have been saying in 1940 was we might be able by legislation to eliminate some of the downside risk, and the purpose of the question was to explore whether or not we have increased the downside risk to the investor.

Let me ask just one more question related to your testimony. On page 8, where you suggest that the limitations on the resale of restricted securities ought to be eliminated after 5 years——

Mr. LITTLE. That was the section—are you referring to the section where we are talking about rule 144, and the question of a venture capital company that becomes an affiliate, and getting rid of or reducing some of the restrictions of resale of securities; is that the section?

Mr. OPPER. Yes. You said that you felt, I guess in connection with the discussion that emerged in connection with rule 242, I believe it was page 8——

Mr. LITTLE. I believe that section starts on page 9.

Mr. OPPER. Yes, that is correct. The suggestion was that the venture capitalists would seek to maximize their returns, so they certainly would not dump securities on the market and drive the price down, and therefore the public shareholders wouldn't be harmed. I am just wondering, though, if there is no public market for the securities, which is often the case with respect to these restricted securities, what is to determine what the market price is, and whether or not it will be driven down? Wouldn't there be enormous incentive merely to dispose of the securities publicly?

Mr. LITTLE. Oh, I see what you are saying. You are saying if it is a privately held company, and we are trying to induce that company to have a public offering and sell all of our securities at that point in time?

Mr. OPPER. Yes, I think that that is the principal objection that at least the Commission has raised.

Mr. LITTLE. Ithink there are a couple of answers to that. One is a practical matter. When companies that we have had stock in, we have invested in them when they were privately owned companies, have gone public, we have been prevented, on a number of occasions, by the underwriter from selling our stock in the initial public offering, because the underwriters' point of view is that if we are selling, certainly if we were selling all of our stock, but even if we are selling a major portion of our stock, that that indicates that there is a lack of confidence on our part in the company, and therefore they don't want to have anything to do with underwriting it.

So your question is a good theoretical one, but I am not sure that in real reality it is too practical, because we just have never been able to—we, a portfolio company indeed at one point where we wanted to sell about half of our stock, and the underwriter just came back to us and said, "No, you can't do it, you have got to hold on for the second time." We could have gotten $15 a share if we could have sold the company under that underwriting. Eventually a large German company came and bought it out at $3 a share.

Mr. Carson. If I understand your question correctly, it related to a company that is privately owned, and what is to prevent a shareholder from selling the stock?

Mr. Opper. Yes, it is really the company that issued restricted securities. I think it probably forms the basis for one of the principal objections to lifting the restrictions after 5 years. It is where you have a company that has made private placements to persons who would qualify as affiliated persons, who would then, after 5 years, distribute the securities publicly without restriction.

The concern is, there is not the kind of information available to the public that you would have with a registered security, so the efficient market theory may not be applicable here. There may not even be a public market for any securities of the issuer. I am trying to determine from Mr. Little's statement about driving the price of the company down, how much of a concern this is, based on the lack of information that is publicly available.

Mr. Carson. Isn't the simple answer to that, though, to have the Commission provide that a company has to be a reporting company before you can dispose of your securities? That certainly is very acceptable to our industry.

Mr. Opper. That could be an alternative. I am not sure that that has necessarily been widely suggested. Would that be an acceptable kind of thing?

Mr. Little. I think it would be. There are two different kinds of situations that you are talking about here. One is the situation in which we have an investment in a privately held company. I would suggest to you before we were able to sell any of that stock in that company to the public, that of course there would have to be an offering memorandum under the 1933 act, which certainly ought to be an awful lot of disclosure; if I recall correctly.

Mr. Opper. Would there have to be an offering circular under the 1933 act?

Mr. Little. If you are selling it to the public. Wouldn't there be? I mean, this is what Mr. Carson is suggesting.

Mr. Opper. I am not aware of any provisions in this bill that require dissemination of any specific information.

Mr Little. Now you get into this accredited investor kind of concept. If we were to sell our position to somebody else who was significantly in the business of making this kind of investment, they ought to be in a position where they could make a determination of whether they, as Mr. Carson stated earlier, want or desire the SEC protection.

If you are going to sell that same block of stock to the public, I would suggest that you need to have reregistration under the 1933 act. What we are talking about specifically in this, what my testimony was directed at, is where you have a publicly owned company, where you have got rule 144 that you are already under, and that you now have the situation where, if you own say 40 percent of the company it is going to take you 10 years to dribble it out.

Mr. OPPER. Thank you very much.

Mr. BROYHILL. Mr. McMahon, do you have any questions?

Mr. MCMAHON. No.

Mr. BROYHILL. Thank you very much, gentlemen, for your testimony. It has been most helpful.

Mr. LITTLE. Thank you, sir.

Mr. BROYHILL. The subcommittee will stand adjourned until 10 a.m., tomorrow morning, in room 2322.

[Whereupon, at 12:55 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., Thursday, November 8, 1979.]

55-753 O - 80 - 13

SMALL BUSINESS INVESTMENT INCENTIVE ACT

THURSDAY, NOVEMBER 8, 1979

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 10 a.m., in room 2322, Rayburn House Office Building, Hon. James T. Broyhill presiding (Hon. James H. Scheur, chairman).

Mr. BROYHILL. The subcommittee will come to order.

Today we are continuing hearings on H.R. 3991, the Small Business Investment Incentive Act.

This morning we are privileged to hear from Mr. Bruce Mann, Pillsbury, Madison & Sutro.

If he would come forward we have your testimony, Mr. Mann.

I understand that Mr. Wallison and Mr. Liftin will come and appear this morning with Mr. Mann.

Mr. WALLISON. We had a different room, and we are looking for Mr. Liftin now.

Mr. BROYHILL. As soon as he comes in, we will hear him.

Mr. Mann, we have the testimony before the committee. If you would like to have it inserted into the record, you may do that, and you will have an opportunity to review it.

You are recognized.

STATEMENTS OF BRUCE ALAN MANN, PILLSBURY, MADISON & SUTRO; AND PETER J. WALLISON, COUNSEL, ON BEHALF OF THE AMERICAN COUNCIL FOR CAPITAL FORMATION, ACCOMPANIED BY JOHN M. LIFTIN, COUNSEL

Mr. MANN. Thank you, sir.

My name is Bruce Mann. I am a partner of the San Franciso law firm of Pillsbury, Madison & Sutro.

I appreciate the opportunity to appear before the subcommittee this morning to discuss H.R. 3991.

I have submitted a formal statement for the record [see p. 197]. I believe that that statement sets forth both my background and my views on H.R. 3991 in some detail, and in the interest of making the discussion this morning as fruitful as possible I would propose not to repeat my formal presentation here this morning, but instead to summarize briefly my views on the provisions of H.R. 3991 and to invite you to test the validity of my views by questioning the positions that I express as I express them.

By way of background, I have been a practicing securities lawyer and speaker and writer on securities law matters for over 20 years with a heavy concentration in representing clients involved in various phases of the capital formation process. The views I express are the result of those experiences, and have come from being somewhere close to the center of capital raising activities in the technology area, at least during the past 20 years.

The provisions of H.R. 3991, are a response to a number of concerns of the venture capital industry. These concerns are genuine, and I believe that they may only be adequately addressed through the legislative process.

First, the bill reflects a recognition that there is a critical need for venture capital within the small business sector of our economy, and that it is in our national interest for Congress to ease the difficulties faced by small business in raising capital.

The dramatic decline in the availability of venture capital for emerging businesses and the adverse impact of this decline on our Nation's economy have been testified to in almost every study of the capital formation process that has been done in recent years.

Second, these studies of the capital formation process have also noted that the expense and time delay inherent in the compliance process under the Securities Act of 1933, the Investment Advisers Act of 1940 and the Investment Company Act of 1940 act as a deterrent to entering the venture capital business and the financing of new enterprises.

Third, the principle of legislative interpretation that exemptions from registration are to be narrowly construed has been applied by the staff of the SEC and the courts without regard to whether a more liberal approach designed to deregulate venture capital formation is in the national interest.

In this regard, I note that yesterday Chairman Williams of the SEC spoke on regulatory reform, and he expressed some views which I would endorse wholeheartedly.

According to this morning's Washington Post, Chairman Williams indicated that an assessment of regulatory policy prepared in the context of broader national objectives is desirable. He said, according to the Post article, that regulatory agencies fail to look at their regulations in terms of larger societal questions and have set inconsistent policies as a result.

If I read Chairman Williams correctly, what he is saying is that any policy mandating the balancing of the regulatory purposes which are set forth in the preamble of the 1933 and 1934 acts with other broader national purposes must be estabished not by the Commission, which receives the mandate, but by Congress, which gives the mandate. This is a view I agree with wholeheartedly. Even if it had not been so clearly stated yesterday by Chairman Williams, the SEC, it seems to me, is not in a position to set these priorities. It is Congress that must do it. It is Congress that must balance the goals of capital formation and the goals of investment protection under the Federal securities laws. Congress has demonstrated in the past an ability to establish goals and thereby causing the SEC to react in a way that recognizes its new mandate. For example, Congress declared in the National Environmental Policy Act that all agencies of the Federal Government had a responsibility to conduct their activities in a manner which promoted the environmental goals of that act.

The SEC reacted to the congressional mandate by requiring issuers of securities to make additional disclosures of environmental matters that were not called for by the traditional standards of materiality to an investment decision.

Conversely, Congress could determine that the promotion of new and emerging enterprises is in the national interest and provide the Commission with a mandate to deregulate venture capital formation. If it did, the Commission would presumably take steps to facilitate the capital formation process, which it may be reluctant to take at the present time because of the absence of any congressional directive.

In this regard, I believe the steps taken and proposed to be taken by the Commission to promote venture capital formation are significant and praiseworthy. The announced agreement of the SEC and Department of Commerce to study jointly the effects of SEC regulation on the ability of small business to raise capital and the establishment of an Office of Small Business Policy within the SEC demonstrate a clear departure from the traditional view that its sole mission is to promote investor protection.

Similarly, adoption of form S–18, the proposal of rule 242 and the proposal to exempt certain registered investment advisers from the prohibition against sharing in gains compensation under the Investment Advisers Act of 1940 all reflect a desire by the Commission to take steps to facilitate capital formation.

Unfortunately, the ability of the Commission to free the financing of small business from the unavoidable delays and costs of complying with the registration requirements of the Federal securities laws is severely limited.

For example, rule 242 has been proposed pursuant to the Commission's authority to grant exemptions under section 3(b) of the 1933 act. Its purposes are similar to those of sections 2 and 3 of H.R. 3991, with two significant differences.

First, proposed rule 242 sets a limit of $2 million. The Intel experience described in my formal submission illustrates that a $2 million limit on venture capital placements was not adequate for a major technological startup in 1969 and today is wholly inadequate. Yet it is Congress not the SEC which has proscribed the Commission's ability to create a more meaningful exemption because the SEC has no authority under section 3(b) to exceed that amount.

Second, rule 242 is proposed as a rule of the Commission which can be modified to reflect experience in its operation. As such, it is a far more flexible means of establishing a venture capital placement exemption than the statutory approach contained in H.R. 3991.

I would, therefore, urge that so long as the Commission continues to pursue its current course of seeking means to free capital formation from regulatory burdens, a more salutary approach would be to increase the limits of section 3(b) to an amount which would be meaningful to the capital formation process, to direct the Commission to adopt rules under sections 3(b) and 4 of the 1933 act to free the capital formation process from as much regulation as practicable and to monitor the efforts of the Commission to utilize its rulemaking power under that section to carry out its new congressional mandate.

This brings us to my second observation on the Commission's efforts to facilitate capital formation. The Commission not only lacks an express mandate and authority to free venture capital formation and investment from regulations generally applicable under the Federal securities laws, but certain laws administered by the Commission seriously impede and may even prevent the effective aggregation of funds for venture capital investment.

For example, venture capital limited partnerships which could have been formed with more than 14 limited partners have been restricted in size because of concern by the general partners that they would have been exposing themselves to potential violation of the Investment Advisers Act of 1940.

This is not a new problem. It is a problem that was first raised in a case known as the *Abrahamson* case. The venture capital industry has appeared before the Commission, and the Commission staff on a number of occasions since that case decided, pointing out its adverse impact on the capital formation process.

Yet nothing has been done by way of proposed exemptive rule which would solve the problem raised by the *Abrahamson* case. To a large extent, I believe this reflects the view by the Commission staff that what we are dealing with is a statutory provision that they are not in a position by rule to change.

Thus, the adoption of statutory exemptions from registration under the Advisers Act and the Investment Company Act to facilitate the formation of venture capital limited partnerships and corporations should not be viewed as reflecting adversely on the efforts of the Commission to develop exemptive rules and regulations.

Rather, they should be considered as the only viable means of removing statutory impediments which the Commission itself is not free to ignore.

Others will testify this morning, I know, on the difficulty, indeed, the impossibility of a venture capital company operating under the Investment Company Act of 1940. Rather than reiterate those difficulties, which I believe have had the effect of limiting the size of venture capital limited partnerships and therefore the amount of capital available for investment in new enterprises, I would like to make a few observations in support of the approach, although not necessarily the details, of section 6 of H.R. 3991.

Venture capital investments are illiquid unless and until the investment proves successful. Investors making them expect that their investments must be held for years before significant appreciation is likely to occur. Venture capital funds have a low turnover rate and are not invested in puts, calls, or other trading vehicles. Thus venture capital pools are unlike traditional mutual funds and the abuses sought to be curbed by Congress when it adopted the Investment Company Act are far less likely to occur.

I believe an exemption from the 1940 act for venture capital companies will permit individual investors, aided by professional advice and sophisticated money management, to return to the greater risk, greater potential reward segment of the securities market they have been effectively barred from since the hot issue market of the 1960's.

As a result of the decline of the new issue market, the increased costs of financing initial public offerings and the institutionalization of venture capital investments, individual investors have few opportunities today to participate in venture capital investments.

Permitting the creation of more broadly owned venture capital companies which would be subject to the disclosure obligations and antifraud rules of the Securities Act and the Securities Exchange Act but would not be subject to the registration requirements and prohibitions contained in the Advisers Act and the Investment Company Act would, in my judgment, allow individual investors to become a viable part of the capital formation process.

Most significantly, it would permit them to share in those venture investments which have the highest likelihood of success and are offered only to large institutional investors, rather than relegating the individual investor to the least likely to succeed leftovers, such as the many high risk startups which were sold to the public in the 1960's because they were not of sufficient quality to attract institutional investor interest.

Broad public participation in venture capital pools should not be considered less desirable or more risky than public investment directly in those companies eligible for form S-18. However, if it is appropriate to restrict investment in venture capital pools, the SEC could be given authority to designate accredited categories of investors.

Section 4 of H.R. 3991 addresses a resale problem which the Commission has dealt with in the most recent amendments to rule 144. In light of the Commission's action, I do not believe section 4 is necessary at the present time.

The only section of H.R. 3991 on which I have not thus far commented, section 5, would eliminate what many consider the draconian consequences of an innocent and immaterial transgression of the vague boundaries of section 4(2) of the 1933 act.

If the issuer can't prove that offers were made only to sophisticated prospective investors, a disgruntled purchaser whose own acquisiton of securities met the letter and the spirit of the private offering exemption can disaffirm his purchase. No fraud or intentional wrongdoing need be demonstrated. This has the potential for causing great financial harm to both the issuer and to other investors who have no desire to rescind the financing.

It is especially anomalous that the right to rescind exists even though the offerers who taint the private offering exemption do not wish to complain and don't even purchase the security that was offered.

For example, in *Henderson* v. *Hayden, Stone Incorporated,* the Court of Appeals for the Fifth Circuit permitted Mr. Henderson, a retired professional investor who had an investment portfolio of several million dollars, to rescind his purchase. There was no fraud. Mr. Henderson thoroughly understood the nature of his investment and did not need the protection of a registration statement.

However, because the defendants could not clearly establish that offers were not made to nonpurchasers who were not sophisticated, Mr. Henderson was permitted to get out of his investment. This strikes me as a gross misuse of the protective provisions Congress thought it was enacting in 1933. Because it would rectify this inequity, I heartily endorse the adoption of section 5 of H.R. 3991.

In summary, I believe that H.R. 3991 contains several sections which are quite desirable because they address problems which the Commission cannot deal with by rulemaking. Other sections of the bill, however, deal with problems which may be handled more effectively by the SEC under its present rulemaking authority if the Commission is given an appropriate congressional mandate.

I would be pleased to respond to any questions you have and wish to thank you again for the opportunity to present my views to you today.

[Testimony resumes on p. 209.]

[Mr. Mann's prepared statement follows:]

Statement of
Bruce Alan Mann

Pillsbury, Madison & Sutro

San Francisco, Ca.

Mr. Chairman and members of the Subcommittee on Consumer Protection and Finance. Thank you for the invitation to appear before your Subcommittee today.

I am Bruce Mann, a partner of the San Francisco law firm of Pillsbury, Madison & Sutro. I appear here today at the invitation of the Subcommittee as an attorney who specializes in dealing with the problems of capital formation. I have spent over 20 years writing, lecturing and actively representing clients in connection with federal securities law matters. One year ago I had the pleasure and honor of serving as a consultant to the Securities and Exchange Commission, concentrating on those steps that could be taken under the existing statutory structure to simplify the securities registration process and facilitate capital formation. I have also served as a member of the Task Force on Capital Formation and Retention for the White House Conference on Small Business scheduled for January, 1980.

Our clients involved in the capital formation process include venture capital investors, investee companies, institutions providing debt financing to emerging companies and underwriters who sell the securities of those companies to the public. During the past four years we are reported to have served as counsel either for the issuer or for the underwriters in more initial public offerings registered under the federal securities laws than any other law firm.

The importance of venture capital to our economy and the potential impact of the securities laws on capital formation is well illustrated by our experience as counsel for Intel Corporation, a leader in semiconductor technology. Intel's initial financing was provided in 1968 by a $500,000 investment by its founders followed by an additional $2,500,000 venture capital private placement. Subsequent venture capital private placements occurred in 1969 and 1970, with the first public offering of its securities occurring in 1971. Today Intel has over 20 million shares outstanding with a market value of $1-1/4 billion. It not only provides employment for over 13,000 individuals but is making a major contribution to our nation's leadership in computer technology. Yet, Intel might never have been formed or been able to obtain the venture capital required for its growth if its counsel and counsel for its investors had not been willing to rely on exemptions from registration under the Securities Act of 1933. Nor would funds have been available from certain of the venture capital investors if they had not raised investment funds in reliance on opinions of counsel that the registration requirements and proscriptions of the Investment Advisers Act of 1940 and the Investment Company Act of 1940 were not applicable. At each stage of Intel's financing, we and other counsel were required to opine that the Company's financing did not violate the federal securities laws.

Each of these opinions was rendered with full recognition that the perimeters of the exemptions on which counsel were relying were less than certain and that reasonable men might disagree as to their availability. Increasingly narrow interpretations of the private offering exemption by the courts and by the staff of the Commission during the past ten years would make it more difficult today for counsel to render similar securities law opinions. Moreover, even if counsel had not become unwilling to render opinions on the private offering exemption during the past ten years, it would be difficult, if not impossible, to finance a start-up similar to Intel as a private placement today.

Stanley Pratt, publisher and editor of "Venture Capital", the most authoritative journal of the venture capital industry, has stated that the $3 million raised initially to fund Intel would be wholly inadequate today. Because of inflation, increased equipment costs and technological advances, the entry costs today would probably exceed $30 million. I know of few venture capitalists who would attempt a $30 million start-up today, and even fewer circumstances in which lawyers could conclude that an amount that large could be raised in reliance on the private offering exemption.

H.R. 3991 is a response to a number of concerns of the venture capital industry which I believe are genuine and which may only be adequately addressed through the legislative process.

First, the bill reflects a recognition that there is a critical need for venture capital within the small business sector of our economy and that it is in our national interest for Congress to ease the difficulties faced by small business in its efforts to obtain adequate capital. The dramatic decline in the availability of venture capital for emerging businesses and the adverse impact of this decline on our nation's economy have been discussed in the report of the SBA Task Force on Venture and Equity Capital for Small Business in 1977, the report of the Joint Industry/Government Committee on Small Business Financing of the National Association of Securities Dealers in 1979 and in virtually every other study of the capital formation process.

Second, these reports have also noted that the expense and time delay inherent in the registration and compliance processes under the Securities Act of 1933, the Investment Advisers Act of 1940 and the Investment Company Act of 1940 have acted as a deterrent to entering the venture capital business and the financing of new enterprises.

Third, the principle of legislative interpretation that exemptions from registration are to be narrowly construed has been applied by the staff of the SEC and the courts without regard to whether a more liberal approach designed to deregulate venture capital formation is in the national interest.

Finally, it is the Congress and not the SEC which has the responsibility for establishing national priorities and balancing the goals of capital formation and the goals of investor protection under the federal securities laws. For example, Congress declared in the National Environmental Policy Act that all agencies of the federal government had a responsibility to conduct their activities in a manner which promoted the environmental goals of that Act. The SEC reacted to the Congressional mandate by requiring issuers of securities to make additional disclosures of environmental matters not called for by the traditional standard of materiality to an investment decision. Conversely, Congress could determine that the promotion of new and emerging enterprises is in the national interest and provide the Commission with a mandate to deregulate venture capital formation. If it did, the Commission would presumably take steps to facilitate the capital formation process, which it may be reluctant to take at the present time because of the absence of any Congressional directive.

In this regard, I believe the steps taken and proposed to be taken by the Commission to promote venture capital formation are significant and praiseworthy. The announced agreement of the SEC and Department of Commerce to study jointly the effects of SEC regulation on the ability of small business to raise capital and the establishment of an Office of Small Business Policy within the SEC demonstrate a clear departure from the traditional view that its sole mission is to promote investor protection. Similarly, adoption of Form S-18, the proposal of Rule 242 and the proposal to exempt certain registered investment advisers from the prohibition against sharing and gains compensation under the Advisers Act of 1940 all reflect a desire by the Commission to take steps to facilitate capital formation.

Unfortunately, the ability of the Commission to free the financing of small business from the unavoidable delays and costs of complying with the registration requirements of the federal securities laws is severely limited.

For example, Rule 242 has been proposed pursuant to the Commission's authority to grant exemptions under section 3(b) of the 1933 Act. Its purposes are similar to those of Sections 2 and 3 of H.R. 3991, with two significant differences. First, proposed Rule 242 sets a limit of $2 million. The Intel experience illustrates that a $2 million limit on venture capital placements was not adequate for a major technological start-up in 1969 and today is wholly inadequate. Yet it is Congress, not the SEC, which has proscribed the Commission's ability to create a more meaningful exemption because the SEC has no authority under section 3(b) to exceed that amount. Secondly, Rule 242 is proposed as a rule of the Commission which can be modified to reflect experience in its operation. As such, it is a far more flexible means of establishing a venture capital placement exemption than the statutory approach contained in H.R. 3991. I would, therefore, urge that so long as the Commission continues to pursue its current course of seeking means to free capital formation from regulatory burdens, a more salutatory approach would be to increase the limits of section 3(b) to an amount which would be meaningful to the capital formation process, to direct the Commission to adopt rules under sectios 3(b) and 4 of the 1933 Act to free the capital formation process from as much regulation as practicable and to monitor the efforts of the Commission to utilize its rule-making power under that section to carry out its new Congressional mandate.

This brings us to my second observation on the Commission's efforts to facilitate capital formation. The Commission not only lacks an express mandate and authority to free venture capital formation and investment from regulations generally applicable under the federal securities laws, but certain laws administered by the Commission seriously impede, and may even prevent, the effective aggregation of funds for venture capital investment. For example, venture capital limited partnerships which could have been formed with more than 14 limited partners and substantially greater capital have been arbitrarily limited in size because of the general partner's concerns as to the applicability of the Advisers Act. Thus, the adoption of statutory exemptions from registration under the Advisers Act and the Investment Company Act to facilitate the formation of venture capital limited partnerships and corporations should not be viewed as reflecting adversely on the efforts of the Commission to develop exemptive rules and regulations. Rather, they should be considered as the only viable means of removing statutory impediments which the Commission itself is not free to ignore.

Others scheduled to testify will, I am sure, speak to the difficulty - indeed, the impossibility - of a venture capital company operating under the Investment Company Act of 1940. Rather than reiterate those difficulties, which I believe have had the effect of limiting the size of venture capital limited partnerships and therefore the amount of capital available for investment in new enterprises, I would like to make a few observations in support of the approach, although not necessarily the details, of section 6 of H.R. 3991.

Venture capital investments are illiquid unless and until the investment proves successful. Investors making them expect that their investments must be held for years before significant appreciation is likely to occur. Venture capital funds have a low turnover rate and are not invested in puts, calls or other trading vehicles. Thus venture capital pools are unlike traditional mutual funds and the abuses sought to be curbed by Congress when it adopted the Investment Company Act are far less likely to occur.

I believe an exemption from the 1940 Act for venture capital companies will permit individual investors, aided by professional advice and sophisticated money management, to return to the greater risk - greater potential reward segment of the securities market they have been effectively barred from since the hot issue market of the 60's. As a result of the decline of the new issue market, the increased costs of financing initial public offerings and the institutionalization of venture capital investments, individual investors have few opportunities today to participate in venture capital investments. Permitting the creation of more broadly owned venture capital companies which would be subject to the disclosure obligations and antifraud rules of the Securities Act and the Securities Exchange Act but would not be subject to the registration requirements and prohibitions contained in the Advisers Act and the Investment Company Act would, in my judgment, allow individual investors to become a viable part of the capital formation process. Most significantly, it would permit them to share in those venture investments which have the highest likelihood of success and are offered only to large institutional investors, rather than relegating the individual investor to the least likely to succeed leftovers, such as the many high risk start-ups which were sold to the public in the 60's because they were not of sufficient quality to attract institutional investor interest. Broad public participation in venture capital pools should not be considered less desirable or more risky than public investment directly in those companies eligible for Form S-18. However, if it is appropriate to restrict investment in venture capital pools, the SEC could be given authority to designate accredited categories of investors.

Section 4 of H.R. 3991 addresses a resale problem which the Commission has dealt with in the most recent amendments to Rule 144. In light of the Commission's action, I do not believe section 4 is necessary at the present time.

The only section of H.R. 3991 on which I have not thus far commented, section 5, would eliminate what many consider the draconian consequences of an innocent and immaterial transgression of the vague boundaries of section 4(2) of the 1933 Act. Under existing law a good faith effort to satisfy the requirements of the private offering exemption is not enough. If the issuer can't prove that offers were made only to sophisticated prospective investors, a disgruntled purchaser whose own acquisition of securities met the letter and the spirit of the private offering exemption can disaffirm his purchase. No fraud or intentional wrongdoing need be demonstrated. This has the potential for causing great financial harm to both the issuer and to other investors who have no desire to rescind the financing. It is especially anomalous that the right to rescind exists even though the offerers who taint the private offering exemption do not wish to complain and don't even purchase the security that was offered.

For example, in Henderson v. Hayden, Stone Incorporated, the Court of Appeals for the Fifth Circuit permitted Mr. Henderson, a retired professional investor who had an investment portfolio of several million dollars, to rescind his purchase. No fraud existed. Mr. Henderson thoroughly understood the nature of his investment and did not need the protection of a registration statement. However, because the defendants could not clearly establish that offers were not made to non-purchasers who were not sophisticated, Mr. Henderson was able to get out of his investment. This strikes me as a gross misuse of the protective provisions Congress thought it was enacting in 1933. Because it would rectify this inequity, I heartily endorse the adoption of section 5 of H.R. 3991.

In summary, I believe that H.R. 3991 contains several sections which are quite desirable because they address problems which the Commission cannot deal with by rule-making. Other sections of the bill, however, deal with problems which may be handled more effectively by the SEC under its present rule-making authority if the Commission is given an appropriate Congressional mandate.

I would be pleased to respond to any questions you have and wish to thank you again for the opportunity to present my views to you today.

Mr. BROYHILL. I regret, before we go on, the subcommittee must stand in a recess for a few minutes and let me respond to the bells that just rang.

[Brief recess.]

Mr. BROYHILL. The subcommittee will come to order.

Thank you, Mr. Mann, for your testimony.

I will now recognize Mr. Wallison of Rogers and Wells.

Mr. Wallison, we have had an opportunity to review your testimony. If you want to have it inserted in the record it will be inserted, and you will have an opportunity to review it.

STATEMENT OF PETER J. WALLISON

Mr. WALLISON. Thank you, Mr. Chairman.

I would like to attempt to shorten my prepared statement somewhat so we can proceed more quickly this morning.

With me today is my colleague, John Lifton, who is also a partner in our firm, and both of us are securities lawyers. Mr. Liftin practices in Washington. I practice in New York.

We are here, and grateful for the opportunity, to represent to the committee the views of the American Council for Capital Formation on H.R. 3991.

We would like to confine our remarks, at least our prepared remarks, to sections 2 and 3 of the bill, but would be pleased to respond to questions on all the other sections of the bill afterward.

Sections 2 and 3 proceed on the theory that the Securities Act of 1933, at least insofar as its registration and disclosure requirements are concerned, was intended to balance the public interest in disclosure with the interest of securities issuers in keeping down the cost and time involved in raising capital.

The balance struck by Congress was a determination that the registration provisions of the act would apply only to offerings which were made to the public generally and not to offerings made privately, so that section 4(2) of the act exempts from the act's registration requirements sales of securities which "do not involve any public offering."

Where the line is to be drawn between public and nonpublic offerings is of course a difficult one, but in 1951, in the leading case of *SEC* v. *Ralston Purina*, the Supreme Court chose what we think is a logical and practical standard, quoting with approval the House committee report on the act to the effect that an offering would not be a public offering for which registration was required "where there is no practical need for [the act's] application."

To the Court in *Ralston*, there was no practical need for the act's application where the offerees could, "fend for themselves"; that is, in the Court's words: "The applicability of section 4(2) should turn on whether the particular class of persons affected need the protection of the act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving a public offering.' "

Thus, in 1951 the Supreme Court appeared to hold that whether a securities offering was public or nonpublic turned on whether the offerees of these securities were able to fend for themselves. The focus, in other words, was on the character of the offerees, and where an issuer could show that its offerees were sophisticated persons who could understand the risks involved and request and analyze information about the issuer necessary for an informed business judgment, it could offer and sell its securities without registration with some assurance that the act would not be violated.

Since that time, however, with the encouragement of the SEC, the lower Federal courts have shifted the focus of inquiry from the character of the offerees to the character of the information furnished to them, holding in many cases that in order to claim the private offering exemption the issuer had to show that it had furnished to its offerees the same information which a registration statement would have provided, or that the offerees otherwise had access to such information through an insider relationship with the issuer. With this information it was contended, the offerees could then "fend for themselves."

This interpretation more or less stood the private offering exemption on its head, since in its fullest flowering—in the SEC's rule 146—the issuer could only be sure that its offering was exempt if it offered only to sophisticated investors and furnished all the information a registration statement would provide. The exemption, in effect, had become more burdensome, although not necessarily more time consuming, than the registration process itself.

H.R. 3991 sets out to restore the balance which we believe was originally envisioned by Congress and explicated by the Supreme Court in *Ralston Purina*. In section 2, it provides that any securities transaction with an "accredited investor"—that is, an institutional investor or a sophisticated person—would be exempt from the registration requirements of the act.

Several things should be noted about this provision:

First, it is not exclusive; other transactions may be exempt, depending on facts and circumstances. In effect, section 2 provides a safe harbor for issuers who propose to offer securities only to institutional investors or sophisticated individuals.

Second, it does not prescribe that any particular information be furnished by an issuer to an accredited investor; it presumes, in other words, that a sophisticated investor knows what to look for and will not risk his money unless he gets it.

Third, it contains no limit on the size of the offering and no limit on the number of accredited investors to whom the issuer may sell. In principle, there does not appear to be any need for limitations of these kinds.

Fourth, the "safe harbor" provided by the bill extends only to an exemption from the registration requirements of the act; any sale of a security through use of false or misleading information would still be covered by sections 12 and 17 of the Securities Act and section 10 of the Securities Exchange Act.

Thus, under section 2 of the bill, an issuer could sell its securities without registration, in unlimited amounts to an unlimited number of investors, provided that these investors meet the standard for "accredited investors" established in section 3(b) of the bill.

At this point, I believe it is appropriate to discuss briefly the SEC's new rule 242, which in some respects responds to the objectives of section 2 of the bill. Rule 242 would provide an exemption from registration under the act for sales of securities into an unlimited number of what the new rule calls "accredited persons" and up to 35 other persons who do not fall into this category. Under the rule, an "accredited person" is an institutional investor or a person who invests $100,000 or more in the securities offered.

The rule would be available for sales of up to $2 million in any 6-month period, and the SEC release which accompanied the proposed rule notes that the issuer would not have to furnish any particular information about itself to accredited persons because of, and I am quoting the SEC here, "the ability of such persons to ask for and obtain the information they feel is necessary to their making an informed investment decision."

The proposed rule, then, reflects an acceptance by the SEC of the underlying premise of the bill: That sophisticated investors, because they have the ability to obtain the information about the issuer which they need for an informed investment decision, do not require the registration protections of the act. The SEC, in this case, has taken the position that it is the character of the offerees, rather than the character of the information furnished to them, which determines whether the registration protections of the act should apply.

In certain important respects, however, rule 242 goes only part of the way toward the reform which H.R. 3991 would effect. The rule would limit the aggregate amount of any offering under its terms to $2 million in any 6-month period and would permit the resale of securities only pursuant to rule 144, the rule which applies to the resale of restricted securities purchased for investment and to resales by affiliates.

The $2 million limitation, which arises out of the SEC's use of section 3(b) of the act as the statutory authority for its proposed rule, will make the rule substantially less useful to issuers.

When proposed rule 242 deals with resales of securities, it attempts to funnel all of them through rule 144, the current SEC rule which permits investors to resell securities they have purchased for investment. Rule 144 provides, in brief, that an investor who has held his securities for 2 years or more may resell them in unsolicited brokerage transactions in amounts which the SEC deems will not disrupt orderly trading in the securities markets. The rule assumes the existence of a public market for the issuer's securities.

It should be noted, however, that the rule is intended to define the boundaries of the term "underwriter" as used in section 4(1) of the act and thus to prevent issuers from evading the registration requirements of the act by selling to persons who would effect a distribution to the public at large without registration. It does not contemplate the theory underlying proposed rule 242—that there is a class of persons sophisticated enough to purchase securities without the disclosure protections of the act.

As long as we assume, as rule 242 does assume, that the accredited person can fend for himself, there is no need to restrict resales made solely to accredited persons. Any such person, before making a purchase of resold securities, will endeavor to acquire information about the issuer which he considers satisfactory for an informed decision. And if he does not, there is no reason the Government should protect him against his own lack of prudence.

Section 3 of H.R. 3991 proceeds on this theory. It is intended to permit resales of securities to accredited investors, without any greater limitations on sale than were initially placed on the issuer itself.

The effect of this, the Council hopes, will be the creation of a new market for securities of developing companies, a market consisting solely of the thousands of institutions and other sophisticated investors whose willingness and ability to take risks will provide capital for new ventures.

The absence of such a market in the United States at the present time is in substantial part, the Council believes, the result of overregulation of the sale of securities—a pattern of regulation which, in attempting to protect the general public. has raised the cost of capital and restricted the availability of capital to the small firm.

In so doing, the securities laws have forced developing companies to seek capital, frequently in the form of debt capital, from the limited number of investors who are willing to accept the illiquidity associated with holding securities over the long term, reduced the ability of individuals with new ideas to establish new businesses and new markets, and contributed significantly, we believe, to the concentration of innovative developments in the hands of established enterprises.

H.R. 3991 would make significant changes in this area. By permitting unfettered resale to accredited investors of securities initially sold to other accredited investors, the bill would free up the capital markets for developing companies. How this will happen may be illustrated by an example.

Let us assume that a small company has developed a device which, if it proves out, could save substantial amounts of electricity. To proceed with the development of its invention, the company needs capital for the following purposes, in roughly the following order: To prove that its theory is workable, to apply for and obtain a patent, to develop a prototype model, to find a market and make estimates of demand, to acquire plant and equipment, and ultimately to expand its plant and refine its product if initial marketing has been successful.

At each of these steps, an investment in the company is slightly less speculative than at each preceding step, and the risk-reward calculus associated with each step would be slightly different. It can be expected that the company's initial investors will be taking high risks for high returns, while those investing at the later stages of its development will be taking lesser risks for lesser rewards.

What is important to recognize is that the amount of risk capital all the way along the line is limited, and if we pursue policies which lock in this risk capital for long periods we are limiting its availability still further.

However, returning to our example, if the company has successfully proved that its invention is workable, or has obtained a patent, the investors who financed this stage of its development should be able to sell out to investors who customarily take lesser risks, thus making their capital and profits available for other speculative ventures.

On the other hand, if resale of these securities must await the development of a public market for the securities of the company, which would be the case if rule 144 were the only way out, the investors' venture capital funds might be tied up for years.

Not only does this reduce the total amount of risk capital available to developing firms, but the prospect of having to carry an illiquid investment for many years will make the investor more reluctant to commit funds and more reluctant to make an equity investment. This in turn will raise the cost of capital to those developing firms lucky enough to have access to it.

Finally, the investor's desire to assure himself of an opportunity to liquidate his investment may lead him to demand and get a commitment from the company to proceed with a public offering of securities within a specified period of time. It is at this point that the proposal for unrestricted resale of securities in H.R. 3991 may be seen to have the effect of protecting the public against excessively speculative investments.

It must be remembered that the securities laws are disclosure statutes, and that as long as disclosure of risks is made the general public investor may purchase any security he pleases.

Although this policy is undoubtedly a sound one on balance, it is questionable whether securities regulation ought to be structured in such a way as to encourage the sale of speculative issues to the general public through the registration process.

As Mr. Mann noted, there have been periods in the past when a substantial number of companies which registered securities for an initial public offering became bankrupt within a few years. For the most part, the risks were disclosed, but the public was of a mind to accept them. The question is whether the risks assumed were appropriate to the economic status of those who assumed them.

It is doubtful that all of the speculative issues which were offered to the public during those periods, or for that matter today, would have found their way into the hands of the public if there had been available to issuers an alternative means of raising capital.

The costs imposed by the Securities Act on an initial offering of securities and the continuing legal, administrative, and accounting costs of reporting to public shareholders and complying with other requirements of the Securities Exchange Act might have discouraged such offerings if other sources of risk capital had been readiliy available.

The enactment of H.R. 3991 in its present form would be a substantial improvement over proposed rule 242, which continues the SEC policy which would have the effect of encouraging the registration and sale of speculative securities to the public.

H.R. 3991, in operation, would permit the risk-reward system of the private capital market to allocate risk and venture capital to developing companies. Those who understand and can afford the risks involved will be taking those risks, and the badly managed or poorly conceived ventures will be winnowed out before the general public is asked to invest.

Most important from the standpoint of those concerned about capital formation, Mr. Chairman, the total amount of venture capital available to small firms will be enlarged, not because dollar amounts will necessarily grow, although they might once the barrier of illiquidity is removed, but because the velocity of risk and venture capital moving through the system will increase.

Thank you very much, Mr. Chairman.

We will be pleased to answer any questions you may have.

[Testimony resumes on p. 230.]

[Mr. Wallison's prepared statement follows:]

Statement of Peter J. Wallison
On Behalf of
The American Council for Capital Formation
before the
Subcommittee on Consumer Protection and Finance
of the
Committee on Interstate and Foreign Commerce
November 8, 1979

Mr. Chairman and Members of the Committee, my name is Peter J. Wallison. With me today is my colleague, John M. Liftin. Mr. Liftin and I are lawyers, respectively, in Washington and New York. We are grateful for this opportunity to present to the Committee the views of the American Council for Capital Formation on the Small Business Investment Incentive Act of 1979 (H.R. 3991).

The American Council for Capital Formation is a rapidly growing association of individuals and businesses dedicated to promoting productive investment that fosters stable growth, limits inflation, and creates jobs for our expanding work force. Established in the early 1970's, the Council has actively supported legislation encouraging saving and productive investment. The Council believes that sound regulatory policies, as well as sound tax policies, are essential to a strong economy.

With your permission, our remarks today will focus solely on Sections 2 and 3 of the bill, although we would be happy to respond to questions concerning the bill as a whole.

H.R. 3991 proceeds on the theory that the Securities Act of 1933, at least insofar as its registration and disclosure requirements are concerned, was intended to balance the public interest in disclosure with the interest of securities issuers in keeping down the cost and time involved in raising capital.

The balance struck by Congress was a determination that the registration provisions of the initial Act would apply only to offerings which were made to the public generally and not to offerings made privately--so that Section 4(2) of the Act exempts from the Act's registration requirements sales of securities which "do not involve any public offering."

Where the line is to be drawn between public and non-public offerings is of course a difficult one, but in 1951, in the leading case of SEC vs. Ralston Purina, the Supreme Court chose a logical and practical standard, quoting with approval the House Committee Report on the Act to the effect that an offering would not be a public offering for which registration was required "where there is no practical need for the (Act's) application."

To the Court in Ralston, there was no practical need for the Act's application where the offerees could "fend for themselves"--that is, in the Court's words, "The applicability of [§ 4(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving a public offering.'"

Thus, in 1951 the Supreme Court appeared to hold that whether a securities offering was public or non-public turned on whether the offerees of these securities were able to fend for themselves. The focus, in other words, was on the character of the offerees, and where an issuer could show that its offerees were sophisticated persons who could understand the risks involved and request and analyze information about the issuer necessary for an informed business judgment, it could offer and sell its securities without registration with some assurance that the Act would not be violated.

Since that time, however, with the encouragement of the SEC, the lower federal courts have shifted the focus of inquiry from the character of the offerees to the character of the information furnished to them, holding in many cases that in order to claim the private offering exemption the issuer had to show that it had furnished to its offerees the same information which a registration statement would have provided, or that the offerees otherwise had access to such information through an insider relationship with the issuer. With this information, it was contended, the offerees could "fend for themselves."

This interpretation more or less stood the private offering exemption on its head, since in its fullest flowering--in the SEC's Rule 146--the issuer could only be sure that its offering was exempt if it offered only to sophisticated investors <u>and</u> furnished all the information a registration statement would provide. The exemption, in effect, had become more burdensome (although not necessarily more time-consuming) than the registration process itself.

H.R. 3991 sets out to restore the balance originally envisioned by Congress and explicated by the Supreme Court in Ralston Purina. In Section 2, it provides that any securities transaction with an "accredited investor" -- that is, an institutional investor or a sophisticated person -- would be exempt from the registration requirements of the Act. Several things should be noted about this provision:

1. It is not exclusive; other transactions may be exempt, depending on facts and circumstances. In effect, Section 2 provides a safe harbor for issuers who propose to offer securities only to institutional investors or sophisticated individuals.
2. It does not prescribe that any particular information be furnished by an issuer to an accredited investor; it presumes, in other words, that a sophisticated investor knows what to look for and will not risk his money unless he gets it.
3. It contains no limit on the size of the offering and no limit on the number of accredited investors to whom the issuer may sell. In principle, there does not appear to be any need for limitations of these kinds.

4. The "safe harbor" provided by the bill extends only to an exemption from the registration requirements of the Act; any sale of a security through use of false or misleading information would still be covered by Sections 12 and 17 of the Securities Act and Section 10 of the Securities Exchange Act.

Thus, under Section 2 of the bill an issuer could sell its securities without registration, in unlimited amounts to an unlimited number of investors -- provided that these investors meet the standard for "accredited investors" established in Section 3(b) of the bill.

At this point, I believe it is appropriate to discuss briefly the SEC's new Rule 242, which in some respects responds to the objectives of Section 2 of the bill. Rule 242 would provide an exemption from registration under the Act for sales of securities to an unlimited number of "accredited persons" and up to 35 other persons who do not fall into this category. Under the Rule, an "accredited person" is an institutional investor or a person who invests $100,000 or more in the securities offered. The Rule would be available for sales of up to $2 million in any six month period, and the SEC release which accompanied the proposed Rule notes that the issuer would not have to furnish any particular information about itself to accredited persons because of "the ability of such persons to ask for and obtain the information they feel is necessary to their making an informed investment decision."

The proposed Rule, then, reflects an acceptance by the SEC of the underlying premise of the bill: that sophisticated investors, because they have the ability to obtain the information about the issuer which they need for an informed investment decision, do not require the registration and disclosure protections of the Act. The SEC, in this case, has taken the position that it is the character of the offerees, rather than the character of the information furnished to them, which determines whether the registration and disclosure protections of the Act should apply.

In certain important respects, however, Rule 242 goes only part of the way toward the reform which the bill would effect. The Rule would limit the aggregate amount of any offering under its terms to $2 million in any six month period, and would permit the resale of securities only pursuant to Rule 144 -- the rule which applies to the resale of restricted securities purchased for investment and to resales by affiliates.

The $2 million limitation arises out of the SEC's use of Section 3(b) of the Act as the statutory authority for its proposed Rule. Section 3(b) grants the SEC the authority to exempt certain securities and offerings from the Act, but limits any such exemption to $2 million. The use of Section 3(b) and the $2 million limitation it imposes both seem unnecessary. Rule 146, which purports to provide a "safe harbor" for private offerings under Section 4(2), does so simply by defining all transactions which comply with its terms as transactions not involving any public offering within the meaning of that Section. The same approach could easily have been used for proposed Rule 242, which with a few modifications could substitute entirely for Rule 146.

In any event, there does not appear to be any reason of policy for limiting offerings to sophisticated persons to $2 million, and the limitation will make the new Rule substantially less useful to issuers.

When proposed Rule 242 deals with resales of securities it attempts to funnel all of them through Rule 144, the current SEC Rule which permits investors to resell securities they have purchased for investment. Rule 144 provides, in brief, that an investor who has held his securities for two years or more may resell them in unsolicited brokerage transactions in amounts which the SEC deems will not disrupt orderly trading in the securities markets. It is important to note that resales under Rule 144 presuppose the existence of an active public market for the securities to be sold.

For this reason, among others, the sole use of Rule 144 for resales of securities under Rule 242 is unsatisfactory and needlessly restrictive. Although Rule 144 continues to have viability for the resale of securities to the general public, it should not be applied to resales to other accredited persons, and for the reasons discussed below its application in this fashion raises the cost of capital to issuers and hinders the free flow of venture capital financing.

To understand why Rule 144 should have no role in resales to accredited persons it is necessary to discuss briefly the background and purposes of Rule 144. In its most important aspects, Rule 144 is a codification of usages which were developed over the years by the SEC staff, and the securities bar to deal with the failure of the Securities Act to provide any objective standard for determining when a person who had purchased securities from an issuer could resell such securities without being classified as an underwriter.

Section 4(1) of the Securities Act exempts from the Act's registration provisions sales by any person other than an issuer, underwriter or dealer. Thus, if a person who is not a dealer in securities purchases securities from an issuer and immediately resells them, his sale might at first glance appear to be exempt from the Act and to provide a way for an issuer to effect a distribution of its shares to the public at large without registration. From the inception of the Act, however, it was held that a person who purchased from an issuer and promptly resold his securities was an underwriter within the meaning of Section 2(11) of the Act, which defines the term "underwriter" to include any person who purchases from an issuer "with a view to" reselling such securities. Thus, even though such a person was not engaged as a business in underwriting or dealing in securities, if he purchased securities from an issuer and resold them to the public he would be a statutory underwriter under the Act and the securities he proposed to resell would have to be registered.

This raised a problem of interpretation. It was obvious that at some time such a person would have held his securities long enough to demonstrate that he had purchased his securities for investment and not with a view to distribution, and the SEC and the securities bar gradually settled on a holding period of 2 to 3 years as indicative of what was called "investment intent".

With the promulgation of Rule 144 in 1974 the SEC determined that two years would be an appropriate holding period, provided that all other provisions of the Rule -- including the public availability of information about the issuer and limitations on the manner of sale and the number of securities sold in given periods of time -- were complied with.

It should be noted, however, that the Rule is intended to define the boundaries of the term "underwriter" as used in Section 4(1) of the Act and thus to prevent issuers from evading the registration requirements of the Act by selling to persons who would effect a distribution to the public at large without registration. It does not contemplate the theory underlying proposed Rule 242 -- that there is a class of persons sophisticated enough to purchase securities without the disclosure protections of the Act.

When this is taken into account, it becomes clear that, for resales to these persons, there is no necessity for funneling resales through Rule 144. If an accredited person under Rule 242 does not require the protection of the Act's disclosure provisions on his initial purchase of a security, he should not require such protections when he purchases the same security from another accredited investor.

In terms of the Act, another way of saying this is that if it is not a public offering to sell to an unlimited number of accredited persons under proposed Rule 242, no accredited person should be considered an underwriter if he resells to another accredited person. Indeed, such an interpretation is fully in accord with Section 2(11) of the Act which defines an underwriter as one who purchases securities from an issuer with a view to distribution. If the issuer has not made a distribution in selling to 100 accredited persons, no accredited person should be classified as an underwriter for reselling to other accredited persons.

As long as we assume -- as Rule 242 does assume -- that the accredited person can fend for himself, there is no need to restrict resales made solely to accredited persons. Any such person, before making a purchase of resold securities, will endeavor to acquire information about the issuer which he considers satisfactory for an informed decision. And if he does not, there is no reason the government should protect him against his own lack of prudence.

Section 3 of H.R. 3991 proceeds on this theory. It is intended to permit resales of securities to accredited investors -- without any greater limitations on sale than were initially placed on the issuer itself. The effect of this, the Council hopes, will be the creation of a new market for securities of developing companies -- a market consisting solely of the thousands of institutions and other sophisticated investors whose willingness and ability to take risks will provide capital for new ventures.

The absence of such a market in the United States at the present time is in substantial part, the Council believes, the result of over-regulation of the sale of securities -- a pattern of regulation which, in attempting to protect the general public has raised the cost of capital and restricted the availability of capital to the small firm. In so doing, the securities laws have forced developing companies to seek capital, frequently in the form of debt capital, from the limited number of investors who are willing to accept the illiquidity associated with holding securities over the long term, reduced the ability of individuals with new ideas to establish new businesses and new markets, and contributed significantly to the concentration of innovative developments in the hands of established enterprises.

H.R. 3991 would make significant changes in this area. By permitting unfettered resale to accredited investors of securities initially sold to other accredited investors, the bill would free up the capital markets for developing companies. How this will happen may be illustrated by an example. Let us assume that a small company has developed a device which, if it proves out, could save substantial amounts of electricity. To proceed with the development of its invention, the Company needs capital for the following purposes, in roughly the following order: to prove that its theory is workable, to apply for and obtain a patent, to develop a prototype model, to find a market and make estimates of demand, to acquire plant and equipment, and ultimately to expand its plant and refine its product if initial marketing has been successful.

At each of these steps, an investment in the company is slightly less speculative than at each preceding step, and the risk-reward calculus associated with each step would be slightly different. It can be expected that the company's initial investors will be taking high risks for high returns, while those investing at the later stages of its development will be taking lesser risks for lesser rewards. What is important to recognize is that the amount of risk capital available is limited, and that if we pursue policies which lock in this risk capital for long periods we are limiting its availability still further.

However, returning to our example, if the company has successfully proved that its invention is workable, or has obtained a patent, the investors who financed this stage of its development should be able to sell out to investors who take lesser risks, thus making their capital and profits available for other speculative ventures. On the other hand, if resale of these securities must await the development of a public market for the securities of the company -- which would be the case if Rule 144 were the only way out -- the investors' venture capital funds might be tied up for years. Not only does this reduce the total amount of risk capital available to developing firms, but the prospect of having to carry an illiquid investment for many years will make the investor more reluctant to commit funds, and more reluctant to make an equity investment. This in turn will raise the cost of capital to those developing firms lucky enough to have access to it.

Finally, the investor's desire to assure himself of an opportunity to liquidate his investment may lead him to demand and get a commitment from the company to proceed with a public offering of securities within a specified period of time. It is at this point that the proposal for unrestricted resale of securities in H.R. 3991 may be seen to have the effect of protecting the public against excessively speculative investments.

It must be remembered that the securities laws are disclosure statutes, and that as long as disclosure of risks is made the general public investor may purchase any security he pleases. Although this policy is undoubtedly a sound one on balance, it is questionable whether securities regulation ought to be structured in such a way as to encourage the sale of speculative issues to the general public through the registration process. There have been periods in the past -- "hot issues" markets -- when a substantial number of companies which registered securities for an initial public offering became bankrupts within a few years. For the most part, the risks were disclosed, but the public was of a mind to accept them. The question is whether the risks assumed were appropriate to the economic status of those who assumed them.

It is doubtful that all of the speculative issues which were offered to the public during those periods, or for that matter today, would have found their way into the hands of the public if there had been available to issuers an alternative means of raising capital. The costs imposed by the Securities Act on an initial offering of securities and the continuing legal, administrative and accounting costs of reporting to public shareholders and complying with other requirements of the Securities Exchange Act might have discouraged such offerings if other sources of risk capital had been readily available.

Yet, in effect, the requirement that all resales take place through Rule 144 compels speculative companies to become publicly held as quickly as possible, so that their investors can liquidate their positions. H.R. 3991 would reduce this pressure, permitting accredited investors to liquidate their positions to other accredited investors. There would be no need for an accredited investor to require that the company become publicly owned in the near future, since he would have an opportunity to recycle his funds -- taking his profit or loss -- without a public market for the company's securities.

In this way, the enactment of H.R. 3991 in its present form would be a substantial improvement over proposed Rule 242, which continues the SEC policy which would have the effect of encouraging the registration and sale of speculative securities to the public. H.R. 3991, in operation, would permit the risk-reward system of the private capital market to allocate risk and venture capital to developing companies. Those who understand and can afford the risks involved will be taking those risks, and the badly-managed or poorly conceived ventures will be winnowed out before the general public is asked to invest.

Most important from the standpoint of those concerned about capital formation, the total amount of venture capital available to small firms will be enlarged -- not because dollar amounts will necessarily grow, although they might once the barrier of illiquidity is removed, but because the "velocity" of risk and venture capital moving through the system will increase.

Thank you very much. We will be pleased to answer any questions you may have.

Mr. BROYHILL. Thank you very much for your testimony.

Mr. Rinaldo, do you have any questions?

Mr. RINALDO. I have one question.

First of all, I want to thank you for your testimony. I think it was exceptionally good. The SEC has said that we shouldn't lock into a statute what they can do by rulemaking. With their proposed rule 242 there is a $2 million ceiling in resale available outside the restrictive terms of rule 144. Could the SEC cure these ills by rulemaking, or do you think that there is real need for legislation?

Mr. WALLISON. As a matter of fact, I believe the SEC could cure these ills by rulemaking, but that is a slightly different question from whether the SEC ought to be permitted to do this on its own motion, or should, by legislation, be required to do it.

The $2 million limitation which is placed on sales of securities in proposed rule 242 arises out of the fact that rule 242 was promulgated by the SEC under section 3(b) of the Securities Act. By law, Congress has placed a $2 million limitation on the exemptions that the SEC can provide under that section.

However, if we focus instead on section 4(2) the situation is different. In rule 146, the SEC has defined the statutory term "distribution" not to include the sale of securities in compliance with that rule, with no limitation as to maximum amount. Using the same theory, it would also be possible for the SEC to promulgate a rule under section 4(2) of the act which would not be subject to the $2 million limitation that Congress has imposed through section 3(b).

However, then you get back to the question of what would happen if you did leave the matter to the SEC. Would the SEC go ahead and do it? On that I must confess I have certain doubts.

The SEC, like any other institution, has developed over a period of time a bureaucratic attitude—not to cast any aspersions on it—but an institutional approach to sales of securities without registration. It would be extremely difficult, without a strong congressional command, it seems to me, to get the SEC to adopt a rule which does not contain the $2 million limitation in rule 242 and also permits the free resales which are part of H.R. 3991.

Mr. BROYHILL. Would the gentleman yield at that point?

Mr. RINALDO. I would be pleased to yield.

Mr. BROYHILL. Mr. Mann testified earlier and it appears to me that perhaps there is some difference of opinion here. I understood Mr. Mann to say that perhaps the SEC could do the job, but it lacks a mandate and that they be given a mandate—an "appropriate mandate", I think, is the term he used. I think that Mr. Wallison is saying, in effect, that the Congress should pass legislation in these areas in order to correct these particular problems, whereas you are saying that they be nudged a little and they can do it by rulemaking.

Am I misinterpreting your remarks?

Mr. MANN. No; that is correct, sir. I did also recommend that the limit of 3(b) be increased so that they could create a viable venture capital exemption under that section. I certainly agree that it is unlikely today without legislation that the SEC will by rulemaking solve the problem.

There are two problems that we are confronted with. One, with respect to any rule under section 4(2) of the act, the Commission, and I believe quite properly, takes the view that no rule of the Commission can go beyond the statutory interpretation placed on section 4(2) by the courts. Thus rule 146, which has rather limited utility, was a reflection in large part of a feeling by the Commission that they couldn't have gone any further under 4(2). That is why rule 242 is proposed under 3(b) where you don't have the courts having limited what can be done the way they have done under 4(2).

Mr. BROYHILL. What I am really getting at here is, with respect to your testimony, if I may interrupt just a minute, what I am not clear on is to what extent or how you would write a congressional mandate.

How broad would it be? It would seem to me that it would be better for the Congress to be more specific in these areas in giving direction to the SEC rather than passing broad brush legislation encouraging the SEC to administer the action in such a way as to create more capital for small businesses in the country.

It would seem to me it would be far better to address each one of these problem areas and to write legislation that would not only give the SEC direction, but would not be subject to a great deal of litigation in the courts.

Mr. MANN. On previous occasions when Congress has given the SEC a mandate, as it did in the environmental area, the Commission has demonstrated that by rulemaking it will carry out the congressional intent. One of the basic problems in not having a mandate was illustrated yesterday by Commissioner Loomis' testimony, where he said the Commission is concerned that small businesses should have an appropriate market to raise capital, and in the next paragraph of his statement he said, "At the same time, the Commission is charged with the responsibility of insuring the integrity of securities markets."

There is a difference between being concerned and being charged with the responsibility, and I believe what I am suggesting is if you charge the Commission with both responsibilities you may very well find rulemaking providing the solution.

Mr. BROYHILL. Thank you. I just wanted to see what the differences were here in the testimony.

Mr. RINALDO. I think you raised a good point, but I am a little unsure of your position. I get the impression you definitely favor legislation. Do you favor legislation or do you think there should be rulemaking; should it be left up to the SEC? Perhaps there should be pressure from Congress.

Mr. MANN. With respect to the private offering or venture capital creation sections of H.R. 3991, I would favor expanding the 3(b) limit to a viable limit for capital formation and providing a mandate to the Commission and then sitting back and watching what they do by rulemaking.

I have a high degree of confidence in the present Commission's desire and ability by rulemaking to accomplish what these sections of the bill are designed for.

Mr. RINALDO. What limit would you suggest?

Mr. MANN. At a minimum, I would suggest a $5 million limit. From my own experience in practice, I would think that a $10 million limit might be quite appropriate.

Mr. RINALDO. Obviously you object to no limit at all, so why not just remove the limit?

Mr. MANN. No, sir; I would not say that I objected to no limit at all, and perhaps it is inappropriate for me to suggest a limit because the suggestion of a limit is a suggestion that a no-limit provision would not be acceptable to Congress.

If Congress would be willing to delegate the Commission authority to adopt exemptions without a dollar limit, then that might very well be a desirable provision to add to the bill.

Mr. RINALDO. How would you feel about indexing the limit to the rate of inflation?

Mr. MANN. I think that is an excellent idea. My formal statement refers to the experience in forming a company called Intel Corp., which is one of the leaders in semiconductor technology in the United States. And at the time Intel was formed in 1969, the total venture capital that went into it was $500,000 from the three founders and $2.5 million from venture capital investors.

By 1979, according to the estimates that I have seen, instead of $3 million, it would take $30 million to form that company, and indexing will in large part address itself to that problem.

Mr. RINALDO. Do you wish to comment?

Mr. LIFTIN. I would like to comment, if I could, Congressman Rinaldo. I have a slightly different opinion than Mr. Mann with respect to the Commission's willingness in all events to follow through with rulemaking to support legislative intent.

I think some recent evidence of that is the performance of the Commission in carrying out the congressional mandate established under the Securities Act Amendments of 1975, in particular with respect to the development of a national market system for securities.

I think the Commission will carry out congressional mandate if it happens to be consistent with its policy at the time or that is seen by the majority of the commissioners, and so, without wanting to seem unduly skeptical about it, I think another point of view would be to enact legislation such as that suggested in this bill and if there is concern about the size or about the policy of other abuses, perhaps give the Commission authority on the making of certain affirmative findings in a formal type of proceeding to then impose restrictions but, in other words, to put the burden on the Commission to cut back with rulemaking rather than giving them the complete initiative and hoping that they will carry through.

Mr. RINALDO. You say they are not carrying through with the national market?

Mr. LIFTIN. It is, of course, a matter of opinion.

I drew the impression from the oversight hearings of several weeks ago that that was the consensus of some members of the subcommittee.

Mr. RINALDO. Just so the record shows, that may have been the opinion of some members.

I think that the national market system is moving along as rapidly as it can. Certainly I wouldn't want to see it changed overnight into a completely automated system, and I feel that the Commission has to tread with caution, because we can't just completely eliminate the human factor that is so necessary to the proper functioning of that system.

My own personal opinion—and I know there are some members of the committee who disagree with me—is that it is moving along at an extremely satisfactory pace.

Mr. LIFTIN. Without disagreeing with that view, I just suggest that that is an area where there is a good deal of difference of opinion. I think here the issues are much clearer cut and easier to deal with and that for that reason it would be a better example of a case where you can spell out exactly what is to be done and then provide for Commission flexibility, for administrative flexibility, by letting the Commission cut back if they find that there are abuses.

Mr. RINALDO. So you, in other words, favor the legislative approach?

Mr. LIFTIN. I do think that is preferable. I think it can clearly be done the other way.

Mr. RINALDO. I have no further questions, Mr. Chairman.

Mr. BROYHILL. Let me ask one or two other questions.

Did I understand, Mr. Wallison, that you feel that the definition of an accredited investor that is included in H.R. 3991 is about right?

Mr. WALLISON. Yes, I would be satisfied with that.

Mr. BROYHILL. It was said yesterday, I think, in testimony that it was too broad. Would you want to respond to that criticism?

Mr. WALLISON. I respond, Mr. Chairman, only by saying that I think the bill gives the right amount of authority to the Securities and Exchange Commission in this area. In subsection (A) it defines those investors who would clearly fall within anyone's definition of sophisticated. In subsection (B), it then permits the SEC, with its specialized knowledge of the securities field, to create yet another class of persons who would fall within the category of sophisticated investors. And then, finally, in subsection (C), it opens up to everyone who wishes to participate in taking risks—and certainly people who are not wealthy should have that right—the possibility that they can make high risk investments if they are advised by persons who can analyze financial and business information. So to me, as drafted, that section of the bill is satisfactory.

Mr. BROYHILL. Do you have any comments as to the definition of an accredited investor in H.R. 3991, as being too broad, or about right, or as I understood you were testifying, that since the SEC was addressing this, legislation is not necessary? Was that your testimony?

Mr. MANN. With respect to this section, yes, sir. I think that the definition is fine and I think that providing the SEC the authority to exempt other classes of accredited investors is extremely desirable, but it seems to me that the purpose of the section can be addressed under rule by the Commission without being locked into the legislative pattern.

Mr. BROYHILL. Then moving on, of course, section 3 would permit the limited resale of these securities and, as pointed out, it would create a new market for developing companies. I felt that this was an innovative idea that would be able to bring more capital into these newer developing companies, and now this section, of course, is being criticized as opening up huge loopholes.

Would you want to comment on that, Mr. Wallison, first?

Mr. WALLISON. Yes.

Mr. Chairman, it seems to me that what section 3(a) does is apply to resales exactly the same standards as are applied to initial sales. If an issuer is to be permitted to sell its securities, with registration, to people who are able to fend for themselves—and we think the SEC has adopted this theory in proposed rule 242—it is very difficult for me to see why the people who purchase such securities, accredited investors, should not be permitted to resell to other accredited investors at any time. The benefits of permitting them to resell, as outlined in my earlier testimony, are very substantial. Obviously, we are dealing here with a policy judgment of the kind that Congress is most equipped to make, but if you permit the sale initially to the accredited investor and then force the accredited investor to hold those securities until he can sell under rule 144, I think you have substantially reduced the value of this legislation. As drafted, I believe the legislation would eliminate the illiquidity which now impedes venture capital investment, and I think that is the heart of the bill.

Mr. BROYHILL. Do you have any further comments?

Mr. MANN. I am not certain that this isn't a solution in search of a problem; that is to say, in my experience any situation that would be covered by section 3(a) of the proposed bill would be a situation today where I would probably be willing to write an opinion to the client that the transaction is exempt already.

The resale to the accredited investor, it seems to me, is not likely to be viewed as a distribution of securities. Since it is not likely to be viewed as a distribution, as what some people would refer to as a reprivate placement or section 4(1½) transaction, it would not require registration because the seller, in this case the initial investor, would not be considered to be a statutory underwriter for purposes of section 2(11).

There is obviously room for people to disagree, and I would not oppose the adoption of section 3(a) because it does perhaps for some people clarify the availability of the exemption, but I am not totally convinced that it would change what happens when venture capital investors decide they want to resell to other sophisticated investors.

Mr. WALLISON. There are two points I would like to make at this juncture. The first is that obviously counsel can disagree substantially about how far they would go in giving an opinion to a client. The issue is certainty. When a client has offered the security through a number of brokers, or someone representing him who had made a number of calls to try to find a buyer for a security, counsel may be reluctant to give an opinion with knowing the number and identity of all the offerees. Second, and I think probably more important, the resale provisions of the bill would permit the development of an infrastructure for this kind of sale. What doesn't exist now, I think, because of current regulation restrictions on resale, is an infrastructure in the securities industry for the resale of securities that have been purchased on a restricted basis.

You may have Goldman Sachs, First Boston, or Merrill Lynch search around for a purchaser for a bloc of stock, but the proposed transaction would have to be very large. In general, these firms don't have personnel who are employed specifically for the purpose of making markets in limited sale securities or restricted securities.

Mr. BROYHILL. Mr. Opper?

Mr. OPPER. Thank you, Mr. Chairman.

Proposed rule 242 would do something which sections 2 and 3 do not. It would permit, without restriction, the resale of restricted securities to any person with $100,000 or more to invest. It does seem to be a little more liberal than the provisions in 2 and 3 and I was wondering whether you had any comment on that?

Mr. Mann?

Mr. MANN. I believe that illustrates the type of flexibility on the part of the Commission which my comments on sections 1 and 3 endorsed. A $100,000 limit may very well be an appropriate limit today.

The Commission, by experience, has modified rule 144 on several occasions, and I would look forward to the day when that $100,000 limit might become a $50,000 limit if experience justified that abuses were not present, and that is a flexibility that the Commission has that unfortunately Congress does not have when it is creating exemptions.

Mr. LIFTIN. Mr. Opper, I would suggest that under the terms of the bill the SEC would have the authority to create an exemption such as that under the definition of an accredited investor, section 15(b) of the act, and I believe the Commission could establish that kind of a limit or any other limit it deemed appropriate, so I don't think that the notion of legislation, as opposed to rule 242, would necessarily be inconsistent with that kind of a standard.

Mr. OPPER. Rule 242, as I understand it, contains reporting requirements, whereas sections 2 and 3 of the bill do not. Are there any benefits to be derived from reporting these kinds of transactions?

Mr. MANN. I think it is important to note the type of reporting requirements that are contained in the rule 242 proposal. They are not reporting requirements addressed to filing of offering circulars or detailed information about the issuer. Rather, they are statistical reporting requirements which the Commission has asked for in order to assess the effectiveness of the rule, the degree to which it is being utilized, and determine whether further amendments to the rule are desirable.

So long as those reports are handled in a manner which is designed to accomplish that purpose, rather than an enforcement purpose, I would think that they would be very useful.

Mr. LIFTIN. It is difficult to disagree with what Mr. Mann says.

I would point out that frequently, whenever an issuer is aware that a transaction that is conducted pursuant to an exemption from the act is to be reported to the Commission, there is a natural reluctance to engaging in the transaction for just the reason that Mr. Mann adverted to; that is, that it will immediately draw the attention of the enforcement division, even if the issuer believes in good faith that there is no reason why it should.

I think it is just perhaps human nature. Therefore, I would just say that this might be a somewhat inhibiting factor. Perhaps it is outweighed by the need to compile reliable information about utilization of the rule, however.

Mr. OPPER. Following up on Congressman Broyhill's question about the term "accredited investor," in section 3 of the bill, it would also define as an accredited investor any person who would otherwise not qualify but who is relying upon the advice of a previously defined accredited investor.

The Commission has criticized that provision as really not providing any assurance that the person who would then qualify as an accredited investor would be sophisticated, and I note that your prepared testimony really does not dwell on that section.

May we assume from that this is not one of the most important provisions of the accredited investor section?

Mr. WALLISON. I don't think it would be warranted to draw that conclusion from the fact that the testimony didn't deal with it extensively.

Mr. OPPER. Didn't deal with it at all.

Mr. WALLISON. In response to what I understand to be your question, it seems to me that the provision as drafted gives the Securities and Exchange Commission the authority to regulate this area in appropriate ways.

As to subsection (C), which permits a person to rely on the investment advice of an accredited investor, strikes me as not substantially different from the offeree representative concept contained in rule 146.

Mr. OPPER. But in this case it could be someone who is relying on the advice of a person who would not necessarily qualify as an offeree representative. For instance, one could be relying upon the advice of any entity registered under the Investment Company Act of 1940, or a fund, or a trust, or an account of a bank or insurance company. That seems to be a bit broader.

I really don't want to belabor it, but if we follow through the logic of subsection (C), a person who becomes an accredited investor by relying on the advice of one of those entities can then presumably advise someone else who would then become an accredited investor and you can continue this string ad infinitum.

Mr. WALLISON. I suppose that as you are reading it one might take that position, but I don't think that is the way it will be interpreted.

Mr. OPPER. It is in the bill and that is one of the problems with statutory inflexibility.

Let me suggest something else. If you make a fund, or a trust, or a bank an accredited investor which could then advise others, who may take these unrestricted securities, but do not so make persons who would in a more normal process be the underwriters, such as brokers and dealers and investment advisers, wouldn't we be creating a situation where an issuer who has restricted securities to place would be going to a bank or putting to an investment company in order to place them, placing brokers and dealers and investment advisers at a decisive competitive disadvantage?

Mr. WALLISON. I believe that a broker-dealer or an investment adviser would probably be declared to be an accredited investor by the SEC under subsection (B).

Mr. OPPER. Only if the Commission did so rule.

Mr. WALLISON. That is right.

Mr. OPPER. But there is nothing here to mandate that.

Mr. WALLISON. Of course, we are in a position where, on the one hand, we are wondering what the Commission can be relied upon to do by regulation if they have no legislative command, and then, on the other hand, you are inquiring as to whether the legislation can be so tightly drawn that the Commission will have no flexibility even on a matter which seems appropriate for rulemaking.

I think it is within the power of the committee and the Congress, if the language of the bill does not sufficiently do it, to give the Commission the authority to adjust these provisions in such a way as to take account of the kinds of concerns you have expressed.

Mr. OPPER. Well, that may be the case. It may be perfectly conceivable for a number of reasons that the Commission may find that an investment adviser, just because he is registered under the Investment Advisers Act of 1940, does not qualify as an accredited investor. Yet, as everyone knows, he is in competition with banks and insurance companies who would qualify, and to the extent that the Commission does not see fit to make an investment adviser an accredited investor, the investment adviser is at a competitive disadvantage.

Mr. LIFTIN. If I could respond to that, I think once again the Commission clearly would have the flexibility to classify investment advisers, distinguish among different characteristics they might have based upon experience, education requirements, the amount of time that they have been in business, and so forth, the amount of money they have in their management perhaps, and this might be a way that they could solve the problem.

Mr. OPPER. I think the last time the Commission tried to classify investment advisers it was——

Mr. LIFTIN. That was for the purpose of whether or not they could be in business.

I think here though when it is for the purpose of whether or not they could qualify someone for an exemption under this statute, it would be far different and I think you seem to be worried about creating an undue burden on competition.

I think while there might be somewhat of a burden, if it were felt by the Commission that it were justified from a regulatory point of view, I think that is not inconsistent with the philosophy of the securities laws.

Mr. OPPER. Since the panelists are encouraging the Commission to raise the section 242 ceiling, would you similarly increase the raising of the ceiling under regulation A or should we subject that to different standards?

Mr. MANN. I think that the regulation A ceiling adopted by the Commission has gone up, although not in tandem and not at the same time with the increase in the limits adopted by Congress under 3(b). My recollection is that there have been two increases within the last few years. I am not sure that regulation A is something which, with the adoption of form S-18, fulfills the same role that it did at one time.

I know the Commission has under consideration a massive revision of regulation A.

I would encourage them, by giving them the mandate to promote capital formation as part of the legislative package, to consider increasing the limit of regulation A to the full limit of the 3(b) amendment, and classifying types of offerings with differential disclosure from different types of issuers. These and other proposals have been considered by the new Office of Small Business of the Commission. I think that it may very well be possible to use regulation A in the capital formation process in a much more constructive manner than it has been used in the past.

Mr. OPPER. Mr. Mann, there seems to be rather general agreement that the provisions of rule 146 and section 4(2) are overly rigid and, accordingly you endorse section 5 of the bill.

The Commission has testified that they are working on a proposal now which would provide some kind of good faith standard in connection with private offerings.

Would that essentially alleviate or eliminate the problem, and even if the Commission did so, would you see the need for some kind of statutory provision?

Mr. MANN. What we are talking about, I am afraid, is, an anomaly in statutory language. The statement was made earlier this morning that the definition of distribution may be considered by many as synonymous with the definition of public offering. I would have to dissent and point out that section 4(2) uses the term "offer and sale," while section 4(1) talks only about a transaction, and the problem that the Commission is faced with, it seems to me, under 4(2) is that the word "offer" is in the statute.

That being the case, we have a problem where good faith may not be enough. I have serious doubts that the Commission, harnessed with the legislative history and also with the court interpretations of section 4(2) of the 1933 act, by rule can do what section 5 of H.R. 3991 would do.

Indeed, the statement by Commissioner Loomis yesterday suggests perhaps a reluctance in some respects to go to the extent of section 5 of the act because, as he said, those investors who could not recover might well feel they were treated unfairly since the company would not have the financing they expected. That is a problem that exists under existing law when an investor finds that a bank line of credit is pulled back from a company has just invested in.

In short, I would suggest that the antifraud rules are sufficient to protect both the person referred to by Commissioner Loomis and the investor today buys because of a misrepresentation as to the issuer's capital or the absence of a material contingent liability. The right of a purchaser to rescind because of an inability to prove a nonoffer to a nonpurchaser is a Draconian way to accomplish the result.

Mr. OPPER. Mr. Wallison, on page 15 of your testimony you discuss the origins of the "hot issues" market. If I follow the thread of what you are saying, you are suggesting that the small investor or the general public need not have been so badly burned in that market if at that time provisions similar to 2 and 3 of the bill had existed.

The reason for that, you suggest, is because these kinds of unseasoned or highly speculative issues would have been absorbed by the venture capitalists. Is that the correct interpretation?

Mr. WALLISON. I think that is an accurate summary.

Mr. OPPER. One of the provisions of the bill essentially would permit the general public to make the same kind of investments, but through the vehicle of venture capital company.

I am wondering, if we follow the logic of what you are saying, it may be no more advisable to allow the public to invest in these kinds of securities? I am assuming the inapplicability of the Investment Company Act of 1940.

Mr. WALLISON. If you are referring to section 6 of the bill——

Mr. OPPER. Yes.

Mr. WALLISON [continuing]. I see section 6 as of a piece with the definitions of accredited investor in section 3. What is created by section 6 is another form of intermediary for the public so that someone can step in who is sophisticated enough to analyze the risks associated with certain kinds of investments and make those investments on behalf of individuals who by and large do not have the opportunity, or in some cases the sophistication, to understand the risks involved.

So I guess in response to your question I would merely say that I think what section 6 proposes to do fits in well with the plan of sections 2 and 3.

Mr. OPPER. Are you suggesting then that the accredited investor would be the person who manages the venture capital fund, or would he be the salesman who is selling shares to the general public, or would he be some other person upon whom the investor has relied?

Mr. WALLISON. You are referring again to section 6?

Mr. OPPER. That is right.

Mr. WALLISON. As I understand it, section 6 permits the creation of an organization, which would not be considered an investment company, and which could purchase the limited sales securities, or restricted securities, as an accredited investor. I guess your concern is not clear to me.

Mr. OPPER. The interests in that pool of securities would be purchased by whom?

Mr. WALLISON. Those, of course, would be purchased by the general public.

Mr. OPPER. Are they more protected through this vehicle than they would have been in the hot issues market where you suggest they probably should not have been at all? Is the reason you are saying this because there would be responsible people or accredited investors running this fund?

Mr. WALLISON. That is right.

Mr. OPPER. But suppose the fund itself is no less risky than any one of the securities? How does this relate to the accredited investor principle? The member of the public, in order to qualify to invest in this fund presumably is relying upon the advice of an accredited investor. Who is this accredited investor on whose advice he is relying?

Mr. WALLISON. I understand your question is how does the investor initially purchase securities in the fund created by section 6?

Mr. OPPER. Right.

Mr. WALLISON. Under those circumstances I think we are back to either a public offering situation with a registration statement for these funds, or these investors would have to rely upon one of the other people who are listed as accredited investors in section 3 of the bill or those who are, of course, defined as accredited investors by the SEC under section 3(b).

Mr. OPPER. But until SEC adopted rules they wouldn't qualify merely because the salesman had recommended the purchase. Is that right?

Mr. LIFTIN. You seem to be getting at the point that it is troublesome that the accredited investor on whom a purchaser might rely could be an affiliate of an issuer.

Mr. OPPER. No; I am not, really. What Mr. Wallison is saying is that the public should really never have been in the hot issue market. The venture capitalists should have been, and those are the persons who should have absorbed those kinds of risks.

I am trying to distinguish that from a fund which section 6 might endorse where the general public could invest directly in these kinds of securities once again.

The only difference seems to be that they would be receiving an undivided interest in a pool of these high risk securities rather than investing in a single security.

I think Mr. Mann has something.

Mr. MANN. Yes, Mr. Opper.

If I could suggest, there is a real difference between the hot issue market and the type of venture pool you are contemplating under section 6. During the hot issue market stock brokers who had been in the business for weeks were selling securities to unsophisticated investors. Although there was such a thing as the shingle theory and there were suitability standards, many of those brokers were out of the industry 1 year later. They were not a solvent, deep pocket. Indeed many of the investment banking or broker-dealer firms that they worked for were not deep pockets because they have disappeared as well.

The contrast between that situation and the situation which would exist under section 6, it seems to me, is that the investment decisions in what companies the money of the public investor is being put would be made by people who know that because of the very nature of venture capital investment they aren't going to be able to leave the business in 1 year This is because they aren't going to be getting any return themselves unless 3, 4, or 5 years downstream as those investments are successful.

It seems to me that that awareness on their part, coupled with the obvious fiduciary duty they have to the investors, makes the venture capital fund far different from the situation of the individual putting his money in a hot issue through someone who is in the industry today and may be out of it tomorrow.

Mr. LIFTIN. There is another point to be made there.

I think that Mr. Wallison probably would agree there were at least a number of issuers who sold stock to the public in those days that probably should never have done so and that no sophisticated venture capital investor would ever have put funds into such investments.

I think that the one thing that this sort of providing would do is create a screen so that those companies that were not only high risks, but low potential reward investments would be eliminated.

Second, I think you can have different types of pools which would appeal to investors with different abilities to accept risks and perhaps the venture capitalist can distinguish between those investments which have a high risk and a high rate of reward and those which have, although they may be new ventures, a lower risk and perhaps a concomitant lower potential reward and match those risks with the types of investors who have invested in their funds.

Mr. WALLISON. One more item we should mention is that diversification by the venture capital company would be of some protection to the purchaser.

One of the problems encountered during the hot issues market was that people were making substantial investments in companies that were highly unstable and disappeared. Here, we would have professional management of the fund making these investments, and this would reduce the risk and spread it through the diversification.

Mr. OPPER. Mr. Mann, I think the discussions yesterday and today have pointed out quite clearly there is a very real problem under the 1940 act for venture capital companies.

One of the most pervasive problems is structuring a definition of venture capital company. It is very difficult to do that without incorporating other kinds of vehicles which really do not qualify as capital venture companies. I was wondering whether or not you have some suggestions for us as to the kind of characteristics that ought to be included in that definition.

Mr. MANN. I think the question of what is a venture capital company is probably the most difficult one faced in determining what your exemption is going to be. It is one that the White House Task Force on Capital Formation certainly wrestled with for a period of time. It would seem to me that the characteristics would include primarily investment in prepublic or nonpublic companies; that is, assuming that the so-called turnaround venture capital investment is not to be covered by the proposal.

If it is to be covered by it, then it would seem to me the nature of the investment might well be the determining factor; that is, investments in private placements, whether they be made by prepublic or by public companies would be the appropriate cornerstone of the definition.

I certainly would not attempt to limit the definition to particular segments of the American economy. I think that if you attempted, for example, to limit venture capital investment to high technology, you would not have found Federal Express qualifying as a venture capital company.

Obviously venture capital can go into almost any type of industry. So I would fall back on the nature of the investment as the basis for the determination and it would seem to me that any investment in basically restricted securities would probably be as much of a definition as you might want.

Mr. OPPER. Could that open the door to eliminating the 1940 act provisions from so-called letter stock funds that prevailed in the 1960's?

Mr. MANN. The problems that were faced with so-called letter stock funds of the 1960's were not really investment company act problems. My recollection of what occurred during that era is that the sales techniques used in connection with some of those funds, the representations made to the investors, and the accounting practices followed by them, were ones which could equally well have been attacked under the antifraud provisions of the 1933 act or the 1934 act.

Mr. OPPER. I think what you refer to is the valuation problem. I am wondering whether, as was suggested yesterday by the Commission, you would agree that one of the very powerful prophylactic effects of the act, is the SEC inspection of funds at certain intervals which may tend to limit the kinds of abuses in this area.

Mr. MANN. Your question is one of first impression to me. I don't know that there have been any empirical studies that have demonstrated that the inspection power of the Commission under the 1940 act has produced the results that you have suggested. There may have been, but I am unaware of them.

Mr. OPPER. That is all I have, Mr. Chairman.

Thank you.

Mr. BROYHILL. Mr. McMahon?

Mr. MCMAHON. In the interest of time, one quick question.

One of the current themes of the hearings this year and last year was the resale of the perspective securities, the so-called lock-in concept, and all of the other witnesses indicated there should be somewhat of a different standard with respect to resales to affiliates.

Do you think there might be some sort of residual middle ground development by the SEC's regulation which would permit a different standard in the resale of securities among affiliates?

Mr. MANN. You mean by affiliates to the public at large without regard to whether the purchaser of a restricted security is a qualified investor?

Mr. MCMAHON. After 5 years, yes, but I caution that with residual legislation in that area to insure that it is done properly, not a wholesale lifting of that exemption but with regulations designed for those people who have undertaken the risks to reap the rewards and not just sit on those securities forever.

Mr. MANN. With that qualification, I certainly would endorse it.

Mr. BROYHILL. Thank you very much, gentlemen. Your testimony has been very valuable to the subcommittee.

Mr. MANN. Thank you, sir.

Mr. BROYHILL. I would like to ask Mr. Heizer and Mr. Garrett if they could come forward and Mr. Chambers, if you could join them at the table?

Mr. Chambers, why don't we hear you separately; OK? We will hear those two gentlemen and then we will come back to you.

That was the understanding.

Mr. Heizer, we will hear you. If you want to summarize your testimony we will include your statement in the record.

STATEMENTS OF E. F. HEIZER, JR., CHAIRMAN AND PRESIDENT, HEIZER CORP., AND RAY GARRETT, JR., SPECIAL COUNSEL TO HEIZER CORP.

Mr. HEIZER. Mr. Chairman, we want to thank you for not only holding these hearings but for inviting us to testify again.

I am here as chairman of Heizer Corp., and Mr. Garrett is here as our special counsel.

My testimony will tend to be that of an emotional businessman for which I apologize, and Mr. Garrett's will be that of a true professional.

As you know, my emotionalism arises from having worked for 10 years to build what is one of the largest business development firms in the country, the largest independent one, and we don't know of anything we have ever done that the 1940 act would say we shouldn't have done.

If we were under the 1940 act we would not have violated any substantive provisions of that act, and yet the facts of life are that we are faced with either having to liquidate or go to the 1940 act, if we go under the 1940 act, we would from all our examinations of it be so tied up in red tape it wouldn't be worth trying to continue to exist, as I say.

This is a bit of introduction that causes me to be somewhat emotional about this. I am active, and have been for some years, in the venture capital community, and have also been Chairman of the White House Task Force on Capital Formation, and though I am here today very selfishly and want to spend what time we have giving you our perspective on this, the Heizer Corp., so if time permits or you want me to come back some other time, I will be glad to give you our perspective on the other aspects of H.R. 3991 to the extent we are familiar.

I know we are pressured timewise so I will take out some of the highlights of my testimony, as you say, and I will let the rest of it be a part of the record.

I think our main message is that, and this message comes after a year of extensive work with the SEC and the staff to seek an exemption, first, we tried to seek one for the industry, and they finally said that they were not going to consider any kind of industry.

Then we have worked with them, trying to seek a meaningful exemption for the Heizer group, and Mr. Garrett can get into this in a more professional way than I will; but I conclude from this whole process that really the venture capital industry needs legislative relief from the 1940 act, as your bill proposes to give it. Administrative relief is just too uncertain and too costly in terms of both management time and money, and very importantly that the public can be adequately protected without the 1940 act applied to venture capital firms.

The part of my emotional testimony, I think, that is relevant, is that over the last 39 years, numerous venture capital firms, including many of the best venture capital firms in the country, have been put out of business by the 1940 act. The SEC does not think they did that, but they did that by indirection, just like they may do it to us by indirection, despite their sincere efforts.

The latest victim, Continental Capital, will testify this morning in a few minutes, and you will hear their story, and the fact is that today only a handful of public companies operate under the 1940 act, and Narragansett testified yesterday as one of those firms.

These firms that are trying to supply capital in any significant way, particularly inequity capital, only can do so under the 1940 act after extraordinary effort and needless delays and unnecessary expense. I want to emphasize equity capital, since it is more feasible to supply debt capital operating under the 1940 act than it is equity capital, but supplying equity capital is the main purpose of the venture capital community and it is what the country so sorely needs.

There is a lot of confusion over that with the SEC, because the firms that do operate under the 1940 act, the SBIC's for the most part that are public, have survived the SEC surveillance. Those firms are supplying debt capital; and when you do that you don't run into all of these problems that you have with equity capital that become so difficult to handle.

Even more damaging to the country than the demise of those firms which try to work under the act and give up in utter frustration is a very much longer list of firms that have gone out of business rather than try to operate as registered investment companies, because they believe they could not function under the 1940 act.

I have known hundreds of people, because I have been in my business full time for 20 years and was in it part time for 10 years before that, so I know hundreds of people who were very good people who looked at that 1940 act and said it is impossible.

I am criticized by many for spending our firm's money even trying to straighten out this situation. Most people just don't even try, so at any rate, as a result of that, today the typical venture capital firm is structured to self-liquidate within 10 years or at least largely because of the 1940 act.

Mr. Opper was asking yesterday, wasn't taxation an important thing. Taxation is a very secondary issue, particularly if you are an equity venture capital firm, you can structure the corporation or a partnership to not pay taxes. We are a corporation, and we are structured to not pay taxes. That means you have to spend some money and figure that out, but that can be done so taxation is not really a key issue here, and we could spend some time on that if you would like to.

As a result, the country is not building the permanent investment structure it needs to build our economy. The really good venture capitalists get into the business, they make some money, and then they disappear and retire too early most of the time because they just don't see a way to build a permanent way of recouping.

In fact, that is one of the problems of the SEC because the SEC tends to think that there is no one hurt by the 1940 act. They say who is it that is hurt, because they don't see the people that are hurt, because most of them don't want to spend their time and money going through what we have been going through. In the alternative, the SEC says there is no one that really needs relief from the 1940 act.

The net effect has been to seriously impair the flow of equity capital to new business and to deny the public the right to invest in new capital ventures.

The Heizer Corp. which is one of the larger independent venture capital firms currently exempt from the 1940 act since it has less than 100 shareholders, and we have spent a lot of money making sure we have less than 100 shareholders which in itself has been a big problem and, as I mentioned, we are going to have to join the list of companies that have disappeared because of the 1940 act.

We are here this morning with a lot of emotion hoping your committee will not only hold these hearings but get a bill through the House and, hopefully, we are willing to work with you to try to get it set up to follow through on the bills because it is so important to us and we think to the industry.

In September we celebrated our 10th anniversary of our firm and we promised when we were formed that we were going to get liquidity for our investors by the end of 10 years. They wanted us to be a partnership because they didn't think we could solve the 1940 problem, and we said we would like the privilege of trying, and so they invested and gave us that opportunity.

We are under pressure, and we have not been able to tell how this is going to come out because when you are dealing with whether bills will get through Congress or not or whether the SEC is going to do something, that is very difficult.

We literally have to plan to liquidate ourselves. We feel our common stock would be a good long-term investment for public shareholders, and we think we would continue to do a number of things that are important to the economy and more important than us, though, I feel, is if we can get this law straightened out I think there would be a lot of firms formed in a different way and a lot of those that exist today would start looking at this and would decide to try to convert their firms into permanent companies that would exist and build over a period of years.

Now, you heard, and we have mentioned that we have been working with the SEC seeking exemption, and you probably heard, since the rumor has been around, that the SEC is going to give us an exemption. Well, then, you can say, why is Heizer Corp. here seeking legislation or why do we feel the venture capital industry needs legislation?

Well, it's true that Heizer Corp. has been working closely with the SEC; it is true that the staff has been fully cooperative and it is true that SEC has shown it wants to help Heizer Corp., and it is true the staff wants to help the venture capital industry.

All of this is true, and it is also true that the staff is considering exemptive relief for Heizer Corp., but the point I want to make is despite all of this Heizer Corp. has been plagued by the uncertainties of the 1940 act for over 10 years, even though they are not registered.

We have had this concerned life-or-death effort going on with the SEC for 1 whole year. We have assistance of very able and experienced legal counsel, and we spent over $300,000 of direct out-of-pocket expenses on our outside legal counsel during this time.

On top of that, we have had additional expenses for myself and our people which adds up to at least another couple of hundred thousand dollars, so we have spent over $500,000 trying to save ourselves from going under.

In addition to that, these are more subtle things, but the Heizer Corp. has not been able to do new deals for 5 years largely due to the uncertainties of the 1940 act.

The reason for that is we told our investors we would get them liquidity. We can't assure them of any liquidity if we are going to continue to do new deals and have a lot of new, young illiquid deals. That would be a real mess, so we said that we would put that original money to work and mature those companies and then we said we would try rather than liquidate the company, we would try to get exemption from the 1940 act so that they could publicly sell their securities without our having to be liquid.

We have been hung up for 5 years in this period of uncertainty, and it has caused us to not do the job. In addition to that, this has been very difficult to build our management team the way we would like to, because our management people have no idea whether they are working for a company that is going to continue to exist or is going to disappear.

When I get back in Chicago, they will all be saying, "How did the hearing go? Are we really going to make it, or are we not?"

That is a very difficult problem.

Mr. BROYHILL. Let me interrupt: Is it possible for you to liquidate and the next day start over under another name?

Mr. HEIZER. Well, we could do that.

Mr. BROYHILL. Do you have tax problems there?

Mr. HEIZER. Well, we can do that but you lose the ongoing entity that has been created, and this is what we have to do.

That is what has been going on for 20 or 30 years, and everybody liquidates. It appears as though they have one fund, and then they go onto another fund. This puts great pressure on the investee companies. As they approach the time for liquidation, the companies become obsessed due to their contracts with forcing the young companies they have financed to merge with other companies.

Why? Because if they don't do that and they don't force the merger out and the sellouts to make themselves liquid, then when it comes time to measure who gets what in their funds they don't do very well, and that is a very understandable self-motivation.

In fact, their huge desire to sell out companies prematurely is one reason we don't like to get involved with a lot of the partnerships, because there are very short-term fuses compared to what we would like to have.

Mr. BROYHILL. What you are saying is it would make you make investment decisions that would be wise—that if you had an opportunity to make those decisions over a longer period of time, you might do it differently rather than have to make those decisions under some time restraints?

Mr. HEIZER. Right; but the effect is most of the venture capital corporations and partnerships do concentrate on financing at a later stage so they can be sure of the life of the partnership.

There are very few firms that do startup like we do, and we need to have a lot more companies that have enough longevity, so they consider them with management, which is a good idea, and help them get going and live with it 10 or 12 years.

It takes a long time to build a company from scratch. Intel is an outstanding exception to the rule in terms of how quickly it went from startup to public company, but that is an unusual company.

Mr. BROYHILL. Would you explain for the record the importance of this liquidity factor that you keep referring to? Otherwise, the investor would put his money into listed securities?

Mr. HEIZER. Yes; there are a few wealthy families in the United States, such as the Rockefellers, who for years have put money to work on a long-term basis, and the people representing them are not under those pressures, but there are very few wealthy families that do that.

Most of the institutions you would think would not be under any pressure, the life insurance companies and trust companies, and so forth; but I imagine that they are. They feel 10 years is a long time to be locked up in something, our investors.

The more successful you are the more valuable their investment becomes, the bigger it becomes and the more unhappy they become over it being liquid, so success breeds an even greater desire to be liquid.

The investors see what we are trying to do and are supporting us in spending all this money so that they can sell their securities without forcing it.

Mr. GARRETT. If I may interject a moment, I think it might be well to make it clear that institutions in a situation like this might be prepared to accept even up to 10 years of illiquidity, but they have to see their way sometime to clear the investment, and they can't realize it on the growth of value as against the income throwoff.

The real investment play is in the capital growth in the underlying securities, unless they can do one of two things: That is to say, sell the portfolio securities and distribute the proceeds or enable the investors to sell their shares in Heizer Corp., and they can't unless there is an active market and a liquid market, so there is a liquidity of the investee level to be able to liquidate if you have to liquidate but also liquidate at the investor level and Heizer as an alternative to liquidate.

Mr. BROYHILL. If we could achieve that liquidity of both levels, you are arguing that there could be substantial capital formed to help small business in developing business?

Mr. HEIZER. Yes; because the public markets, I think, would supply many times the amount of money that is currently being supplied the way the system works due to the law. It would open up the institutions more, because one of the problems institutions have is the one we are describing.

For instance, in our fifth year of business, one of our institutions had a liquidity problem. The insurance commission that governed them was saying, you must be more liquid in your investments, so naturally their investment in us came under scrutiny. They called me up and said, this is a real problem for us, could we find another institution to buy that investment?

We said we think we could, and we found two institutions, and they said, thank you. Now that the insurance commission knows that they consolidated we have no more problem, so there is a subtle tie involved in all of this with the institutions, that if we were public the institutions could also invest in us with less concern over this whole question.

Mr. BROYHILL. So what happens is that this capital, under the present situation, the present regulations and laws, tends to flow to those larger corporations which are listed on the major exchange?

Mr. HEIZER. The venture capital community has to try very hard to make sure whatever it invested in is something that can be listed pretty quickly to be liquid, or they have to plan on merging it out.

Mr. BROYHILL. So the big get bigger and the small shrivel and die.

Mr. HEIZER. It is certainly a lack of capital for them, so the point is here and this point I don't know how to make without maybe offending someone, but in our discussions with the SEC where we are today, if we get an exemption from them I would characterize it, as a businessman, if you stood back from the whole thing we would be free to do all of the things we have done in the past, substantively or most of the things. This is hard to say, because we haven't lived under it, but it looks like most of the substantive things could be rebuilt.

You might say why would we object to being under the 1940 act? The problem is, I will call it redtape, and Mr. Garrett can explain this more professionally, but there are a number of parts to that act that the SEC must operate under, and they are not substantive things for the most part but there are things that interfere with your business indirectly and chew up tremendous amounts of time and money, which people that have been under the act will tell you.

None of this is really the fault of the SEC or its staff. Everybody we have worked with is very sincere and very interested in solving this problem. They want to solve this problem with small business, and the new front-end rules, as we call them, that they talked to the committee about yesterday, will be very helpful in getting funds going, and they are to be applauded for what they have done in the front-end rules.

We want to point out that there is nothing that they have proposed under rulemaking so far that solves the problem we are talking about; that is, how does the company continue? The front-end rule helps more firms getting going maybe. We say the fault lies in the 1940 act and must be remedied by Congress.

From a legislative standpoint, Congress should ask itself some very basic questions, the first one being what are we fencing in and what are we fencing out?

Is the 1940 act needed to protect the public investors who might invest in a private venture like Heizer? We say no, the 1940 act is not needed to protect the public. With the proper legislative exemption the 1933 and 1934 acts as well as State laws would adequately protect the public.

Can venture capital firms operate under the 1940 act? We say no. The 39-year record speaks for itself. Is the 1940 act typical of the kinds of legislation that our Constitution envisioned? We feel sincere about it, that the 1933 and 1934 acts are good acts. They assume you are innocent until proven guilty, and you are entitled to a trial to determine if you have done anything wrong and if so who was damaged, and if so in what amount.

If you step back from the 1940 act, as a business person, that act assumes you guilty until proven innocent, and the penalty is completely rescission of your transactions, should somebody technically find you have done something wrong without proof of harm to anyone, no statute of limitations and with no trial.

I am surprised over all of these years that someone somewhere has not attacked the 1940 act just on those grounds but that hasn't happened. I am sort of amazed at that act in its basic format.

Should other venture capital—this is another key question—firms be asked to go through what Heizer Corp. has been going through, even if you assume Heizer Corp. eventually obtains meaningful exemptive relief from the SEC?

We say again no. Very few firms can afford the costs of hiring counsel for this purpose and the fear, uncertainties, and costs would continue to discourage venture capital firms from even planning to be continuing companies.

Public investors would continue to be denied access to professional management, and the flow of equity funds would continue to be severely restricted and the future of America's new and innovative companies would continue to reside—and I don't mean to make this so emotional—in the hands of relatively few firms representing only the big institutions and a few extremely wealthy families.

Our industry is a noncompetitive industry. We have not lost one deal we wanted in 20 years, and this is not said to brag. I say that to complain. It's absolutely ridiculous that an industry so important to the future of this country should have so few firms and so little money compared to the need that someone like myself could make that statement.

Anyway we compliment the committee for getting these hearings underway, and we hope that you seek a compromise with those companion bills in the Senate and have something come out of all this good effort. In seeking that compromise, we urge you not to belabor this point that was brought yesterday and again this morning of trying to define venture capital.

My point, and Ray Garrett will look at it a little differently, I think the public shareholders should be protected irrespective of what business the company is in or, put another way, the public shareholder should not be subjected to undue risk because SEC or a Congress thinks that venture capital firms or small businesses are a good idea.

In other words, we should in making this legislation still protect the public and not get into the exemption game because we are good people. The essence of the legislation should be to protect the public while letting venture capital firms go public through removing the need for SEC supervision under the 1940 act, and in our opinion this can be done by predicating the exemption on an outside board of directors and professional management, an outside board of directors, coupled with maybe you couldn't insist on it, legislation but certainly by legislation allowing the board of directors and the management to buy stock in the venture capital firm creating a continuity of interest between the board and the management with the public shareholder.

If you have that continuity of interest the board or management is not going to do any of those things that the 1940 act was written to prevent, and then have an absolute prohibition in the exemption to be entitled to the exemption you have an absolute prohibition that you cannot have any investments by the boards of directors of these companies or their management in the investees, only allow the investment in the venture capital firm and then you cannot get the self-dealing and the doubledealing and everything else that went on in the 1930's that the 1940 act was intended to stop.

There would be no incentive. You might have someone still doing it who is stupid but you wouldn't have them doing it on purpose, so given these conditions we say there is no reason to expect a recurrence of abuses that the 1940 act was passed to stop.

In fact, public shareholders of a venture capital firm would be better protected than they are in the case of a normal industrial company with those kinds of provisions.

The SEC staff would not have to waste time and taxpayers money administering the action of the good people which they do today under the 1940 act. They can spend their time on a management by exception basis pursuing and prosecuting the bad people.

The public will be able to invest in the future of America to manage venture capital firms and in time this will greatly expand the infrastructure available to help small business and medium-size businesses. It will also increase Government tax revenues obviously, and it will decrease Government redtape and expense.

How often does Congress have an opportunity to accomplish all of those things in the same bill? It's pretty unusual, so I would like to finish on a light note. Listening to your questions yesterday, Mr. Broyhill, I scribbled out a little poem called, "The Ode to the 1940 Act."

What are we fencing in? What are we fencing out?
The venture capitalists are fenced in; the conglomerates are fenced out;
The professional investor is fenced in; the free-wheeling operator is out;
The wealthy and institutions can invest; the public shareholder is out;
All without meaningful distinction;
And true protection in great doubt.

[Testimony resumes on p. 273.]

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